REALNETWORKS INC
Form 10-Q
November 09, 2007

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

FORM 10-Q

(Mark One)

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

For the Quarterly Period Ended September 30, 2007

OR

o **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 0-23137

RealNetworks, Inc.

(Exact name of registrant as specified in its charter)

Washington	**91-628146**
(State of incorporation)	*(I.R.S. Employer Identification Number)*
2601 Elliott Avenue, Suite 1000 Seattle, Washington	**98121**
(Address of principal executive offices	*(Zip Code)*

(206) 674-2700

(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 þ No o

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

Large accelerated filer þ Accelerated filer o Non-accelerated filer o

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

The number of shares of the registrant s Common Stock outstanding as of October 31, 2007 was 145,288,749.

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PART I. FINANCIAL INFORMATION

Item 1. Financial Statements

REALNETWORKS, INC. AND SUBSIDIARIES
UNAUDITED CONDENSED CONSOLIDATED BALANCE SHEETS
(In thousands, except per share data)

	September 30, 2007	December 31, 2006
ASSETS		
Current assets:		
Cash and cash equivalents	$ 197,738	$ 525,232
Short-term investments	392,625	153,688
Trade accounts receivable, net of allowances for doubtful accounts and sales returns	80,734	65,751
Deferred costs, current portion	6,280	1,643
Deferred tax assets, net, current portion	224	891
Prepaid expenses and other current assets	27,235	21,990
Total current assets	704,836	769,195
Equipment, software, and leasehold improvements:		
Equipment and software	102,337	83,587
Leasehold improvements	30,496	29,665
Total equipment, software, and leasehold improvements, at cost	132,833	113,252
Less accumulated depreciation and amortization	78,676	65,509
Net equipment, software, and leasehold improvements	54,157	47,743
Restricted cash equivalents	15,500	17,300
Equity investments	7,814	22,649
Other assets	7,967	5,148
Deferred tax assets, net, non-current portion	37,584	27,150
Other intangible assets, net	109,681	105,109
Goodwill	337,406	309,122
Total assets	$ 1,274,945	$ 1,303,416
LIABILITIES AND SHAREHOLDERS EQUITY		
Current liabilities:		
Accounts payable	$ 54,241	$ 52,097
Accrued and other liabilities	119,128	104,328
Deferred revenue, current portion	38,601	24,137
Related party payable	8,025	
Accrued loss on excess office facilities, current portion	3,398	4,508
Total current liabilities	223,393	185,070
Deferred revenue, non-current portion	2,815	3,440

Accrued loss on excess office facilities, non-current portion	7,563	9,993
Deferred rent	4,503	4,331
Deferred tax liabilities, net, non-current portion	23,634	27,076
Convertible debt	100,000	100,000
Other long-term liabilities	9,884	3,740
Total liabilities	371,792	333,650
Minority interest in Rhapsody America	7,685	
Shareholders equity:		
Preferred stock, $0.001 par value, no shares issued and outstanding Series A: authorized 200 shares		
Undesignated series: authorized 59,800 shares		
Common stock, $0.001 par value authorized 1,000,000 shares; issued and outstanding 147,512 shares in 2007 and 163,278 shares in 2006	148	162
Additional paid-in capital	680,594	791,108
Accumulated other comprehensive income	14,085	23,485
Retained earnings	200,641	155,011
Total shareholders equity	895,468	969,766
Total liabilities and shareholders equity	$ 1,274,945	$ 1,303,416

See accompanying notes to unaudited condensed consolidated financial statements.

REALNETWORKS, INC. AND SUBSIDIARIES
UNAUDITED CONDENSED CONSOLIDATED STATEMENTS OF OPERATIONS
AND COMPREHENSIVE INCOME
(In thousands, except per share data)

	Three Months ended September 30,		Nine Months ended September 30,	
	2007	2006	2007	2006
Net revenue (A)	$ 145,095	$ 93,676	$ 410,738	$ 269,687
Cost of revenue (B)	56,644	28,389	151,786	81,788
Gross profit	88,451	65,287	258,952	187,899
Operating expenses:				
Research and development	26,528	18,344	75,012	55,127
Sales and marketing	52,812	37,560	152,593	111,604
Advertising with related party	7,747		7,747	
General and administrative	16,750	14,043	51,167	41,586
Loss on excess office facilities				738
Subtotal operating expenses	103,837	69,947	286,519	209,055
Antitrust litigation benefit, net		(61,861)	(60,747)	(159,554)
Total operating expenses, net	103,837	8,086	225,772	49,501
Operating (loss) income	(15,386)	57,201	33,180	138,398
Other income (expenses):				
Interest and other, net	7,290	10,618	24,457	27,978
Gain on sale of equity investment			132	2,286
Equity in net loss of investments			(132)	
Minority interest in Rhapsody America	6,466		6,466	
Gain on sale of interest in Rhapsody America	7,946		7,946	
Other income, net	38	242	990	432
Other income, net	21,740	10,860	39,859	30,696
Income before income taxes	6,354	68,061	73,039	169,094
Income taxes	(2,012)	(25,908)	(27,409)	(63,180)
Net income	$ 4,342	$ 42,153	$ 45,630	$ 105,914

Basic net income per share	$ 0.03	$ 0.26	$ 0.30	$ 0.66
Diluted net income per share	$ 0.03	$ 0.24	$ 0.27	$ 0.59
Shares used to compute basic net income per share	149,667	160,578	154,670	160,466
Shares used to compute diluted net income per share	163,094	178,913	169,840	178,551
Comprehensive income:				
Net income	$ 4,342	$ 42,153	$ 45,630	$ 105,914
Unrealized holding gains (losses) on short-term and equity investments, net of income taxes	(3,228)	28	(8,947)	(12,887)
Foreign currency translation gains (losses)	1,206	388	(453)	1,760
Comprehensive income	$ 2,320	$ 42,569	$ 36,230	$ 94,787
(A) Components of net revenue:				
License fees	$ 23,869	$ 22,528	$ 67,918	$ 68,014
Service revenue	121,226	71,148	342,820	201,673
	$ 145,095	$ 93,676	$ 410,738	$ 269,687
(B) Components of cost of revenue:				
License fees	$ 8,436	$ 9,675	$ 24,610	$ 28,865
Service revenue	48,208	18,714	127,176	52,923
	$ 56,644	$ 28,389	$ 151,786	$ 81,788

See accompanying notes to unaudited condensed consolidated financial statements.

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REALNETWORKS, INC. AND SUBSIDIARIES
UNAUDITED CONDENSED CONSOLIDATED STATEMENTS OF CASH FLOWS
(in thousands)

	Nine Months Ended September 30,	
	2007	**2006**
Cash flows from operating activities:		
Net income	$ 45,630	$ 105,914
Adjustments to reconcile net income to net cash (used in) provided by operating activities:		
Depreciation and amortization	32,865	12,480
Stock-based compensation	17,291	12,332
Loss on disposal of equipment, software, and leasehold improvements	275	76
Equity in net loss of investments	132	
Gain on sale of equity investment	(132)	(2,286)
Accrued loss on excess office facilities	(3,540)	(2,640)
Unrealized gain on trading securities	(5,426)	
Deferred income taxes	(13,224)	56,508
Purchases of trading securities	(270,000)	
Minority interest in Rhapsody America	(6,466)	
Gain on sale of interest in Rhapsody America	(7,946)	
Other	72	73
Net change in certain operating assets and liabilities, net of acquisitions	3,658	(48,496)
Net cash (used in) provided by operating activities	(206,811)	133,961
Cash flows from investing activities:		
Purchases of equipment, software, and leasehold improvements	(19,051)	(9,316)
Purchases of short-term investments	(117,762)	(177,868)
Proceeds from sales and maturities of short-term investments	154,251	156,006
Purchases of other intangibles assets	(2,723)	
Proceeds from sale of equity investments	1,615	2,286
Purchases of equity investments		(834)
Decrease in restricted cash equivalents	1,800	
Cash used in acquisitions, net of cash acquired	(25,316)	(7,086)
Net cash used in investing activities	(7,186)	(36,812)
Cash flows from financing activities:		
Net proceeds from sale of common stock under employee stock purchase plan and exercise of stock options	14,058	41,976
Net proceeds from sales of interest in Rhapsody America	15,007	
Repurchase of common stock	(142,150)	(98,869)

Net cash used in financing activities	(113,085)	(56,893)
Effect of exchange rate changes on cash and cash equivalents	(412)	830
Net increase (decrease) in cash and cash equivalents	(327,494)	41,086
Cash and cash equivalents, beginning of period	525,232	651,971
Cash and cash equivalents, end of period	$ 197,738	$ 693,057
Supplemental disclosure of cash flow information:		
Cash paid for income taxes	$ 28,750	$ 14,181
Supplemental disclosure of non-cash investing and financing activities:		
Accrued acquisition costs	$ 310	$
Accrued acquisition consideration	$ 8,596	$ 2,079

See accompanying notes to unaudited condensed consolidated financial statements.

REALNETWORKS, INC. AND SUBSIDIARIES
NOTES TO UNAUDITED CONDENSED CONSOLIDATED FINANCIAL STATEMENTS
As of September 30, 2007 and 2006 and for the Three and Nine Month Periods Then Ended

Note 1. Summary of Significant Accounting Policies

Description of Business. RealNetworks, Inc. and subsidiaries (RealNetworks or Company) is a leading global provider of network-delivered digital media products and services. The Company also develops and markets software products and services that enable the creation, distribution and consumption of digital media, including audio and video.

Inherent in the Company s business are various risks and uncertainties, including limited history of certain of its product and service offerings and its limited history of offering premium subscription services on the Internet. The Company s success will depend on the acceptance of the Company s technology, products, and services and the ability to generate related revenue.

Basis of Presentation. The unaudited condensed consolidated financial statements include the accounts of the Company and its wholly-owned and majority-owned subsidiaries. All significant intercompany balances and transactions have been eliminated in consolidation.

On August 20, 2007, RealNetworks and MTV Networks, a division of Viacom International Inc. (MTVN), created Rhapsody America LLC (Rhapsody America) to jointly own and operate a business-to-consumer digital audio music service. RealNetworks held a 51% interest in Rhapsody America as of September 30, 2007. Rhapsody America s financial position and operating results have been consolidated into RealNetworks financial statements since its formation in August 2007. The minority interest s proportionate share of income (loss) is included in Minority interest in Rhapsody America in the unaudited consolidated statements of operations and comprehensive income. MTVN s proportionate share of equity is included in Minority interest in Rhapsody America in the unaudited condensed consolidated balance sheet.

The Company acquired 99.7% of WiderThan Co., Ltd. (WiderThan) during the three months ended December 31, 2006. The Company acquired substantially all of the remaining shares of WiderThan during the three months ended June 30, 2007. The accompanying unaudited condensed consolidated financial statements include 100% of the financial results of WiderThan from the date of acquisition. The minority interest in the earnings of WiderThan for the nine months ended September 30, 2007 was nominal. The minority interest liability related to WiderThan as of September 30, 2007 and December 31, 2006 was nominal.

The unaudited condensed consolidated financial statements reflect all adjustments, consisting only of normal, recurring adjustments that, in the opinion of the Company s management, are necessary for a fair presentation of the results of operations for the periods presented. Operating results for the three and nine months ended September 30, 2007 are not necessarily indicative of the results that may be expected for any subsequent quarter or for the year ending December 31, 2007. Certain information and disclosures normally included in financial statements prepared in conformity with accounting principles generally accepted in the United States of America have been condensed or omitted pursuant to the rules and regulations of the Securities and Exchange Commission (SEC).

These unaudited condensed consolidated financial statements should be read in conjunction with the audited consolidated financial statements and related notes included in the Company s Annual Report on Form 10-K for the year ended December 31, 2006.

Revenue Recognition. The Company recognizes revenue in accordance with the following authoritative literature: AICPA Statement of Position (SOP) No. 97-2, *Software Revenue Recognition;* SOP No. 98-9, *Software Revenue Recognition with Respect to Certain Arrangements*; SOP No. 81-1, *Accounting for Performance of Construction-Type and Certain Production-Type Contracts*; SEC Staff Accounting Bulletin (SAB) No. 104, *Revenue Recognition in Financial Statements*; Financial Accounting Standards Board s (FASB) Emerging Issues Task Force (EITF) Issue No. 99-19, *Reporting Revenue Gross as a Principal versus Net as an Agent;* and EITF Issue No. 00-21, *Revenue Arrangements with Multiple Deliverables*. Generally the Company recognizes revenue when there is persuasive evidence of an arrangement, the fee is fixed or determinable, the product or services have been delivered and collectibility of the resulting receivable is reasonably assured.

Consumer subscription products are paid in advance, typically for monthly, quarterly or annual periods. Subscription revenue is recognized ratably over the related subscription period. Revenue from sales of downloaded individual tracks, albums and games are recognized at the time the music or game is made available, digitally, to the end user.

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REALNETWORKS, INC. AND SUBSIDIARIES
NOTES TO UNAUDITED CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (Continued)

The Company recognizes revenue under the residual method for multiple element software arrangements when vendor specific objective evidence (VSOE) exists for all of the undelivered elements of the arrangement, but does not exist for one or more of the delivered elements in the arrangement, under SOP No. 97-2. Under the residual method, at the outset of the arrangement with a customer, the Company defers revenue for the fair value of the arrangement s undelivered elements such as post contract support (PCS), and recognizes revenue for the remainder of the arrangement fee attributable to the elements initially delivered, such as software licenses. VSOE for PCS is established on standard products for which no installation or customization is required based upon amount charged when PCS is sold separately. For multiple element software arrangements involving significant production, modification, or customization of the software, which are accounted for in accordance with the provisions of SOP No. 81-1, VSOE for PCS is established if customers have an optional renewal rate specified in the arrangement and the rate is substantive.

The Company has arrangements whereby customers pay one price for multiple products and services and in some cases, involve a combination of products and services. For arrangements with multiple deliverables, revenue is recognized upon the delivery of the individual deliverables in accordance with EITF Issue No. 00-21. In the event that there is no objective and reliable evidence of fair value of the delivered items, the revenue recognized upon delivery is the total arrangement consideration less the fair value of the undelivered items. The Company applies significant judgment in establishing the fair value of multiple elements within revenue arrangements.

The Company recognizes revenue on a gross or net basis in accordance with EITF Issue No. 99-19. In most arrangements, the Company contracts directly with end user customers, is the primary obligor and carries all collectibility risk. In such arrangements the Company reports revenue on a gross basis. In some cases, the Company utilizes third-party distributors to sell products or services directly to end user customers and carries no collectibility risk. In such instances the Company reports revenue on a net basis.

Revenue generated from advertising on the Company s websites and from advertising included in its products is recognized as revenue as the delivery of the advertising occurs.

Accounting for Taxes Collected From Customers. The Company collects various types of taxes from its customers, assessed by governmental authorities, that are imposed on and concurrent with revenue-producing transactions. Such taxes are recorded on a net basis and are not included in net revenue of the Company.

