UNITED STATES
SECURITIES AND EXCHANGE COMMISSION
Washington, D.C. 20549

FORM 10-Q

☒ **QUARTERLY REPORT PURSUANT TO SECTION 13 OR 15(d) OF THE SECURITIES EXCHANGE ACT OF 1934**

For the Quarterly Period Ended March 31, 2006

OR

☐ **TRANSITION REPORT PURSUANT TO SECTION 13 OR 15(d) OF THE SECURITIES EXCHANGE ACT OF 1934**

For the Transition Period From _______ To _______

Commission File Number: 001-32431

DOLBY LABORATORIES, INC.

(Exact name of registrant as specified in its charter)

Delaware	**90-0199783**
(State or other jurisdiction of incorporation or organization)	*(I.R.S. Employer Identification No.)*
100 Potrero Avenue **San Francisco, CA**	**94103-4813**
(Address of principal executive offices)	*(Zip Code)*

(415) 558-0200
(Registrant's telephone number, including area code)

Indicate by check mark whether the registrant (1) has filed all reports required to be filed by Section 13 or 15(d) of the Securities Exchange Act of 1934 during the preceding 12 months (or for such shorter period that the registrant was required to file such reports), and (2) has been subject to such filing requirements for the past 90 days. Yes ☒ No ☐

Indicate by check mark whether the registrant is a large accelerated filer, an accelerated filer, or a non–accelerated filer. See definition of "accelerated filer and large accelerated filer" in Rule 12b–2 of the Exchange Act. (Check one):

Large Accelerated Filer ☐ Accelerated Filer ☐ Non–Accelerated Filer ☒

Indicate by check mark whether the registrant is a shell company (as defined in Rule 12b–2 of the Exchange Act). Yes ☐ No ☒

Indicate the number of shares outstanding of each of the issuer's classes of common stock, as of the latest practicable date.

On April 26, 2006, the registrant had 36,128,722 shares of Class A common stock, par value $0.001 per share, and 69,870,979 shares of Class B common stock, par value $0.001 per share, outstanding.

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PART I – FINANCIAL INFORMATION
ITEM 1 – CONSOLIDATED FINANCIAL STATEMENTS

DOLBY LABORATORIES, INC.
CONSOLIDATED BALANCE SHEETS
(in thousands)

	September 30, 2005	March 31, 2006
		(unaudited)
ASSETS		
Current assets:		
Cash and cash equivalents	$ 372,403	$450,583
Restricted cash	205	243
Accounts receivable, net of allowances	25,221	22,737
Inventories	11,722	13,146
Income tax receivable	8,021	7,843
Deferred income taxes	31,183	33,230
Prepaid expenses and other current assets	5,433	3,919
Total current assets	454,188	531,701
Property, plant and equipment, net	76,462	75,037
Intangible assets, net	17,184	16,043
Goodwill	23,865	22,669
Long-term deferred income taxes	6,781	9,208
Other assets	7,797	7,038
Total assets	**$ 586,277**	**$661,696**
LIABILITIES AND STOCKHOLDERS' EQUITY		
Current liabilities:		
Accounts payable and accrued liabilities	$ 65,126	$ 71,779
Income taxes payable	3,054	4,019
Current portion of debt	1,346	1,375
Deferred revenues	3,268	4,558
Total current liabilities	72,794	81,731
Long-term debt	12,124	11,437
Other non-current liabilities	21,956	21,686
Total liabilities	106,874	114,854
Controlling interest	18,264	18,795
Stockholders' equity:		
Class A common stock	33	36
Class B common stock	71	70
Additional paid-in capital	308,354	304,559
Deferred stock-based compensation	(26,422)	—
Retained earnings	177,369	222,617
Accumulated other comprehensive income	1,734	765
Total stockholders' equity	461,139	528,047
Total liabilities and stockholders' equity	**$ 586,277**	**$661,696**

See accompanying notes to consolidated financial statements

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DOLBY LABORATORIES, INC.
CONSOLIDATED STATEMENTS OF OPERATIONS
(in thousands, except per share amounts)

	Fiscal Quarter Ended		Fiscal Year-to-Date Ended	
	April 1, 2005	March 31, 2006	April 1, 2005	March 31, 2006
	(unaudited)			
Revenue:				
Licensing	$ 64,717	$ 83,183	$126,908	$152,165
Product sales	14,807	15,708	31,294	31,712
Production services	5,577	5,833	11,162	11,872
Total revenue	85,101	104,724	169,364	195,749
Cost of revenue:				
Cost of licensing	14,062	7,177	30,211	13,778
Cost of product sales (1)	7,472	6,883	16,284	19,564
Cost of production services (1)	2,181	2,338	4,196	5,227
Total cost of revenue	23,715	16,398	50,691	38,569
Gross margin	61,386	88,326	118,673	157,180
Operating expenses:				
Selling, general and administrative (1)	35,610	38,584	68,467	75,121
Research and development (1)	7,740	8,363	16,029	16,305
Settlements	—	—	(2,000)	—
Total operating expenses	43,350	46,947	82,496	91,426
Operating income	18,036	41,379	36,177	65,754
Other income, net	751	4,594	1,038	8,293
Income before provision for income taxes and controlling interest	18,787	45,973	37,215	74,047
Provision for income taxes	8,000	17,652	15,743	28,138
Income before controlling interest	10,787	28,321	21,472	45,909
Controlling interest in net income, net of tax	(457)	(342)	(765)	(661)
Net income	**$ 10,330**	**$ 27,979**	**$ 20,707**	**$ 45,248**
Basic earnings per share	$ 0.11	$ 0.27	$ 0.23	$ 0.43
Diluted earnings per share	$ 0.10	$ 0.25	$ 0.20	$ 0.41
Weighted-average shares outstanding (basic)	94,806	105,254	90,649	104,774
Weighted-average shares outstanding (diluted)	105,544	111,387	101,573	111,056
Expense for royalties payable to related party	$ 7,657	$ —	$ 18,710	$ —
Expense for rent payable to related party	2,306	337	4,478	1,210

(1) Stock-based compensation included above was classified as follows:

Cost of product sales	$ 56	$ 196	$ 110	$ 398
Cost of production services	30	126	56	256
Selling, general and administrative	4,603	4,106	6,790	8,210
Research and development	570	663	1,251	1,336
Total stock-based compensation	$ 5,259	$ 5,091	$ 8,207	$ 10,200

See accompanying notes to consolidated financial statements

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DOLBY LABORATORIES, INC.
CONSOLIDATED STATEMENTS OF CASH FLOWS
(*in thousands*)

	Fiscal Year-to-Date Ended April 1, 2005	Fiscal Year-to-Date Ended March 31, 2006
	(unaudited)	
Operating activities:		
Net income	$ 20,707	$ 45,248
Adjustments to reconcile net income to net cash provided by operating activities:		
Depreciation and amortization	5,141	6,205
Stock-based compensation expense	8,207	10,200
Excess tax benefit from exercise of stock options	—	(8,388)
Provision for doubtful accounts	170	241
Deferred income taxes	(3,923)	(4,960)
Other non-cash items affecting net income	752	569
Changes in operating assets and liabilities:		
Restricted cash	—	(38)
Accounts receivable	1,193	2,175
Inventories	(849)	(1,412)
Prepaid expenses and other current assets	1,832	1,504
Accounts payable and accrued liabilities	5,463	6,734
Accounts payable and accrued royalties due to related parties	7,388	—
Income taxes, net	2,549	9,992
Deferred revenues	197	1,832
Other non-current liabilities	369	44
Net cash provided by operating activities	**49,196**	**69,946**
Investing activities:		
Purchases of property, plant and equipment	(9,138)	(3,933)
Acquisitions, net of cash acquired	(1,446)	—
Purchases of intangible assets	(11,773)	—
Proceeds from sale of equipment	39	—
Net cash used in investing activities	**(22,318)**	**(3,933)**
Financing activities:		
Payments on debt	(644)	(658)
Proceeds from the exercise of Class B stock options	2,606	2,691
Issuance of Class A common stock, net of issuance costs of $20.8 million	242,490	—
Issuance of Class A common stock from ESPP purchase	—	1,501
Excess tax benefit from exercise of stock options	—	8,388
Repurchases of Class B common stock	(72)	—
Net cash provided by financing activities	**244,380**	**11,922**
Effect of foreign exchange rate changes on cash and cash equivalents	681	245
Net increase in cash and cash equivalents	271,939	78,180
Cash and cash equivalents at beginning of year	78,711	372,403
Cash and cash equivalents at end of quarter	**$350,650**	**$450,583**
Supplemental disclosure:		
Cash paid for income taxes	$ 17,135	$ 24,755
Cash paid for interest	860	488

See accompanying notes to consolidated financial statements

DOLBY LABORATORIES, INC.
NOTES TO CONSOLIDATED FINANCIAL STATEMENTS
(unaudited)

1. Summary of Business and Significant Accounting Policies

Dolby Laboratories, Inc. (Dolby Laboratories, we or us), a Delaware corporation, develops and delivers innovative products and technologies that make the entertainment experience more realistic and immersive in theatres, homes, automobiles and elsewhere. Ray Dolby, our principal stockholder, founded Dolby Laboratories in 1965 to develop noise reduction technologies. Today, we deliver a broad range of sound technologies for use in both professional and consumer applications. In recent years we have expanded our focus to include other technologies that facilitate the delivery of digital entertainment. We conduct our business on a global basis.

Unaudited Interim Financial Statements

The accompanying interim consolidated balance sheet as of March 31, 2006, the consolidated statements of operations for the fiscal quarters and fiscal year-to-date periods ended April 1, 2005 and March 31, 2006 and the consolidated statements of cash flows for the fiscal year-to-date periods ended April 1, 2005 and March 31, 2006 are unaudited. These interim consolidated financial statements have been prepared in accordance with accounting principles generally accepted in the United States of America (U.S. GAAP). In our opinion, the interim consolidated financial statements have been prepared on the same basis as the audited consolidated financial statements for the fiscal year ended September 30, 2005 and include all adjustments necessary for fair presentation. The results for the fiscal quarter and fiscal year-to-date period ended March 31, 2006 are not necessarily indicative of the results to be expected for any subsequent quarterly or annual financial period, including the fiscal year ending September 29, 2006. The fiscal year-to-date period ended March 31, 2006 consisted of 26 weeks as compared to the fiscal year-to-date period ended April 1, 2005, which consisted of 27 weeks. Our 2006 fiscal year consists of 52 weeks and ends on September 29, 2006. Our 2005 fiscal year consisted of 53 weeks and ended on September 30, 2005.

The accompanying interim financial statements are prepared in accordance with Securities and Exchange Commission (SEC) rules and regulations, which allow certain information and footnote disclosures, normally included in annual financial statements, to be condensed or omitted. As a result, the accompanying interim financial statements should be read in conjunction with our consolidated financial statements for the fiscal year ended September 30, 2005, included in our Annual Report on Form 10-K and filed with the SEC.

Use of Estimates

The preparation of consolidated financial statements in accordance with U.S. GAAP requires management to make certain estimates and assumptions that affect the amounts reported and disclosed in our consolidated financial statements and accompanying notes. Significant items subject to such estimates and assumptions include valuation allowances for receivables, inventories, goodwill, intangible assets, stock-based compensation and deferred income tax assets. Actual results could differ from our estimates.

Per Share Data

Basic earnings per share is computed by dividing net income by the weighted-average number of shares of Class A common stock and Class B common stock outstanding during the period. Diluted earnings per share is computed by dividing net income by the sum of the weighted-average number of shares of Class A common stock and Class B common stock outstanding and the potential number of shares of dilutive Class A common stock and Class B common stock equivalents outstanding during the period. The dilutive shares are comprised entirely of options to purchase shares of Class A common stock and Class B common stock.

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The following table sets forth the computation of basic and diluted earnings per share:

	Fiscal Quarter Ended		Fiscal Year-to-Date Ended	
	April 1, 2005	March 31, 2006	April 1, 2005	March 31, 2006
	(in thousands, except per share amounts)			
Numerator:				
Net income	$ 10,330	$ 27,979	$ 20,707	$ 45,248
Denominator:				
Weighted-average shares outstanding (basic)	94,806	105,254	90,649	104,774
Common stock equivalents from options to purchase Class A common stock and Class B common stock	10,738	6,133	10,924	6,282
Weighted-average shares outstanding (diluted)	105,544	111,387	101,573	111,056
Basic earnings per share	$ 0.11	$ 0.27	$ 0.23	$ 0.43
Diluted earnings per share	$ 0.10	$ 0.25	$ 0.20	$ 0.41

A total of zero and 1,697,030 options were excluded from the calculation for the second quarter of fiscal 2005 and 2006, respectively, because their inclusion would have been anti-dilutive. A total of zero and 1,651,001 options were excluded from the calculation for the fiscal year-to-date periods ended April 1, 2005 and March 31, 2006, respectively, because their inclusion would have been anti-dilutive.

Stock-Based Compensation

On October 1, 2005, we adopted the provisions of Statement of Financial Accounting Standards No. 123(R), "Share-Based Payment" (SFAS 123R) using the modified prospective application transition method. SFAS 123R requires measurement of all employee stock-based compensation awards using a fair-value method and recording of such expense in the consolidated financial statements over the requisite service period. Previously, we had applied the provisions of Accounting Principles Board Opinion No. 25, "Accounting for Stock Issued to Employees" (APB 25) and related interpretations and elected to utilize the disclosure option of Statement of Financial Accounting Standards No. 123, "Accounting for Stock-Based Compensation" (SFAS 123). In the second quarter of fiscal 2006, we recorded stock-based compensation expense of $5.1 million under the fair-value provisions of SFAS 123R, compared to $5.3 million in the second quarter of fiscal 2005 under the provisions of APB 25 and related interpretations. In addition, the deferred compensation balance of $26.4 million related to stock-based awards accounted for under APB 25 as of September 30, 2005 was eliminated and there was a corresponding reduction in additional paid-in capital. See Note 4 "Stock-Based Compensation" for further discussion.

Comprehensive Income

Comprehensive income includes net income and foreign currency translation adjustments, which are reflected as a component of stockholders' equity. The components of comprehensive income, net of tax, were as follows:

	Fiscal Quarter Ended		Fiscal Year-to-Date Ended	
	April 1, 2005	March 31, 2006	April 1, 2005	March 31, 2006
	(in thousands)			
Net income	$ 10,330	$ 27,979	$ 20,707	$ 45,248
Other comprehensive income (loss):				
Foreign currency translation adjustment, net of tax	210	663	1,246	(969)
Comprehensive income	$ 10,540	$ 28,642	$ 21,953	$ 44,279

2. Composition of Certain Financial Statement Captions

Restricted Cash

Restricted cash includes deposits from new customers that, in accordance with certain of our licensing agreements, remain in escrow until we have rightful ownership of the funds, which occurs upon delivery of certain materials.

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Accounts Receivable

Accounts receivable consists of the following:

	September 30, 2005	March 31, 2006
	(in thousands)	
Trade accounts receivable, licensing	$ 4,046	$ 7,720
Trade accounts receivable, products and services	9,349	10,286
Accounts receivable related to patent administration program	12,994	6,381
Other accounts receivable	862	508
	27,251	24,895
Less: Allowance for doubtful accounts	(2,030)	(2,158)
Accounts receivable, net	**$ 25,221**	**$22,737**

Inventories

Inventories are stated at the lower of cost (first-in, first-out) or market and consist of the following:

	September 30, 2005	March 31, 2006
	(in thousands)	
Raw material	$ 2,376	$ 4,040
Work in process	1,571	2,046
Finished goods	7,775	7,060
Inventories	**$ 11,722**	**$13,146**

Goodwill and Intangible Assets

Following is a summary of goodwill and intangible assets:

	September 30, 2005	March 31, 2006
	(in thousands)	
Amortized intangible assets:		
Patents	$ 4,489	$ 4,436
Acquired technology	3,796	3,745
Other intangibles	11,507	11,498
	19,792	19,679
Less: Accumulated amortization	(2,608)	(3,636)
Intangible assets, net	**$ 17,184**	**$16,043**
Non-amortized intangible assets:		
Goodwill	**$ 23,865**	**$22,669**

Amortization expense associated with our intangible assets was $0.5 million in both the second quarter of fiscal 2005 and 2006, and is included in cost of licensing, cost of product sales and selling, general and administrative expenses in the accompanying consolidated statements of operations. The decrease in goodwill from September 30, 2005 to March 31, 2006 was due to fluctuations in foreign exchange rates.

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Accounts Payable and Accrued Liabilities

Accounts payable and accrued liabilities consist of the following:

	September 30, 2005	March 31, 2006
	(in thousands)	
Accounts payable	$ 6,539	$ 5,639
Accrued compensation and benefits	18,374	15,232
Accrued royalties	4,762	6,568
Accrued professional fees	2,495	1,892
Current portion of litigation settlement	2,417	2,806
Amounts payable to patent pool members	23,303	29,856
Other accrued liabilities	7,236	9,786
Accounts payable and accrued liabilities	**$ 65,126**	**$71,779**

3. Segment Information

Operating Segments

Our chief operating decision maker is our Chief Executive Officer (CEO). While the CEO evaluates results in a number of different ways, the primary basis upon which the allocation of resources and financial results is assessed is by examining our business in two operating segments: our technology licensing segment and our products and services segment. The technology licensing segment licenses technology, trademarks and know-how to consumer electronics, personal computer, broadcast, automotive and gaming companies and administers third-party patent-only licenses. The products and services segment provides professional products to movie theatres and to the recording, broadcast, cable and video post-production industries. Additionally, this segment provides services to broadcast, film production and distribution companies and movie theatres.

Accounting policies for each of the operating segments are the same as those used on a consolidated basis. Our reportable segment information for the fiscal quarters and fiscal year-to-date periods ended April 1, 2005 and March 31, 2006 is as follows:

	Revenue			
	Fiscal Quarter Ended		Fiscal Year-to-Date Ended	
	April 1, 2005	March 31, 2006	April 1, 2005	March 31, 2006
	(in thousands)			
Technology licensing	$ 64,717	$ 83,183	$ 126,908	$ 152,165
Products and services	20,384	21,541	42,456	43,584
Total revenue	**$ 85,101**	**$ 104,724**	**$ 169,364**	**$ 195,749**

	Gross Margin			
	Fiscal Quarter Ended		Fiscal Year-to-Date Ended	
	April 1, 2005	March 31, 2006	April 1, 2005	March 31, 2006
	(in thousands)			
Technology licensing	$ 50,655	$ 76,006	$ 96,697	$ 138,387
Products and services	10,731	12,320	21,976	18,793
Total gross margin	**$ 61,386**	**$ 88,326**	**$ 118,673**	**$ 157,180**

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	Reconciliation to Income before Provision for Income Taxes and Controlling Interest			
	Fiscal Quarter Ended		Fiscal Year-to-Date Ended	
	April 1, 2005	March 31, 2006	April 1, 2005	March 31, 2006
	(in thousands)			
Total segment gross margin	$ 61,386	$ 88,326	$ 118,673	$ 157,180
Operating expenses	(43,350)	(46,947)	(82,496)	(91,426)
Other income, net	751	4,594	1,038	8,293
Total income before provision for income taxes and controlling interest	**$ 18,787**	**$ 45,973**	**$ 37,215**	**$ 74,047**

Geographic Data

	Revenue by Geographic Region			
	Fiscal Quarter Ended		Fiscal Year-to-Date Ended	
	April 1, 2005	March 31, 2006	April 1, 2005	March 31, 2006
	(in thousands)			
United States	$ 22,345	$ 27,105	$ 43,001	$ 50,096
International	62,756	77,619	126,363	145,653
Total revenue	**$ 85,101**	**$ 104,724**	**$ 169,364**	**$ 195,749**

Revenue by geographic region was determined based on the location of our licensees for licensing revenue, the location of our direct customers or distributors for product sales, and the location where services were performed for production services revenue. Revenue generated from customers in Japan accounted for 26% and 23% of total revenue in the second quarter of fiscal 2005 and 2006, respectively, and 26% and 23% of total revenue in the fiscal year-to-date periods ended April 1, 2005 and March 31, 2006, respectively. Revenue generated from customers in China accounted for 7% and 11% of total revenue for the second quarter of fiscal 2005 and 2006, respectively, and 9% and 10% in the fiscal year-to-date periods ended April 1, 2005 and March 31, 2006, respectively. In the second quarter of fiscal 2005, revenue from our largest customer made up 10% of total revenue for the quarter. In the second quarter of fiscal 2006 no customer accounted for 10% or more of total revenue.