Accounting for Gains on Sale of Subsidiary Stock. The effects of any changes in the Company s ownership interest resulting from the issuance of equity capital by consolidated subsidiaries are accounted for as either a gain or loss in the statement of operations pursuant to SAB No. 51, *Accounting for the Sales of Stock of a Subsidiary*. SAB No. 51 requires that the difference between the carrying amount of the parent s investment in a subsidiary and the underlying net book value of the subsidiary after the issuance of stock by the subsidiary be reflected as either a gain or loss in the statement of operations if the appropriate recognition criteria has been met or reflected as an equity transaction. RealNetworks has elected to reflect SAB No. 51 gains or losses in its statement of operations.

Reclassifications. Certain reclassifications have been made to the 2007 year-to-date information to conform to the presentation for the nine months ended September 30, 2007.

Note 2. Recent Accounting Pronouncements

In June 2006, the FASB issued Financial Interpretation (FIN) No. 48, *Accounting for Uncertainty in Income Taxes an interpretation of FASB Statement No. 109.* FIN No. 48 clarifies the accounting for uncertainty in income taxes recognized in an enterprise s financial statements in accordance with Statement of Financial Accounting Standards (SFAS) No. 109, *Accounting for Income Taxes*, and prescribes a recognition threshold and measurement process for financial statement recognition and measurement of tax positions taken or expected to be taken in tax returns. FIN No. 48 also provides guidance on derecognition, classification, interest and penalties, accounting in interim periods, disclosure and transition. On January 1, 2007, date of adoption of FIN No. 48, the Company had $7.5 million of unrecognized tax benefits, of which $7.2 million would affect the effective tax rate if recognized. Although the implementation of FIN No. 48 did not impact the amount of liability for unrecognized tax benefits, the Company reclassified $5.3 million of liability for unrecognized tax benefits from current income taxes payable to other

long-term liabilities to conform with the balance sheet presentation requirements of FIN No. 48.

In accordance with FIN No. 48, the Company recognizes potential accrued interest and penalties related to unrecognized tax benefits as a component of income tax expense. As of January 1, 2007, the Company had approximately $300,000 of accrued interest and penalties related to uncertain tax positions, which is included as a component of the $5.3 million of unrecognized tax benefit noted above. To the extent interest and penalties are not assessed with respect to uncertain tax positions, amounts accrued will be reduced

REALNETWORKS, INC. AND SUBSIDIARIES
NOTES TO UNAUDITED CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (Continued)

and reflected as a reduction of the overall income tax provision. The Company does not anticipate that total unrecognized tax benefits will significantly change within the next twelve months.

The Company files numerous consolidated and separate income tax returns in the United States Federal, state, local, and foreign jurisdictions. With few exceptions, the Company is no longer subject to United States Federal, state, local, or foreign income tax examinations for years before 1993.

In September 2006, the FASB issued SFAS No. 157, *Fair Value Measurements*, which defines fair value, establishes a framework for measuring fair value in generally accepted accounting principles, and expands disclosures about fair value measurements. SFAS No. 157 does not require any new fair value measurements, but provides guidance on how to measure fair value by providing a fair value hierarchy used to classify the source of the information. SFAS No. 157 is effective for fiscal years beginning after November 15, 2007 and interim periods within those fiscal years. The Company is currently assessing the impact of SFAS No. 157 on its consolidated financial statements.

In February 2007, the FASB issued SFAS No. 159 *The Fair Value Option for Financial Assets and Financial Liabilities*, which provides companies with an option to report selected financial assets and liabilities at fair value. The objective of SFAS No. 159 is to reduce both the complexity in accounting for financial instruments and the volatility in earnings caused by measuring related assets and liabilities differently. SFAS No. 159 is effective for fiscal years beginning after November 15, 2007. The Company is currently assessing the impact of SFAS No. 159 on its consolidated financial statements.

Note 3. Stock-Based Compensation

The Company accounts for stock-based compensation in accordance with SFAS No. 123R revised 2004, *Share-Based Payment*. Under the fair value provisions of the statement, stock-based compensation cost is measured at the grant date based on the fair value of the award and is recognized as expense over the requisite service period, which is the vesting period. The Company uses the Black-Scholes option-pricing model to determine the fair-value of stock-based awards under SFAS No. 123R. The Company recognizes compensation cost related to stock options granted prior to the adoption of SFAS No. 123R on an accelerated basis over the applicable vesting period using the methodology described in FIN No. 28, *Accounting for Stock Appreciation Rights and Other Variable Stock Option or Award Plans*. The Company recognizes compensation cost related to options granted subsequent to the adoption of SFAS No. 123R on a straight-line basis over the applicable vesting period.

The expected term of the options represents the estimated period of time until exercise and is based on historical experience of similar awards, including the contractual terms, vesting schedules, and expectations of future employee behavior. Expected stock price volatility is based on a combination of historical volatility of the Company s stock for the related expected term and the implied volatility of its traded options. The risk-free interest rate is based on the implied yield available on U.S. Treasury zero-coupon issues with a term equivalent to the expected term of the stock options. The Company has not paid dividends in the past.

The fair value of options granted was determined using the Black-Scholes model and the following weighted average assumptions:

	Three Months Ended September 30,		Nine Months Ended September 30,	
	2007	**2006**	**2007**	**2006**
Expected dividend yield	0%	0%	0%	0%
Risk-free interest rate	4.44%	5.02%	4.56%	4.91%
Expected life (years)	4.1	4.3	4.1	4.3
Volatility	42.1%	49.1%	42.1%	48.8%

Recognized stock-based compensation expense is as follows (in thousands):

	Three Months Ended	Nine Months Ended

	September 30,		September 30,	
	2007	**2006**	**2007**	**2006**
Cost of service revenue	$ 208	$ 57	$ 520	$ 148
Research and development	1,740	1,878	5,153	4,565
Sales and marketing	2,395	1,920	6,985	4,713
General and administrative	1,641	1,166	4,633	2,906
Total stock-based compensation expense	$ 5,984	$ 5,021	$ 17,291	$ 12,332

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REALNETWORKS, INC. AND SUBSIDIARIES
NOTES TO UNAUDITED CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (Continued)

No stock-based compensation was capitalized as part of the cost of an asset during the nine months ended September 30, 2007 and 2006. As of September 30, 2007, $49.6 million of total unrecognized compensation cost, net of estimated forfeitures, related to stock options is expected to be recognized over a weighted-average period of 2.9 years.

Note 4. Rhapsody America

Formation

On August 20, 2007, RealNetworks and MTVN created Rhapsody America to jointly own and operate a business-to-consumer digital audio music service. Under the Rhapsody America venture agreements:

- RealNetworks contributed its Rhapsody service subscribers, certain RadioPass subscribers, cash of $16.4 million, contracts, revenue from existing Rhapsody subscribers, marketing materials, player hardware, rhapsody.com and related URLs, certain liabilities, and distribution arrangements in exchange for a 51% equity interest in Rhapsody America. RealNetworks also licensed certain assets to Rhapsody America, including Rhapsody content, Rhapsody technology, the Rhapsody brands and related materials.

- MTVN contributed its URGE service subscribers, cash, contracts, marketing materials, and revenue from existing URGE subscribers, certain liabilities, plus the note payable described below, in exchange for a 49% equity interest in Rhapsody America. MTVN has also licensed certain assets to Rhapsody America, including URGE content, brands and related materials.

- In addition to the assets described above, MTVN also contributed a $230 million five-year note payable in consideration for acquiring MTVN s interest in the venture. Rhapsody America must use the proceeds from the note solely to purchase advertising from MTVN. As MTVN makes payments on the note, Rhapsody America records equity and RealNetworks realizes an immediate appreciation in the carrying value of the Company s interests in the venture and recognizes a gain if the gain is reasonably assured in accordance with SAB No. 51. As of September 30, 2007, $8.0 million in payments were made on the note and RealNetworks realized and recorded a gain of $4.1 million during the three months ended September 30, 2007 as all of the SAB No. 51 gain criteria were met.

The assets and liabilities contributed by RealNetworks to Rhapsody America have been recorded at their historical cost basis as RealNetworks maintained a controlling interest in the assets and liabilities. The assets and liabilities contributed by MTVN to Rhapsody America have been recorded at their estimated fair values in the unaudited condensed consolidated balance sheet at September 30, 2007. MTVN s contribution included identifiable intangible assets with estimated fair values of $7.6 million. The respective estimated fair values were determined by management as of the date of the acquisition. RealNetworks realized an immediate appreciation in the carrying value of its interests in Rhapsody America and recognized a gain on sale of music interests upon formation of $3.9 million under SAB No. 51 as all of the gain criteria were met.

A summary of the intangible assets contributed by MTVN is as follows (in thousands):

Trade Name and Trademarks	$ 4,000
Existing Technology	1,900
Existing Subscribers	1,680
Total Identifiable Intangible Assets	$ 7,580

The identified intangible assets have a weighted average estimated useful life of 4.1 years. All of the intangible assets are being amortized over their estimated useful lives on a straight line basis.

As part of the initial formation of Rhapsody America, RealNetworks and MTVN are obligated to provide additional funding for future operations of $17.4 and $16.7 million, respectively in December 2007. No amounts were

recorded within our condensed consolidated financial statements as of September 30, 2007 in relation to these obligations.

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REALNETWORKS, INC. AND SUBSIDIARIES
NOTES TO UNAUDITED CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (Continued)

Call and Put Rights

Pursuant to the terms of the Rhapsody America limited liability company agreement, RealNetworks has the right to purchase from MTVN, and MTVN has a right to require RealNetworks to purchase, MTVN s interest in Rhapsody America. The Company has accounted for these call and put rights in accordance with SFAS No. 150 *Accounting for Certain Financial Instruments with Characteristics of Both Liabilities and Equity*. The impact of the call and put rights within our consolidated financial statements is not material as of and for the three months ended September 30, 2007.

These call and put rights are exercisable upon the occurrence of certain events and during certain periods in each of 2012, 2013 and 2014 and every two years thereafter. If MTVN exercises its put right, RealNetworks has the right to pay a portion of the purchase price for MTVN s interest in cash and shares of RealNetworks capital stock, subject to certain maximum amounts with the balance (if any) paid with a note. If RealNetworks exercises their call right, MTVN has the right to demand payment of part of the purchase price for its membership interest in shares of RealNetworks capital stock. If a portion of the purchase price for MTVN s interest is payable in shares of RealNetworks capital stock, such shares could consist of our common stock representing up to 15% of the outstanding shares of RealNetworks common stock immediately prior to the transaction, and shares of our non-voting stock representing up to an additional 4.9% of the outstanding shares of RealNetworks common stock immediately prior to the transaction representing a maximum of 19.9% of RealNetworks capital stock. If RealNetworks pays a portion of the purchase price for MTVN s membership interest in shares of RealNetworks common stock and non-voting stock, RealNetworks other stockholders voting and economic interests in RealNetworks could be diluted and MTVN will become one of RealNetworks significant stockholders.

The value of both the call and put rights are calculated based on the provisions within the limited liability agreement and are impacted by the total appraised value of Rhapsody America. The total call and put value cannot exceed the product of MTVN s percentage ownership and the appraised value of Rhapsody America.

Note 5. Business Combinations

Business Combinations During 2007

Sony NetServices GmbH

On May 15, 2007, the Company acquired all of the outstanding securities of Sony NetServices GmbH (SNS) in exchange for $13.7 million in cash payments, including $902,000 in direct acquisition related costs consisting primarily of professional fees.

SNS is located in Salzburg, Austria and is a provider of end-to-end white label digital music services to mobile operators in Europe. The Company believes that combining SNS assets and technology with its existing business will enhance the Company s digital music offerings in the European market. The results of SNS operations are included in the Company s condensed consolidated financial statements starting from the date of acquisition.

A summary of the preliminary purchase price is as follows (in thousands):

Cash paid at acquisition	$ 12,795
Estimated direct acquisition costs	902
Total	$ 13,697

The aggregate purchase consideration has been allocated to the assets and liabilities acquired, including identifiable intangible assets, based on their respective estimated fair values as summarized below. The respective estimated fair values were determined by management as of the date of acquisition and resulted in excess purchase consideration over the net tangible and identifiable intangible assets acquired of $10.2 million. Goodwill in the amount of $10.2 million is not deductible for tax purposes.

A summary of the preliminary allocation of the purchase price is as follows (in thousands):

Current assets	$ 5,110
Property and equipment	2,351
Intangible assets subject to amortization:	
Technology	1,760
Customer relationships	1,610
Goodwill	10,212

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REALNETWORKS, INC. AND SUBSIDIARIES
NOTES TO UNAUDITED CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (Continued)

Total assets acquired	21,043
Current liabilities	(7,346)
Net assets acquired	$ 13,697

Technology has weighted average estimated useful life of seven years. Customer relationships have weighted average estimated useful lives of nine years. All of the intangible assets are being amortized over their estimated useful lives on a straight line basis.

Pro forma results are not presented as they are not material to the Company s overall unaudited condensed consolidated financial statements.

Exomi Oy

On June 8, 2007, the Company acquired all of the outstanding securities of Exomi Oy (Exomi) in exchange for $11.2 million in cash payments, including $468,000 in direct acquisition related costs consisting primarily of professional fees. The Company may be obligated to pay an additional 3.6 million ($5.1 million at September 30, 2007) over a three-year period, dependent on whether certain performance criteria are achieved. Such amounts are not included in the initial aggregate purchase price and, to the extent earned, will be recorded as goodwill when the performance criteria are achieved. No such payments were accrued during the period ended September 30, 2007.

Exomi is located in Helsinki, Finland and is a provider of short message service (SMS) messaging and gateway products and services with customers primarily in Europe and Latin America. The Company believes that combining Exomi s assets and network with the Company s products and services will enhance its presence in the European and Latin American markets. The results of Exomi s operations are included in the Company s condensed consolidated financial statements starting from the date of acquisition.

A summary of the purchase price is as follows (in thousands):

Cash paid at acquisition	$ 10,745
Estimated direct acquisition costs	468
Total	$ 11,213

The aggregate purchase consideration has been allocated to the assets and liabilities acquired, including identifiable intangible assets, based on their respective estimated fair values as summarized below. The respective estimated fair values were determined by management as of the date of acquisition and resulted in excess purchase consideration over the net tangible and identifiable intangible assets acquired of $2.9 million. Goodwill in the amount of $2.9 million is not deductible for tax purposes.

A summary of the preliminary allocation of the purchase price is as follows (in thousands):

Current assets	$ 5,409
Property and equipment	265
Other long-term assets	109
Intangible assets subject to amortization:	
Customer relationships	3,270
Technology	2,545

Tradenames and trademarks	287
Non-compete agreements	80
Goodwill	2,852
Total assets acquired	14,817
Current liabilities	(1,761)
Net deferred tax liabilities	(1,472)
Other long-term liabilities	(371)
Total liabilities assumed	(3,604)
Net assets acquired	$ 11,213

REALNETWORKS, INC. AND SUBSIDIARIES
NOTES TO UNAUDITED CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (Continued)

Customer relationships have weighted average estimated useful lives of eight years. Technology and tradenames and trademarks have weighted average estimated useful lives of four years. Non-compete agreements have weighted average estimated useful life of one year. All of the intangible assets are being amortized over their estimated useful lives on a straight line basis.