We do not track capital expenditures or assets by geographic region. Consequently, it is not practical to show assets by geographic region.

4. Stock-Based Compensation

We utilize stock-based awards as a form of compensation for employees, officers, directors and certain non-employee consultants. On October 1, 2005, we adopted the provisions of SFAS 123R using the modified prospective application transition method. Under this method, previously reported amounts should not be restated to reflect the provisions of SFAS 123R. The table below shows net income and earnings per share as if the fair-value method required by SFAS 123 had been applied to periods prior to our actual date of adoption:

	Fiscal Quarter Ended	Fiscal Year-to-Date Ended
	April 1, 2005	April 1, 2005
	(in thousands, except per share amounts)	
Net income as reported	$ 10,330	$ 20,707
Stock-based compensation included in net income as reported, net of tax	5,041	7,762
Stock-based compensation under the fair-value method, net of tax	(4,592)	(8,135)
Pro forma net income	**$ 10,779**	**$ 20,334**
Basic earnings per share		
As reported	$ 0.11	$ 0.23
Pro forma	$ 0.11	$ 0.22
Diluted earnings per share		
As reported	$ 0.10	$ 0.20
Pro forma	$ 0.10	$ 0.20

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Net income included $5.1 million and $10.2 million in stock-based compensation expense for the second quarter of fiscal 2006 and the fiscal year-to-date period ended March 31, 2006, respectively. Net income included $5.3 million and $8.2 million in stock-based compensation expense for the second quarter of fiscal 2005 and the fiscal year-to-date period ended April 1, 2005, respectively. Included in stock-based compensation for the second quarter of fiscal 2005 and the fiscal year-to-date period ended April 1, 2005 was $2.3 million related to an acceleration of vesting terms for a long-term employee at retirement.

We recognized $5.4 million and $9.1 million in tax benefits related to stock-based compensation arrangements in the second quarter of fiscal 2006 and the fiscal year-to-date period ended March 31, 2006, respectively. No tax benefits related to stock-based compensation arrangements were recognized in either the second quarter of fiscal 2005 or the fiscal year-to-date period ended April 1, 2005.

We have issued stock-based awards in the form of stock options, stock appreciation rights, shares issued under our employee stock purchase plan and stock grants. Below is a summary of the different types of stock-based awards issued under our stock plans:

Stock Options. We have granted stock options to our employees, officers and directors under our 2005 Stock Plan and our 2000 Stock Incentive Plan. Stock options are generally granted at fair market value on the date of grant. Options granted to employees and officers generally vest over 4 years, with equal annual cliff-vesting and expire on the earlier of 10 years or 3 months after termination of service. Options granted to outside directors generally vest over 3 years. All options granted vest over the requisite service period and are settled through issuance of shares of Dolby Laboratories common stock. Our 2005 Stock Plan also allows us to grant stock awards which vest based on the satisfaction of specific performance criteria, though no such awards have been granted as of March 31, 2006. Upon the exercise of stock options, we issue new shares of Class B common stock under the 2000 Stock Incentive Plan and new shares of Class A common stock under the 2005 Stock Plan. We utilize a Black-Scholes option pricing model to determine the fair value of employee stock options at the date of grant. The fair value of our stock-based awards was estimated using the following weighted-average assumptions for the second quarter of fiscal 2005 and fiscal 2006 and the fiscal year-to-date periods ended April 1, 2005 and March 31, 2006:

	Fiscal Quarter Ended		Fiscal Year-to-Date Ended	
	April 1, 2005	March 31, 2006	April 1, 2005	March 31, 2006
Expected term (in years)	6.00	6.14	6.00	6.22
Risk-free interest rate	4.2%	4.6%	4.2%	4.4%
Expected stock price volatility	82.4%	50.0%	82.4%	50.0%
Dividend yield	—	—	—	—

To determine the expected term of our employee stock options granted in fiscal 2006 we utilized the simplified approach as defined by SEC Staff Accounting Bulletin No. 107, "Share-Based Payment" (SAB 107). This approach resulted in a weighted-average expected term of 6.14 years for options granted during the second quarter of fiscal 2006 based on an expected term of 6.25 years for options that vest over 4 years and 6.00 years for options that vest over 3 years. To determine the risk-free interest rate we utilized an average interest rate based on U.S. Treasury instruments whose term was consistent with the expected term of our awards. To determine the expected stock price volatility we first examined the historical volatilities for our common stock and those of our peers. In addition, we considered the implied volatilities of our publicly-traded options and those publicly-traded options of our peers with similar terms to those of our employee stock options. We then utilized a weighted-average of historical and implied volatility to determine our expected stock price volatility.

Included in stock-based compensation expense for the second quarter of fiscal 2006 was $4.1 million related to employee stock options under the provisions of SFAS 123R, net of estimated forfeitures, and $8.4 million for the fiscal year-to-date period ended March 31, 2006. Total unrecorded stock-based compensation cost at March 31, 2006 associated with employee stock options was $38.1 million, which is expected to be recognized over a weighted-average period of 2.1 years.

Non-Employee Stock Options. We have also granted stock options to employees whose status subsequently changed to non-employee consultants subsequent to the dates of grant. In the second quarter of fiscal 2006, we recognized $0.9 million of stock-based compensation expense related to stock options held by non-employee consultants, and $1.5 million for the fiscal year-to-date period ended March 31, 2006. In accordance with Emerging Issues Task Force Issue 96-18, "Accounting for Equity Instruments That Are Issued to Other Than Employees for Acquiring or in Conjunction with Selling, Goods or Services" (EITF 96-18), compensation cost for options issued to non-employee consultants is determined based on the fair value at the end of each reporting period. We utilized a Black-Scholes option pricing model to determine the fair value of the services provided, and recognize compensation over the service period.

The following table summarizes information about stock options issued to officers, directors, employees and non-employee consultants under our 2000 Stock Incentive Plan and 2005 Stock Plan:

	Shares	Weighted Average Exercise Price	Weighted Average Remaining Contractual Life	Aggregate Intrinsic Value
	(in thousands)		(in years)	(in thousands)
Options outstanding at September 30, 2005	11,917	$ 4.11		
Grants	263	17.61		
Exercises	(1,661)	1.62		
Forfeitures	(98)	8.41		
Options outstanding at March 31, 2006	10,421	4.81	7.5	$ 167,727
Options exercisable at March 31, 2006	4,060	1.72	6.1	$ 77,883

The weighted-average fair value of stock options granted during the second quarter of fiscal 2005 and the second quarter of fiscal 2006 was $10.51 and $10.92 per option, respectively. The weighted-average fair value of options granted during the fiscal year-to-date periods ended April 1, 2005 and March 31, 2006 was $10.90 and $9.49 per option, respectively. The total intrinsic value of stock options exercised during the second quarter of fiscal 2005 and the second quarter of fiscal 2006 was $27.2 million and $17.0 million, respectively. The total intrinsic value of stock options exercised during the fiscal year-to-date periods ended April 1, 2005 and March 31, 2006 was $30.3 million and $28.3 million, respectively.

The following table summarizes information about stock options outstanding and exercisable at March 31, 2006:

	Outstanding Options			Options Exercisable	
Range of Exercise Prices	Shares	Weighted Average Remaining Contractual Life	Weighted Average Exercise Price	Shares	Weighted Average Exercise Price
	(in thousands)	(in years)		(in thousands)	
$1.00 - $1.50	3,224	5.3	$ 1.26	2,770	$ 1.26
$1.51 - $6.50	5,471	8.1	2.54	1,263	2.45
$6.51 - $15.50	144	9.0	14.72	27	14.50
$15.51 - $22.75	1,582	9.3	19.00	—	—
	10,421			**4,060**	

Stock Appreciation Rights. Stock-based compensation expense included in net income related to stock appreciation rights was $0.1 million in the second quarter of fiscal 2006 and $0.2 million for the fiscal year-to-date period ended March 31, 2006.

Employee Stock Purchase Plan. We have an employee stock purchase plan (ESPP). During the second quarter of fiscal 2006, the terms of our ESPP were considered non-compensatory under SFAS 123R and, therefore, no stock-based compensation expense associated with our ESPP was recognized.

5. Related Party Transactions

Prior to our initial public offering in February 2005, we had licensing and royalty agreements with Ray Dolby and his affiliates for the use of patents on which a portion of our operations is based. Under these agreements we recorded expenses for royalty obligations to Ray Dolby of $7.7 million for the second quarter of fiscal 2005. This amount is included in cost of licensing and cost of product sales in the accompanying consolidated statements of operations, depending on the nature of the licensed technology. In February, 2005, in connection with our initial public offering, Ray Dolby contributed to us all rights in the intellectual property related to our business that he and his affiliates held. In connection with the asset contribution, our previous licensing arrangements with Ray Dolby terminated, and we have no further obligation to pay royalties to Ray Dolby. Consequently, we have not recorded any expenses for royalty obligations to Ray Dolby subsequent to February 16, 2005.

6. Legal Proceedings

In May 2001, we filed a lawsuit against Lucent Technologies, Inc. and Lucent Technologies Guardian I, LLC together "Lucent," contending that Lucent was wrongly asserting that our licensees using Dolby AC-3 audio compression technology required licenses to the patents at issue and seeking a declaration that the patents at issue are not infringed and/or are invalid. Lucent filed a counterclaim alleging that we have infringed the patents at issue.

These patents generally involve a process and means for digitally encoding and decoding audio signals. On April 22, 2005, the U.S. District Court for the Northern District of California granted our motions for summary judgment, finding that we have not infringed, induced others to infringe, or contributed to the infringement of the patents at issue. In granting summary judgment of non-infringement, the court found that Lucent had not presented evidence from which a reasonable fact-finder could find that Dolby AC-3 technology infringes the patents at issue. In light of the Court's finding of non-infringement, it dismissed our claims that the Lucent patents are invalid. Lucent has appealed the court's April 22, 2005 ruling granting summary judgment of non-infringement to the United States Federal Circuit Court of Appeals.

In March 1997, an unrelated third party filed a lawsuit against us alleging breach of a written agreement. In April 2002, we settled the dispute and agreed to pay a total of $30.0 million, without interest, in ten equal annual installments of $3.0 million per year beginning in June 2002. We recorded this liability at its present value of $24.2 million on the consolidated balance sheet using a discount rate of 5.125%, which approximated our incremental cost of borrowing rate. Interest related to this liability is recorded quarterly and is included in interest expense on the accompanying consolidated statements of operations. Other than such payments, neither party has any material obligations as a result of the settlement. As of March 31, 2006, we had $18.0 million remaining to be paid under this settlement.

In addition, we are involved in various legal proceedings from time to time arising from the normal course of business activities, including claims of alleged infringement of intellectual property rights, commercial, employment and other matters. In our opinion, resolution of these proceedings is not expected to have a material adverse effect on our operating results or financial condition. However, it is possible that an unfavorable resolution of one or more such proceedings could materially affect our future operating results or financial condition in a particular period.

7. Recently Issued Accounting Standards

In March 2006, the Financial Accounting Standards Board (FASB) issued Statement of Financial Accounting Standards No 156, "Accounting for Servicing of Financial Assets" (SFAS 156), which requires all servicing assets and servicing liabilities be recognized separately and initially measured at fair value. SFAS 156 permits, but does not require, the subsequent measurement of servicing assets and servicing liabilities at fair value. Adoption is required as of the beginning of the first fiscal year that begins after September 15, 2006. Early adoption is permitted. We do not expect the adoption of SFAS 156 to have a material impact on our consolidated financial position, results of operations or cash flows.

In February 2006, the FASB issued Statement of Financial Accounting Standards No. 155, "Accounting for Certain Hybrid Financial Instruments" (SFAS 155) which amends Statement of Financial Accounting Standards No. 133, "Accounting for Derivative Instruments and Hedging Activities" (SFAS 133) and Statement of Financial Accounting Standards No. 140, "Accounting for Transfers and Servicing of Financial Assets and Extinguishments of Liabilities" (SFAS 140). SFAS 155 simplifies the accounting for certain derivatives embedded in other financial instruments by allowing them to be accounted for as a whole if the holder elects to account for the whole instrument on a fair value basis. SFAS 155 also clarifies and amends certain other provisions of SFAS 133 and SFAS 140. SFAS 155 is effective for all financial instruments acquired, issued or subject to a remeasurement event occurring in fiscal years beginning after September 15, 2006. We do not expect the adoption of SFAS 155 to have a material impact on our consolidated financial position, results of operations or cash flows.

ITEM 2 - MANAGEMENT'S DISCUSSION AND ANALYSIS OF FINANCIAL CONDITION AND RESULTS OF OPERATIONS

The following discussion and analysis should be read in conjunction with our consolidated financial statements and the related notes that appear elsewhere in this Form 10-Q. This discussion contains forward-looking statements reflecting our current expectations that involve risks and uncertainties. In some cases, you can identify forward-looking statements by terminology such as "may," "will," "should," "expects," "plans," "anticipates," "believes," "estimates," "predicts," "potential," "continue" or the negative of these terms or other comparable terminology. Forward-looking statements include, but are not limited to: statements regarding demand for and future revenues from the sale of consumer electronics products incorporating our technologies, including traditional DVD players; growth opportunities in the consumer electronics market; the impact of inclusion of certain of our technologies in audio standards; the rate of adoption of and sales of next-generation DVD players; diversification of sources of licensing revenue; concentration of manufacturing of consumer electronic products containing our technologies in emerging economies and the associated challenges in royalty collection and intellectual property enforcement; increase in sales of our products and demand for consumer electronics products containing our technologies in emerging economies; the pace of the movie industry's transition to digital cinema and our expected revenue associated with the transition; our critical accounting policies, including those regarding revenue recognition, allowance for doubtful accounts, accounting for goodwill, accounting for income taxes, personal holding company matters and stock-based compensation; increases in research and development expenses; projections of our effective tax rate; and statements regarding the sufficiency of our cash reserves for the next twelve months. Actual results may differ materially from those discussed in these forward-looking statements due to a number of factors, including: the rate of growth of the markets for consumer electronics that include our technologies; whether our technologies are selected for and remain part of audio standards; the rate of deployment and adoption of next-generation DVD players; the extent to which our expectations regarding new licensing markets are realized; the extent to which consumer electronics manufacturers concentrate their production in emerging economies that present royalty collection and intellectual property enforcement challenges; the extent to which consumers in emerging economies elect to purchase products containing our technologies; the extent to which professionals using our equipment continue to demand innovative technology solutions developed by us; the pace of the movie industry's transition to digital cinema; our ability to tailor our traditional model of selling to respond to market trends; the accuracy of our identification of critical accounting policies and the accuracy of the assumptions we make in implementing such policies; the accuracy of our estimates regarding our taxable income and cash needs for the next twelve months; and risks set forth in the section entitled "Risk Factors" and elsewhere in this filing. Although we believe that the expectations reflected in the forward-looking statements are reasonable, we cannot guarantee future results, levels of activity, performance or achievements. Moreover, neither we nor any other person assumes responsibility for the accuracy and completeness of these forward-looking statements. We are under no duty to update any of the forward-looking statements after the date of this Quarterly Report on Form 10-Q to conform our prior statements to actual results. The periods presented herein consist of our second quarters of fiscal 2005 and 2006 and the fiscal year-to-date periods ended April 1, 2005 and March 31. 2006. Our fiscal year-to-date period ended April 1, 2005 consisted of 27 weeks, compared to the fiscal year-to-date period ended March 31, 2006, which consisted of 26 weeks. Our 2006 fiscal year consists of 52 weeks and ends on September 29, 2006. The results for the fiscal quarter and fiscal year-to-date period ended March 31, 2006 are not necessarily indicative of the results to be expected for any subsequent quarterly or annual financial period, including the fiscal year ending September 29, 2006.

Overview

Dolby Laboratories develops and delivers innovative products and technologies that make the entertainment experience more realistic and immersive in theatres, homes, automobiles and elsewhere. Ray Dolby founded Dolby Laboratories in 1965 to develop noise reduction technologies. Today, we deliver a broad range of sound technologies for use in both professional and consumer applications. In addition, in recent years we have expanded our focus to include other technologies that facilitate the delivery of digital entertainment.

We conduct our business in two segments: our technology licensing segment and our products and services segment.

In our technology licensing segment, we work with manufacturers of integrated circuits, or ICs, to help them incorporate our technologies into their ICs. These manufacturers then sell ICs to consumer electronics product manufacturers that license our technologies for incorporation in products such as DVD players, DVD recorders, audio/video receivers, television sets, set-top boxes, video game consoles, portable audio and video players, personal computers and in-car entertainment systems. We also license our technologies to software developers who implement our technologies for use in personal computer software DVD players and DVD authoring applications. Our licensing arrangements typically entitle us to receive a specified royalty for every product shipped by our consumer electronics product manufacturer and software developer licensees that incorporates our technologies. We do not receive royalties from IC manufacturers.

In our products and services segment, we sell professional products and related production services to filmmakers, broadcasters, music producers, video game designers, cinema operators and DVD producers. These products are used in sound recording, distribution and playback to improve sound quality, providing surround sound and increasing the efficiency of sound storage and distribution. Our production services engineers work alongside artists and content producers throughout the world to help them record and reproduce the high quality sound they envision. Our engineers also work with cinema operators to help ensure that movie soundtracks are replayed with consistent high quality sound in their theatres.

We are a global organization. We have licensed our technologies to manufacturers of consumer electronics products in nearly 30 countries, including countries in North America, Europe and Asia. In fiscal 2003, 2004, 2005, and the fiscal year-to-date period ended March 31, 2006, revenue from licensees outside the United States represented 80%, 80%, 76% and 78% of our licensing revenue, respectively. Our licensees distribute consumer electronics products incorporating our technologies throughout the world. We sell our professional products and production services in over 50 countries. In fiscal 2003, 2004, 2005, and the fiscal year-to-date period ended March 31, 2006, revenue from sales outside the United States represented 60%, 59%, 61% and 62% of our professional products sales and production services revenue, respectively. Nearly all of our revenue is derived from transactions denominated in United States dollars.

Management Discussion Regarding Opportunities, Challenges and Risks

Our Technology Licensing Segment

We categorize our technology licensing segment into a variety of markets:

- Consumer electronics market – primarily comprised of DVD players, DVD recorders, audio/video receivers and home-theatres-in-a-box.
- Personal computer market – primarily comprised of software DVD players and DVD authoring applications.
- Broadcast market – primarily comprised of digital televisions and set-top boxes.
- Gaming market – primarily comprised of video game consoles.
- Automotive market – comprised of in-car entertainment products.
- Licensing services – revenue from patent pool administration performed by our subsidiary Via Licensing.

Traditionally, the consumer electronics market has been our largest market representing approximately 50% of our licensing revenue and has been driven primarily by revenues attributable to DVD player sales. While licensing revenue from our consumer electronics market has been strong in the first half of fiscal 2006 primarily due to a particularly strong holiday season for our licensees, we expect revenue from this market to be substantially lower in the second half of fiscal 2006. In addition, the continued maturation of the market for traditional consumer DVD players may result in lower revenue from this market in the future. Also, the industry has experienced a movement by discount retailers towards lower-end DVD players thereby decreasing the number of processors on which we earn licensing revenue. As a result of this movement, manufacturing of these lower-end DVD players appears to be growing in emerging economies, which we believe will pose challenges in royalty collection and intellectual property enforcement.

There continues to be a number of growth opportunities in the consumer electronics market, such as next generation DVD players for high-definition content and recordable DVD players. In anticipation of the introduction of the next generation DVD players, we have worked with developers to ensure that our technologies will be included as a standard audio format. Our Dolby Digital, Dolby Digital Plus and TrueHD technologies have been selected as mandatory audio standards in the High-Definition Digital Versatile Disc (HD-DVD) format. Dolby Digital has been selected as a mandatory audio standard and Dolby Digital Plus and TrueHD have been selected as optional audio standards in the Blu-ray format. However, the release and consumer adoption of next generation DVD players has been delayed due, in part, to the competing HD-DVD and Blu-ray formats. Consequently, we expect our ability to generate royalties from incorporation of our technology in next generation DVD players will also be delayed.

We are continuing to diversify our sources of licensing revenue by actively promoting the incorporation of our technologies for use in growing markets outside of our traditional consumer electronics market, such as personal computers, broadcast, gaming and automotive. The personal computing market, which represents over 25% of our licensing revenue, has been primarily driven by demand for software DVD players and to a lesser extent, DVD authoring applications. Revenue generated from the broadcast, gaming and automotive markets has primarily been driven by demand for Dolby Digital in set-top boxes, televisions, video game consoles and in-car entertainment systems. Although these markets have been growing, there is a risk that future growth may not fully offset a potential decline in the growth of revenue generated from our consumer electronics market. For example, in an effort to offer lower-cost business PCs, PC manufacturers may exclude software DVD players in their business-oriented offerings, which may result in lower than anticipated revenues.

We expect that sales of products incorporating our technologies in emerging economies, such as China and India, will increase in the future, as consumers in these geographical markets have more disposable income which may result in increased purchases of entertainment products with surround sound capabilities for use in homes, automobiles and elsewhere, although there can be no assurance that this will occur. We also expect that manufacturers from lower-cost manufacturing countries, including China, will increase production of these products in the future to satisfy this increased demand. Associated with opportunities of doing business in these emerging economies, such as China, are unique risks that have and will continue to affect our operating results, such as manufacturers failing to report or licensees underreporting product shipments.

Our Products and Services Segment

We are committed to developing technologies for use by professionals in the entertainment industry. We believe that filmmakers, broadcasters, music producers and video game designers will continue to push for technology solutions to help create, distribute and play back rich, high quality sounds and images. As a result, we believe that major advances in sound, imaging and other technologies for the recording, delivery and playback of entertainment will likely first be introduced in products designed for use by professionals.

Sales of our professional products and production services tend to fluctuate based on the underlying trends in the motion picture and broadcast industries. For example, when box office receipts for the motion picture industry increase, we have typically seen sales of our professional products increase as well, as cinema owners are more likely to build new theatres and upgrade existing theatres with our more advanced cinema products when they are doing well financially. Conversely, when box office receipts are down cinema owners tend to scale back on plans to upgrade their systems or build new theatres. In the broadcast industry, sales of our professional products have recently been influenced by the launch of digital services by broadcasters seeking to deliver content in Dolby Digital 5.1 surround sound. Our production services revenue, both in the United States and internationally, is also tied to the strength of the motion picture production industry and, in particular, to the number of films being made by studios and independent filmmakers. The number of films that are produced can be affected by a number of factors, including strikes and work-stoppages within the motion picture industry, as well as by the tax incentive arrangements that many foreign governments provide filmmakers to promote local filmmaking.

We are also committed to helping the motion picture industry develop system solutions for digital cinema; this continues to be a major initiative in our products and services segment. Digital cinema offers the motion picture industry possible means to achieve substantial cost savings in printing and distributing movies, to combat piracy, and to enable movies to be played repeatedly without degradation in image and audio quality. It also provides additional revenue opportunities for cinema operators, as concerts and sporting events already in digital format could be broadcast live via satellite to digitally-equipped theatres. The cinema industry is in the early stages of the adoption of digital cinema for the distribution and exhibition of movies. As this market evolves, we are continuing to investigate other opportunities, in addition to our traditional model of selling our products directly to our customers. Industry participants are discussing various business models to facilitate adoption of digital cinema by allocating the costs among industry participants. These opportunities have inherent risks. Digital cinema may require a significant investment per screen by cinema operators. If the market for digital cinema develops more slowly than we anticipate or if our technologies, products and services for this market are not widely adopted, our significant investment in developing digital cinema technology may not yield the returns we anticipate. In addition, a number of competitors and potential competitors are developing similar or alternative solutions for digital cinema, some of which may provide cost or technological advantages over our products, technologies and services.

In an effort to encourage the motion picture industry to increase the pace of conversion to digital cinema, we entered into a collaboration agreement with Walt Disney Pictures and Television in the third quarter of fiscal 2005 under which we deployed digital cinema systems in selected theatres throughout the U.S. We funded the majority of the equipment and installation costs related to this deployment, resulting in a total expense of $7.8 million to cost of product sales and cost of production services for the fourth quarter of fiscal 2005 and the first quarter of fiscal 2006. While the primary reason for this investment was to establish us as a leader in digital cinema, we also expect to receive a fee, which we refer to as a virtual print fee, each time a participating studio delivers a digital print for exhibition on the systems installed in this deployment.

In recent years, our products and services segment has grown more slowly than our technology licensing segment. In addition, the profit margin for our products and services segment has been lower than our technology licensing segment and is expected to remain so. The future deployment of digital cinema equipment in this competitive market may adversely affect our gross margin.

Pro Forma Presentation

Prior to our initial public offering in February 2005, Ray Dolby retained ownership of the intellectual property he created related to our business and licensed those rights to us in exchange for royalty payments. In connection with our initial public offering, Ray Dolby contributed to us all of these intellectual property rights in February 2005. As a result of this contribution, all of our licensing agreements with Ray Dolby terminated and we are no longer obligated to pay royalties to Ray Dolby for the use of his intellectual property rights. The pro forma financial information included in this discussion gives effect to the asset contribution as though it had been completed prior to the second quarter of fiscal 2005. We believe the pro forma results to be meaningful as they enable comparison of our pre-asset-contribution operating results to our operating results on a going-forward basis. The pro forma results presented below are not necessarily indicative of financial results to be achieved in future periods. The pro forma adjustments reverse the effects of $7.7 million and $18.7 million in royalties payable to Ray Dolby that were recorded in the second quarter of fiscal 2005 and the fiscal year-to-date period ended April 1, 2005, respectively. As these agreements were terminated as a result of the contribution in the second quarter of fiscal 2005, there are no pro forma adjustments made to our results for the second quarter of fiscal 2006 and the fiscal year-to-date period ended March 31, 2006.

The following table shows the pro forma effects of the asset contribution made by Ray Dolby described above on the respective line items of our consolidated statements of operations:

	Fiscal Quarter Ended		Fiscal Year-to-Date Ended	
	April 1, 2005	March 31, 2006	April 1, 2005	March 31, 2006
	(in thousands)			
Net income	$10,330	$27,979	$ 20,707	$ 45,248
Adjustments to pro forma net income by line item:				
Cost of licensing	7,273	—	17,424	—
Cost of product sales	384	—	1,286	—
Provision for income taxes	(3,070)	—	(7,587)	—
Pro forma net income	**$14,917**	**$27,979**	**$ 31,830**	**$ 45,248**

The following pro forma results presented below are not necessarily indicative of the results expected for any subsequent quarterly or annual financial period, including the fiscal year ending September 29, 2006:

	Fiscal Quarter Ended		Fiscal Year-to-Date Ended	
	April 1, 2005	March 31, 2006	April 1, 2005	March 31, 2006
	(pro forma)		(pro forma)	
	(unaudited) (in thousands, except per share amounts)			
Revenue:				
Licensing	$ 64,717	$ 83,183	$126,908	$ 152,165
Product sales	14,807	15,708	31,294	31,712
Production services	5,577	5,833	11,162	11,872
Total revenue	85,101	104,724	169,364	195,749
Cost of revenue:				
Cost of licensing	6,789	7,177	12,787	13,778
Cost of product sales (1)	7,088	6,883	14,998	19,564
Cost of production services (1)	2,181	2,338	4,196	5,227
Total cost of revenue	16,058	16,398	31,981	38,569
Gross margin	69,043	88,326	137,383	157,180
Operating expenses:				
Selling, general and administrative (1)	35,610	38,584	68,467	75,121
Research and development (1)	7,740	8,363	16,029	16,305
Settlements	—	—	(2,000)	—
Total operating expenses	43,350	46,947	82,496	91,426
Operating income	25,693	41,379	54,887	65,754
Other income, net	751	4,594	1,038	8,293
Income before provision for income taxes and controlling interest	26,444	45,973	55,925	74,047
Provision for income taxes	11,070	17,652	23,330	28,138
Income before controlling interest	15,374	28,321	32,595	45,909
Controlling interest in net income, net of tax	(457)	(342)	(765)	(661)
Net income	**$ 14,917**	**$ 27,979**	**$ 31,830**	**$ 45,248**
Basic earnings per share	$ 0.16	$ 0.27	$ 0.35	$ 0.43
Diluted earnings per share	$ 0.14	$ 0.25	$ 0.31	$ 0.41
Weighted-average shares outstanding (basic)	94,806	105,254	90,649	104,774
Weighted-average shares outstanding (diluted)	105,544	111,387	101,573	111,056

(1) Stock-based compensation included above was classified as follows:

Cost of product sales	$ 56	$ 196	$ 110	$ 398
Cost of production services	30	126	56	256
Selling, general and administrative	4,603	4,106	6,790	8,210
Research and development	570	663	1,251	1,336
Total stock-based compensation	$ 5,259	$ 5,091	$ 8,207	$ 10,200

Critical Accounting Policies

The discussion and analysis of our financial condition and results of operations are based on our consolidated financial statements, which have been prepared in accordance with accounting principles generally accepted in the United States of America, or U.S. GAAP. The preparation of these financial statements in accordance with U.S. GAAP requires us to utilize accounting policies and make certain estimates and assumptions that affect the reported amounts of assets and liabilities, the disclosure of contingencies as of the date of the financial statements and the reported amounts of revenue and expenses during a fiscal period. The SEC considers an accounting policy to be critical if it is important to a company's financial condition and results of operations, and if it requires significant judgment and estimates on the part of management in its application. We have discussed the selection and development of the critical accounting policies with the Audit Committee of our Board of Directors, and the Audit Committee has reviewed our related disclosures in this Form 10-Q. Although we believe that our judgments and estimates are appropriate and correct, actual results may differ from those estimates.

The following are our critical accounting policies because we believe they are both important to the portrayal of our financial condition and results of operations and require critical management judgments and estimates about matters that are uncertain. If actual results or events differ materially from those contemplated by us in making these estimates, our reported financial condition and results of operations for future periods could be materially affected. See "Risk Factors" for certain matters bearing risks on our future results of operations.

Revenue Recognition

We evaluate revenue recognition for transactions to sell products and services and to license technology, trademarks and know-how using the criteria set forth by the SEC in Staff Accounting Bulletin 104, "Revenue Recognition" (SAB 104). SAB 104 states that revenue is recognized when each of the following criteria are met: persuasive evidence of an arrangement exists, delivery has occurred or services have been rendered, the seller's price to the buyer is fixed or determinable, and collectibility is reasonably assured.

Licensing. Our licensing revenue is primarily derived from royalties paid to us by licensees of our intellectual property rights, including patents, trademarks and know-how. Royalties are recorded as reported at their gross amounts and are recognized when all revenue recognition criteria have been met. We make judgments as to whether collectibility can be reasonably assured based on the licensee's recent payment history or the existence of a standby letter-of-credit between the licensee's financial institution and our financial institution. In the absence of a favorable collection history or a letter-of-credit, we recognize revenue upon receipt of cash, provided that all other revenue recognition criteria have been met.

Product Sales and Production Services. Our revenue from the sale of products is recognized when the risk of ownership has transferred to our customer as provided under the terms of the governing purchase agreement, which is typically the invoice we deliver to the customer, and all the other revenue recognition criteria have been met. Generally, these purchase agreements provide that the risk of ownership is transferred to the customer when the product is shipped. Production services revenue is recognized as the services related to a given project are performed and all the other revenue recognition criteria have been met.

Allowance for Doubtful Accounts

We continually monitor customer payments and maintain a reserve for estimated losses resulting from our customers' inability to make required payments. In determining the reserve, we evaluate the collectibility of our accounts receivable based upon a variety of factors. In cases where we are aware of circumstances that may impair a specific customer's ability to meet its financial obligations, we record a specific allowance against amounts due, and thereby reduce the net recognized receivable to the amount reasonably believed to be collectible. For all other customers, we recognize allowances for doubtful accounts based on our actual historical write-off experience in conjunction with the length of time the receivables are past due, customer creditworthiness and geographic risk. Actual future losses from uncollectible accounts may differ from our estimates and may have a material effect on our consolidated statements of operations and our financial condition. Our allowance for doubtful accounts totaled $2.2 million at March 31, 2006. An incremental change of 1% in our allowance for doubtful accounts as a percentage of trade accounts receivables would have a $0.2 million increase or decrease in our operating results.

Goodwill

We account for goodwill in accordance with Statement of Financial Accounting Standards No. 142, "Goodwill and Other Intangible Assets" (SFAS 142). SFAS 142, among other things, established new standards for goodwill acquired in a business combination, eliminated the amortization of goodwill and requires the carrying value of goodwill and certain non-amortizing intangibles to be evaluated for impairment on an annual basis. As required by SFAS 142, we perform an impairment test on recorded goodwill by comparing the estimated fair value of each of our reporting units to the carrying value of the assets and liabilities of each unit, including goodwill. This value is determined by using a discounted cash-flow model which considers a number of factors, including estimated future cash-flows, risks facing us and our current market capitalization. If the carrying value of the assets and liabilities of the reporting units, including goodwill, were to exceed our estimate of the fair value of the reporting units, we would record an impairment charge in an amount equal to the excess of the carrying value of goodwill over the implied fair value of the goodwill. Our fiscal 2005 impairment test of goodwill, which was performed in the third fiscal quarter, resulted in no impairment charge. Fluctuations in our fair value, which may result from changes in economic conditions, our results of operations and other factors, relative to the carrying value, could result in impairment charges in future periods.

Accounting for Income Taxes

In preparing our consolidated financial statements, we are required to make estimates and judgments that affect our accounting for income taxes. This process includes estimating actual current tax exposure together with assessing temporary differences resulting from differing treatment of items for tax and accounting purposes. These differences, including differences in the timing of recognition of stock-based compensation expense, result in deferred tax assets and liabilities, which are included in our consolidated balance sheets. We also assess the likelihood that our deferred tax assets will be recovered from future taxable income and, to the extent that we believe that recovery is not likely, we have established a valuation allowance.

Significant judgment is required in determining the provision for income taxes, deferred tax assets and liabilities and the valuation allowance against our deferred tax assets. Our financial position and results of operations may be materially impacted if actual results significantly differ from these estimates or the estimates are adjusted in future periods.

Personal Holding Company Tax Matters. For United States federal income tax purposes, a corporation is generally considered to be a "personal holding company" under the United States Internal Revenue Code if (i) at any time during the last half of its taxable year more than 50% of its stock by value is owned, directly or indirectly, by virtue of the application of certain stock ownership attribution rules set forth in the Internal Revenue Code for purposes of applying the personal holding company rules, by five or fewer individuals and (ii) at least 60% of its adjusted ordinary gross income, as defined for United States federal income tax purposes, is "personal holding company income." Personal holding company income is generally passive income, including royalty income, subject to certain exceptions such as qualifying software royalties. A personal holding company is subject to an additional tax on its undistributed after-tax income, calculated at the statutory tax rate, which is currently 15%. Since the personal holding company tax is imposed only on undistributed income, a personal holding company can avoid or mitigate liability for the tax, but not interest or penalties, by paying a dividend to its stockholders.

During fiscal 2005, and the fiscal year-to-date period ended March 31, 2006, more than 50% of the value of our stock was held by Ray Dolby and stockholders considered affiliated with him pursuant to the stock ownership attribution rules applicable to personal holding companies. We expect this will continue to be the case in the foreseeable future. In addition, a significant portion of our income is from licensing fees, which may constitute personal holding company income. Currently, however, less than 60% of Dolby Laboratories' adjusted ordinary gross income is personal holding company income.

Stock-Based Compensation

We account for stock-based compensation arrangements in accordance with SFAS 123R and related interpretations. SFAS 123R requires measurement of all employee stock-based compensation awards using a fair-value method and recording of such expense in the consolidated financial statements over the requisite service period. We estimate the fair value of stock options and ESPP awards using the Black-Scholes valuation model as permitted by the provisions of SFAS 123R and SAB 107. To determine the fair value of our stock-based awards at the date of grant using the Black-Scholes model, we make assumptions about the expected stock price volatility of our common stock, employee exercise patterns, risk-free interest rates, and expected dividend yield. Limitations on the effectiveness of the Black-Scholes option pricing model are that it was developed for use in estimating the fair value of traded options which have no vesting restrictions and are fully transferable, and that the model requires the use of highly subjective assumptions including expected stock price volatility. In addition, under the provisions of SFAS 123R, we are required to make assumptions about the expected rate of forfeitures for our stock-based awards. Due to the limited amount of data available to us, particularly with respect to stock-price volatility, employee exercise patterns and forfeitures, actual results may differ from our assumptions.

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Results of Operations

Revenue

	Fiscal Quarter Ended		Change		Fiscal Year-to-Date Ended		Change	
	April 1, 2005	March 31, 2006	$	%	April 1, 2005	March 31, 2006	$	%
	($ in thousands)							
Revenue:								
Licensing	$64,717	$ 83,183	$18,466	29%	$126,908	$152,165	$25,257	20%
Percentage of total revenue	*76%*	*79%*			*75%*	*78%*		
Product sales	14,807	15,708	901	6%	31,294	31,712	418	1%
Percentage of total revenue	*17%*	*15%*			*18%*	*16%*		
Production services	5,577	5,833	256	5%	11,162	11,872	710	6%
Percentage of total revenue	*7%*	*6%*			*7%*	*6%*		
Total revenue	**$85,101**	**$104,724**	**$19,623**	**23%**	**$169,364**	**$195,749**	**$26,385**	**16%**

Licensing. The $18.5 million, or 29%, increase in licensing revenue from the second quarter of fiscal 2005 to the second quarter of fiscal 2006 was primarily due to increased sales reported by our licensees of their products that incorporate our technologies. The growth was primarily driven by increases in revenue from our consumer electronics (CE) and personal computer (PC) markets, and to a lesser extent, by our gaming, broadcast and automotive markets. The increase in the CE market was primarily due to a particularly strong holiday season for our licensees and improved collections of royalties from licensees. The increase in the PC market was driven by growth in sales of personal computer software DVD players and DVD authoring applications. The growth in the gaming, broadcast and automotive markets was driven by sales of video game consoles, set-top boxes, digital televisions and in-car entertainment systems that incorporate our technologies.

The $25.3 million, or 20%, increase in licensing revenue from the fiscal year-to-date period ended April 1, 2005 to the fiscal year-to-date period ended March 31, 2006 was primarily attributable to growth in the PC, CE and gaming markets and, to a lesser extent, by our broadcast and automotive markets for the same reasons discussed above with respect to the second quarter. While licensing revenue from our CE market has been strong in the first half of fiscal 2006 primarily due to a particularly strong holiday season for our licensees, we expect revenue from this market to be substantially lower in the second half of fiscal 2006.

Product Sales. The $0.9 million, or 6%, increase in our product sales revenue from the second quarter of fiscal 2005 to the second quarter of fiscal 2006 was principally attributable to an increase in sales of our broadcast products in Europe as broadcasters continued to increase their capabilities for broadcasting content in Dolby Digital 5.1 surround sound.

The $0.4 million, or 1%, increase in our revenue from product sales from the fiscal year-to-date period ended April 1, 2005 to the fiscal year-to-date period ended March 31, 2006 was principally attributable to sales of our broadcast products for the same reasons discussed above with respect to the second quarter. This increase was partially offset by a decrease in sales of our cinema products which appears to have been driven by weakness in European box office receipts during calendar year 2005.

Production Services. The $0.3 million, or 5%, increase in production services revenue from the second quarter of fiscal 2005 to the second quarter of fiscal 2006 was primarily attributable to an increase in services provided for original films as well as services related to digital cinema and services provided to encrypt films for awards group presentations.