Pro forma results are not presented as they are not material to the Company s overall unaudited condensed consolidated financial statements.

Business Combinations During 2006

WiderThan Co. Ltd.

The Company acquired 99.7% of the outstanding common shares and American Depository Shares of WiderThan Co. Ltd. (WiderThan) during the three months ended December 31, 2006 for a total purchase price of $342.7 million. The results of WiderThan operations are included in the Company s unaudited condensed consolidated financial statements starting from the closing date of October 31, 2006. The Company acquired substantially all of the remaining 0.3% of the outstanding common shares and American Depository Shares of WiderThan during the three months ended June 30, 2007.

Zylom Media Group B.V.

On January 31, 2006, the Company acquired all of the outstanding securities of Zylom Media Group B.V. (Zylom) in exchange for $8.2 million in cash payments, including $293,000 in direct acquisition related costs consisting primarily of professional fees. The Company is also obligated to pay an additional 1.6 million ($2.0 million as of January 31, 2006), to be made in equal payments on the first and second anniversaries of the acquisition date. The Company made the first payment of 0.8 million ($1.1 million) during the six months ended June 30, 2007. Also, under the original purchase agreement, the Company was obligated to pay up to 9.0 million ($10.9 million as of January 31, 2006) over a three-year period, dependent on whether certain performance criteria are achieved. The Company made the first payment of 3.3 million ($4.4 million) during the three months ended March 31, 2007. These amounts were not included in the initial aggregate purchase price and were recorded as goodwill.

The Company modified the purchase agreement on September 27, 2007 to remove the requirement to achieve the performance criteria on the remaining payments of 5.7 million ($8.1 million as of September 30, 2007) since the criteria were either already achieved or expected to be achieved. The remaining 5.7 million was accrued for as of September 30, 2007 and will be paid in two separate payments of 3.2 million and 2.5 million during the first quarter of 2008 and 2009, respectively. These amounts were not included in the initial aggregate purchase price and were recorded as goodwill in the third quarter of 2007 as the amounts are no longer contingent.

Zylom is located in Eindhoven, The Netherlands and is a distributor, developer, and publisher of PC-based games in Europe. The Company believes that combining Zylom s assets and distribution network with the Company s downloadable PC-based games assets and distribution platform will enhance the Company s presence in the European games market. The results of Zylom s operations are included in the Company s condensed consolidated financial statements starting from the date of acquisition.

A summary of the purchase price is as follows (in thousands):

Cash paid at acquisition	$ 7,922
Additional payments related to initial purchase price	2,000
Additional accruals and payments for achievement of performance criteria and modification of the purchase agreement	12,471
Direct acquisition costs	293
Total	$ 22,686

The aggregate purchase consideration has been allocated to the assets and liabilities acquired, including identifiable intangible assets, based on their respective estimated fair values as summarized below. The respective estimated fair values were determined by management as of the date of acquisition and resulted in excess purchase consideration over the net tangible and identifiable intangible assets acquired of $20.6 million. Goodwill in the amount of $20.6 million is not deductible for tax purposes.

A summary of the allocation of the purchase price is as follows (in thousands):

Current assets	$ 1,830
Property and equipment	166

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REALNETWORKS, INC. AND SUBSIDIARIES
NOTES TO UNAUDITED CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (Continued)

Intangible assets subject to amortization:	
Distributor and customer relationships	1,290
Technology and games	570
Tradenames and trademarks	560
Non-compete agreements	180
Goodwill	20,639
Total assets assumed	25,235
Current liabilities	(1,781)
Net deferred tax liabilities	(768)
Total liabilities assumed	(2,549)
Net assets acquired	$ 22,686

Distributor and customer relationships have weighted average estimated useful lives of five years. Technology, games, tradenames, and trademarks have weighted average estimated useful lives of three years. Non-compete agreements have weighted average estimated useful life of four years. All of the intangible assets are being amortized over their estimated useful lives on a straight line basis.

Pro forma results are not presented as they are not material to the Company s overall unaudited condensed consolidated financial statements.

REALNETWORKS, INC. AND SUBSIDIARIES
NOTES TO UNAUDITED CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (Continued)

Note 6. Cash, Cash Equivalents, Trading Securities, Short-Term Investments, and Restricted Cash Equivalents

Cash, cash equivalents, trading securities, short-term investments, and restricted cash equivalents as of September 30, 2007 consist of the following (in thousands):

	Amortized Cost	Gross Unrealized Gains	Gross Unrealized Losses	Estimated Fair Value
Cash and cash equivalents:				
Cash	$ 67,433	$	$	$ 67,433
Money market mutual funds	99,205			99,205
Corporate notes and bonds	31,100			31,100
Total cash and cash equivalents	197,738			197,738
Trading securities:				
Money market mutual fund	270,000	5,426		275,426
Available-for-sale investments:				
Corporate notes and bonds	42,673	14	(527)	42,160
U.S. Government agency securities	74,987	52		75,039
Total available-for-sale investments	117,660	66	(527)	117,199
Total short-term investments	387,660	5,492	(527)	392,625
Total cash, cash equivalents, trading securities, and short-term investments	$ 585,398	$ 5,492	$ (527)	$ 590,363
Restricted cash equivalents	$ 15,500	$	$	$ 15,500

Cash, cash equivalents, short-term investments, and restricted cash equivalents as of December 31, 2006 consist of the following (in thousands):

	Amortized Cost	Gross Unrealized Gains	Gross Unrealized Losses	Estimated Fair Value
Cash and cash equivalents:				
Cash	$ 108,415	$	$	$ 108,415
Money market mutual funds	231,634			231,634

Corporate notes and bonds	182,184			182,184
U.S. Government agency securities	2,999			2,999
Total cash and cash equivalents	525,232			525,232
Short-term investments:				
U.S. Government agency securities	153,520	188	(20)	153,688
Total short-term investments	153,520	188	(20)	153,688
Total cash, cash equivalents, and short-term investments	$ 678,752	$ 188	$ (20)	$ 678,920
Restricted cash equivalents	$ 17,300	$	$	$ 17,300

At September 30, 2007 and December 31, 2006, restricted cash equivalents represent cash equivalents pledged as collateral against two letters of credit for a total of $15.5 million and $17.3 million, respectively, in connection with two lease agreements.

Realized gains or losses on sales of available-for-sale securities for the three and nine months ended September 30, 2007 and 2006 were not significant.

Unrealized gain on trading securities for the nine months ended September 30, 2007 of $5.4 million is included in interest and other, net in the unaudited condensed consolidated statements of operations and comprehensive income. The Company did not own any trading securities during 2006.

Changes in estimated fair values of short-term investments are primarily related to changes in interest rates and are considered to be temporary in nature.

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REALNETWORKS, INC. AND SUBSIDIARIES
NOTES TO UNAUDITED CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (Continued)

The contractual maturities of available-for-sale investments at September 30, 2007 are as follows (in thousands):

	Amortized Cost	Estimated Fair Value
Within one year	$ 89,665	$ 89,718
Between one year and five years	27,995	27,481
Total available-for-sale investments	$ 117,660	$ 117,199

Note 7. Allowance for Doubtful Accounts Receivable and Sales Returns

Activity in the allowance for doubtful accounts receivable and sales returns is as follows (in thousands):

	Allowance For	
	Doubtful Accounts Receivable	Sales Returns
Balances, December 31, 2006	$ 1,101	$ 1,389
Additions charged to expenses/revenue	216	2,977
Amounts written off	(275)	(2,996)
Balances, September 30, 2007	$ 1,042	$ 1,370

As of September 30, 2007 and December 31, 2006 one international customer accounted for 23% and 25%, respectively, of trade accounts receivable. In addition, one domestic customer accounted for 16% of trade accounts receivable as of September 30, 2007. The international customer mentioned above accounted for 13% and 13% of total revenue during the three and nine months ended September 30, 2007, respectively. No one customer accounted for more than 10% of total revenue during the three and nine months ended September 30, 2006.

Note 8. Equity Investments

As of September 30, 2007 and December 31, 2006, the carrying value of equity investments in publicly traded companies primarily relates to J-Stream Inc. (J-Stream), a Japanese media services company, which the Company owns approximately 10.6% of the outstanding shares. These equity investments are accounted for as available-for-sale and the increase over the cost basis, net of income taxes, is reflected as a component of accumulated other comprehensive income.

Summary of equity investments is as follows (in thousands):

	September 30, 2007		December 31, 2006	
	Cost	Carrying Value	Cost	Carrying Value
Publicly traded investments	$ 913	$ 6,880	$ 913	$ 20,235
Privately held investments	1,552	934	1,879	2,414
Total equity investments	$ 2,465	$ 7,814	$ 2,792	$ 22,649

Note 9. Other Intangible Assets

Other intangible assets at September 30, 2007 consist of the following (in thousands):

	Gross Amount	Accumulated Amortization	Net
Customer relationships	$ 80,284	$ 12,084	$ 68,200
Developed technology	43,522	16,102	27,420
Patents, trademarks and tradenames	13,651	4,078	9,573
Service contracts and other	6,867	2,379	4,488
Total other intangible assets	$ 144,324	$ 34,643	$ 109,681

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REALNETWORKS, INC. AND SUBSIDIARIES
NOTES TO UNAUDITED CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (Continued)

Other intangible assets at December 31, 2006 consist of the following (in thousands):

	Gross Amount	Accumulated Amortization	Net
Customer relationships	$ 73,061	$ 3,386	$ 69,675
Developed technology	36,891	9,981	26,910
Patents, trademarks and tradenames	7,114	2,226	4,888
Service contracts and other	4,680	1,044	3,636
Total other intangible assets	$ 121,746	$ 16,637	$ 105,109

Amortization expense related to other intangible assets during the three and nine months ended September 30, 2007 was $6.1 million and $17.5 million, respectively. Amortization expense related to other intangible assets during the three and nine months ended September 30, 2006 was $464,000 and $1.6 million, respectively.

As of September 30, 2007, estimated future amortization of other intangible assets is as follows (in thousands):

2007 (remaining three months)	$ 6,940
2008	26,035
2009	23,175
2010	19,014
2011	12,066
Thereafter	22,451
Total	$ 109,681

Note 10. Goodwill

Changes in goodwill are as follows (in thousands):

Balance, December 31, 2006	$ 309,122
Increases for accruals and payments related to the acquisition of Zylom	12,471
Adjustments to purchase price for WiderThan	(1,296)
Purchase of additional shares of WiderThan	1,160
Increase due to current year acquisitions	12,962
Effects of foreign currency translation	2,987
Balance, September 30, 2007	$ 337,406

Note 11. Accrued and Other Liabilities

Accrued and other liabilities consist of (in thousands):

	September 30, 2007	December 31, 2006
Royalties and other fulfillment costs	$ 33,746	$ 29,968

Employee compensation, commissions and benefits		22,348		25,244
Income taxes payable		9,256		8,455
Sales, VAT and other taxes payable		13,854		13,364
Legal fees and contingent legal fees		3,062		4,075
Accrued charitable donations		281		2,048
Other		36,581		21,174
Total	$	119,128	$	104,328

Note 12. Loss on Excess Office Facilities

In October 2000, the Company entered into a 10-year lease agreement for additional office space located near its corporate headquarters in Seattle, Washington. Due to a subsequent decline in the market for office space in Seattle and the Company s re-assessment of its facilities requirements in 2001, the Company accrued for estimated future losses on excess office facilities. The Company has accrued additional estimates of future losses on this facility since 2001 based on changes in market conditions, securing tenants at rates lower than those used in the original estimate, and certain other factors.

REALNETWORKS, INC. AND SUBSIDIARIES
NOTES TO UNAUDITED CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (Continued)

During the three months ended March 31, 2006 the Company recorded $738,000 of additional loss due to building operating expenses that are not expected to be recovered under the terms of the existing sublease arrangements. The Company did not identify any factors which caused it to revise its estimates during the period ended September 30, 2007. The estimated loss as of September 30, 2007 consists of $8.5 million of sublease income under existing sublease arrangements.

A summary of activity for accrued loss on excess office facilities is as follows (in thousands):

Accrued loss on excess office facilities, December 31, 2006	$ 14,501
Less amounts paid on accrued loss on excess office facilities, net of sublease income	(3,540)
Accrued loss on excess office facilities, September 30, 2007	10,961
Less current portion	3,398
Accrued loss on excess office facilities, non-current portion	$ 7,563

Note 13. Repurchase of Common Stock

In April 2006, the Company s Board of Directors authorized a share repurchase program of up to an aggregate of $100.0 million of the Company s outstanding common stock. During the three months ended March 31, 2007, the Company purchased 9.8 million shares at an average cost of $7.99 per share for an aggregate value of $78.5 million. No amounts remained authorized for repurchase under the repurchase program as of March 31, 2007.

In May 2007, the Board of Directors of the Company authorized a new share repurchase program for the repurchase of up to an aggregate of $100.0 million of the Company s outstanding common stock. Under this plan the Company purchased 4.8 million shares at an average cost of $7.07 per share for an aggregate value of $34.2 million during the three months ended September 30, 2007. The Company purchased 8.4 million shares at an average cost of $7.60 per share for an aggregate value of $63.7 million during the nine months ended September 30, 2007 under this plan. As of September 30, 2007, $36.4 million remained authorized for repurchase under the May 2007 repurchase program.

Note 14. Earnings Per Share

Basic net income per share is computed by dividing net income by the weighted average number of common shares outstanding during the period. Diluted net income per share is computed by dividing net income by the weighted average number of common and dilutive potential common shares outstanding during the period. Share count used to compute basic and diluted net income per share is calculated as follows (in thousands):

	Three Months Ended September 30,		Nine Months Ended September 30,	
	2007	**2006**	**2007**	**2006**
Weighted average common shares outstanding used to compute basic net income per share	149,667	160,578	154,670	160,466
Dilutive potential common shares:				
Stock options and restricted stock	2,677	7,585	4,420	7,335
Convertible debt	10,750	10,750	10,750	10,750
Shares used to compute diluted net income per share	163,094	178,913	169,840	178,551

During the three and nine months ended September 30, 2007, 27.8 million and 19.2 million, respectively, shares of common stock potentially issuable from stock options are excluded from the calculation of diluted net income per share because of their antidilutive effect. During the three and nine months ended September 30, 2006, 9.2 million and 7.6 million, respectively, shares of common stock potentially issuable from stock options are excluded from the calculation of diluted net income per share because of their antidilutive effect.

Note 15. Commitments and Contingencies

Borrowing Arrangements. The Company s subsidiary, WiderThan, has entered into three lines of credit with three Korean domestic banks with an aggregate maximum available limit of $4.3 million at interest rates ranging primarily from 1.3% to 1.63% over the rate earned on the underlying deposits. WiderThan has entered into a separate line of credit with a Korean domestic bank with maximum available limit of $1.1 million bearing interest at 6.0%. During the nine months ended September 30, 2007 the Company did not draw on these lines of credit and there were no balances outstanding as of September 30, 2007 and December 31, 2006.