The $0.7 million, or 6%, increase in production services revenue from the fiscal year-to-date period ended April 1, 2005 to the fiscal year-to-date period ended March 31, 2006 was primarily attributable to the same reasons discussed above with respect to the second quarter.

Gross Margin

	Actual				Pro Forma			
	Fiscal Quarter Ended		Fiscal Year-to-Date Ended		Fiscal Quarter Ended		Fiscal Year-to-Date Ended	
	April 1, 2005	March 31, 2006	April 1, 2005	March 31, 2006	April 1, 2005	March 31, 2006	April 1, 2005	March 31, 2006
Gross margin:								
Licensing gross margin percentage	*78%*	*91%*	*76%*	*91%*	*90%*	*91%*	*90%*	*91%*
Product sales margin percentage	*50%*	*56%*	*48%*	*38%*	*52%*	*56%*	*52%*	*38%*
Production services gross margin percentage	*61%*	*60%*	*62%*	*56%*	*61%*	*60%*	*62%*	*56%*
Total gross margin percentage	**72%**	**84%**	**70%**	**80%**	**81%**	**84%**	**81%**	**80%**

Licensing Gross Margin. We license intellectual property to our customers that may be internally developed, acquired by us or licensed from other parties. Our cost of licensing consists principally of royalty obligations to third parties for the licensing of intellectual property rights that we sublicense as part of our licensing arrangements with our customers. Our cost of licensing also includes amortization expenses associated with purchased intangible assets. Prior to our initial public offering in February 2005, our cost of licensing included royalty obligations to Ray Dolby. In February 2005, in connection with our initial public offering, Ray Dolby contributed to us all rights in the intellectual property related to our business that he and his affiliates held. In connection with the asset contribution, our previous licensing arrangements with Ray Dolby terminated, and we have no further obligation to pay royalties to Ray Dolby. The increase in licensing gross margin from the second quarter of fiscal 2005 to the second quarter of fiscal 2006 and from the fiscal year-to-date period ended April 1, 2005 to the fiscal year-to-date period ended March 31, 2006 was due primarily to the elimination of royalty obligations to Ray Dolby as a result of the February 2005 contribution of his intellectual property rights.

Pro forma licensing gross margin for the second quarter of fiscal 2005 and the fiscal year-to-date period ended April 1, 2005 excludes $7.3 million and $17.4 million, respectively, of expenses we recorded for sublicensing royalty obligations to Ray Dolby.

Product Sales Gross Margin. Cost of product sales primarily consists of material costs related to the products sold, applied labor and manufacturing overhead and, to a lesser extent, amortization of certain intangible assets. Prior to our initial public offering in February 2005, our cost of product sales also included royalty obligations for technologies we licensed from Ray Dolby. These royalty obligations terminated in connection with Ray Dolby's asset contribution discussed above. In the second quarter of fiscal 2005 and the fiscal year-to-date period ended April 1, 2005, we recorded $0.4 million and $1.3 million, respectively, in royalty expenses to cost of product sales in connection with these obligations. The increase in product sales gross margin for the second quarter of fiscal 2006 was primarily due to the elimination of royalties due to Ray Dolby.

Cost of product sales for the fiscal year-to-date period ended March 31, 2006 includes a $5.7 million charge recorded in the first quarter of fiscal 2006 in connection with our digital cinema collaboration with Walt Disney Pictures and Television discussed above in our product and services segment overview in the "Management Discussion Regarding Opportunities, Challenges and Risks" section. The decrease in product sales gross margin on a fiscal year-to-date basis from fiscal 2005 to fiscal 2006 is primarily due to the charge recognized in connection with our digital cinema collaboration, partially offset by an increase due to the elimination of royalties due to Ray Dolby.

Pro forma product sales gross margin for the second quarter of fiscal 2005 and the fiscal year-to-date period ended April 1, 2005 excludes $0.4 million and $1.3 million, respectively, of expenses we recorded for royalty obligations to Ray Dolby. The increase in pro forma product sales gross margin from the second quarter of fiscal 2005 to the second quarter of fiscal 2006 was primarily due to higher than expected production levels, which reduced our actual per-unit overhead costs. On a fiscal year-to-date basis, the decrease in pro forma product sales gross margin was due to the charge associated with the digital cinema collaboration discussed above, but was partially offset by higher than expected production levels, which reduced our actual per-unit overhead costs.

Production Services Gross Margin. Cost of production services consists of the payroll and benefits costs of employees performing our professional services, the cost of outside consultants and reimbursable expenses incurred on behalf of customers. In the first quarter of fiscal 2006, we recorded a charge of $0.7 million related to the digital cinema collaboration with Walt Disney Pictures and Television discussed above. Due to this charge, production services gross margin decreased from the fiscal year-to-date period ended April 1, 2005 to the fiscal year-to-date period ended March 31, 2006. Pro forma production services gross margin was not affected by royalty obligations to Ray Dolby.

Operating Expenses

	Fiscal Quarter Ended April 1, 2005	Fiscal Quarter Ended March 31, 2006	Change $	Change %	Fiscal Year-to-Date Ended April 1, 2005	Fiscal Year-to-Date Ended March 31, 2006	Change $	Change %
	($ in thousands)							
Operating expenses:								
Selling, general and administrative	$35,610	$38,584	$2,974	8%	$68,467	$ 75,121	$6,654	10%
Percentage of total revenue	*42%*	*37%*			*40%*	*38%*		
Research and development	7,740	8,363	623	8%	16,029	16,305	276	2%
Percentage of total revenue	*9%*	*8%*			*9%*	*8%*		
Settlements	—	—	—	—	(2,000)	—	2,000	—
Percentage of total revenue	—	—			*(1%)*	—		
Total operating expenses	**$43,350**	**$46,947**	**$3,597**	**8%**	**$82,496**	**$ 91,426**	**$8,930**	**11%**

Selling, General and Administrative. Selling, general and administrative expense consists primarily of personnel and personnel-related expenses, facility costs and professional service fees for our sales, marketing and administrative functions. The $3.0 million, or 8%, increase from the second quarter of fiscal 2005 to the second quarter of fiscal 2006 was principally due to a $3.0 million increase in compensation and benefits costs due to growth in headcount and increases in annual pay rates. We also experienced increases in professional and consulting expenses due to IT support services, travel and entertainment expense related primarily to tradeshows and depreciation expense due to amortization of software implementations and leasehold improvements completed in fiscal 2005. These increases were partially offset by a decrease of $0.8 million in promotional expenses from the second quarter of fiscal 2005 to the second quarter of fiscal 2006 primarily associated with an investment made in fiscal 2005 to provide Cinea's secure DVD players to members of certain awards organizations in order to promote Cinea's encryption technology. While there was no direct revenue associated with the distribution of these players, we believe it was a valuable investment to demonstrate the benefits of Cinea's technology to the motion picture industry. Stock-based compensation expense decreased by $0.5 million due to a charge in the second quarter of fiscal 2005 related to an acceleration of vesting terms for a long-term employee at retirement, offset by the adoption of SFAS 123R.

The $6.7 million, or 10%, increase in selling, general and administrative expense from the fiscal year-to-date period ended April 1, 2005 to the fiscal year-to-date period ended March 31, 2006 was principally due to a $4.4 million increase in compensation and benefits costs due to growth in headcount and increases in annual pay rates coupled with a $0.4 million rise in occupancy costs to accommodate our headcount growth, and a $1.4 million increase in stock-based compensation expense due to the adoption of SFAS 123R. In addition, we experienced increases in professional and consulting expenses due to IT support services and depreciation expense due to amortization of software implementations and leasehold improvements completed in fiscal 2005. Selling, general and administrative expenses also increased due to the inclusion of an additional week in the fiscal year-to-date period ended April 1, 2005 compared to the fiscal year-to-date period ended March 31, 2006. These increases were partially offset by a decrease of $2.3 million in promotional expenses, primarily associated with our investment made in fiscal 2005 to provide Cinea's secure DVD players to members of certain awards organizations in order to promote Cinea's encryption technology.

Research and Development. Research and development expense consists primarily of compensation and benefits related costs for personnel responsible for the research and development of new technologies and products. The $0.6 million, or 8%, increase in research and development expense from the second quarter of fiscal 2005 to the second quarter of fiscal 2006 was primarily driven by an increase in compensation and benefits costs due to growth in headcount and increases in annual pay rates.

The $0.3 million, or 2%, increase in research and development expense from the fiscal-year-to date period ended April 1, 2005 to the fiscal year-to-date period ended March 31, 2006 was primarily driven by increased compensation and benefits costs due to growth in headcount and increases in annual pay rates. We anticipate that research and development expense will continue to increase in absolute dollars in fiscal 2006 as compared to fiscal 2005, as we expect to hire additional personnel to support the development of new technologies.

Settlements. Settlements include interest and penalties related to the collection of royalties and resolution of disputes in our favor or against us. Settlements of royalty disputes from licensees that specifically represent unpaid royalties are recorded as licensing revenue in the period in which all revenue recognition criteria are met. Settlements of other disputes, such as disputes with implementation licensees from which we typically do not receive royalties, are recorded as settlements. In the first quarter of fiscal 2005, we recognized $2.0 million in connection with the settlement of disputes with two of IC manufacturers regarding violation of the terms of their licensing agreements with us.

Other Income, Net

	Fiscal Quarter Ended		Change		Fiscal Year-to-Date Ended		Change	
	April 1, 2005	March 31, 2006	$	%	April 1, 2005	March 31, 2006	$	%
	($ in thousands)							
Other income, net	$ 751	$ 4,594	$3,843	512%	$ 1,038	$ 8,293	$7,255	699%

Other income, net, primarily consists of interest income earned on cash and cash equivalent balances, offset by interest expense on outstanding balances on our facility debt obligations. Also included are gains and losses on interest rate swap agreements associated with our facility debt obligations and foreign exchange rate fluctuations. Other income, net was $4.6 million in the second quarter of fiscal 2006 compared to $0.8 million in the second quarter of fiscal 2005, and $8.3 million in the fiscal year-to-date period ended March 31, 2006 compared to $1.0 million in the fiscal year-to-date period ended April 1, 2005. The increase in the second quarter of fiscal 2006 and on a fiscal year-to-date basis was primarily due to increased interest earned on our higher cash and cash equivalent balances as a result of our initial public offering in February 2005 and additional cash generated from operations.

Income Taxes

	Actual				Pro Forma			
	Fiscal Quarter Ended		Fiscal Year-to-Date Ended		Fiscal Quarter Ended		Fiscal Year-to-Date Ended	
	April 1, 2005	March 31, 2006	April 1, 2005	March 31, 2006	April 1, 2005	March 31, 2006	April 1, 2005	March 31, 2006
	($ in thousands)							
Income taxes:								
Provision for income taxes	$8,000	$17,652	$ 15,743	$ 28,138	$11,070	$17,652	$ 23,330	$ 28,138
Effective tax rate	*43%*	*38%*	*42%*	*38%*	*42%*	*38%*	*42%*	*38%*

Our effective tax rate is based upon projection of annual fiscal year results. In the second quarter of fiscal 2005, our effective tax rate was 43%, while our effective tax rate for fiscal 2005 was 41%. Our effective tax rate for the second quarter of fiscal 2006 was 38%, lower than in the second quarter of fiscal 2005, primarily due to income from a foreign subsidiary which is not included in taxable income in the second quarter of fiscal 2006 compared to a loss from a foreign subsidiary in the second quarter of fiscal 2005 as well as an update to our fiscal 2006 projections from which we determine our expected effective tax rate. We expect our effective tax rate for fiscal year 2006 to be approximately 40%.

Liquidity and Capital Resources

The following table presents selected financial information for the fiscal quarters ended on the dates indicated:

	September 30, 2005	March 31, 2006
	(in thousands)	
Cash and cash equivalents	$ 372,403	$450,583
Accounts receivable, net	25,221	22,737
Accounts payable and accrued liabilities	65,126	71,779
Working capital[a]	381,394	449,970

	April 1, 2005	March 31, 2006
Operating cash flow (fiscal year-to-date)	$ 49,196	$ 69,946
Capital expenditures (fiscal year-to-date)[b]	9,138	3,933
Cash provided by financing activities (fiscal year-to-date)	244,380	11,922

(a) Working capital consists of total current assets less total current liabilities.

(b) Capital expenditures consist of purchases of office equipment, building fixtures, computer hardware and software, leasehold improvements and production and test equipment.

As of March 31, 2006, we had cash and cash equivalents of $450.6 million, an increase of $78.2 million over the balance of $372.4 million at September 30, 2005. The net increase was primarily due to cash generated from operating activities of $69.9 million, which was driven by net income of $45.2 million and non-cash expenses of $16.4 million related to stock-based compensation expense and depreciation and amortization for the fiscal year-to-date period ended March 31, 2006. In addition, cash held on behalf of patent pool members that had been collected from licensees but had not yet been paid out to patent pool members increased by $13.8 million. As a result of this increase in cash collected by our patent pool administration program, accounts receivable related to the program decreased by $6.6 million, while amounts payable to patent pool members increased by $6.6 million during the fiscal year-to-date period ended March 31, 2006. The change in income taxes of $10.0 million was partially offset by $8.4 million in excess tax benefits from the exercise of stock options which are reflected in financing activities.

We believe that our cash, cash equivalents and potential cash flow from operations will be sufficient to satisfy our cash requirements through at least the next 12 months.

Cash used in investing activities was $3.9 million for the fiscal year-to-date period ended March 31, 2006 and $22.3 million for the fiscal year-to-date period ended April 1, 2005. Cash used in investing activities for the fiscal year-to-date period ended April 1, 2005 included an $11.0 million payment for an exclusive irrevocable right to sublicense a third party's technology to our customers, as well as $9.1 million in capital expenditures. Capital expenditures decreased $5.2 million from the fiscal year-to-date period ended April 1, 2005 to the fiscal year-to-date period ended March 31, 2006 primarily due to the completion of leasehold improvements and ERP implementations that occurred in fiscal 2005.

Cash provided by financing activities was $11.9 million for the fiscal year-to-date period ended March 31, 2006. Cash provided by financing activities decreased $232.5 million from the fiscal year-to-date period ended March 31, 2006 compared to the fiscal year-to-date period ended April 1, 2005 primarily due to $242.5 million in net proceeds generated from the issuance of Class A common stock in our initial public offering in February, 2005. This decrease was partially offset by excess tax benefits from the exercise of stock options and cash received from the exercise of stock options and the issuance of common stock related to our ESPP.

In the first quarter of fiscal 2006 we adopted SFAS 123R using the modified prospective application transition method. Prior to our adoption of SFAS 123R, excess tax benefits from the exercise of stock options were reported as operating cash flows. SFAS 123R requires excess tax benefits be reported as a financing activity rather than as a reduction of taxes paid in operating activities.

Personal Holding Company Tax Matters

If we or any of our subsidiaries were to become liable for personal holding company tax, we expect that it is likely that instead of paying the personal holding company tax, we would elect to pay a dividend to our stockholders in an amount equal to all or a significant part of our undistributed personal holding company income. We expect that we would pay such a dividend out of our available working capital, which could significantly decrease our cash, unless we sought additional financing for this purpose. Any such financing might not be available on terms acceptable to us or at all. If instead of paying a dividend we elect to pay the tax, this could significantly increase our consolidated tax expense. We expect we would pay any such tax out of our available working capital, which could also significantly decrease our cash, unless we sought additional financing. For further explanation of matters related to personal holding company tax, refer to our "Critical Accounting Policies – Accounting for Income Taxes".

ITEM 3 – QUANTITATIVE AND QUALITATIVE DISCLOSURES ABOUT MARKET RISK

Interest Rate Sensitivity

Cash and Cash Equivalents. As of March 31, 2006, we had cash and cash equivalents of $450.6 million, which consisted of cash, highly liquid money market instruments and United States government-backed securities with original maturities of three months or less. In the future, we may invest some of our cash in other types of financial instruments, such as overnight money market funds, United States government securities, corporate debt and municipal debt. If we invest in these instruments, our results could become more sensitive to fluctuations in interest rates. Utilizing our cash and cash equivalents balance as of March 31, 2006, a hypothetical 1.0% change in interest rates would result in a $4.5 million impact to our interest income over a one-year period.

Interest Rate Swap Agreements. We have entered into interest rate swap agreements to manage our exposure to interest rate changes on our facility debt obligations. The swap agreements involve the exchange of fixed and variable interest rate payments without exchanging the notional principal amount. Gains and losses associated with the swap agreements are included in other income, net, in our consolidated statements of operations.

We do not utilize financial instruments for trading or other speculative purposes, nor do we utilize leveraged financial instruments.

Foreign Currency Exchange Risk

We maintain sales, marketing and business operations in foreign countries, most significantly in the United Kingdom. Consequently, we have exposure to adverse changes in exchange rates associated with our foreign business operations. Nearly all of our revenue is derived from transactions denominated in United States dollars. In fiscal 2005, we began selling more products in United States dollars from our United Kingdom branch and maintained the receipts in a United States dollar account in the United Kingdom. The functional currency of our United Kingdom branch is the British pound sterling. Therefore, we were required to remeasure balances that were in currencies other than the functional currency and recognize the impact of these foreign exchange rate fluctuations in our results of operations. As the balance in the account grew throughout fiscal 2005, our results of operations became exposed to foreign exchange gains and losses. In the first quarter of fiscal 2006, we converted much of the balance into British pound sterling, thereby significantly mitigating the exposure from fluctuations in foreign exchange rates on our statement of operations. We periodically convert balances denominated in United States dollars at our United Kingdom branch into British pound sterling to mitigate this exposure.

ITEM 4 – CONTROLS AND PROCEDURES

Evaluation of Disclosure Controls and Procedures

We maintain “disclosure controls and procedures,” as such term is defined in Rules 13a-15(e) and 15d-15(e) under the Securities Exchange Act of 1934 (the “Exchange Act”), that are designed to ensure that information required to be disclosed by us in reports that we file or submit under the Exchange Act is recorded, processed, summarized, and reported within the time periods specified in SEC rules and forms, and that such information is accumulated and communicated to our management, including our Chief Executive Officer and Chief Financial Officer, as appropriate, to allow timely decisions regarding required disclosure. In designing and evaluating our disclosure controls and procedures, management recognized that disclosure controls and procedures, no matter how well conceived and operated, can provide only reasonable, not absolute, assurance that the objectives of the disclosure controls and procedures are met. Additionally, in designing disclosure controls and procedures, our management necessarily was required to apply its judgment in evaluating the cost-benefit relationship of possible disclosure controls and procedures. The design of any disclosure controls and procedures is based in part upon certain assumptions about the likelihood of future events, and there can be no assurance that any design will succeed in achieving its stated goals under all potential future conditions.

Subject to the limitations noted above, our management, with the participation of our Chief Executive Officer and Chief Financial Officer, has evaluated the effectiveness of the design and operation of our disclosure controls and procedures as of the end of the fiscal period covered by this Quarterly Report on Form 10-Q. Based on that evaluation, the Chief Executive Officer and Chief Financial Officer have concluded that, as of such date, our disclosure controls and procedures were effective to ensure that information we are required to disclose in reports under the Exchange Act is accumulated and communicated to our management, including our principal executive and principal financial officers, as appropriate, to allow timely decisions regarding required disclosure, and that such information is recorded, processed, summarized and reported within the time periods specified in the SEC rules and forms.

Changes in Internal Control Over Financial Reporting

There were no changes in our internal control over financial reporting during the fiscal quarter ended March 31, 2006, that have materially affected or are reasonably likely to affect, our internal control over financial reporting.

PART II – OTHER INFORMATION

ITEM 1. LEGAL PROCEEDINGS

In May 2001, we filed a lawsuit against Lucent Technologies, Inc. and Lucent Technologies Guardian I, LLC together "Lucent," contending that Lucent was wrongly asserting that our licensees using Dolby AC-3 audio compression technology required licenses to the patents at issue and seeking a declaration that the patents at issue are not infringed and/or are invalid. Lucent filed a counterclaim alleging that we have infringed the patents at issue. These patents generally involve a process and means for digitally encoding and decoding audio signals. On April 22, 2005, the U.S. District Court for the Northern District of California granted our motions for summary judgment, finding that we have not infringed, induced others to infringe, or contributed to the infringement of the patents at issue. In granting summary judgment of non-infringement, the court found that Lucent had not presented evidence from which a reasonable fact-finder could find that Dolby AC-3 technology infringes the patents at issue. In light of its finding of non-infringement, the court dismissed our invalidity claims. Lucent has appealed the court's April 22, 2005, ruling granting summary judgment of non-infringement to the United States Federal Circuit Court of Appeals.

In addition, we are involved in various legal proceedings from time to time arising from the normal course of business activities, including claims of alleged infringement of intellectual property rights, commercial, employment and other matters. In our opinion, resolution of these proceedings is not expected to have a material adverse effect on our operating results or financial condition. However, it is possible that an unfavorable resolution of one or more such proceedings could materially affect our future operating results or financial condition in a particular period.

ITEM 1A. RISK FACTORS

Because of the following factors, as well as other variables affecting our operating results and financial condition, past performance may not be a reliable indicator of future performance, and historical trends should not be used to anticipate results or trends in future periods.

Our business and prospects depend on the strength of our brand, and if we do not maintain and strengthen our brand, our business will be materially harmed.

Maintaining and strengthening the "Dolby" brand is critical to maintaining and expanding both our products and services business and our technology licensing business, as well as to our ability to enter new markets for our sound and other technologies. Our continued success depends, in part, on our reputation for providing high quality products, services and technologies across a wide range of entertainment industries, including the consumer electronics products industry. If we fail to promote and maintain the Dolby brand successfully on either the products and services or the licensing sides of our business, our business and prospects will suffer. Moreover, we believe that the likelihood that our technologies will be adopted as industry standards in various markets and for various applications depends, in part, upon the strength of our brand, because professional organizations and industry participants are more likely to accept, as an industry standard, technologies developed by a well-respected and well-known brand. Maintaining and strengthening our brand will depend heavily on our ability to continue to develop innovative technologies for the entertainment industry and to continue to provide high quality products and services, which we may not do successfully. Moreover, because we engage in relatively little direct brand advertising, the promotion of our brand depends upon entertainment industry participants displaying our trademarks on their products that incorporate our technologies, such as film prints and consumer electronics products. Although we do not require our customers to place our brand on their products, we actively encourage them to do so. For example, we rely on consumer electronics product manufacturers that license our technologies to display our trademarks on their products in order to promote our brand. If our customers choose for any reason not to display our trademarks on their products, our ability to maintain or increase our brand awareness may be harmed, which would have an adverse effect on our business and prospects. In addition, if we fail to maintain high quality standards for our professional products, or if we fail to maintain high quality standards for the products that incorporate our technologies through the quality-control certification process that we require of our licensees, the strength of our brand could be adversely affected.

We do not expect sales of traditional consumer DVD players to sustain their past growth rates. To the extent that sales of DVD players and home theatre systems level off or decline, or alternative technologies in which we do not participate replace DVDs as a dominant medium for consumer video entertainment, our licensing revenue will be adversely affected.

Growth in our revenue over the past several years has been the result, in large part, of the rapid growth in sales of DVD players and home theatre systems incorporating our technologies. However, as the markets for DVD players mature, we do not expect sales of traditional consumer DVD players to sustain their past growth rates. Also, the industry has experienced a movement by discount retailers towards lower-end DVD players thereby decreasing the number of processors on which we earn licensing revenue. As a result of this movement, manufacturing of these lower-end DVD players appears to be growing in emerging economies, which we believe will pose challenges in royalty collection and intellectual property enforcement. To the extent that sales of DVD players and home theatre systems level off or decline, our licensing revenue will be adversely affected. Additionally, the release and consumer adoption of next generation DVD players has been delayed. There are currently two potential, incompatible formats for next generation high-definition disc format proposed, and consumers may not react favorably to having to make a choice between formats. The delay in the release and consumer adoption of the next generation disc format, as well as the inability of traditional DVD players to sustain their past growth rates, could adversely affect our licensing revenue. In addition, if new technologies are developed for use with DVDs or new technologies are developed that substantially compete with or replace DVDs as a dominant medium for consumer video entertainment, and if we are unable to develop and successfully market technologies that are incorporated into or compatible with such new technologies, our business, operating results and prospects will be adversely affected.

We are dependent on the sale by our licensees of products that incorporate our technologies, and a reduction in those sales would adversely affect our licensing revenue.

We derive most of our revenue from the licensing of our technologies to consumer electronics product manufacturers. We derived 73%, 73% and 75% of our total revenue from our technology licensing business in fiscal 2003, 2004 and 2005, respectively. We do not manufacture consumer electronics products ourselves and our licensing revenue is dependent on sales by our licensees of products that incorporate our technologies. We cannot control these manufacturers' product development or commercialization efforts or predict their success. In addition, our license agreements, which typically require manufacturers of consumer electronics products and software developers to pay us a specified royalty for every electronics product shipped that incorporates our technologies, do not require these manufacturers to include our technologies in any specific number or percentage of units, and only a few of these agreements guarantee us a minimum aggregate licensing fee. Accordingly, if our licensees sell fewer products incorporating our technologies, or otherwise face significant economic difficulties, our revenue will decline. Some manufacturers have begun to reduce the complexity of their low-end DVD players, thereby decreasing the number of processors on which we earn licensing revenue in each player. Moreover, we have a widespread presence in certain markets for electronics products, such as the consumer electronics product market, which includes DVD players, audio/video receivers and other home theatre consumer electronics products, and, as a result, there is little room for us to further penetrate such markets. Lower sales of products incorporating our technologies could occur for a number of reasons. Changes in consumer tastes or trends, or changes in industry standards, may adversely affect our licensing revenue. Demand for new products incorporating our technologies could also be adversely affected by increasing market saturation, durability of products in the marketplace, competing products and alternate consumer entertainment options. In addition, our licensees, for whatever reason, may not choose to or may not be able to incorporate our technologies into their products in the future.

We face risks in conducting business in emerging economies, such as China, particularly due to the limited recognition and enforcement of intellectual property and contractual rights in these countries.

We expect consumer electronics product manufacturing in emerging economies, such as China, to continue to increase due to the availability of lower manufacturing costs as compared to in other industrial countries. We also expect that our sales of professional products and production services in emerging economies will expand in the future to the extent that the use of digital surround sound technologies increases in these countries, including in movies, broadcast television and video games. We further expect that the sale of products incorporating our technologies will increase in emerging economies to the extent that consumers there become more affluent. However, we face many risks associated with operating in these emerging economies, in large part, due to limited recognition and enforcement of contractual and intellectual property rights. Recently, the consumer electronics industry has experienced a movement by discount retailers towards lower-end DVD players, thereby decreasing the number of processors on which we earn licensing revenue. As a result of this movement, manufacturing of these lower-end DVD players appears to be growing in emerging economies, which we believe will pose challenges for us in royalty collection and intellectual property enforcement. In particular, we have many times experienced, and expect to continue to experience, problems with consumer electronics product manufacturers in emerging economies, such as China, failing to report or underreporting shipments of their products that incorporate our technologies or incorporating our technologies and trademarks into their products without our authorization and without paying us any licensing fees, which adversely affects our operating results. We may also experience difficulties in enforcing our intellectual property rights in these emerging economies, where intellectual property rights are not as respected as they are in the United States, Japan and Europe. We believe that it is critical that we strengthen existing relationships and develop new relationships with entertainment industry participants world-wide to increase our ability to enforce our intellectual property and contractual rights without relying solely on the legal systems in the countries in which we operate. If we are unable to develop, maintain and strengthen these relationships, our revenue from these countries could be adversely affected.

If we fail to develop and deliver innovative technologies in response to changes in the entertainment industry, our business could decline.

The markets for our professional products and the markets for consumer electronics products using our licensed technologies are characterized by rapid change and technological evolution. We will need to expend considerable resources on research and development in the future in order to continue to design and deliver enduring, innovative entertainment products and technologies. Despite our efforts, we may not be able to develop and effectively market new products, technologies and services that adequately or competitively address the needs of the changing marketplace. In addition, we may not correctly identify new or changing market trends at an early enough stage to capitalize on market opportunities. At times such changes can be dramatic, such as the shift from VHS tapes to DVDs for consumer playback of movies in homes and elsewhere. Our future success depends to a great extent on our ability to develop and deliver innovative technologies that are widely adopted in response to changes in the entertainment industry and that are compatible with the technologies or products introduced by other entertainment industry participants.

Our operating results may fluctuate depending upon the timing of when we receive royalty reports from our licensees and of the satisfaction of our revenue recognition criteria.

Our quarterly operating results may fluctuate depending upon the timing of when we receive royalty reports from our licensees and of the satisfaction of our revenue recognition criteria. We recognize license revenue only after we receive royalty reports from our licensees regarding the shipment of their products that incorporate our technologies. As a result, the timing of our revenue is dependent upon the timing of our receipt of those reports. In addition, it is not uncommon for royalty reports to include positive or negative corrective or retroactive royalties that cover extended periods of time. Furthermore, there have been times in the past when we have recognized an unusually large amount of licensing revenue from a licensee in a given quarter because not all of our revenue recognition criteria were met in prior periods. This can result in a large amount of licensing revenue from a licensee being recorded in a given quarter that is not necessarily indicative of the amounts of licensing revenue to be received from that licensee in future quarters, thus causing fluctuations in our operating results.

If our products and technologies fail to be adopted as in industry standards, our business prospects could be limited and our operating results could be adversely affected.

The entertainment industry depends upon industry standards to ensure the compatibility of its content across a wide variety of entertainment systems and products. Accordingly, we make significant efforts to design our products and technologies to address capabilities, quality and cost considerations so that they either meet, or, more importantly, are adopted as, industry standards across the broad range of entertainment industry markets in which we participate, as well as the markets in which we hope to compete in the future, including digital cinema. To have our products and technologies adopted as industry standards, we must convince a broad spectrum of professional organizations throughout the world, as well as our major customers and licensees who are members of such organizations, to adopt them as such and to ensure that other industry standards are consistent with our products and technologies. If our technologies are not adopted or do not remain as industry standards, our business, operating results and prospects could be materially and adversely affected. We expect that meeting, maintaining and establishing industry standard technologies will continue to be critical to our business in the future. In addition, the market for broadcast technologies has traditionally been heavily based upon industry standards, often set by governments or other regulatory bodies, and we expect this to continue to be the case in the future. If our technologies are not chosen as industry standards for broadcasting in particular geographic areas, this could adversely affect our ability to compete in these markets.

It may be more difficult for us, in the future, to have our technologies adopted as individual industry standards to the extent that entertainment industry participants collaborate on the development of industry standard technologies.

Increasingly, standards-setting organizations are adopting or establishing technology standards for use in a wide-range of consumer electronics products. As a result, it is more difficult for individual companies to have their technologies adopted wholesale as an informal industry standard. We call this type of standard a “de facto” industry standard, meaning that the standard is not explicitly mandated by any industry standards-setting body but is nonetheless widely adopted. In addition, increasingly there are a large number of companies, including ones that typically compete against one another, involved in the development of new technologies for use in consumer entertainment products. As a result, these companies often license their collective intellectual property rights as a group, making it more difficult for any single company to have its technologies adopted widely as a de facto industry standard or to have its technologies adopted as an exclusive, explicit industry standard for consumer electronics products.

Even if our technologies are adopted as an industry standard for a particular market, market participants may not widely adopt our technologies.

Even when our technologies are mandated for a particular market by a standards-setting body, which we call an “explicit” industry standard, our technologies may not be the sole technologies adopted for that market as an industry standard. Accordingly, our operating results depend upon participants in that market choosing to adopt our technologies instead of competitive technologies that also may be acceptable under such standard. For example, the continued growth of our revenue from the broadcast market will depend upon both the continued adoption of digital television generally and the choice to use our technologies where it is an optional industry standard.

Our licensing of industry standard technologies can be subject to limitations that could adversely affect our business and prospects.

When our technologies are adopted as explicit industry standards by a standards-setting body, we generally must agree to license such technologies on a fair, reasonable and non-discriminatory basis, which could limit our control over the use of these technologies. In these situations, we must often limit the royalty rates we charge for these technologies, which could adversely affect our gross margins. Furthermore, we may be unable to limit to whom we license such technologies, and may be unable to restrict many terms of the license. From time to time we may be subject to claims that our licenses of our industry standard technologies may not conform to the requirements of the standards-setting body. Private parties have raised this type of issue with us in the past. Allegations such as these could be asserted in private actions seeking monetary damages and injunctive relief, or in regulatory actions. Claimants in such cases could seek to restrict or change our licensing practices or our ability to license our technologies in ways that could injure our reputation and otherwise materially and adversely affect our business, operating results and prospects.

Our relationships with entertainment industry participants are particularly important to our products and services and our technology licensing businesses, and if we fail to maintain such relationships our business could be materially harmed.

If we fail to maintain and expand our relationships with a broad range of participants throughout the entertainment chain, including motion picture studios, broadcasters, video game designers, music producers and manufacturers of consumer electronics products, our business and prospects could be materially harmed. Relationships have historically played an important role in the entertainment industries that we serve, both on the professional and consumer sides of our business. For example, our products and services business is particularly dependent upon our relationships with the major motion picture studios and broadcasters, and our technology licensing business is particularly dependent upon our relationships with consumer electronics product manufacturers, software developers and integrated circuit, or IC, manufacturers. If we fail to maintain and strengthen these relationships, these entertainment industry participants may be more likely not to purchase and use our products, services and technologies, or create content incorporating our technologies, which could materially harm our business and prospects. In addition to directly providing substantially all of our revenue, these relationships are also critical to our ability to have our technologies adopted as industry standards. Moreover, if we fail to maintain our relationships, or if we are not able to develop relationships in new markets in which we intend to compete in the future, including markets for new technologies and expanding geographic markets, such as China, India and other emerging economies, our business, operating results and prospects could be materially and adversely affected. In addition, if major industry participants form strategic relationships that exclude us, whether on the products and services side or the licensing side of our business, our business and prospects could be materially adversely affected.

Third parties from whom we license technologies may challenge our calculation of the royalties we owe them for inclusion of their technologies in our products and licensed technologies, which could adversely affect our operating results, business and prospects.

In some cases, primarily in connection with the licensing of our Dolby Digital technologies, the products we sell and the technologies we license to our customers include intellectual property that we have licensed from third parties. Our agreements with these third parties generally require us to pay them royalties for that use, and give the third parties the right to audit our calculation of those royalties. As a result of such an audit, a third party could challenge the accuracy of our calculation. A successful challenge could increase the amount of royalties we have to pay to the third party, decrease our gross margin and adversely affect our operating results. Such a challenge could also impair our ability to continue to use and re-license intellectual property from that third party, which could adversely affect our business and prospects.

We rely on our licensees to accurately prepare royalty reports in determining our licensing revenue, and if these reports are inaccurate, our operating results could be materially adversely affected.

Our licensing revenue is generated primarily from consumer electronics product manufacturers and software developers who license our technologies and incorporate them in their products. Under our existing arrangements, these licensees typically pay us a specified royalty for every product they ship that incorporates our technologies. We rely on our licensees to accurately report the number of units shipped that incorporate our technologies. We calculate our license fees, prepare our financial reports, projections and budgets, and direct our sales and product development efforts based on these reports we receive from our licensees. However, it is often difficult for us to independently determine whether or not our licensees are reporting shipments accurately. This is especially true with respect to software incorporating our technologies because software can be copied relatively easily and we oftentimes do not have easy ways to determine how many copies have been made. Most of our license agreements permit us to audit our licensees' records, but audits are generally expensive and time consuming and initiating audits could harm our customer relationships. To the extent that our licensees understate or fail to report the number of products incorporating our technologies that they ship, we will not collect and recognize revenue to which we are entitled, which would adversely affect our operating results. Conversely, to the extent that our licensees overstate the number of products incorporating our technologies, or report the products under the wrong categories, negative corrections could result in reductions of royalty revenue in subsequent periods. In addition, some of our licensees may begin to more closely scrutinize their past or future licensing statements which may result in an increased receipt of negative corrective statements.

Our licensing revenue depends in large part upon semiconductor manufacturers incorporating our technologies into integrated circuits, or ICs, for sale to our electronics product licensees and if, for any reason, our technologies are not incorporated in these ICs or fewer ICs are sold that incorporate our technologies, our operating results would be adversely affected.

Our licensing revenue from consumer electronics product manufacturers depends in large part upon the availability of integrated circuits, or ICs, that implement our technologies. IC manufacturers incorporate our technologies into these ICs, which are then incorporated in consumer electronics products. We do not manufacture these ICs, but rather depend on IC manufacturers to develop, produce and then sell them to licensed consumer electronics product manufacturers. We do not control the IC manufacturers' decision whether or not to incorporate our technologies into their ICs, and we do not control their product development or commercialization efforts nor predict their success. As a result, if these IC manufacturers are unable or unwilling, for any reason, to implement our technologies into their ICs, or if, for any reason, they sell fewer ICs incorporating our technologies, our operating results will be adversely affected.

Our future success depends, in part, upon the growth of new and existing markets for our technologies and our ability to develop and adapt our technologies for those markets. If such markets fail to grow or we are unable to develop successful products for them, our business prospects could be limited.

We expect that the future growth of our licensing revenue will depend, in part, upon the growth of, and our successful participation in, new opportunities for our technologies, including:

- Digital television and radio broadcasting;
- HDTV;
- Personal computer technology;

- Video game consoles and video games;
- Home DVD recording;
- In-car entertainment systems;
- DVD-Audio;
- Personal audio and video players, including Internet music applications;
- Broadband Internet;
- Mobile devices; and
- Connected home.

The development of these markets depends on increased consumer demand for products that contain our technologies, which may not occur. Any failure of such markets to develop or consumer demand to grow would have a material adverse effect on our business and prospects. For example, in an effort to offer lower cost business PCs, PC manufacturers may exclude software DVD players in their business-oriented offerings, which may result in lowered demand for our technology. In another example, only a small number of automobile manufacturers currently offer in-car entertainment systems incorporating our surround sound technologies, and most of those that do limit those systems only to certain models. Additional manufacturers may not offer surround sound entertainment systems, and, even if they do, the car models on which surround sound may be offered are likely to be, at least initially, limited to the high end of these manufacturers' lines. Whether our revenue from digital broadcast networks and broadband Internet services increases depends upon the expansion of digital broadcast technologies and broadband Internet as a medium of entertainment, which may not occur. In addition, even when our technologies are adopted as industry standards for a particular market, such market may not fully develop. In such case, our success depends not only on whether our technologies are adopted as industry standards for such market, but also on the development of that market, which may not occur. Demand for our technologies in any of these developing markets may not continue to grow, and a sufficiently broad base of consumers and professionals may not adopt or continue to use these technologies. In addition, our ability to generate revenue from these markets may be limited to the extent that service providers in these markets choose to provide certain technologies and entertainment for little or no cost, such as many of the services provided in connection with broadband Internet services. Moreover, some of these markets are ones in which we have not previously participated and, because of our limited experience, we may not be able to adequately adapt our business and our technologies to the needs of customers in these fields.

If we do not identify opportunities and successfully execute our initiatives to participate in the emerging digital cinema market, our future prospects could be limited and our business could be adversely affected.

The cinema industry is in the early stages of the adoption of digital cinema for the distribution and exhibition of movies. Industry participants are discussing various business models to facilitate adoption of digital cinema by allocating the costs among industry participants, but no arrangements have yet emerged as definitive business models that will result in significant installations of digital cinema systems. If we do not identify, and successfully execute on, the business models that result in generating revenues from our digital cinema products and services, our future prospects in this market will be limited and our business could be adversely affected. Participating in some of the models under discussion may require us to depart from our traditional model of selling our professional products pursuant to one-time contracts, and could expose us to various risks we have not faced in the past. Furthermore, some of these models could cause our product sales and services margins to decline. For example, in the third quarter of fiscal 2005, we entered into a collaboration agreement with Walt Disney Pictures and Television to deploy digital cinema systems in selected theatres throughout the U.S. In connection with this deployment, we incurred charges of $1.4 million and $6.4 million in the fourth quarter of fiscal 2005 and the first quarter of fiscal 2006, respectively. We may incur charges for digital cinema system deployments in the future.