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REALNETWORKS, INC. AND SUBSIDIARIES
NOTES TO UNAUDITED CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (Continued)

The Company s subsidiary, WiderThan India Pvt. Ltd., has entered into two separate lines of credit with a Korean bank in India with maximum available limit of $122,000 bearing interest at 10.25%. At September 30, 2007 the Company had $0.1 million outstanding under these arrangements which is included in accrued and other liabilities in the accompanying unaudited condensed consolidated balance sheets.

The Company s subsidiary, WiderThan, uses corporate charge cards issued by a Korean domestic bank with an aggregate line of credit of up to $5.4 million. The charged amounts are generally payable in the following month depending on the billing cycle and are included in accounts payable in the accompanying unaudited condensed consolidated balance sheets. In general, the term of the arrangement is one year, with automatic renewal in April of each year. The arrangement may be terminated in writing by mutual agreement between the bank and the Company. The Company is not subject to any financial or other restrictive covenants under the terms of this arrangement.

The Company s subsidiary, WiderThan, has a letter of credit of up to $5.0 million with a Korean domestic bank for importing goods, with one-year maturity (renewable every April), and bears interest at 2.5% over the London Inter-Bank Offer Rate (LIBOR). Borrowings under this letter of credit are collateralized by import documents and goods being imported under such documentation. To the extent that the Company has any outstanding balance, the Company is subject to standard covenants and notice requirements under the terms of this facility, such as covenants to consult with the lender prior to engaging in certain events, which include, among others, mergers and acquisitions or sale of material assets or to furnish certain financial and other information. The Company is not, however, subject to any financial covenant requirements or other restrictive covenants that restrict the Company s ability to utilize this facility or to obtain financing elsewhere. During the nine months ended September 30, 2007 the Company did not draw on the letter of credit and there was no balance outstanding as of September 30, 2007 and December 31, 2006.

The Company s subsidiary, WiderThan, has purchased guarantees amounting to $0.6 million from Seoul Guarantee Insurance which guarantees payments for one year under certain supply contracts the Company has with a customer in Korea.

Litigation. In August 2005, a lawsuit was filed against the Company in the U.S. District Court for the District of Maryland by Ho Keung Tse, an individual residing in Hong Kong. The suit alleges that certain of the Company s products and services infringe the plaintiff s patent relating to the distribution of digital files, including sound tracks, music, video and executable software in a manner which restricts unauthorized use. The plaintiff seeks to enjoin the Company from the allegedly infringing activity and to recover treble damages for the alleged infringement. The Company s co-defendants were granted a motion to transfer the lawsuit from the District of Maryland to the Northern District of California in 2006, and on October 4, 2007, the district court for the Northern District of California granted the motion to stay the case pending reexamination of the proceedings. The Company disputes the plaintiff s allegations in the action and intends to vigorously defend itself.

In June 2005, an association representing certain music producers in the Republic of Korea sent the Company s WiderThan subsidiary a notice demanding payment of fees for the Company s use in its carrier application services since July 2004 of songs over which the association claims it holds certain rights. The Company used, and paid fees for, these songs under licensing agreements with independent music label companies and such agreements contain representations that these music label companies are the rightful, legal owner of the songs. Nevertheless, the association is claiming that it is the rightful owner. The Company is currently investigating the merit of the association s claims and the scope of any potential liability. Under the Company s licensing agreements, the independent music label companies are required to indemnify the Company for any losses resulting from their breach of representations. Should the Company become liable to the association in this matter, the Company intends to exercise its indemnity rights under its licensing agreements with the independent music label companies.

In June 2003, a lawsuit was filed against the Company and Listen.com, Inc. (Listen) in federal district court for the Northern District of Illinois by Friskit, Inc. (Friskit), alleging that certain features of the Company s and Listen s products and services willfully infringe certain patents relating to allowing users to search for streaming media files, to create custom playlists, and to listen to the streaming media file sequentially and continuously. Friskit sought to enjoin the Company from the alleged infringing activity and to recover treble damages from the alleged infringement.

The court granted the Company s motion for summary judgment in July 2007 and invalidated all claims on grounds of obviousness. Friskit filed a notice of appeal in September 2007.

In December 2003, the Company filed suit against Microsoft Corporation (Microsoft) in the U.S. District Court for the Northern District of California, pursuant to U.S. and California antitrust laws, alleging that Microsoft has illegally used its monopoly power to restrict competition, limit consumer choice, and attempt to monopolize the field of digital media. On October 11, 2005, the Company

REALNETWORKS, INC. AND SUBSIDIARIES
NOTES TO UNAUDITED CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (Continued)

and Microsoft entered into a settlement agreement pursuant to which the Company agreed to settle all antitrust disputes worldwide with Microsoft, including the U.S. litigation. Upon settlement of the legal disputes, the Company and Microsoft entered into two commercial agreements that provide for collaboration in digital music and casual games. The combined contractual payments related to the settlement agreement and the two commercial agreements to be made by Microsoft to the Company over the terms of the agreements are $761.0 million. The Company had received such payments in full as of March 31, 2007. The Company recorded a gain of $60.7 million during the three months ended March 31, 2007 that is included in antitrust litigation benefit, net in the unaudited condensed consolidated statement of operations and comprehensive income. For the three and nine months ended September 30, 2007, no gain and a gain of $60.7 million was recorded, respectively. A gain of $61.9 million and $160.0 million was recorded during the three and nine months ended September 30, 2006, respectively. These amounts are included within the unaudited condensed consolidated statement of operations and comprehensive income as antitrust litigation benefit, net .

In April 2007, the Copyright Royalty Board (CRB) issued a decision setting new royalty rates for the use of sound recordings in Internet radio from 2006 through 2010. These rates are still under appeal and are subject to industry-wide settlement negotiations, some of which the Company is a participant. The appeal or other industry settlement may result in higher rates or other terms that are unfavorable to the Company whether or not the Company directly participates in the settlement.

From time to time the Company is, and expects to continue to be, subject to legal proceedings and claims in the ordinary course of its business, including employment claims, contract-related claims, and claims of alleged infringement of third-party patents, trademarks and other intellectual property rights. These claims, including those described above, even if not meritorious, could force the Company to spend significant financial and managerial resources. The Company is not aware of any legal proceedings or claims that the Company believes will have, individually or taken together, a material adverse effect on the Company s business, prospects, financial condition or results of operations. However, the Company may incur substantial expenses in defending against third-party claims and certain pending claims are moving closer to trial. The Company expects that its potential costs of defending these claims may increase as the disputes move into the trial phase of the proceedings. In the event of a determination adverse to the Company, the Company may incur substantial monetary liability, and/or be required to change its business practices. Either of these could have a material adverse effect on the Company s financial position and results of operations.

Note 16. Segment Information

SFAS No. 131, *Disclosures about Segments of an Enterprise and Related Information*, establishes standards for the way in which public companies disclose certain information about operating segments in their financial reports. After the formation of Rhapsody America in August 2007, the Company has defined three reportable segments consistent with SFAS No. 131, based on factors such as how the Company manages its operations and how its Chief Operating Decision Maker reviews results. The Company s Chief Operating Decision Maker is considered to be the Company s CEO Staff (CEOS), which is comprised of the Company s Chief Executive Officer, Chief Financial Officer, and Executive and Senior Vice Presidents. The CEOS reviews financial information presented on both a consolidated basis and on a business segment basis, accompanied by disaggregated information about products and services and geographical regions for purposes of making decisions and assessing financial performance. The CEOS reviews discrete financial information regarding profitability of the Company s Music, Consumer and Technology Products and Solutions segments and, therefore, the Company reports these as operating segments as defined by SFAS No. 131.

With the formation of the Rhapsody America in August of 2007, the Company determined it has three reportable segments: Music, Consumer, and Technology Products and Solutions. In conjunction with the formation of Rhapsody America, the Company changed the method in which corporate overhead and general and administrative costs are allocated. The Company was able to use the new allocation methodology for amounts incurred since January 1, 2007. However, the Company does not have data available to perform the allocation of amounts incurred prior to January 1, 2007. Therefore comparative data from 2006 is not presented with the exception of Revenue which is not affected by

the allocations. In addition, the Company deemed it impracticable to perform the allocation under the old method for the current period to provide comparative information due to the complexity of the calculations required. The accounting policies used to derive segment results are generally the same as those described in Note 1.

The Music segment includes the operations of Rhapsody America as well as our other music business. The revenue and costs from these businesses include: digital media subscription services such as Rhapsody and RadioPass; and sales of digital music and advertising. These products and services are sold and provided primarily through the Internet and the Company charges customers credit cards at the time of sale. Billing periods for subscription services typically occur monthly, quarterly or annually, depending on the service purchased.

The Consumer segment primarily includes revenue and costs from: the sale of individual games through the Company s RealArcade service and its Games related websites; the Company s GamePass and FunPass subscription service; the Company s SuperPass and stand-alone premium video subscription services; RealPlayer Plus and related products; sales and distribution of third-

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REALNETWORKS, INC. AND SUBSIDIARIES
NOTES TO UNAUDITED CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (Continued)

party software products; and all advertising other than that related directly to the Company s Music business. These products and services are sold and provided primarily through the Internet and the Company charges customers credit cards at the time of sale. Billing periods for subscription services typically occur monthly, quarterly or annually, depending on the service purchased.

Technology Products and Solutions segment includes revenue and costs from: sales of ringback tone, music-on-demand, video-on-demand, messaging, and information services; sales of media delivery system software, including Helix system software and related authoring and publishing tools, both directly to customers and indirectly through original equipment manufacturer (OEM) channels; support and maintenance services sold to customers who purchase software products; broadcast hosting services; and consulting and professional services that are offered to customers. These products and services are primarily sold to corporate customers.

Amounts that are not included within the above segment descriptions are shown below as Reconciling Amounts. Included within these amounts are items such as interest income and net Antitrust litigation benefit.

Segment income (loss) before income taxes for the three months ended September 30, 2007 is as follows (in thousands):

	Music	Consumer	Technology Products and Solutions	Reconciling Amounts	Consolidated
Net revenue	$ 37,658	$ 54,166	$ 53,271	$	$ 145,095
Cost of revenue	20,891	10,326	25,427		56,644
Gross profit	16,767	43,840	27,844		88,451
Other operating expenses	33,426	36,782	33,428	201	103,837
Operating income (loss)	(16,659)	7,058	(5,584)	(201)	(15,386)
Total non-operating income, net	14,412			7,328	21,740
Income (loss) before income taxes	$ (2,247)	$ 7,058	$ (5,584)	$ 7,127	$ 6,354

Segment income (loss) before income taxes for the nine months ended September 30, 2007 is as follows (in thousands):

	Music	Consumer	Technology Products and Solutions	Reconciling Amounts	Consolidated
Net revenue	$ 108,586	$ 155,393	$ 146,759	$	$ 410,738
Cost of revenue	59,570	28,890	63,326		151,786
Gross profit	49,016	126,503	83,433		258,952
Other operating expenses	82,412	104,503	97,062	(58,205)	225,772

Operating income (loss)	(33,396)	22,000	(13,629)	58,205	33,180
Total non-operating income, net	14,412			25,447	39,859
Income (loss) before income taxes	$ (18,984)	$ 22,000	$ (13,629)	$ 83,652	$ 73,039

Net revenue by segment compared to the same periods in 2006 is as follows (in thousands):

	Three Months Ended September 30,		**Nine Months Ended September 30,**	
	2007	**2006**	**2007**	**2006**
Music	$ 37,658	$ 30,375	$ 108,586	$ 89,411
Consumer	54,166	52,122	155,393	145,339
Technology Products and Services	53,271	11,179	146,759	34,937
Total net revenue	$ 145,095	$ 93,676	$ 410,738	$ 269,687

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REALNETWORKS, INC. AND SUBSIDIARIES
NOTES TO UNAUDITED CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (Continued)

The Company s customers consist primarily of end users located in the U.S., Republic of Korea, and various foreign countries. Revenue by geographic region is as follows (in thousands):

	Three Months Ended September 30,		Nine Months Ended September 30,	
	2007	2006	2007	2006
United States	$ 91,281	$ 69,433	$ 263,870	$ 201,675
Europe	22,150	15,895	60,382	45,725
Republic of Korea	20,591		57,875	
Rest of the World	11,073	8,348	28,611	22,287
Total net revenue	$ 145,095	$ 93,676	$ 410,738	$ 269,687

Long-lived assets, consisting of equipment, software, leasehold improvements, other intangible assets, and goodwill by geographic region are as follows (in thousands):

	September 30, 2007	December 31, 2006
United States	$ 180,731	$ 172,846
Republic of Korea	245,423	256,032
Europe	66,972	26,807
Rest of the World	8,118	6,289
Total long-lived assets	$ 501,244	$ 461,974

Net assets by geographic location are as follows (in thousands):

	September 30, 2007	December 31, 2006
United States	$ 585,289	$ 621,532
Republic of Korea	237,117	314,106
Europe	72,973	26,298
Rest of the World	7,774	7,830
Total net assets	$ 903,153	$ 969,766

Goodwill is assigned to the Company s segments as follows (in thousands):

	September 30, 2007	December 31, 2006
Music	$ 37,029	$ 37,029

Consumer		110,093		94,968
Technology products and solutions		190,284		177,125
Total goodwill	$	337,406	$	309,122

Note 17. Related Party Transactions

Transactions with MTVN. As part of the formation of Rhapsody America, MTVN contributed a $230 million five-year note payable in partial consideration for acquiring MTVN s interest in the venture. Rhapsody America is obligated to purchase $230 million in advertising and related integrated marketing on MTVN network properties over a five-year period. During the period ended September 30, 2007, Rhapsody America received $8.0 million in cash as a note payment and has spent $7.7 million in advertising with MTVN.

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REALNETWORKS, INC. AND SUBSIDIARIES
NOTES TO UNAUDITED CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (Continued)

MTVN provides various support services directly to Rhapsody America for which it bills the venture directly. Included within the support services are items such as facilities, personnel and overhead which are allocated based on various measures depending on the service provided, including employee headcount, or number of users of a service. MTVN directly billed $0.3 million to Rhapsody America for these services rendered during the period ended September 30, 2007. This amount is included in the consolidated financial statements within the payable to related party of $7.7 million. The total related party payable was $8.0 million as of September 30, 2007.

The Company also agreed to grant stock options to acquire shares of RealNetworks, Inc. common stock to Rhapsody America employees as part of the venture with MTVN and has included the expense associated with these options in its statement of operations. MTVN s share of the expense associated with the stock options granted to Rhapsody America employees is calculated based on its ownership percentage and is billed directly by the Company to MTVN under a separate agreement. The Company has not charged any amount to MTVN related to stock options since the formation of the venture but expects amounts to be recorded in the future.

RealNetworks also provides various support services, including items such as facilities, information technology systems, personnel and overhead, directly to Rhapsody America. The allocation of other support service costs are based on various measures depending on the service provided, including employee headcount, time employees spend on providing services to Rhapsody America, server usage or number of users of a service. The allocations of these costs are billed directly to Rhapsody America. RealNetworks has treated these allocations as intercompany transactions and all such transactions were eliminated in consolidation.