If the market for digital cinema does not develop, our future prospects could be limited and our business could be adversely affected.

The conversion of movie theatres from film to digital cinema will require significant expenditures, and we cannot predict how quickly digital cinema will become widely adopted, if at all. There are at present only a very limited number of movie theatres that have been converted to digital cinema and we expect that the conversion of theatres to digital cinema technologies, if it occurs, will be a long-term process due to both technological and financial obstacles. Depending on the business models that emerge, digital cinema may require a significant investment per screen by cinema operators. If the market for digital cinema fails to develop, or develops more slowly than expected, or if there is significant and sustained resistance by the motion picture industry or cinema operators to this technology or the cost of implementation, we may not realize significant returns on our investment in this area, which could adversely affect our operating results. In addition, because the conversion from film-based to digital cinema is in the early stages, it is impossible to predict accurately how the roles and allocation of costs among various industry participants may develop, if or how quickly digital cinema will be adopted and what, if any, industry standards may be adopted. In addition, if a large number of cinema owners decide to convert their theatres to digital cinema over a relatively short period of time and our products are selected for these conversions, we may see an initial increase in professional product sales that will not likely be sustained over time.

If our products and services in the market for digital cinema are not competitive, our future prospects could be limited and our business could be adversely affected.

Even if the market for digital cinema develops, we may not be successful in selling our products, technologies and services in this market, which could have a material adverse effect on our business and prospects. Our effort with respect to digital cinema is one of the areas where we are expanding our business beyond sound technology. As a result, our relative lack of experience in this area may harm our ability to compete successfully. A number of competitors and potential competitors, including Avica, Doremi, EVS, GDC, Kodak, NEC, QuVis and Sony, are developing similar or alternative solutions for digital cinema, some of which may provide cost or technological advantages over our products, technologies and services. In addition, our products, technologies and services may not be compatible with the products and technologies developed by other companies for digital cinema. Moreover, it is possible that we will be selling components or technologies that will be incorporated into products sold by other companies, which would be a departure from our traditional business of manufacturing our own professional products and could limit our ability to control the distribution and use of our professional products. In addition, we are building components of the digital cinema delivery solution that are not solely related to sound and we do not have a long track record of providing these types of products, which may adversely affect our ability to compete in the digital cinema market. Our competitors may develop entire system solutions for digital cinema, which could make the technologies that we develop for incorporation in digital cinema systems unnecessary. In addition, we expect that our digital cinema products, technologies and services may not be priced as low as those of our competitors, which may make it more difficult for us to compete or have our products and technologies become widely adopted.

If our digital cinema initiatives do not perform to expectations, our reputation may suffer and demand for our digital cinema products and services may not develop.

As we participate in digital cinema initiatives, if we or our equipment does not perform to expectations, our relationships with cinema industry participants may be adversely affected and our reputation may suffer, affecting the demand for our digital cinema products and services. Any negative publicity or negative impact relating to problems with our digital cinema initiatives could adversely affect the perception of our brand. Additionally, our current digital cinema products need to be upgraded to meet recommendations issued by the major studios for digital cinema. If we are unable successfully to engineer our products to meet these specifications, our ability to participate in the digital cinema market will be adversely affected.

If the sale of consumer electronics products incorporating our technologies does not grow in emerging markets, our ability to increase our licensing revenue may be limited.

We also expect that growth in our licensing revenue will depend, in part, upon the growth of sales of consumer electronics products incorporating our technologies in emerging economies, as consumers in these markets have more disposable income and are increasingly purchasing entertainment products with surround sound capabilities. However, if our licensing revenue from the use of our technologies in these new markets or geographic areas does not expand, our prospects could be adversely affected.

We face significant competition in various markets, and if we are unable to compete successfully, our business will suffer.

The markets for entertainment industry technologies are highly competitive, and we face competitive threats and pricing pressure in our markets. Competitors on the professional side of our business include Avica, DTS, Doremi, EVS, GDC, Kodak, Microsoft, NEC, Panastereo, QuVis, Sony and UltraStereo. Competitors on the consumer side of our business include Coding Technologies, DTS, Fraunhofer Institute for Integrated Circuits, Philips, Microsoft, RealNetworks, Sony, SRS Labs and Thomson. In addition, other companies may become competitors in the future. The quality of sound produced by some of our competitors' technologies may be perceived by some people as equivalent or superior to that produced by ours. In addition, some of our current and/or future competitors may have significantly greater financial, technical, marketing and other resources than we do, or may have more experience or advantages in the markets in which they compete. For example, Microsoft and RealNetworks may have an advantage over us in the market for Internet technologies because of their greater experience and presence in that market. In addition, some of our current or potential competitors, such as Microsoft and RealNetworks, may be able to offer integrated system solutions in certain markets for sound or non-sound entertainment technologies, including audio, video and rights management technologies related to personal computers or the Internet, which could make competing technologies that we develop unnecessary. By offering an integrated system solution, these potential competitors also may be able to offer competing technologies at lower prices than our technologies, which could adversely affect our operating results. Further, many of the consumer electronics products that include our sound technologies also include sound technologies developed by our competitors. As a result, we must continue to invest significant resources in research and development in order to enhance our technologies and our existing products and services and introduce new high-quality products and services to meet the wide variety of such competitive pressures. Our business will suffer if we fail to do so successfully.

Some of our customers are also our current or potential competitors, and if those customers were to choose to use their competing technologies rather than ours, our business and operating results would be adversely affected.

We face competitive risks in situations where our customers are also current or potential competitors. For example, Sony is a significant licensee customer and is a significant purchaser of our professional products and production services, but Sony is also a competitor with respect to certain of our professional and consumer technologies. To the extent that our customers choose to utilize competing technologies they have developed or in which they have an interest, rather than use our technologies, our business and operating results could be adversely affected.

Pricing pressures on the electronics product manufacturers who incorporate our technologies into their products could limit the licensing fees we charge for our technologies, which could adversely affect our revenues.

The markets for the consumer electronics products in which our technologies are incorporated are intensely competitive and price sensitive. Retail prices for consumer electronics products that include our sound technology, such as DVD players and home theatre systems, have decreased significantly, and we expect prices to continue to decrease for the foreseeable future. In response, manufacturers have sought to reduce their product costs, which can result in downward pressure on the licensing fees we charge our customers who incorporate our technologies into the consumer electronics products that they sell. A decline in the licensing fees we charge could materially and adversely affect our operating results.

Surround sound technologies could be treated as a commodity in the future, which could adversely affect our business, operating results and prospects.

We believe that the success we have had licensing our surround sound technologies to consumer electronics product manufacturers is due, in part, to the strength of our brand and the perception that our technologies provide a high-quality solution for surround sound. However, as applications that incorporate surround sound technologies become increasingly prevalent, we expect more competitors to enter this field with other solutions. Furthermore, to the extent that competitors' solutions are perceived, accurately or not, to provide the same advantages as our technologies, at a lower or comparable price, there is a risk that sound encoding technologies such as ours will be treated as commodities, resulting in loss of status of our technologies, decline in their use, and significant pricing pressure. To the extent that our audio technologies become a commodity, rather than a premium solution, our business, operating results and prospects could be adversely affected.

We have limited or no patent protection for our technologies in certain countries, including China and India, which could limit our ability to grow our business in these markets.

We have relatively few or no issued patents in certain countries, including China and India. For example, in China we have only limited patent protection, especially with respect to our Dolby Digital technologies. In India, we have no issued patents. As such, growing our licensing revenue in these emerging countries will depend on our ability to obtain patent rights in these counties for existing and new technologies, which is uncertain. Moreover, because of the limitations of the legal systems in many of these countries, the effectiveness of patents obtained or that may in the future be obtained, if any, is likewise uncertain.

We face diverse risks in our international business, which could adversely affect our operating results.

We are dependent on international sales for a substantial amount of our total revenue. For fiscal 2003, 2004 and 2005, our sales outside the United States were 60%, 59% and 61%, respectively, of our professional products and production services revenue, and royalties from licensees outside the United States were 80%, 80% and 76%, respectively, of our licensing revenue. We expect that international and export sales will continue to represent a substantial portion of our revenue for the foreseeable future. This future revenue will depend to a large extent on the continued use and expansion of our technologies in entertainment industries worldwide. Increased worldwide use of our technologies is also an important factor in our future growth.

Due to our reliance on sales to customers outside the United States, we are subject to the risks of conducting business internationally, including:

- Our ability to enforce our contractual and intellectual property rights, especially in those foreign countries that do not respect and protect intellectual property rights to the same extent as do the United States, Japan and European countries, which increases the risk of unauthorized, and uncompensated, use of our technology;
- United States and foreign government trade restrictions, including those which may impose restrictions on importation of programming, technology or components to or from the United States;
- Foreign government taxes, regulations and permit requirements, including foreign taxes that we may not be able to offset against taxes imposed upon us in the United States, and foreign tax and other laws limiting our ability to repatriate funds to the United States;
- Foreign labor laws, regulations and restrictions;
- Changes in diplomatic and trade relationships;
- Difficulty in staffing and managing foreign operations;
- Fluctuations in foreign currency exchange rates and interest rates, including risks related to any interest rate swap or other hedging activities we undertake;
- Political instability, natural disasters, war or events of terrorism; and
- The strength of international economies.

The licensing of patents constitutes a significant source of our revenue. If we are unable to replace expiring patents with new patents or proprietary technologies, our revenue could decline.

We hold patents covering much of the technology that we license to consumer electronics product manufacturers, and our licensing revenue is tied in large part to the life of those patents. Our right to receive royalties related to our patents terminates with the expiration of the last patent covering the relevant technologies. However, many of our licensees choose to continue to pay royalties for continued use of our trademarks and know-how even after the licensed patents have expired, although at a reduced royalty rate. Accordingly, to the extent that we do not continue to replace licensing revenue from technologies covered by expiring patents with licensing revenue based on new patents and proprietary technologies, our revenue could decline.

As of March 31, 2006, we had over 950 individual issued patents and over 1,350 pending patent applications in nearly 35 jurisdictions throughout the world. Our issued patents are scheduled to expire at various times through February 2025. Of these, 54 patents are scheduled to expire in calendar year 2006, 48 patents are scheduled to expire in calendar year 2007 and 19 patents are scheduled to expire in calendar year 2008. We derive our licensing revenue principally from our Dolby Digital technologies. Patents relating to our Dolby Digital technologies generally expire between 2008 and 2017, and patents relating to our Dolby Digital Plus technologies, an extension of Dolby Digital, expire between 2019 and 2020. In addition, the remaining patents relating to Dolby Digital Live technologies, an extension of Dolby Digital, are scheduled to expire in 2021.

We are, and may in the future be, subject to intellectual property rights claims, which are costly to defend, could require us to pay damages and could limit our ability to use certain technologies in the future.

Companies in the technology and entertainment industries own large numbers of patents, copyrights, trademarks and trade secrets and frequently enter into litigation based on allegations of infringement or other violations of intellectual property rights. We have faced such claims in the past and we expect to face similar claims in the future. For example, Lucent has asserted that we infringe certain patents held by them, prompting us to file a complaint for declaratory judgment of non-infringement and/or invalidity of such Lucent patents. These patents generally involve a process and means for encoding and decoding audio signals. Lucent contended that products incorporating our AC-3 technology infringe those patents. The U.S. District Court of Northern District of California recently granted our motions for summary judgment that we have not infringed the Lucent patents at issue and have not contributed to or induced infringement by others. In light of the court's finding of non-infringement, it dismissed our claims that the Lucent patents are invalid. Lucent appealed the court's ruling granting summary judgment of non-infringement to the United States Federal Circuit Court of Appeals. An adverse ruling for us on appeal and a subsequent determination against us in the Lucent litigation could materially impact our technology licensing business, which may seriously harm our financial condition and results of operations.

Any intellectual property claims, with or without merit, could be time-consuming, expensive to litigate or settle and could divert management resources and attention. In the past we have settled claims relating to infringement allegations and agreed to make payments in connection with such settlements. We expect that similar claims will be asserted against us in the future in the ordinary course of our business. For example, in December 2005, we received notice that an action had been filed against us alleging that our Dolby Virtual Speaker technology infringes certain U.S. patents held by Cooper Bauck Corp. An adverse determination in any intellectual property claim could require that we pay damages or stop using technologies found to be in violation of a third party's rights and could prevent us from offering our products and services to others. In order to avoid these restrictions, we may have to seek a license for the technology. This license may not be available on reasonable terms, could require us to pay significant royalties and may significantly increase our operating expenses. The technologies also may not be available for license to us at all. As a result, we may be required to develop alternative non-infringing technologies, which could require significant effort and expense. If we cannot license or develop technologies for any infringing aspects of our business, we may be forced to limit our product and service offerings and may be unable to compete effectively. In addition, at times in the past, we have chosen to defend our licensees from third-party intellectual property infringement claims even where such defense was not contractually required, and we may choose to take on such defense in the future. Any of these results could harm our brand, our operating results and our financial condition. In addition, from time to time we are engaged in disputes regarding the licensing of our intellectual property rights, including matters related to our royalty rates and other terms of our licensing arrangements. These types of disputes can be asserted by our customers or prospective customers or by other third parties as part of negotiations with us or in private actions seeking monetary damages or injunctive relief, or in regulatory actions. In the past, licensees have threatened to initiate litigation against us regarding our licensing royalty rate practices, including potential antitrust claims. Damages and requests for injunctive relief asserted in claims like these could be material, and could have a significant impact on our business. Any disputes with our customers or potential customers or other third parties could adversely affect our business, results of operations and prospects.

Licensing some of our technologies in "patent pools" is a different business model for us, and we may face many challenges in conducting this business.

In fiscal 2002, we began licensing some of our patents through our wholly-owned subsidiary Via Licensing Corporation in "patent pools" with other companies in an effort to ensure that our technologies are compatible with other technologies in the entertainment industry and to promote our technologies as industry standards. These patent pools allow product manufacturers streamlined access to certain foundational technologies and are comprised of a group of patents held by a number of companies, including us in some cases, and administered by Via Licensing. This is a different business model for us and we cannot predict all of the challenges we may face or whether we will be successful. For instance, Via Licensing licenses patents in areas such as wireless markets in which we have not competed previously. As a result, our control over the license of our technologies from these patent pools may be limited as compared to our traditional business model in which we license our patents as bundles of technologies and interact directly with our customers. In addition, our control over the application and quality control of our technologies that are included in these pools may be limited.

Our ability to develop proprietary technology in markets in which "open standards" are adopted may be limited, which could adversely affect our ability to generate revenue.

Standards-setting bodies, such as those for digital cinema technologies, may require the use of so-called "open standards," meaning that the technologies necessary to meet those standards are freely available without the payment of a licensing fee or royalty. The use of open standards may reduce our opportunity to generate revenue, as open standards technologies are based upon non-proprietary technology platforms in which no one company maintains ownership over the dominant technologies.

Events and conditions in the motion picture industry may affect sales of our professional products and production services.

Sales of our professional products and production services tend to fluctuate based on the underlying trends in the motion picture industry. For example, when box office receipts for the motion picture industry increase, we have typically seen sales of our professional products increase as well, as cinema owners are more likely to build new theatres and upgrade existing theatres with our more advanced cinema products when they are doing well financially. Conversely, when box office receipts are down cinema owners tend to scale back on plans to upgrade their systems or build new theatres. Our professional product sales are also subject to fluctuations based on events and conditions in the theatre industry generally that may or may not be tied to box office receipts in particular periods. In fiscal 2005 changes within the U.S. cinema industry, including recent restructuring and consolidations, appears to have delayed purchasing decisions by exhibitors. To a lesser extent, the sale of our professional products is influenced by the launch of new digital services by broadcasters. On the other hand, our production services revenue, both in the United States and internationally, is tied to the number of films being made by studios and independent filmmakers. The number of films that are produced can be affected by a number of factors, including strikes and work stoppages within the motion picture industry, as well as by the tax incentive arrangements that many foreign governments provide filmmakers to promote local filmmaking.

We may be unable to significantly expand our current professional product sales in the cinema industry because our professional products are already used by the vast majority of major cinema operators and major motion picture studios in the United States and much of the rest of the world. If the cinema industry does not expand, or if it contracts, the demand for our professional products will be adversely affected.

Our ability to further penetrate the market for motion picture sound technologies is limited because of the widespread use of our current professional products by major motion picture content creators, distributors and cinema operators. As a result, our future revenue from our professional products for the cinema industry will depend, in part, upon events and conditions in that industry—specifically, the continued production and distribution of motion pictures, and the construction of new theatres and the renovation of existing theatres, using our products and services. For example, in the late 1990s cinema operators in the United States built a large number of new cinema megaplexes. This initially resulted in increased sales of our cinema processors, but also resulted in an oversupply of screens in some markets. This oversupply led to significant declines in new theatre construction in the United States in the early 2000s, resulting in a corresponding decline in sales of our cinema processors. As a result, future growth in sales of our existing cinema products may be limited, and may decrease in the future, as the number of new cinemas being built and the number of existing cinemas without our products continues to decline.

The piracy of motion pictures could adversely affect the motion picture industry and therefore our operating results.

The construction of new screens and the renovation of existing theatres, as well as the continued production of new motion pictures, are also adversely impacted by the growth in piracy of motion pictures. Technological advances and the conversion of motion pictures into digital formats have made it easier to create, transmit and "share" high-quality unauthorized copies of motion pictures, including on pirated DVDs and on the Internet. If cinema operators decide to close a significant number of screens in the future or cut their capital spending as a result of piracy, demand for our playback systems and cinema processors will decline, which could negatively impact our operating results.

The demand for our current professional products and production services could decline if the film industry broadly adopts digital cinema.

If the film industry broadly adopts digital cinema, the demand for our current professional products and production services could decline. Such a decline in our products and services business could also adversely affect our technology licensing business, because the strength of our brand and our ability to use professional developments to advance our consumer licensing technologies would be impaired. If, in such circumstances, we are unable to adapt our professional products and production services or introduce new products for the market for digital cinema successfully, our business could be materially adversely affected.

If we are unable to expand our business into non-sound technologies, our future growth could be limited.

Our future growth will depend, in part, upon our expansion into areas beyond sound technologies. For example, in addition to our digital cinema initiative, we are exploring other areas that facilitate delivery of digital entertainment, such as technologies for processing digital moving images and content protection. We will need to spend considerable resources on research and development in the future in order to deliver innovative non-sound technologies. However, we have limited experience in these markets and, despite our efforts, we cannot predict whether we will be successful in developing and marketing non-sound products, technologies and services. In addition, many of these markets are relatively new and may not develop as we currently anticipate. Moreover, although we believe that many of the technological advances we may develop for digital cinema may have applicability in other areas, such as broadcasting or consumer electronics products, we may not ever be able to achieve these anticipated benefits in these other markets. A number of competitors and potential competitors may develop non-sound technologies similar to those that we develop, some of which may provide advantages over our products, technologies and services. Some of these competitors have much greater experience and expertise in the non-sound fields we may enter. The non-sound products, technologies and services we expect to market may not achieve or sustain market acceptance, may not meet the needs of the movie industry, and may not be accepted as industry standards. If we are unsuccessful in selling non-sound products, technologies and services, the future growth of our business may be limited. In addition, our efforts to enter or strengthen our positions in non-sound markets may be tied to the success of specific programs.

Fluctuations in our quarterly and annual operating results may adversely affect the value of our stock.

A number of factors, many of which are outside our control, may cause or contribute to significant fluctuations in our quarterly and annual revenue and operating results. These fluctuations may make financial planning and forecasting more difficult. In addition, these fluctuations may result in unanticipated decreases in our available cash, which could negatively impact our business and prospects. As discussed more fully below, these fluctuations also could increase the volatility of our stock price. Factors that may cause or contribute to fluctuations in our operating results and revenue include:

- Fluctuations in demand for our products and for the consumer electronics products of our licensees;
- Fluctuations in the timing of royalty reports we receive from our licensees, including late, sporadic or inaccurate reports;
- Sporadic payments we may be able to recover from companies utilizing our technologies without licenses;
- Corrections to licensees’ reports received in periods subsequent to those in which the original revenue was reported;
- Introduction or enhancement of products, services and technologies by us, our licensees and our competitors, and market acceptance of these new or enhanced products, services and technologies;
- Rapid, wholesale changes in technology in the entertainment industries in which we compete;
- Events and conditions in the motion picture industry, including box office receipts that affect the number of theatres constructed and the number of movies produced and exhibited the popularity of motion pictures generally and strikes by motion picture industry participants;
- The financial resources of cinema operators available to buy our products or to equip their theatres to accommodate upgraded or new technologies;
- Consolidation by participants in the markets in which we compete, which could result among other things in pricing pressure;
- The amount and timing of our operating costs and capital expenditures, including those related to the expansion of our business, operations and infrastructure;

- Variations in the time-to-market of our technologies in the entertainment industries in which we operate;
- Seasonal electronics product shipment patterns by our consumer electronics product licensees and seasonal product purchasing patterns by customers of our professional products;
- The impact of, and our ability to react to, interruptions in the entertainment distribution chain, including as a result of work stoppages at our facilities, our customers' facilities and other points throughout the entertainment distribution chain;
- Changes in business cycles that affect the markets in which we sell our products and services or the markets for consumer electronics products incorporating our technologies;
- Adverse outcomes of litigation or governmental proceedings, including any foreign, federal, state or local tax assessments or audits; and
- Costs of litigation and intellectual property protection.

One or more of the foregoing or other factors may cause our operating expenses to be disproportionately higher or lower or may cause our revenue and operating results to fluctuate significantly in any particular quarterly or annual period. Results from prior periods are thus not necessarily indicative of the results of future periods.

The loss of or interruption in operations of one or more of our key suppliers could materially delay or stop the production of our professional products and impair our ability to generate revenue.

Our reliance on outside suppliers for some of the key materials and components we use in manufacturing our professional products involves risks, including limited control over the price, timely delivery and quality of such components. We have no agreements with our suppliers to ensure continued supply of materials and components. Although we have identified alternate suppliers for most of our key materials and components, any required changes in our suppliers could cause material delays in our production operations and increase our production costs. In addition, our suppliers may not be able to meet our future production demands as to volume, quality or timeliness. Moreover, we rely on sole source suppliers for some of the components that we use to manufacture our professional products, including certain charged coupled devices, light emitting diodes and digital signal processors. These sole source suppliers may become unable or unwilling to deliver these components to us at an acceptable cost or at all, which could force us to redesign certain of our products. Our inability to obtain timely delivery of key components of acceptable quality, any significant increases in the prices of components, or the redesign of our professional products could result in material production delays, increased costs and reductions in shipments of our products, any of which could increase our operating costs, harm our customer relationships or materially and adversely affect our business and operating results.

Revenue from our professional products may suffer if our production processes encounter problems or if we are not able to match our production capacity to fluctuating levels of demand.

Our professional products are highly complex, and production difficulties or inefficiencies can interrupt production, resulting in our inability to deliver products on time in a cost effective manner, which could harm our competitive position. If production is interrupted at one of our two manufacturing facilities, we may not be able to shift production to the other facility on a timely basis, and customers may purchase products from our competitors. A shortage of manufacturing capacity for our professional products could adversely affect our operating results and damage our customer relationships. We generally cannot quickly adapt our manufacturing capacity to rapidly changing market conditions. Likewise, we may be unable to respond to fluctuations in customer demand. At times we under utilize our manufacturing facilities as a result of reduced demand for some of our professional products. Any inability to respond to fluctuations in customer demand for our professional products may adversely affect our gross margins.

Our professional products, from time to time, experience quality problems that can result in decreased sales and higher operating expenses.

Our professional products are complex and sometimes contain undetected software or hardware errors, particularly when first introduced or when new versions are released. In addition, our professional products are sometimes combined with or incorporated into products from other vendors, sometimes making it difficult to identify the source of a problem. These errors could result in a loss of or delay in market acceptance of our professional products or cause delays in delivering them and meeting customer demands, any of which could reduce our revenue and raise significant customer relations issues. In addition, if our professional products contain errors we could be required to replace or reengineer them, which would increase our costs. Moreover, if any such errors cause unintended consequences, we could face claims for product liability. Although we generally attempt to contractually limit liability for defective products to the cost of repairing or replacing these products, if these contract provisions are not enforced, or are unenforceable for any reason, or if liabilities arise that are not effectively limited, we could incur substantial costs in defending and settling product liability claims.

A loss of one or more of our key customers or licensees in any of our markets could adversely affect our operating results.

From time to time, one or a small number of our customers or licensees may represent a significant percentage of our professional products and services or licensing revenue. Although we have agreements with many of these customers, these agreements typically do not require any minimum purchases or minimum royalty fees and do not prohibit customers from purchasing products and services from competitors. A decision by any of our major customers or licensees not to use our technologies, or their failure or inability to pay amounts owed to us in a timely manner, or at all, whether due to strategic redirections or adverse changes in their businesses or for other reasons, could have a significant effect on our operating results.

We are subject to various environmental laws and regulations that could impose substantial costs upon us and may adversely affect our business, operating results and financial condition.

Some of our operations use substances regulated under various federal, state, local and international laws governing the environment, including those governing the discharge of pollutants into the air and water, the management, disposal and labeling of hazardous substances and wastes and the cleanup of contaminated sites. We could incur costs, fines and civil or criminal sanctions, third-party property damage or personal injury claims, or could be required to incur substantial investigation or remediation costs, if we were to violate or become liable under environmental laws. Liability under environmental laws can be joint and several and without regard to comparative fault. The ultimate costs under environmental laws and the timing of these costs are difficult to predict. We also face increasing complexity in our product design as we adjust to new and future requirements relating to the materials composition of our products, including the restrictions on lead and other hazardous substances that will apply to specified electronic products put on the market in the European Union as of July 1, 2006 (Restriction on the Use of Hazardous Substances Directive 2002/95/EC, also known as the “RoHS Directive”) and similar legislation proposed for China. We are redesigning our products regulated under the RoHS Directive in order to be able to continue to offer them for sale within the European Union. For some products, substituting certain components containing regulated hazardous substances will be more difficult or costly, and the additional redesign efforts could result in production delays. Certain electronic products that we maintain in inventory may be rendered obsolete if not in compliance with the RoHS Directive, which could negatively impact our ability to generate revenue from those products. We could also face significant costs and liabilities in connection with product take-back legislation. The European Union Directive 2002/96/EC on Waste Electrical and Electronic Equipment Directive (also known as the “WEEE Directive”) requires producers of certain electrical and electronic equipment, including broadcast equipment, to be financially responsible for specified collection, recycling, treatment and disposal of past and future covered products. As of March 2006, not all member states within the EU have enacted enabling legislation under the WEEE Directive, and in the absence of such legislation, it is difficult to determine the costs to comply with the WEEE Directive. Similar legislation may be enacted in other countries, such as China, and the United States, the cumulative impact of which could significantly increase our operating costs and adversely affect our operating results. We also expect that our operations, whether manufacturing or licensing, will be affected by other new environmental laws and regulations on an ongoing basis. Although we cannot predict the ultimate impact of any such new laws and regulations, they will likely result in additional costs or decreased revenue, and could require that we redesign or change how we manufacture our products, any of which could have a material adverse effect on our business.

Any inability to protect our intellectual property rights could reduce the value of our products, services and brand.

Our business is dependent upon our patents, trademarks, trade secrets, copyrights and other intellectual property rights. We derived 73%, 73% and 75% of our total revenue from licensing revenue in the fiscal years 2003, 2004 and 2005, respectively. Effective intellectual property rights protection, however, may not be available under the laws of every country in which our products and services and those of our licensees are distributed. Also, the efforts we have taken to protect our proprietary rights may not be sufficient or effective. Any significant impairment of our intellectual property rights could harm our business or our ability to compete. In addition, protecting our intellectual property rights is costly and time consuming. We have taken steps in the past to enforce our intellectual property rights and expect to continue to do so in the future. However, it may not be practicable or cost effective for us to enforce our intellectual property rights fully, particularly in certain countries or where the initiation of a claim might harm our business relationships. For example, we have many times experienced, and expect to continue to experience, problems with consumer electronics product manufacturers incorporating our technologies into their products without our authorization. Recently, the industry has experienced a movement by discount retailers towards lower-end DVD players thereby decreasing the number of processors on which we earn licensing revenue. As a result of this movement, manufacturing of these lower-end DVD players appears to be growing in emerging economies, which we believe will pose challenges in royalty collection and intellectual property enforcement. If we are unable to successfully identify and stop unauthorized use of our intellectual property, we could experience increased operational and enforcement costs, which could adversely affect our financial condition and results of operations. We generally seek patent protection for our innovations. It is possible, however, that some of these innovations may not be protectable. In addition, given the costs of obtaining patent protection, we may choose not to protect certain innovations that later turn out to be important. Moreover, we have limited or no patent protection in certain foreign jurisdictions. For example, in China we have only limited patent protection, especially with respect to our Dolby Digital technologies, and in India we have no issued patents. Furthermore, there is always the possibility, despite our efforts, that the scope of the protection gained will be insufficient or that an issued patent may later be found to be invalid or unenforceable. Moreover, we seek to maintain certain intellectual property as trade secrets. These trade secrets could be compromised by third parties, or intentionally or accidentally by our employees, which would cause us to lose the competitive advantage resulting from them.

It is possible that we may be treated as a personal holding company, which could adversely affect our operating results and financial condition.

The Internal Revenue Service may assert that we or any of our subsidiaries are currently, or previously have been, liable for personal holding company tax, plus interest and penalties, if applicable. In addition, we and our subsidiaries may be liable for personal holding company tax in the future. For United States federal income tax purposes, a corporation is generally considered to be a “personal holding company” under the United States Internal Revenue Code if (i) at any time during the last half of its taxable year more than 50% of its stock by value is owned, directly or indirectly, by virtue of the application of certain stock ownership attribution rules set forth in the Internal Revenue Code for purposes of applying the personal holding company rules, by five or fewer individuals and (ii) at least 60% of its adjusted ordinary gross income, as defined for United States federal income tax purposes, is “personal holding company income.” Personal holding company income is generally passive income, including royalty income, subject to certain exceptions such as qualifying software royalties. A personal holding company is subject to an additional tax on its undistributed after-tax income, calculated at the statutory tax rate, which is currently 15%. Since the personal holding company tax is imposed only on undistributed income, a personal holding company can avoid or mitigate liability for the tax, but not interest or penalties, by paying a dividend to its stockholders.

More than 50% of the value of our stock is held by Ray Dolby and stockholders considered affiliated with him pursuant to the stock ownership attribution rules applicable to personal holding companies. We expect this will continue to be the case in the foreseeable future. In addition, a significant portion of our income is from licensing fees, which may constitute personal holding company income. Currently, however, less than 60% of Dolby Laboratories’ adjusted ordinary gross income is personal holding company income.

However, the Internal Revenue Service may assert that we or one of our subsidiaries are currently, or previously have been, liable for personal holding company tax, plus interest and penalties, if applicable. In addition, we or our subsidiaries may be liable for personal holding company tax in the future. The treatment of certain items of our income and the income of our subsidiaries, for purposes of the personal holding company tax, may be subject to challenge. In the event that we or any of our subsidiaries is determined to be a personal holding company, or for prior taxable years, to have been a personal holding company, we or our subsidiary could be liable for additional taxes, and possibly interest and penalties, based on the undistributed income and the tax rate in effect at that time, but only if we or our subsidiary, as the case may be, decides not to fully abate the tax by the payment of a dividend, although such a dividend will not eliminate interest and penalties. In addition, we believe that there exists a meaningful risk that in the relatively near future the mix of our revenue will change so that more of our adjusted ordinary gross income may be classified as personal holding company income. In such event, it is possible that we or one of our subsidiaries could become liable for the personal holding company tax, assuming the ownership test continues to be met. In that case, we or our subsidiary, as the case may be, may be required to pay additional tax in the event we or the subsidiary decides not to fully abate the tax by the payment of a dividend. Because no claim or assessment has been made against us with respect to personal holding company taxes, we are unable to quantify the amount of any additional taxes, and possibly interest and penalties, for which we may be liable in the future for past periods or the amount of the dividend that we may pay to abate the tax. Furthermore, we are unable to quantify the amount of personal holding company tax that we may be liable for or the dividend that we may elect to pay for future periods as such amounts, if any, would be based upon the application of the rules discussed above to the results of our future operations. We have explored options to reduce our exposure and the exposure of our subsidiaries to the personal holding company tax in the future, as well as continue to actively monitor our current exposure.

If we or any of our subsidiaries were to pay personal holding company tax (and possibly interest and penalties), this could significantly increase our consolidated tax expense and adversely affect our operating results. In addition, if the statutory tax rate increases in the future, the amount of any personal holding company tax we or any of our subsidiaries may have to pay could increase significantly, further impairing our operating results. In that regard, the statutory tax rate, which is currently 15%, is scheduled to return to ordinary income tax rate levels for tax years beginning on or after January 1, 2009. If we are deemed to be a personal holding company and, instead of paying the personal holding company tax, we elect to pay a dividend to our stockholders in an amount equal to all or a significant part of our undistributed personal holding company income, we may consume a significant amount of cash resources and be unable to retain or generate working capital. This would adversely affect our financial condition. As a result, if we pay such a dividend, we may decide to seek additional financing, although that financing may not be available to us when and as required on commercially reasonable terms, if at all.

Failure to comply with applicable current and future government regulations could have a negative effect on our business.

Our operations and business practices are subject to federal, state and local government laws and regulations, as well as international laws and regulations, including those relating to consumer and other safety-related compliance for electronic equipment, as well as compulsory license requirements as a prerequisite to being included as part of the industry standards, such as the United States HDTV standard. Any failure by us to comply with the laws and regulations applicable to us or our products could result in our inability to sell those products, additional costs to redesign products to meet such laws and regulations, fines or other administrative actions by the agencies charged with enforcing compliance and, possibly, damages awarded to persons claiming injury as the result of our non-compliance. Changes in or enactment of new statutes, rules or regulations applicable to us could have a material adverse effect on our business.

Acquisitions could result in operating difficulties, dilution to our stockholders and other harmful consequences.

We have evaluated, and expect to continue to evaluate, a wide array of possible strategic transactions, including acquisitions. For example, we consider these types of transactions in connection with our efforts to expand our business beyond sound technologies, such as in digital cinema and other technologies related to the delivery of digital entertainment. Although we cannot predict whether or not we will complete any such acquisition or other transactions in the future, any of these transactions could be material in relation to our financial condition and results of operations. The process of integrating an acquired company, business or technology may create unforeseen difficulties and expenditures. The areas where we may face risks include:

- Diversion of management time and focus from operating our business to acquisition integration challenges;
- Cultural challenges associated with integrating employees from acquired businesses into our organization;
- Retaining employees from businesses we acquire;
- The need to implement or improve internal controls, procedures and policies appropriate for a public company at businesses that prior to the acquisition lacked these controls, procedures and policies;
- Possible write-offs or impairment charges resulting from acquisitions;
- Unanticipated or unknown liabilities relating to acquired businesses; and
- The need to integrate acquired businesses' accounting, management information, manufacturing, human resources and other administrative systems to permit effective management.

Foreign acquisitions involve unique risks in addition to those mentioned above, including those related to integration of operations across different geographies, cultures and languages, currency risks and risks associated with the particular economic, political and regulatory environment in specific countries. Also, the anticipated benefit of our acquisitions may not materialize. Future acquisitions could result in potentially dilutive issuances of our equity securities, the incurrence of debt, contingent liabilities or amortization expenses, or write-offs of goodwill, any of which could harm our operating results or financial condition. Future acquisitions may also require us to obtain additional equity or debt financing, which may not be available on favorable terms or at all.

The loss of members of our management team could substantially disrupt our business operations.

Our success depends to a significant degree upon the continued individual and collective contributions of our management team. A limited number of individuals have primary responsibility for managing our business, including our relationships with key customers and licensees. We have key executives and senior technical people who have been with us for a number of years, including over 150 employees who have been with us for over 10 years. These individuals, as well as the rest of our management team and key employees, are at-will employees, and we do not maintain any key-person life insurance policies. Losing the services of any key member of our team, whether from retirement, competing offers or other causes, could prevent us from executing our business strategy, cause us to lose key customer or licensee relationships, or otherwise materially affect our operations.

We rely on highly skilled personnel, and if we are unable to retain or motivate key personnel or hire qualified personnel, we may not be able to maintain our operations or grow effectively.

Our performance is largely dependent on the talents and efforts of highly skilled individuals. Our future success depends on our continuing ability to identify, hire, develop, motivate and retain highly skilled personnel for all areas of our organization. In this regard, we currently plan to hire a number of employees throughout fiscal 2006 in response to our growth and our current initiatives and if we are unable to hire and train a sufficient number of qualified employees for any reason, we may not be able to implement our current initiatives or grow effectively. In this regard, we have in the past maintained a rigorous, highly selective and time-consuming hiring process. We believe that our approach to hiring has significantly contributed to our success to date. However, our highly selective hiring process has made it more difficult for us to hire a sufficient number of qualified employees, and, as we grow, our hiring process may prevent us from hiring the personnel we need in a timely manner. In addition, we are aware that certain of our competitors have directly targeted our employees. Moreover, the high cost of living in the San Francisco Bay Area, where our corporate headquarters and a significant portion of our operations are located, has been an impediment in attracting new employees and retaining existing employees in the past, and we expect that this high cost of living will continue to impair our ability to attract and retain employees in the future. Furthermore, for much of our history we have relied upon cash compensation arrangements, such as cash bonuses, rather than option grants, to motivate our employees. In recent years, we have granted options to key employees. Nonetheless, there is no assurance that either of these approaches will provide adequate incentives to attract, retain and motivate employees in the future. If we do not succeed in attracting excellent personnel and retaining and motivating existing personnel, our existing operations may suffer and we may be unable to grow effectively.

If we cannot maintain our corporate culture as we grow, we could lose the innovation, teamwork and focus that we believe our culture fosters, and our business may be harmed.

We believe that a critical contributor to our success has been our corporate culture, which we believe fosters innovation, teamwork and a focus both on developing and strengthening long-term relationships with entertainment industry participants and on developing practical, enduring technology solutions for the entertainment industry. As we grow and change in response to the requirements of being a public company, we may find it difficult to maintain important aspects of our corporate culture, which could negatively affect our future success. We intend to continue to focus on developing technologies for the entertainment industries that provide long-term benefits, and we intend to keep our focus on long-term results.

We will incur increased costs and demands upon management as a result of complying with the laws and regulations affecting public companies, which could affect our operating results.

As a public company we have incurred and will continue to incur significant legal, accounting and other expenses that we did not incur as a private company, including costs associated with public company reporting requirements. We also have incurred and will incur costs associated with recently adopted corporate governance requirements, including requirements under the Sarbanes-Oxley Act, as well as new rules implemented by the SEC and the NYSE. In addition, our management team will have to adapt to the requirements of being a public company, as most of our senior executive officers do not have significant experience in the public company environment. The expenses incurred by public companies generally for reporting and corporate governance purposes have increased. These rules and regulations have increased our legal and financial compliance costs and have made some activities more time-consuming and costly, although we are unable to currently estimate these costs with any degree of certainty. We do believe, however, that we will be able to fund these costs out of our available working capital. It is possible that these new rules and regulations may make it more difficult and more expensive for us to obtain director and officer liability insurance, and we may be required to accept reduced policy limits and coverage or incur substantially higher costs to obtain the same or similar coverage than used to be available. As a result, it may be more difficult for us to attract and retain qualified individuals to serve on our board of directors or as our executive officers.

If we fail to maintain proper and effective internal controls, our ability to produce accurate financial statements could be impaired, which could adversely affect our operating results, our ability to operate our business and our investors' views of us.