Note 18. Subsequent Event

On September 21, 2007, the Company entered into a merger agreement with the shareholders of Game Trust Inc. (Game Trust), a privately-held company based in New York, to acquire all the shares of Game Trust. The closing of the merger transaction occurred on October 1, 2007, at which time Game Trust became a wholly-owned subsidiary of RealNetworks. Game Trust provides a scalable and secure infrastructure for community and commerce applications in online casual games. RealNetworks paid approximately $20 million in cash in the merger transaction, and management is currently assessing the purchase price allocation. The acquisition is part of RealNetworks strategy to grow its consumer base on a worldwide basis by adding community elements to its existing games service and platform.

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Item 2. Management s Discussion and Analysis of Financial Condition and Results of Operations

This Quarterly Report on Form 10-Q and the documents incorporated herein by reference contain forward-looking statements that have been made pursuant to the provisions of the Private Securities Litigation Reform Act of 1995. These forward-looking statements are based on current expectations, estimates, and projections about RealNetworks industry, products, management s beliefs, and certain assumptions made by management. Words such as anticipates, expects, intends, plans, believes, seeks, estimates, and similar expressions are intended to identify forward-lo statements. Forward-looking statements include statements with respect to:

future revenues, income taxes, net income per diluted share, acquisition costs and related amortization, and other measures of results of operations;

the effects of acquiring WiderThan, Sony NetServices GmbH (SNS), and Exomi Oy (Exomi), including our position as a technology services provider for leading wireless carriers;

plans, strategies and expected opportunities for growth, increased profitability and innovation in 2007 and future years;

the expected growth and profitability of our Technology Products and Solutions business;

the governance, management, accounting and integration of our Rhapsody America venture;

the dilutive impact on our shareholders if the call or put rights contained in the limited liability agreement for Rhapsody America are exercised and result in the issuance of additional shares of our common stock.

the financial performance and growth of our Games business, including future international growth;

the migration of our Media Software and Services businesses from general purpose subscription businesses toward premium services and free-to-consumer services, the popularity of the RealPlayer and our expected introduction of new products and innovations in our Media Software and Services business;

our ability to grow our Music business, including opportunities for us to become the platform of choice for the Consumer Electronics industry, the integration of our Rhapsody DNA into the digital devices of an expanding list of partners and our plans to introduce additional innovations;

the effect of future interoperability on our Music business, the significance of growth opportunities in the digital music market and our expectations for short-term progress and long-term success in our Music business;

our financial position, planned capital expenditures, and the availability of capital resources;

our expectations regarding acquisition activity in 2007 and our focus on the integration of completed acquisitions;

future competition; and

the degree of seasonality in our revenue.

These statements are not guarantees of future performance and actual actions or results may differ materially. These statements are subject to certain risks, uncertainties and assumptions that are difficult to predict, including those noted in the documents incorporated herein by reference. Particular attention should also be paid to the cautionary language in section Item 1 of Part II entitled Legal Proceedings and Item 1A of Part II entitled Risk Factors. RealNetworks undertakes no obligation to update publicly any forward-looking statements as a result of new information, future events or otherwise, unless required by law. Readers should, however, carefully review the risk factors included in other reports or documents filed by RealNetworks from time to time with the Securities and Exchange Commission, particularly the Quarterly Reports on Form 10-Q and any Current Reports on Form 8-K.

Overview

We are a leading creator of digital media services and software. Consumers use our services and software, such as Rhapsody, RealArcade, and RealPlayer to find, play, purchase, and manage free and premium digital content, including music, games, and video. Broadcasters, cable and wireless communication companies, media companies and enterprises, such as Verizon Wireless and AT&T in the U.S. and SK Telecom in the Republic of Korea (South Korea), use our digital media applications and services to create, secure and deliver digital media to PCs, mobile phones, portable music players and other consumer electronics devices and to provide entertainment services to their customers.

Our strategy is to continue to leverage our Internet and mobile media technology, business partnerships and worldwide user base to increase our sales of digital media products, services and advertising in order to build a sustainable and profitable global business. We intend to continue our strategy of expanding our products and services

beyond the PC to mobile devices and to create compelling digital media and entertainment experiences on a variety of devices. We also intend to use our strong cash position to continue to seek acquisition opportunities to further our strategic initiatives and to enhance our competitive position.

In recent years, we have focused our efforts on growing our consumer businesses through both internal initiatives and strategic acquisitions of businesses and technologies. We have also increased our focus on free-to-consumer products and services, such as our Rhapsody.com website and our introduction of downloadable games containing in-game advertising. These products and services generate advertising revenue and are also designed to increase the exposure of our paid digital music and games products and services to consumers. As a result, combined revenue in our Music and Consumer segments grew 11% from both the three and nine months ended September 30, 2006.

Revenue in 2007 from our Technology Products and Solutions segment grew significantly compared to 2006, increasing by 377%. This increase was driven primarily by our acquisitions of WiderThan in October 2006 and SNS and Exomi during the second quarter of 2007. WiderThan delivers integrated digital entertainment solutions to communications service providers worldwide. WiderThan s applications, content, and services enable wireless carriers to provide a broad range of mobile entertainment to their subscribers, including ringback tones, music-on-demand, mobile games, ringtones, messaging, and information services. We expect revenue in our Technology Products and Solutions segment to grow as a percentage of total revenue and in absolute dollars during 2007 as it will include a full year of the results of operations of WiderThan. We also believe that WiderThan s technology platform and history of wireless innovation will assist our strategy of moving our content and services beyond the PC to multiple platforms.

On May 15, 2007, we acquired all of the outstanding securities of SNS for $13.7 million in cash payments, including $902,000 in direct acquisition related costs. SNS is located in Salzburg, Austria and is a provider of end-to-end white label digital music services to mobile operators in Europe. We believe that combining SNS assets and technology with our existing business will enhance our digital music offerings in the European market.

On June 8, 2007, we acquired all of the outstanding securities of Exomi in exchange for $11.2 million in cash payments, including $468,000 in direct acquisition related costs. We may be obligated to pay an additional 3.6 million ($5.1 million at September 30, 2007) over a three-year period, dependent on whether certain performance criteria are achieved. Exomi is located in Helsinki, Finland and is a provider of short message service (SMS) messaging and gateway products and services with customers primarily in Europe and Latin America. We believe that combining Exomi s assets and network with our products and services will enhance our presence in the Latin American market.

On August 20, 2007, we and MTVN agreed to create Rhapsody America to jointly own and operate a business-to-consumer digital audio music service. The Rhapsody America music service will be a free, advertising-supported and/or subscription-based service that will offer a combination of permanent downloads, conditional downloads and on demand streaming services. The elements necessary to create, build, operate and grow the Rhapsody America music service were either contributed, licensed to, or furnished by the way of services provided to Rhapsody America by each of MTVN and Real, through a series of related agreements. Rhapsody America will operate primarily in the United States, although the parties are not precluded from expanding the territory in the future by mutual agreement.

We manage our business, and correspondingly report segment revenue and profit (loss), based on three segments: Music, Consumer and Technology Products and Solutions, each of which is described further below under *Revenue by Segment* and *Costs of Revenue by Segment* .

Critical Accounting Policies and Estimates

The preparation of our financial statements requires us to make estimates and assumptions that affect the reported amounts of assets and liabilities and disclosure of contingent assets and liabilities at the date of the financial statements and the reported amounts of revenue and expenses during the reported period. Our critical accounting policies and estimates are as follows:

Revenue recognition;

Estimating music publishing rights and music royalty accruals;

Recoverability of deferred costs;

Estimating allowances for doubtful accounts and sales returns;

Estimating losses on excess office facilities;

Determining whether declines in the fair value of investments are other-than-temporary and estimating fair market value of investments in privately held companies;

Valuation of other intangible assets;

Valuation of goodwill;

Stock-based compensation;

Accounting for gains on sale of subsidiary stock; and

Accounting for income taxes.

Revenue Recognition. We recognize revenue in accordance with the following authoritative literature: AICPA Statement of Position (SOP) No. 97-2, *Software Revenue Recognition;* SOP No. 98-9, Software Revenue Recognition with Respect to Certain *Arrangements; SOP No. 81-1, Accounting for Performance of Construction-Type and Certain Production-Type Contracts;* Securities and Exchange Commission (SEC) Staff Accounting Bulletin (SAB) No. 104, Revenue Recognition in Financial Statements; Financial Accounting Standards Board s Emerging Issues Task Force (EITF) Issue No. 00-21, Revenue Arrangements with Multiple Deliverables; and EITF Issue No. 99-19, Reporting Revenue Gross as a Principal versus Net as an Agent. Generally we recognize revenue when there is persuasive evidence of an arrangement, the fee is fixed or determinable, the product or services have been delivered and collectibility of the resulting receivable is reasonably assured.

Consumer subscription products are paid in advance, typically for monthly, quarterly or annual periods. Subscription revenue is recognized ratably over the related subscription period. Revenue from sales of downloaded individual tracks, albums and games are recognized at the time the music or game is made available, digitally, to the end user.

We recognize revenue under the residual method for multiple element software arrangements when VSOE exists for all of the undelivered elements of the arrangement, but does not exist for one or more of the delivered elements in the arrangement, under SOP No. 97-2. Under the residual method, at the outset of the arrangement with a customer, we defer revenue for the fair value of the arrangement s undelivered elements such as Post Contract Support (PCS), and recognize revenue for the remainder of the arrangement fee attributable to the elements initially delivered, such as software licenses. VSOE for PCS is established on standard products for which no installation or customization is required based upon amount charged when PCS is sold separately. For multiple element software arrangements involving significant production, modification, or customization of the software, which are accounted for in accordance with the provisions of SOP No. 81-1, VSOE for PCS is established if customers have an optional renewal rate specified in the arrangement and the rate is substantive.

We have arrangements whereby customers pay one price for multiple products and services and in some cases, involve a combination of products and services. For arrangements with multiple deliverables, revenue is recognized upon the delivery of the individual deliverables in accordance with EITF Issue No. 00-21. In the event that there is no objective and reliable evidence of fair value of the delivered items, the revenue recognized upon delivery is the total arrangement consideration less the fair value of the undelivered items. We apply significant judgment in establishing the fair value of multiple elements within revenue arrangements.

We recognize revenue on a gross or net basis, in accordance with EITF Issue No. 99-19. In most arrangements, we contract directly with end user customers, are the primary obligor and carry all collectibility risk. In such arrangements we report revenue on a gross basis. In some cases, we utilize third-party distributors to sell products or services directly to end user customers and carry no collectibility risk. In such instances we report revenue on a net basis.

Revenue generated from advertising appearing on our websites and from advertising included in our products is recognized as revenue as the delivery of the advertising occurs.

Music Publishing Rights and Music Royalty Accruals. We must make estimates of amounts owed related to our music publishing rights and music royalties for our domestic and international music services. Material differences may result in the amount and timing of our expense for any period if management made different judgments or utilized different estimates. Under copyright law, we may be required to pay licensing fees for digital sound recordings and compositions we deliver. Copyright law generally does not specify the rate and terms of the licenses, which are determined by voluntary negotiations among the parties or, for certain compulsory licenses where voluntary negotiations are unsuccessful, by arbitration. There are certain geographies and agencies for which we have not yet completed negotiations with regard to the royalty rate to be applied to the current or historic sales of our digital music offerings. Our estimates are based on contracted or statutory rates, when established, or management s best estimates based on facts and circumstances regarding the specific music services and agreements in similar geographies or with similar agencies. While we base our estimates on historical experience and on various other assumptions that management believes to be reasonable under the circumstances, actual results may differ materially from these estimates under different assumptions or conditions.

Recoverability of Deferred Costs. We defer costs on projects for service revenue and system sales. Deferred costs consist primarily of direct and incremental costs to customize and install systems, as defined in individual customer contracts, including costs to acquire hardware and software from third parties and payroll costs for our employees and other third parties.

We recognize such costs in accordance with our revenue recognition policy by contract. For revenue recognized under the completed contract method, costs are deferred until the products are delivered, or upon completion of services or, where applicable, customer acceptance. For revenue recognized under the percentage of completion method, costs are recognized as products are delivered or services are provided in accordance with the percentage of completion calculation. For revenue recognized ratably over the term of the contract, costs are recognized ratably over the term of the contract, commencing on the date of revenue recognition. At each balance sheet date, we review deferred costs, to ensure they are ultimately recoverable. Any anticipated losses on uncompleted contracts are recognized when evidence indicates the estimated total cost of a contract exceeds its estimated total revenue.

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Allowances for Doubtful Accounts and Sales Returns. We must make estimates of the uncollectibility of our accounts receivable. We specifically analyze the age of accounts receivable and historical bad debts, customer credit-worthiness and current economic trends when evaluating the adequacy of the allowance for doubtful accounts. Similarly, we must make estimates of potential future product returns related to current period revenue. We analyze historical returns, current economic trends, and changes in customer demand and acceptance of our products when evaluating the adequacy of the sales returns allowance. Significant judgments and estimates must be made and used in connection with establishing allowances for doubtful accounts and sales returns in any accounting period. Material differences may result in the amount and timing of our revenue for any period if we were to make different judgments or utilize different estimates.

Accrued Loss on Excess Office Facilities. We made significant estimates in determining the appropriate amount of accrued loss on excess office facilities. If we made different estimates, our loss on excess office facilities could be significantly different from that recorded, which could have a material impact on our operating results. Our original estimate has been revised in previous periods in response to changes in market conditions for commercial real estate in the area where the excess office facilities are located, or to reflect negotiated changes in sublease rates charged to occupying tenants. The significant factors we consider when making our estimates are discussed in the section entitled Loss on Excess Office Facilities.

Impairment of Investments. We periodically evaluate whether any declines in the fair value of our investments are other-than-temporary. Significant judgments and estimates must be made to assess whether an other-than-temporary decline in fair value of investments has occurred and to estimate the fair value of investments in privately held companies. Material differences may result in the amount and timing of any impairment charge if we were to make different judgments or utilize different estimates.

Valuation of Other Intangible Assets. Other intangible assets consist primarily of fair value of customer agreements and contracts, developed technology, trademarks, patents, and tradenames acquired in business combinations. Other intangible assets are amortized on a straight line basis over their useful lives and are subject to periodic review for impairment. The initial recording and periodic review processes require extensive use of estimates and assumptions, including estimates of undiscounted future cash flows expected to be generated by the acquired assets. Should conditions be different than management s current assessment, material write-downs of intangible assets may be required. We periodically review the estimated remaining useful lives of other intangible assets. A reduction in the estimated remaining useful life could result in accelerated amortization expense in future periods.

Valuation of Goodwill. We assess the impairment of goodwill on an annual basis, in our fourth quarter, or whenever events or changes in circumstances indicate that the fair value of the reporting unit to which goodwill relates is less than the carrying value. Factors we consider important which could trigger an impairment review include the following:

poor economic performance relative to historical or projected future operating results;

significant negative industry, economic or company specific trends;

changes in the manner of our use of the assets or the plans for our business; and

loss of key personnel.