We have a complex business organization that is international in scope. Ensuring that we have adequate internal financial and accounting controls and procedures in place to help ensure that we can produce accurate financial statements on a timely basis is a costly and time-consuming effort that needs to be re-evaluated frequently. We are in the process of documenting, reviewing and, if appropriate, improving our internal controls and procedures in connection with Section 404 of the Sarbanes-Oxley Act, which requires annual management assessments of the effectiveness of our internal controls over financial reporting and a report by our independent auditors addressing these assessments. Both we and our independent auditors will periodically test our internal controls in connection with the Section 404 requirements and could, as part of that documentation and testing, identify areas for further attention or improvement. Implementing any appropriate changes to our internal controls may require specific compliance training of our directors, officers and employees, entail substantial costs in order to modify our existing accounting systems, and take a significant period of time to complete. Such changes may not, however, be effective in maintaining the adequacy of our internal controls, and any failure to maintain that adequacy, or consequent inability to produce accurate financial statements on a timely basis, could increase our operating costs and could materially impair our ability to operate our business. In addition, investors' perceptions that our internal controls are inadequate or that we are unable to produce accurate financial statements may seriously affect our stock price.

Issues arising from the implementation of our new enterprise resource planning system could affect our operating results and ability to manage our business effectively.

We are currently implementing a PeopleSoft enterprise resource planning, or ERP, system over an anticipated three-year period ending in 2007 that is critical to our accounting, financial, operating and manufacturing functions. Implementing a new ERP system raises costs and risks inherent in the conversion to a new computer system, including disruption to our normal accounting procedures, potential delays and problems achieving accuracy in the conversion of electronic data. Failure to properly or adequately address these issues could result in increased costs, the diversion of management's attention and resources and could materially adversely affect our operating results and ability to manage our business effectively. In addition, we do not know whether or not the acquisition of PeopleSoft by Oracle will affect the implementation and future use of our ERP system. To the extent that this acquisition delays, complicates or prevents the full implementation, future use or service of our ERP system, our operating results and financial condition could be adversely affected.

For the foreseeable future, Ray Dolby or his affiliates will be able to control the selection of all members of our board of directors, as well as virtually every other matter that requires stockholder approval, which will severely limit the ability of other stockholders to influence corporate matters.

At March 31, 2006, Ray Dolby and persons and entities affiliated with Ray Dolby owned approximately 64% of our Class A and Class B common stock, representing 93% of the combined voting power of our outstanding Class A and Class B common stock. Under our charter, holders of shares of Class B common stock may generally transfer such shares to family members, including spouses and descendents or the spouses or domestic partners of such descendents, without having the shares automatically convert into shares of Class A common stock. Because of this dual class structure, Ray Dolby, his affiliates, and his family members and descendents will, for the foreseeable future, have significant influence over our management and affairs, and will be able to control virtually all matters requiring stockholder approval, including the election of directors and significant corporate transactions such as mergers or other sales of our company or assets, even if they come to own considerably less than 50% of the total number of outstanding shares of our Class A and Class B common stock. Moreover, these persons may take actions in their own interests that you or our other stockholders do not view as beneficial. There is no threshold or time deadline at which the shares of Class B common stock will automatically convert into shares of Class A common stock. Assuming conversion of all shares of Class B common stock held by persons not affiliated with Ray Dolby into shares of Class A common stock, so long as Ray Dolby and his affiliates continue to hold shares of Class B common stock representing approximately 11% or more of the total number of outstanding shares of our Class A and Class B common stock, they will hold a majority of the combined voting power of the Class A and Class B common stock.

Future sales of shares by insiders could cause our stock price to decline.

If our founder, officers, directors or employees sell, or indicate an intention to sell, substantial amounts of our Class A common stock, including shares of Class A common stock issuable upon conversion of shares of Class B common stock, in the public market, the trading price of our Class A common stock could decline. As of March 31, 2006, we had outstanding a total of 105,675,406 shares of Class A and Class B common stock. Of these shares, 31,625,000 shares of Class A common stock were sold in our initial public offering by us and the selling stockholders.

As of March 31, 2006, our directors and executive officers held 68,811,000 shares of Class B common stock and vested options to purchase 599,597 shares of Class B common stock. We expect that any sale of our Class A common stock by our directors and executive officers would be subject to compliance with Rule 144 under the Securities Act.

ITEM 2. UNREGISTERED SALES OF EQUITY SECURITIES AND USE OF PROCEEDS

Sales of Unregistered Securities

In the fiscal quarter ended March 31, 2006, we issued an aggregate of 926,403 shares of our Class B common stock to certain employees, consultants, officers and directors upon the exercise of options awarded under our 2000 Stock Incentive Plan and from March 31, 2006 through April 26, 2006, we issued an aggregate of 324,295 shares of our Class B common stock to certain employees and officers upon the exercise of options awarded under our 2000 Stock Incentive Plan. We received aggregate proceeds of $1.4 million in the fiscal quarter ended March 31, 2006, and $0.6 million in the period from March 31, 2006 through April 26, 2006, as a result of the exercise of these options. We believe these transactions were exempt from the registration requirements of the Securities Act in reliance on Rule 701 thereunder as transactions pursuant to compensatory benefit plans and contracts relating to compensation as provided under Rule 701. As of April 26, 2006 options to purchase an aggregate of 8,472,340 shares of our Class B common stock remained outstanding. All issuances of shares of our Class B common stock pursuant to the exercise of these options will be made in reliance on Rule 701. All option grants made under the 2000 Stock Incentive Plan were made prior to the effectiveness of our initial public offering. No further option grants will be made under our 2000 Stock Incentive Plan.

None of the foregoing transactions involved any underwriters, underwriting discounts or commissions, or any public offering.

Each share of our Class B common stock is convertible into one share of our Class A common stock at any time at the option of the holder or upon the affirmative vote of the holders of a majority of the shares of Class B common stock. In addition, each share of Class B common stock shall convert automatically into one share of Class A common stock upon any transfer, except for certain transfers described in our amended and restated certificate of incorporation.

Use of Proceeds from Public Offering

The SEC declared our registration statement, filed on Form S-1 (File No. 333-120614) under the Securities Act of 1933 in connection with the initial public offering of our Class A common stock, $0.001 par value, effective on February 16, 2005.

ITEM 4. SUBMISSION OF MATTERS TO A VOTE OF SECURITY HOLDERS

We held our 2006 Annual Meeting of Stockholders (the "Annual Meeting") on February 14, 2006 at our executive offices located at 100 Potrero Avenue, San Francisco, CA 94103–4813. At the Annual Meeting, our stockholders:

1. Elected five directors to serve until the 2007 Annual Meeting of Stockholders or until their successors are duly elected and qualified;
2. Approved the amendment and restatement of our 2005 Stock Plan to permit certain future awards under the plan to qualify as performance–based compensation under Section 162(m) of the Internal Revenue Code and to permit the granting of performance cash bonus awards under the plan; and
3. Ratified the appointment of KPMG LLP as our independent registered public accounting firm for our fiscal year ending September 29, 2006.

Each share of Class A common stock is entitled to one vote, and each share of Class B common stock is entitled to ten votes, on all matters submitted to a vote of stockholders, unless otherwise required by law. The Class A Common Stock and Class B Common Stock vote together as a single class. At the Annual Meeting, the holders of Class A common stock and Class B common stock voted as follows:

1. Election of Directors

Directors	Votes For	Votes Withheld
Ray Dolby	725,167,792	210,587
Bill Jasper	725,169,975	208,404
Peter Gotcher	725,249,489	128,890
Sanford Robertson	723,087,528	2,290,851
Roger Siboni	725,240,699	137,680

2. Amendment and restatement of our 2005 Stock Plan to permit certain future awards under the plan to qualify as performance–based compensation under Section 162(m) of the Internal Revenue Code and to permit the granting of performance cash bonus awards under the plan.

Votes For:	716,034,766
Votes Against:	1,587,592
Abstentions:	453,063
Broker Non-Votes:	7,302,958

3. Ratification of the appointment of KPMG LLP as the Company’s independent registered public accounting firm for our fiscal year ending September 29, 2006.

Votes For:	725,077,539
Votes Against:	45,456
Abstentions:	255,384

ITEM 6. EXHIBITS

Exhibit Number	Description	Incorporated by Reference Herein	
		Form	Date
4.1	Form of Class B Common Stock certificate.	Form 8-A	January 25, 2006
10.1*	Dolby Laboratories, Inc. 2005 Stock Plan, as amended and restated.	Form 8-K	February 16, 2006
10.2*	2006 Dolby Annual Incentive Plan.	Form 8-K	February 16, 2006
10.3*	First Amendment to Lease for 100 Potrero Avenue, San Francisco, California		
31.1	Certification by the Chief Executive Officer Pursuant to Rule 13a-14(a) or 15d-14(a) under the Securities Exchange Act of 1934 as adopted pursuant to Section 302 of the Sarbanes-Oxley Act of 2002.		
31.2	Certification by the Chief Financial Officer Pursuant to Rule 13a-14(a) or 15d-14(a) under the Securities Exchange Act of 1934 as adopted pursuant to Section 302 of the Sarbanes-Oxley Act of 2002.		
32.1 ‡	Certification by the Chief Executive Officer and the Chief Financial Officer Pursuant to 18 U.S.C. Section 1350 as adopted pursuant to Section 906 of the Sarbanes-Oxley Act of 2002.		

* Denotes a management contract or compensatory plan or arrangement

‡ Furnished herewith

SIGNATURES

Pursuant to the requirements of the Securities Exchange Act of 1934, the registrant has duly caused this report to be signed on its behalf by the undersigned, thereunto duly authorized.

Date: May 2, 2006

DOLBY LABORATORIES, INC.

By: /s/ Kevin J. Yeaman

Kevin J. Yeaman
Chief Financial Officer
(Principal Financial and Accounting Officer and Duly Authorized Officer)

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INDEX TO EXHIBITS

Exhibit Number	Description	Incorporated by Reference Herein	
		Form	Date
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‡ Furnished herewith

Exhibit 10.3

FIRST AMENDMENT TO LEASE AGREEMENT

THIS FIRST AMENDMENT TO LEASE AGREEMENT (this "**Amendment**") is made and entered into as of March 31, 2006, by and between RAY DOLBY AND DAGMAR DOLBY, AS TRUSTEES OF THE DOLBY FAMILY TRUST, DATED MAY 7, 1999, and RAY AND DAGMAR DOLBY REAL ESTATE INVESTMENTS, L.P., a California limited partnership (collectively, "**Landlord**"), and DOLBY LABORATORIES, INC., a California corporation, ("**Tenant**").

RECITALS

A. Landlord and Tenant have entered into that certain Lease Agreement dated as of December 31, 2005 (the "**Original Lease**"), whereby Landlord leased to Tenant certain premises ("**Premises**"), commonly known as 100 Potrero Avenue, San Francisco, California, more particularly described in the Original Lease.

B. Landlord and Tenant now desire to amend the Original Lease as provided in Section 2.2(b) of the Original Lease pursuant to the terms, covenants and conditions set forth herein.

AGREEMENT

NOW THEREFORE, for good and valuable consideration, the receipt and adequacy of which are hereby acknowledged, Buyer and Seller hereby agree as follows:

1. ***Defined Terms.*** Unless otherwise expressly set forth herein, capitalized terms used but not otherwise defined herein shall have the meanings ascribed to such terms in the Original Lease. As used herein and in the Original Lease, the term "**Lease**" shall mean the Original Lease as amended hereby.

2. ***Measurement of Premises.***

(a) Landlord caused its representative to meet with Tenant's Architect to review the calculation of the rentable area of the Premises made by Tenant's Architect, and Tenant's Architect provided additional information concerning such calculation to Landlord and Tenant. As a result of such meeting and review of such calculation, Landlord and Tenant hereby agree that the correct measurement of the rentable area of the Premises is seventy thousand four hundred sixteen (70,416) square feet. Accordingly, the phrase "69,641 square feet (subject to adjustment pursuant to Section 2.2)" set forth in the Basic Lease Information of the Original Lease is hereby deleted and replaced with "70,416 square feet".

3. ***Rent.*** As a result of the increase in the rentable area of the Premises pursuant to Section 2 above, the Base Rent shall be increased to Nine Hundred Eighty-Five Thousand Eight Hundred Twenty-Four and 00/100 Dollars ($985,824.00) annually, payable in monthly installments of Eighty-Two Thousand One Hundred Fifty-Two and 00/100 Dollars ($82,152.00), to reflect the additional 775 square feet included in the revised measurement of the Premises.

(a) Accordingly, the Base Rent as set forth in the Basic Lease Information of the Original Lease is hereby deleted and replaced with the following:

Monthly: $82,152.00

Annual: $985,824.00

(b) The Base Rent adjustment pursuant to this Section 3 is retroactive to the Commencement Date, thus (i) Tenant shall pay the increased monthly Base Rent commencing with the monthly installment of Base Rent due on April 1, 2006, and (ii) Tenant shall pay to Landlord, no later than May 1, 2006, the additional Base Rent owed for the period January 1, 2006 through March 31, 2006, in the amount of Two Thousand Seven Hundred Twelve and 51/100 Dollars ($2,712.51), as a result of the adjustment of the rentable square footage of the Premises pursuant to this Amendment.

4. ***No Further Adjustment Pursuant to Section 2.2 of Original Lease.*** Landlord and Tenant agree that the adjustment of the rentable square footage of the Premises and Base Rent pursuant to this Amendment is made pursuant to Section 2.2 of the Original Lease and that no further adjustment of the rentable square footage of the Premises or Base Rent shall be made pursuant to Section 2.2 of the Original Lease.

5. ***Ratification; Miscellaneous.*** Except as expressly modified hereby, the Original Lease shall remain unmodified and in full force and effect. This Amendment, after due execution by each party, may be delivered via electronic or facsimile transmission, with original signatures to follow, and in any number of counterparts, each of which shall be considered an original and all of which, taken together, shall constitute one and the same instrument.

[Signatures appear on next page]

IN WITNESS WHEREOF, Landlord and Tenant have executed this Amendment effective as of the date set forth above.

LANDLORD:

/s/ Ray Dolby
RAY DOLBY, as Trustee of the
Dolby Family Trust, dated May 7, 1999

/s/ Dagmar Dolby
DAGMAR DOLBY, as Trustee of the
Dolby Family Trust, dated May 7, 1999

RAY AND DAGMAR DOLBY REAL ESTATE
INVESTMENTS, L.P.,
a California limited partnership

By /s/ Ray Dolby
Ray Dolby, as Trustee of the Dolby Family
Trust, dated May 7, 1999, its general partner

By /s/ Dagmar Dolby
Dagmar Dolby, as Trustee of the Dolby Family
Trust, dated May 7, 1999, its general partner

TENANT: DOLBY LABORATORIES, INC.,
a California corporation

By /s/ N. W. Jasper, Jr.
N. William Jasper, Jr.
President and CEO

Exhibit 31.1

CERTIFICATION

I, N. W. Jasper, Jr., certify that:

1. I have reviewed this Quarterly Report on Form 10-Q of Dolby Laboratories, Inc.;

2. Based on my knowledge, this report does not contain any untrue statement of a material fact or omit to state a material fact necessary to make the statements made, in light of the circumstances under which such statements were made, not misleading with respect to the period covered by this report;

3. Based on my knowledge, the financial statements, and other financial information included in this report, fairly present in all material respects the financial condition, results of operations and cash flows of the registrant as of, and for, the periods presented in this report;

4. The registrant's other certifying officer and I are responsible for establishing and maintaining disclosure controls and procedures (as defined in Exchange Act Rules 13a-15(e) and 15d-15(e)) for the registrant and have:

   (a) Designed such disclosure controls and procedures, or caused such disclosure controls and procedures to be designed under our supervision, to ensure that material information relating to the registrant, including its consolidated subsidiaries, is made known to us by others within those entities, particularly during the period in which this report is being prepared;

   (b) Evaluated the effectiveness of the registrant's disclosure controls and procedures and presented in this report our conclusions about the effectiveness of the disclosure controls and procedures, as of the end of the period covered by this report based on such evaluation; and

   (c) Disclosed in this report any change in the registrant's internal control over financial reporting that occurred during the registrant's most recent fiscal quarter (the registrant's fourth fiscal quarter in the case of an annual report) that has materially affected, or is reasonably likely to materially affect, the registrant's internal control over financial reporting; and

5. The registrant's other certifying officer and I have disclosed, based on our most recent evaluation of internal control over financial reporting, to the registrant's auditors and the audit committee of the registrant's board of directors (or persons performing the equivalent functions):

   (a) All significant deficiencies and material weaknesses in the design or operation of internal control over financial reporting which are reasonably likely to adversely affect the registrant's ability to record, process, summarize and report financial information; and

   (b) Any fraud, whether or not material, that involves management or other employees who have a significant role in the registrant's internal control over financial reporting.

Date: May 2, 2006

/s/ N.W. Jasper, Jr.
N. W. Jasper, Jr.
President and Chief Executive Officer

Exhibit 31.2

CERTIFICATION

I, Kevin J. Yeaman, certify that:

1. I have reviewed this Quarterly Report on Form 10-Q for Dolby Laboratories, Inc.;
2. Based on my knowledge, this report does not contain any untrue statement of a material fact or omit to state a material fact necessary to make the statements made, in light of the circumstances under which such statements were made, not misleading with respect to the period covered by this report;
3. Based on my knowledge, the financial statements, and other financial information included in this report, fairly present in all material respects the financial condition, results of operations and cash flows of the registrant as of, and for, the periods presented in this report;
4. The registrant's other certifying officer and I are responsible for establishing and maintaining disclosure controls and procedures (as defined in Exchange Act Rules 13a-15(e) and 15d-15(e)) for the registrant and have:

   (a) Designed such disclosure controls and procedures, or caused such disclosure controls and procedures to be designed under our supervision, to ensure that material information relating to the registrant, including its consolidated subsidiaries, is made known to us by others within those entities, particularly during the period in which this report is being prepared;

   (b) Evaluated the effectiveness of the registrant's disclosure controls and procedures and presented in this report our conclusions about the effectiveness of the disclosure controls and procedures, as of the end of the period covered by this report based on such evaluation; and

   (c) Disclosed in this report any change in the registrant's internal control over financial reporting that occurred during the registrant's most recent fiscal quarter (the registrant's fourth fiscal quarter in the case of an annual report) that has materially affected, or is reasonably likely to materially affect, the registrant's internal control over financial reporting; and
5. The registrant's other certifying officer and I have disclosed, based on our most recent evaluation of internal control over financial reporting, to the registrant's auditors and the audit committee of the registrant's board of directors (or persons performing the equivalent functions):

   (a) All significant deficiencies and material weaknesses in the design or operation of internal control over financial reporting which are reasonably likely to adversely affect the registrant's ability to record, process, summarize and report financial information; and

   (b) Any fraud, whether or not material, that involves management or other employees who have a significant role in the registrant's internal control over financial reporting.

Date: May 2, 2006

/s/ Kevin J. Yeaman
Kevin J. Yeaman
Chief Financial Officer

Exhibit 32.1

CERTIFICATION PURSUANT TO
18 U.S.C. SECTION 1350,
AS ADOPTED PURSUANT TO
SECTION 906 OF THE SARBANES-OXLEY ACT OF 2002

In connection with the Quarterly Report of Dolby Laboratories, Inc (the "Company"), on Form 10-Q for the quarter ended March 31, 2006, as filed with the Securities and Exchange Commission (the "Report"), N.W. Jasper, Jr., President and Chief Executive Officer of the Company and Kevin J. Yeaman, Chief Financial Officer of the Company, respectively, do each hereby certify, pursuant to 18 U.S.C. Section 1350, as adopted pursuant to Section 906 of the Sarbanes-Oxley Act of 2002, that:

- The Report fully complies with the requirements of section 13(a) or 15(d) of the Securities Exchange Act of 1934; and
- The information in the Report fairly presents, in all material respects, the financial condition and results of operations of the Company.

Dated: May 2, 2006

/s/ N.W. Jasper, Jr.
N.W. Jasper, Jr.
President and Chief Executive Officer

/s/ Kevin J. Yeaman
Kevin J. Yeaman
Chief Financial Officer