If we were to determine that the fair value of a reporting unit was less than its carrying value, including goodwill, based upon the annual test or the existence of one or more of the above indicators of impairment, we would measure impairment based on a comparison of the implied fair value of reporting unit goodwill with the carrying amount of goodwill. The implied fair value of goodwill is determined by allocating the fair value of a reporting unit to its assets (recognized and unrecognized) and liabilities in a manner similar to a purchase price allocation. The residual fair value after this allocation is the implied fair value of the goodwill of the reporting unit. To the extent the carrying amount of reporting unit goodwill is greater than the implied fair value of reporting unit goodwill, we would record an impairment charge for the difference. Judgment is required in determining our reporting units and assessing fair value of the reporting units. There were no impairments related to goodwill in any of the periods presented.

Stock-Based Compensation. We account for stock-based compensation in accordance with Statement of Financial Accounting Standards (SFAS) No. 123R, Share-Based Payment. Under the provisions of SFAS No. 123R, which we adopted as of January 1, 2006, stock-based compensation cost is estimated at the grant date based on the award s fair-value as calculated by the Black-Scholes option-pricing model and is recognized as expense over the requisite service period, which is the vesting period. The Black-Scholes model requires various highly judgmental assumptions including volatility and expected option life. If any of the assumptions used in the Black-Scholes model change significantly, stock-based compensation expense may differ materially in the future from the amounts recorded in our consolidated statement of operations. We are required to estimate forfeitures at the time of grant and revise those estimates in subsequent periods if actual forfeitures differ from those estimates. We use historical data to estimate pre-vesting option forfeitures and record stock-based compensation expense only for those awards that are expected to vest.

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Accounting for Gains on Sale of Subsidiary Stock. We account for any changes in our ownership interest resulting from the issuance of equity capital by consolidated subsidiaries as either a gain or loss in the statement of operations pursuant to SAB No. 51. SAB No. 51 requires that the difference between the carrying amount of the parent s investment in a subsidiary and the underlying net book value of the subsidiary after the issuance of stock by the subsidiary be reflected as either a gain or loss in the statement of operations if the appropriate recognition criteria has been met or reflected as an equity transaction. We have elected to reflect SAB No. 51 gains or losses in our unaudited condensed consolidated statement of operations.

Accounting for Income Taxes. We use the asset and liability method of accounting for income taxes. Under this method, income tax expense is recognized for the amount of taxes payable or refundable for the current year. In addition, deferred tax assets and liabilities are recognized for the expected future tax consequences of temporary differences between the financial reporting and tax bases of assets and liabilities, and for operating losses and tax credit carryforwards. Deferred tax assets and liabilities and operating loss and tax credit carryforwards are measured using enacted tax rates expected to apply to taxable income in the years in which those temporary differences and operating loss and tax credit carryforwards are expected to be recovered or settled. We must make assumptions, judgments and estimates to determine current provision for income taxes, deferred tax assets and liabilities and any valuation allowance to be recorded against deferred tax assets. Our judgments, assumptions, and estimates relative to the current provision for income tax take into account current tax laws, our interpretation of current tax laws and possible outcomes of future audits conducted by foreign and domestic tax authorities. Changes in tax law or our interpretation of tax laws and future tax audits could significantly impact the amounts provided for income taxes in our consolidated financial statements.

We must periodically assess the likelihood that our deferred tax assets will be recovered from future taxable income, and to the extent that recovery is not likely, a valuation allowance must be established. The establishment of a valuation allowance and increases to such an allowance result in either increases to income tax expense or reduction of income tax benefit in the statement of operations. Factors we consider in making such an assessment include, but are not limited to: past performance and our expectation of future taxable income, macro-economic conditions and issues facing our industry, existing contracts, our ability to project future results and any appreciation of our investments and other assets.

We have not provided for U.S. deferred income taxes or withholding taxes on non-U.S. subsidiaries undistributed earnings. These earnings are intended to be permanently reinvested in operations outside of the U.S. If these amounts were distributed to the U.S., in the form of dividends or otherwise, we could be subject to additional U.S. income taxes. It is not practicable to determine the U.S. federal income tax liability or benefit on such earnings due to the availability of foreign tax credits and the complexity of the computation, if such earnings were not deemed to be permanently reinvested.

In June 2006, the FASB issued Financial Interpretation (FIN) No. 48, Accounting for Uncertainty in Income Taxes an interpretation of FASB Statement No. 109. FIN No. 48 clarifies the accounting for uncertainty in income taxes recognized in an enterprise s financial statements in accordance with SFAS No. 109, Accounting for Income Taxes, and prescribes a recognition threshold and measurement process for financial statement recognition and measurement of tax positions taken or expected to be taken in tax returns. FIN No. 48 also provides guidance on derecognition, classification, interest and penalties, accounting in interim periods, disclosure and transition. On January 1, 2007, date of adoption of FIN No. 48, we had $7.5 million of unrecognized tax benefits, of which $7.2 million would affect the effective tax rate if recognized. Although the implementation of FIN No. 48 did not impact the amount of liability for unrecognized tax benefits, we reclassified $5.3 million of liability for unrecognized tax benefits from current income taxes payable to other long-term liabilities to conform with the balance sheet presentation requirements of FIN No. 48.

In accordance with FIN No. 48, we recognize potential accrued interest and penalties related to unrecognized tax benefits as a component of income tax expense. As of January 1, 2007, we had approximately $300,000 of accrued interest and penalties related to uncertain tax positions, which is included as a component of the $5.3 million of unrecognized tax benefit noted above. To the extent interest and penalties are not assessed with respect to uncertain tax positions, amounts accrued will be reduced and reflected as a reduction of the overall income tax provision. As of September 30, 2007, we did not anticipate that total unrecognized tax benefits will significantly change within the

next twelve months.

We file numerous consolidated and separate income tax returns in the United States Federal, state, local, and foreign jurisdictions. With few exceptions, we are no longer subject to United States Federal, state, local, or foreign income tax examinations for years before 1993.

Revenue by Segment

Revenue by segment is as follows (dollars in thousands):

	Three Months Ended September 30,			Nine Months Ended September 30,		
	2007	Change	2006	2007	Change	2006
Music	$ 37,658	24%	$ 30,375	$ 108,586	21%	$ 89,411
Consumer	54,166	4	52,122	155,393	7	145,339
Technology Products and Solutions	53,271	377	11,179	146,759	320	34,937
Total net revenue	$ 145,095	55%	$ 93,676	$ 410,738	52%	$ 269,687

Revenue by segment as a percentage of total net revenue is as follows:

	Three Months Ended September 30,		Nine Months Ended September 30,	
	2007	2006	2007	2006
Music	26%	32%	26%	33%
Consumer	37	56	38	54
Technology Products and Solutions	37	12	36	13
Total net revenue	100%	100%	100%	100%

Music. Music revenue primarily includes revenue from: our Rhapsody and RadioPass subscription services; sales of digital music content through our Rhapsody service and our RealPlayer music store; and advertising from our music websites. These products and services are sold and provided primarily through the Internet and we charge customers credit cards at the time of sale. Billings for subscription services typically occur monthly, quarterly or annually, depending on the service purchased.

Music revenue increased 24% and 21%, respectively, during the three and nine months ended September 30, 2007 compared to the three and nine months ended September 30, 2006. Substanitally all of the growth in subscription revenue resulted from increases in our subscription-based music products and advertising. No other single factor contributed materially to the change during the periods. We believe the continued growth of our Music revenue is due primarily to the broader acceptance of paid online music services and the increased focus of our marketing efforts on our music offerings.

Consumer. Consumer primarily includes revenue from: digital media subscription services such as GamePass, FunPass, SuperPass and stand-alone subscriptions; sales and distribution of third-party software and services; sales of digital content such as game downloads; sales of premium versions of our RealPlayer and related products; and advertising. These products and services are sold and provided primarily through the Internet and we charge customers credit cards at the time of sale. Billings for subscription services typically occur monthly, quarterly or annually, depending on the service purchased.

Consumer revenue increased 4% and 7%, respectively, during the three and nine months ended September 30, 2007 compared to the three and nine months ended September 30, 2006, due primarily to increased sales of our Games products. Additional factors contributing to the change in revenue are discussed below in the sections included within Consumer revenue. We believe the growth in Games is due in part to the continued shift in our marketing and promotional efforts to these services as well as product improvements and increasing consumer acceptance and

adoption of digital media products and services. We cannot predict with accuracy how these product offerings will perform in the future, at what rate digital media products and services will grow, if at all, or the nature or potential impact of anticipated competition.

Technology Products and Solutions. Technology Products and Solutions revenue is derived from products and services that enable wireless carriers, cable companies, and other media and communications companies to distribute digital media content to PCs, mobile phones, and other non-PC devices. Technology Products and Solutions that we sell as application services consist of ringback tones, music-on-demand, video-on-demand, and inter-carrier messaging, and are primarily sold to wireless carriers. Technology Products and Solutions that we sell as software consist of Helix system software and related authoring and publishing tools, digital rights management technology, messaging gateways, and support and maintenance services that we sell to customers who purchase these products. We also offer broadcast hosting and consulting services to our customers. These products and services are primarily sold to corporate, government and educational customers. We do not require collateral from our customers, but we often require payment before or at the time products and services are delivered. Many of our customers are given standard commercial credit terms, and for these customers we do not require payment before products and services are delivered.

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Technology Products and Solutions revenue increased 377% and 320%, respectively, during the three and nine months ended September 30, 2007 compared to the three and nine months ended September 30, 2006, due primarily to our acquisitions of WiderThan (acquired in October 2006) and SNS (acquired in May 2007). For the remainder of 2007, we expect Technology Products and Solutions revenue to continue to increase in absolute dollars and as a percentage of total revenue as compared to the same period in 2006 because future quarters in 2007 will include revenue from these acquisitions and from our acquisition of Exomi completed in June 2007. We also believe that sales of certain of our business software products will continue to be substantially affected by Microsoft s continuing practice of bundling its competing Windows Media Player and server software for free with its Windows operating system products. No assurance can be given when, or if, we will experience increased sales of our Technology Products and Solutions to customers in these markets.

Consumer Revenue

A further analysis of our Consumer revenue is as follows (dollars in thousands):

	Three Months Ended September 30,			Nine Months Ended September 30,		
	2007	Change	2006	2007	Change	2006
Games	28,820	28%	22,536	77,617	24%	62,349
Media Software and Services	25,346	(14)	29,586	77,776	(6)	82,990
Total consumer products and services revenue	$ 54,166	4%	$ 52,122	$ 155,393	7%	$ 145,339

Games. Games revenue primarily includes revenue from: the sale of individual games through our RealArcade service and our Games related websites including GameHouse, Mr. Goodliving, Zylom (acquired in January 2006), and Atrativa (acquired in November 2006); our GamePass and FunPass subscription service; and advertising through RealArcade and our Games related websites.

Games revenue increased 28% and 24% respectively, during the three and nine months ended September 30, 2007 compared to the three and nine months ended September 30, 2006, due primarily to increased advertising, syndication and subscription revenue generated through our RealArcade service and our websites, including Zylom and GameHouse. Advertising, syndication and subscription revenue together accounted for 89% and 98%, respectively, of this revenue increase; no other single factor contributed materially to the change during the periods.

Media Software and Services. Media Software and Services revenue primarily includes revenue from: our SuperPass and stand-alone premium video subscription services; RealPlayer Plus and related products; sales and distribution of third-party software products; and all advertising other than that related directly to our Music and Games businesses.

Media Software and Services revenue decreased 14% and 6%, respectively, during the three and nine months ended September 30, 2007 compared to the three and nine months ended September 30, 2006. A decline in subscription revenue accounted for 94% of the revenue decrease for the three months ended September 30, 2007. A decline in subscription revenue, offset by an increase in advertising revenue accounted for 75% of the revenue decrease for the nine months ended September 30, 2007; no other single factor contributed materially to the change during the periods. The decreases were due primarily to a shift in our marketing and promotional efforts towards our Music and Games businesses, which we believe represent a greater growth opportunity for us.

Geographic Revenue

Revenue by geographic region is as follows (dollars in thousands):

	Three Months Ended September 30,			Nine Months Ended September 30,		
	2007	Change	2006	2007	Change	2006

United States	$ 91,281	31%	$ 69,433	$ 263,870	31%	$ 201,675
Europe	22,150	39	15,895	60,382	32	45,725
Republic of Korea	20,591	n/a		57,875	n/a	
Rest of the world	11,073	33	8,348	28,611	28	22,287
Total net revenue	$ 145,095	55%	$ 93,676	$ 410,738	52%	$ 269,687

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Revenue in the U.S. increased 31% for each of the three and nine months ended September 30, 2007 compared to the three and nine months ended September 30, 2006, due primarily to our acquisition of WiderThan and the growth of our Music and Games businesses. See *Revenue by Segment* above for further discussion of these changes. Revenue in Europe increased 39% and 32%, respectively, during the three and nine months ended September 30, 2007 compared to the three and nine months ended September 30, 2006, due primarily to the continued growth of our Games business and the acquisitions of SNS and Zylom. Revenue in the Republic of Korea resulted directly from our acquisition of WiderThan.

Revenue

License fees and Service revenue in accordance with SEC regulations, are as follows (dollars in thousands):

	Three Months Ended September 30,			Nine Months Ended September 30,		
	2007	Change	2006	2007	Change	2006
License fees	$ 23,869	6%	$ 22,528	$ 67,918	(0)%	$ 68,014
Service revenue	121,226	70	71,148	342,820	70	201,673
Total net revenue	$ 145,095	55%	$ 93,676	$ 410,738	52%	$ 269,687

License fees and Service revenue as a percentage of total revenue is as follows:

	Three Months Ended September 30,		Nine Months Ended September 30,	
	2007	2006	2007	2006
License fees	16%	24%	17%	25%
Service revenue	84	76	83	75
Total net revenue	100%	100%	100%	100%

License Fees. License fees primarily include revenue from: sales of content such as game licenses and digital music tracks; sales of our media delivery system software; sales of premium versions of our RealPlayer Plus and related products; sales of messaging gateways to mobile carriers; and sales of third-party products. License fees include revenue from all of our segments. License revenue increased 6% and 0%, respectively, during the three and nine months ended September 30, 2007 compared to the three and nine months ended September 30, 2006. An increase in Games license revenue offset in part by lower TPS and Music licence revenue, accounted for all of this revenue increase; no other single factor contributed materially to the change during the periods. The decrease in Music license revenue was due primarily to a shift in our marketing and promotional efforts towards our Music subscription services, which we believe represent a greater growth opportunity for us.

Service Revenue. Service revenue primarily includes revenue from: digital media subscription services such as SuperPass, Rhapsody, RadioPass, GamePass, FunPass and stand-alone subscriptions; sales of application services sold to wireless carriers to deliver ringback tones, music-on-demand, video-on-demand, messaging, and information services to wireless carriers customers; support and maintenance services that we sell to customers who purchase our software products; broadcast hosting and consulting services that we offer to our customers; distribution of third-party software; and advertising. Service revenue includes revenue from all of our reporting segments. Service revenue increased 70% each of the three and nine months ended September 30, 2007 compared to the three and nine months ended September 30, 2006. Sales of application services to wireless carriers, including ringback tones, music-on-demand, inter-carrier messaging, and video-on-demand services accounted for 90% and 87%, respectively, of the increases in service revenue; no other single factor contributed materially to the change during the periods.

Deferred Revenue

Deferred revenue is comprised of unrecognized revenue and prepayments related to application services, unearned subscription services, support contracts, prepayments under OEM arrangements and other prepayments for which the earnings process has not been completed. Total deferred revenue at September 30, 2007 was $41.4 million compared to $27.6 million at December 31, 2006. Substantially all of the increase in deferred revenue was due to prepayments from wireless carriers for applications to deliver ringback tone, music-on-demand, and video-on-demand services.

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Cost of Revenue by Segment

Cost of revenue by segment is as follows (dollars in thousands):

	Three Months Ended September 30, 2007	Nine Months Ended September 30, 2007
Music	$ 20,891	$ 59,570
Consumer	10,326	28,890
Technology products and solutions	25,427	63,326
Total cost of revenue	$ 56,644	$ 151,786

Cost of revenue as a percentage of segment revenue is as follows:

	Three Months Ended September 30, 2007	Nine Months Ended September 30, 2007
Music	55%	55%
Consumer	19	19
Technology products and solutions	48	43
Total cost of revenue	39%	37%

Cost of Music. Cost of Music revenue consist primarily of cost of content and delivery of the content included in our music subscription service offerings; royalties paid on sales and streams of music; hardware devices and accessories; and fees paid to third-party vendors for order fulfillment and support services

Cost of Consumer. Cost of Consumer revenue consist primarily of cost of content and delivery of the content included in our digital media subscription service offerings; royalties paid on sales of games and other third-party products; amounts paid for licensed technology; costs of product media, duplication, manuals and packaging materials; and fees paid to third-party vendors for order fulfillment and support services.

Cost of Technology Products and Solutions. Cost of Technology Products and Solutions revenue includes amounts paid for licensed technology, costs of product media, duplication, manuals, packaging materials, fees paid to service carriers and third-party vendors for order fulfillment, cost of personnel providing support and consulting services, and expenses incurred in providing our streaming media hosting services.

We have not provided comparative results for the three and nine months ended September 30, 2006 for cost of revenue by segment as we changed our allocation methodology to accommodate the formation of Rhapsody America. We were able to use the new allocation methodology for amounts incurred since January 1, 2007, however we do not have the data available to perform the allocation of amounts incurred prior to January 1, 2007. In addition, we deemed it impracticable to perform the allocation under the old method for the current period to provide comparative information due to the complexity of the calculations required.

Cost of Revenue

Cost of revenue is as follows (dollars in thousands):

	Three Months Ended September 30,			Nine Months Ended September 30,		
	2007	Change	2006	2007	Change	2006
License fees	$ 8,436	(13)%	$ 9,675	$ 24,610	(15)%	$ 28,865

Service revenue	48,208	158	18,714	127,176	140	52,923
Total cost of revenue	$ 56,644	100%	$ 28,389	$ 151,786	86%	$ 81,788

Cost of revenue as a percentage of related revenue is as follows:

	Three Months Ended September 30,		Nine Months Ended September 30,	
	2007	**2006**	**2007**	**2006**
License fees	35%	43%	36%	42%
Service revenue	40	26	37	26
Total cost of revenue	39%	30%	37%	30%

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Cost of License Fees. Cost of license fees includes royalties paid on sales of games, music and other third-party products, amounts paid for licensed technology, amortization of acquired technology, costs of product media, duplication, manuals, packaging materials, and fees paid to third-party vendors for order fulfillment. Cost of license fees decreased 13% in for the quarter ended September 30, 2007 and 15% for the nine months ended September 30, 2007 compared to the quarter and nine months ended September 30, 2006 due primarily to the decrease in online sales of individual songs through our Rhapsody subscription service and our RealPlayer Music Store as well as lower amortization of acquired technology related to assets that became fully amortized during the periods. Decreases in these costs accounted for 74% and 58% of the decline in the respective periods; no other single factor contributed materially to the change.

Cost of Service Revenue. Cost of service revenue includes the cost of content and delivery of the content included in our digital media subscription and mobile service offerings, cost of in-house and contract personnel providing support, amortization of acquired technology, and consulting services, royalties, and expenses incurred in providing our streaming media hosting services. Content costs are expensed over the period the content is available to our subscription services customers. Cost of service revenue increased 158% and 140%, respectively, during the quarter and nine months ended September 30, 2007 compared to the quarter and nine months ended September 30, 2006, due primarily to the acquisition of WiderThan. Costs related to the development and delivery of application services sold to wireless carriers accounted for 68% and 71%, respectively, of the increase in cost of service revenue; costs related to the delivery of streaming music accounted for 14% of total cost of service revenue both during the quarter and nine months ended September 30, 2007; no other single factor contributed materially to the change during the periods.

Operating Expenses

Research and Development

Research and development expenses consist primarily of salaries and related personnel costs, expense associated with stock-based compensation, and consulting fees associated with product development. To date, all research and development costs have been expensed as incurred because technological feasibility for software products is generally not established until substantially all development is complete. Research and developments costs and changes are as follows (dollars in thousands):

	Three Months Ended September 30,			Nine Months Ended September 30,		
	2007	**Change**	**2006**	**2007**	**Change**	**2006**
Research and development	$26,528	45%	$18,344	$75,012	36%	$55,127
As a percentage of total net revenue	18%		20%	18%		20%

Research and development expenses, including non-cash stock-based compensation, increased 45% during the three months ended September 30, 2007 compared to the three months ended September 30, 2006. This increase was due primarily to an overall increase in personnel and related costs, including costs related to WiderThan (acquired in October 2006) and SNS (acquired in May 2007) and consulting services which accounted for 88% of the total increase in research and development costs. No other single factor contributed materially to the increase during the period. The decrease in research and development expenses as a percentage of total net revenue is due primarily to a higher growth in total net revenue.

Research and development expenses increased 36% during the nine months ended September 30, 2007 compared to the nine months ended September 30, 2006. This increase was due primarily to an overall increase in personnel and related costs, which including costs related to WiderThan (acquired in October 2006) and SNS (acquired in May 2007), and third party consulting services which accounted for 82% of the total increase in research and development costs. No other single factor contributed materially to the increase during the period. The decrease in research and development expenses as a percentage of total net revenue is due primarily to a higher growth in total net revenue.

Sales and Marketing

Sales and marketing expenses consist primarily of salaries and related personnel costs, sales commissions, amortization of certain intangible assets capitalized in our acquisitions, credit card fees, subscriber acquisition costs, consulting fees, trade show expenses, advertising costs and costs of marketing collateral. Sales and marketing costs and changes are as follows (dollars in thousands):

	Three Months Ended September 30,			Nine Months Ended September 30,		
	2007	**Change**	**2006**	**2007**	**Change**	**2006**
Sales and marketing	$52,812	41%	$37,560	$152,593	37%	$111,604
As a percentage of total net revenue	36%		40%	37%		41%

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Sales and marketing expenses, including non-cash stock-based compensation, increased 41% during the three months ended September 30, 2007 compared to the three months ended September 30, 2006. Personnel and related costs accounted for 41% of the total increase in sales and marketing expenses including costs related to WiderThan (acquired in October 2006) and SNS (acquired in May 2007). An additional 27% of the increase in sales and marketing expenses was due to an increase in amortization of other intangible assets capitalized in our acquisition of WiderThan and SNS. No other single factor contributed materially to the increase during the period. The decrease in sales and marketing expenses as a percentage of total net revenue is due to a higher growth in total net revenue.

Sales and marketing expenses, including non-cash stock-based compensation, increased 37% during the nine months ended September 30, 2007 compared to the nine months ended September 30, 2006. Personnel and related costs accounted for 46% of the total increase in sales and marketing expenses including costs related to WiderThan (acquired in October 2006) and SNS (acquired in May 2007). An additional 26% of the increase in sales and marketing expenses was due to an increase in amortization of other intangible assets capitalized in our acquisition of WiderThan and SNS. No other single factor contributed materially to the increase during the period. The decrease in sales and marketing expenses as a percentage of total net revenue is due to a higher growth in total net revenue.

General and Administrative

General and administrative expenses consist primarily of salaries and related personnel costs, fees for professional and temporary services and contractor costs, stock-based compensation, and other general corporate costs. General and administrative costs and changes are as follows (dollars in thousands):

	Three Months Ended September 30,			Nine Months Ended September 30,		
	2007	Change	2006	2007	Change	2006
General and administrative	$16,750	19%	$14,043	$51,165	23%	$41,586
As a percentage of total net revenue	12%		15%	12%		15%

General and administrative expenses, including non-cash stock-based compensation, increased 19% during the three months ended September 30, 2007 compared to the three months ended September 30, 2006. Personnel and related costs, including costs related to WiderThan (acquired in October 2006) and SNS (acquired in May 2007) and consulting and professional services accounted for substantially all of the increase in general and administrative expenses during the period. The decrease in general and administrative expenses as a percentage of total net revenue is due to a higher growth in total net revenue.

General and administrative expenses, including non-cash stock-based compensation, increased 23% during the nine months ended September 30, 2007 compared to the nine months ended September 30, 2006. Personnel and related costs, including costs related to WiderThan (acquired in October 2006) and SNS (acquired in May 2007) and consulting and professional services accounted for substantially all of the increase in general and administrative expenses during the period. The decrease in general and administrative expenses as a percentage of total net revenue is due to a higher growth in total net revenue.

Advertising with Related Party

Rhapsody America is obligated to purchase $230 million in advertising and related integrated marketing on MTVN cable channels over the term of the agreement. During the period ended September 30, 2007, Rhapsody America spent $7.7 million in advertising with MTVN. No such amounts were spent during the nine months ended September 30, 2006.

Loss on Excess Office Facilities

In October 2000, we entered into a 10-year lease agreement for additional office space located near our corporate headquarters in Seattle, Washington. Due to a subsequent decline in the market for office space in Seattle and our re-assessment of our facilities requirements in 2001, we accrued for estimated future losses on excess office facilities. Additionally, we accrued for estimated future losses on this facility in 2002 and 2003 based on changes in market conditions and securing tenants at rates lower than those used in the original estimate.

During the quarter ended March 31, 2006, we increased our loss estimate by $738,000 to account for building operating expenses that are not expected to be recovered under the terms of the existing sublease agreements. No such charge was recorded during the nine months ended September 30, 2007.

The total accrued loss of $12.7 million at September 30, 2007 is shown net of expected future sublease income of $8.8 million, which was committed under sublease contracts at the time of the estimate. We regularly evaluate the market for office space in the cities where we have operations. If the market for such space declines further in future periods, we may have to revise our estimates further, which may result in additional losses on excess office facilities.

Antitrust Litigation Benefit, Net

On October 11, 2005, we entered into a settlement agreement with Microsoft pursuant to which we agreed to settle all antitrust disputes worldwide with Microsoft, including the U.S. litigation. Antitrust litigation benefit, net consist of settlement income, legal fees, personnel costs, communications, equipment, technology and other professional services costs incurred directly attributable to our antitrust case against Microsoft, as well as our participation in various international antitrust proceedings against Microsoft, including the European Union. No antitrust litigation benefit, net was recorded during the quarter ended September 30, 2007. Antitrust litigation benefit, net of $60.7 million was recorded during the quarter ended March 31, 2007 when we received the final payment under the settlement. Antitrust litigation benefit, net of $61.9 million and $159.6 million was recorded during the three and nine months ended September 30, 2006, respectively.

Other Income, Net

Other income, net consists primarily of: interest income on our cash, cash equivalents, trading securities, and short-term investments, which are net of interest expense from amortization of offering costs related to our convertible debt and equity in net loss of investments. Other income, net and quarter-over-quarter changes are as follows (dollars in thousands):

	Three Months Ended September 30,			Nine Months Ended September 30,		
	2007	Change	2006	2007	Change	2006
Interest and other, net	$ 7,290	(31)%	$ 10,618	$ 24,457	(13)%	$ 27,978
Gain on sale of equity investments		n/a		132	(94)	2,286
Equity in net loss of investments		n/a		(132)	n/a	
Minority interest in Rhapsody America	6,466	n/a		6,466	n/a	
Gain on sale of interest in Rhapsody America	7,946	n/a		7,946	n/a	
Other income, net	38	(84)	242	990	129	432
Other income, net	$ 21,740	100%	$ 10,860	$ 39,859	30%	$ 30,696

Other income, net increased during the three and nine months ended September 30, 2007 due primarily to minority interest in Rhapsody America and the gains recognized on the sale of equity interest of our music business. These were offset in part by a decrease in interest income due to a decrease in our average investment balance. The decline in the average investment balance was due to the use of cash for acquisitions and stock buy-backs.

As of September 30, 2007, the carrying value of equity investments in publicly traded companies consists primarily of approximately 10.6% of the outstanding shares of J-Stream Inc., a Japanese media services company. The market value of these shares has increased from the original cost of $913,000, resulting in a carrying value of $6.4 million and $20.2 million as of September 30, 2007 and December 31, 2006, respectively. These equity investments are accounted for as available-for-sale and the increase over the cost basis, net of income taxes, is reflected as a component of

accumulated other comprehensive income. Although the carrying value of our J-Stream investment was $6.4 million at September 30, 2007, there can be no assurance that any gain can be realized through the disposition of these shares because the market for these shares is relatively limited and the share price is volatile.

Income Taxes

During the quarters ended September 30, 2007 and 2006, we recognized income tax expense of $2.0 million and $25.9 million, respectively, related to U.S. and foreign income taxes. During the nine months ended September 30, 2007 and 2006, we recognized income tax expense of $27.4 million and $63.2 million, respectively, related to U.S. and foreign income taxes. The decrease in income tax expense is a result of the change in income before income tax primarily related to the decline in settlement income from Microsoft. The increase in tax expense as a percentage of pre-tax income during the three months ended September 30, 2007 was the result of our lower net income combined with losses not benefited in certain foreign jurisdictions.

In June 2006, the FASB issued Financial Interpretation (FIN) No. 48, *Accounting for Uncertainty in Income Taxes an interpretation of FASB Statement No. 109.* FIN No. 48 clarifies the accounting for uncertainty in income taxes recognized in an enterprise s financial statements in accordance with SFAS No. 109, *Accounting for Income Taxes*, and prescribes a recognition threshold and measurement process for financial statement recognition and measurement of tax positions taken or expected to be taken in tax returns. FIN No. 48 also provides guidance on derecognition, classification, interest and penalties, accounting in interim periods, disclosure and transition. On January 1, 2007, date of adoption of FIN No. 48, we had $7.5 million of unrecognized tax benefits, of which $7.2 million would affect the effective tax rate if recognized. Although the implementation of FIN No. 48 did not impact the amount of liability for unrecognized tax benefits, we reclassified $5.3 million of liability for unrecognized tax benefits from current income taxes payable to other long-term liabilities to conform with the balance sheet presentation requirements of FIN No. 48.

In accordance with FIN No. 48, we recognize potential accrued interest and penalties related to unrecognized tax benefits as a component of income tax expense. As of January 1, 2007, we had approximately $300,000 of accrued interest and penalties related to uncertain tax positions, which is included as a component of the $5.3 million of unrecognized tax benefit noted above. To the extent interest and penalties are not assessed with respect to uncertain tax positions, amounts accrued will be reduced and reflected as a reduction of the overall income tax provision. We do not anticipate that total unrecognized tax benefits will significantly change within the next twelve months.

We file numerous consolidated and separate income tax returns in the United States Federal, state, local, and foreign jurisdictions. With few exceptions, we are no longer subject to United States Federal, state, local, or foreign income tax examinations for years before 1993.

During the quarter ended March 31, 2007, WiderThan Americas, Inc. (WTA) became a directly wholly-owned subsidiary of RealNetworks, Inc. WTA was previously a wholly-owned subsidiary of WiderThan Co., Ltd. The restructuring decreased our deferred tax liabilities and goodwill by $1.8 million.

New Accounting Pronouncements

In September 2006, the FASB issued SFAS No. 157, *Fair Value Measurements*, which defines fair value, establishes a framework for measuring fair value in generally accepted accounting principles, and expands disclosures about fair value measurements. SFAS No. 157 does not require any new fair value measurements, but provides guidance on how to measure fair value by providing a fair value hierarchy used to classify the source of the information. SFAS No. 157 is effective for fiscal years beginning after November 15, 2007 and interim periods within those fiscal years. We are currently assessing the impact of SFAS No. 157 on our consolidated financial statements.

In February 2007, the FASB issued SFAS No. 159 *The Fair Value Option for Financial Assets and Financial Liabilities*, which provides companies with an option to report selected financial assets and liabilities at fair value. The objective of SFAS No. 159 is to reduce both the complexity in accounting for financial instruments and the volatility in earnings caused by measuring related assets and liabilities differently. SFAS No. 159 is effective for fiscal years beginning after November 15, 2007. We are currently assessing the impact of SFAS No. 159 on our consolidated financial statements.

Liquidity and Capital Resources

The following summarizes working capital, cash, cash equivalents, trading securities, short-term investments, and restricted cash (in thousands):

	September 30, 2007	December 31, 2006
Working capital	$481,443	$584,125
Cash, cash equivalents, trading securities, and short-term investments	590,363	678,920
Restricted cash	15,500	17,300

Working capital decreased primarily due to the use of $142.2 million for the repurchase of our common stock offset by cash generated from operations. Restricted cash declined by $1.8 million due to a change in the contractual terms of the related letter of credit.

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The following summarizes cash flows (in thousands):

	September 30, 2007	September 30, 2006
Cash (used in) provided by operating activities	$(206,811)	$133,961
Cash used in investing activities	(7,186)	(36,812)
Cash used in financing activities	(113,085)	(56,893)

Net use of cash in operating activities in 2007 was primarily for the purchase of trading securities of $270.0 million, and an increase in accounts receivable and deferred costs of $19.6 million offset by net income, including net antitrust litigation benefit of $58.2 million, and an increase in deferred revenue of $13.8 million and accrued and other liabilities of $14.8 million. Trading securities were purchased to generate capital gains to offset expiring capital loss carryforwards. Operating activities provided cash in 2006 primarily from net income, including antitrust litigation benefit, net of $152.1 million, offset by a decrease in accrued and other liabilities of $38.8 million.

In 2007, investing activities used cash primarily for purchases of equipment, software, and leasehold improvements of $19.1 million as well as the additional purchase price for the achievement of performance criteria paid to the selling shareholders of Zylom and the acquisitions of SNS and Exomi of an aggregate of $25.3 million. In 2006, investing activities used cash primarily for purchases of equipment, software, and leasehold improvements of $9.3 million as well as the acquisition of Zylom of $7.1 million. Sales and maturities net of purchases of short-term investments provided cash of $36.5 million during 2007. Purchases net of proceeds from sales and maturities of short-term investments used cash of $21.8 million during 2006.

Financing activities used cash for the repurchase of our common stock of $142.2 million and $98.9million during the nine months ended September 30, 2007 and 2006, respectively. The use of cash was partially offset by cash received from the proceeds from the sales of interest in Rhapsody America of $15.0 million in 2007 and sales of common stock under employee stock purchase plan and exercise of stock options of $14.3 million and $42.0 million during 2007 and 2006, respectively.

In April 2006, the Company s Board of Directors authorized a share repurchase program of up to an aggregate of $100.0 million of the Company s outstanding common stock. During the quarter ended March 31, 2007, we purchased 9.8 million shares at an average cost of $7.99 per share for an aggregate value of $78.5 million. No amounts remained authorized for repurchase under the repurchase program as of March 31, 2007.

In May 2007, our Board of Directors authorized a new share repurchase program for the repurchase of up to an aggregate of $100.0 million of our outstanding common stock. The May 2007 program replaces the April 2006 program. During the three months ended September 30, 2007, we purchased 4.8 million shares at an average cost of $7.07 per share for an aggregate value of $34.2 million. As of September 30, 2007, $36.4 million remained authorized for repurchase under the May 2007 repurchase program.

We currently have no planned significant capital expenditures for 2007 other than those in the ordinary course of business. In the future, we may seek to raise additional funds through public or private equity financing, or through other sources such as credit facilities. The sale of additional equity securities could result in dilution to our shareholders. In addition, in the future, we may enter into cash or stock acquisition transactions or other strategic transactions that could reduce cash available to fund our operations or result in dilution to shareholders.

Our contractual obligations include convertible debt, office leases, and contractual payments due to content and other service providers. As of September 30, 2007, we have $7.5 million of uncertain tax positions in accordance with FIN No. 48. We believe that our current cash, cash equivalents, and short-term investments will be sufficient to meet our anticipated cash needs for working capital and capital expenditures for at least the next 12 months.

We do not hold derivative financial instruments or equity securities in our short-term investment portfolio. Our cash equivalents and short-term investments consist of high quality securities, as specified in our investment policy guidelines. The policy limits the amount of credit exposure to any one non-U.S. Government or non-U.S. Agency issue or issuer to a maximum of 5% of the total portfolio. These securities are subject to interest rate risk and will decrease in value if interest rates increase. Because we have historically had the ability to hold our fixed income

investments until maturity, we do not expect our operating results or cash flows to be significantly affected by a sudden change in market interest rates in our securities portfolio.

We conduct our operations in ten primary functional currencies: the U.S. dollar, the Korean won, the Japanese yen, the British pound, the Euro, the Mexican peso, the Brazilian real, the Australian dollar, the Hong Kong dollar, and the Singapore dollar. Historically, neither fluctuations in foreign exchange rates nor changes in foreign economic conditions have had a significant impact

on our financial condition or results of operations. We currently do not hedge the majority of our foreign currency exposures and are therefore subject to the risk of exchange rate fluctuations. We invoice our international customers primarily in U.S. dollars, except in Korea, Japan, Germany, France, the United Kingdom and Australia, where we invoice our customers primarily in won, yen, euros, pounds, and Australian dollars, respectively. We are exposed to foreign exchange rate fluctuations as the financial results of foreign subsidiaries are translated into U.S. dollars in consolidation. Our exposure to foreign exchange rate fluctuations also arises from intercompany payables and receivables to and from our foreign subsidiaries. Foreign exchange rate fluctuations did not have a material impact on our financial results during the nine months ended September 30, 2007 and 2006.

Off-Balance Sheet Agreements

Our only significant off-balance sheet arrangements relate to operating lease obligations for office facility leases and other contractual obligations related primarily to minimum contractual payments due to content and other service providers.

Item 3. Quantitative and Qualitative Disclosures About Market Risk

The following discussion about our market risk involves forward-looking statements. Actual results could differ materially from those projected in the forward-looking statements.

Interest Rate Risk. Our exposure to interest rate risk from changes in market interest rates relates primarily to our short-term investment portfolio. We do not hold derivative financial instruments or equity investments in our short-term investment portfolio. Our short-term investments consist of trading and available-for-sale high quality debt securities as specified in our investment policy. Investments in both fixed and floating rate instruments carry a degree of interest rate risk. The fair value of fixed rate securities may be adversely impacted due to a rise in interest rates, while floating rate securities may produce less income than expected if interest rates fall. Additionally, a declining rate environment creates reinvestment risk because as securities mature the proceeds are reinvested at a lower rate, generating less interest income. Due in part to these factors, our future interest income may be adversely impacted due to changes in interest rates. In addition, we may incur losses in principal if we are forced to sell securities that have declined in market value due to changes in interest rates. Because we have historically had the ability to hold our short-term investments until maturity and the substantial majority of our short-term investments mature within one year of purchase, we would not expect our operating results or cash flows to be significantly impacted by a sudden change in market interest rates. There have been no material changes in our investment methodology regarding our cash equivalents and short-term investments since December 31, 2006. Based on our cash, cash equivalents, short-term investments, and restricted cash equivalents at September 30, 2007, a hypothetical 10% increase/decrease in interest rates would increase/decrease our annual interest income and cash flows by approximately $0.5 million during the remainder of 2007.

Investment Risk. As of September 30, 2007, we had investments in voting capital stock of both publicly traded and privately-held technology companies for business and strategic purposes. Our investments in publicly traded companies are accounted for as available-for-sale, carried at current market value and are classified as long-term as they are strategic in nature. We periodically evaluate whether any declines in fair value of our investments are other-than-temporary based on a review of qualitative and quantitative factors. For investments with publicly quoted market prices, these factors include the time period and extent by which its accounting basis exceeds its quoted market price. We consider additional factors to determine whether declines in fair value are other-than-temporary, such as the investee s financial condition, results of operations, and operating trends. The evaluation also considers publicly available information regarding the investee companies. For investments in private companies with no quoted market price, we consider similar qualitative and quantitative factors as well as the implied value from any recent rounds of financing completed by the investee. No impairment charge was recorded during any of the periods presented.

Foreign Currency Risk. We conduct business internationally in several currencies. As such, we are exposed to adverse movements in foreign currency exchange rates.

Our exposure to foreign exchange rate fluctuations arise in part from: (1) translation of the financial results of foreign subsidiaries into U.S. dollars in consolidation; (2) the re-measurement of non-functional currency assets, liabilities and intercompany balances into U.S. dollars for financial reporting purposes; and (3) non-U.S. dollar denominated sales to foreign customers. A portion of these risks is managed through the use of financial derivatives,

but fluctuations could impact our results of operations and financial position.

Generally, our practice is to manage foreign currency risk for the majority of material short-term intercompany balances through the use of foreign currency forward contracts. These contracts require us to exchange currencies at rates agreed upon at the contract s inception. Because the impact of movements in currency exchange rates on forward contracts offsets the related impact on the short-term intercompany balances, these financial instruments help alleviate the risk that might otherwise result from certain changes in currency exchange rates. We do not designate our foreign exchange forward contracts related to short-term intercompany accounts as hedges and, accordingly, we adjust these instruments to fair value through results of operations. However, we may periodically hedge a portion of our foreign exchange exposures associated with material firmly committed transactions, long-term investments, highly predictable anticipated exposures and net investments in foreign subsidiaries.

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Our foreign currency risk management program reduces, but does not entirely eliminate, the impact of currency exchange rate movements.

Historically, neither fluctuations in foreign exchange rates nor changes in foreign economic conditions have had a significant impact on our financial condition or results of operations. Foreign exchange rate fluctuations did not have a material impact on our financial results during the nine months ended September 30, 2007 and 2006.

Item 4. Controls and Procedures

(a) *Evaluation of Disclosure Controls and Procedures.* Based on an evaluation as of the end of the period covered by this report, the Company s principal executive officer and principal financial officer have concluded that the Company s disclosure controls and procedures (as defined in Rules 13a-15(e) and 15d-15(e) under the Securities Exchange Act of 1934, as amended (the Exchange Act)) were effective to ensure that information required to be disclosed by the Company in reports that it files or submits under the Exchange Act (1) is recorded, processed, summarized and reported within the time periods specified in Securities and Exchange Commission rules and forms, and (2) is accumulated and communicated to the Company s management, including its principal executive officer and principal financial officer, as appropriate to allow timely decisions regarding required disclosure.

(b) *Changes in Internal Controls.* There have not been any changes in the Company s internal control over financial reporting (as such term is defined in Rule 13a-15(f) and 15d-15(f) under the Exchange Act) during the fiscal quarter ended September 30, 2007 that have materially affected, or are reasonably likely to materially affect, the Company s internal control over financial reporting.

PART II. OTHER INFORMATION

Item 1. Legal Proceedings

In August 2005, a lawsuit was filed against the Company in the U.S. District Court for the District of Maryland by Ho Keung Tse, an individual residing in Hong Kong. The suit alleges that certain of the Company s products and services infringe the plaintiff s patent relating to the distribution of digital files, including sound tracks, music, video and executable software in a manner which restricts unauthorized use. The plaintiff seeks to enjoin the Company from the allegedly infringing activity and to recover treble damages for the alleged infringement. The Company s co-defendants were granted a motion to transfer the lawsuit from the District of Maryland to the Northern District of California in 2006, and on October 4, 2007, the district court for the Northern District of California granted a motion to stay the case pending reexamination of the proceedings. The Company disputes the plaintiff s allegations in the action and intends to vigorously defend itself.

In June 2003, a lawsuit was filed against the Company and Listen.com, Inc. (Listen) in federal district court for the Northern District of Illinois by Friskit, Inc. (Friskit), alleging that certain features of the Company s and Listen s products and services willfully infringe certain patents relating to allowing users to search for streaming media files, to create custom playlists, and to listen to the streaming media file sequentially and continuously. Friskit sought to enjoin the Company from the alleged infringing activity and to recover treble damages from the alleged infringement. The court granted the Company s motion for summary judgment in July 2007 and invalidated all claims on grounds of obviousness. Friskit filed a notice of appeal in September 2007.

From time to time the Company is, and expects to continue to be, subject to legal proceedings and claims in the ordinary course of its business, including employment claims, contract-related claims, and claims of alleged infringement of third-party patents, trademarks and other intellectual property rights. These claims, including those described above, even if not meritorious, could force the Company to spend significant financial and managerial resources. The Company is not aware of any legal proceedings or claims that the Company believes will have, individually or taken together, a material adverse effect on the Company s business, prospects, financial condition or results of operations. However, the Company may incur substantial expenses in defending against third-party claims and certain pending claims are moving closer to trial. The Company expects that its potential costs of defending these claims may increase as the disputes move into the trial phase of the proceedings. In the event of a determination adverse to the Company, the Company may incur substantial monetary liability, and/or be required to change its business practices. Either of these could have a material adverse effect on the Company s financial position and results of operations.

Item 1A. Risk Factors

You should carefully consider the risks described below together with all of the other information included in this quarterly report on Form 10-Q. The risks and uncertainties described below are not the only ones facing our company. If any of the following risks actually occurs, our business, financial condition or operating results could be harmed. In such case, the trading price of our common stock could decline, and investors in our common stock could lose all or part of their investment.

Risks Related to Our Music, Games and Media Software and Services Businesses

We require the consent of Viacom International Inc. with respect to certain matters in the governance and management of our Rhapsody America joint venture. Any disagreement with Viacom on such matters may have an adverse impact on the business, results of operations and financial condition of Rhapsody America and, consequently, our business.

We and Viacom International Inc., on behalf of its division MTV Networks (MTVN), have formed Rhapsody America LLC, a Delaware limited liability company. We own, through a wholly owned subsidiary, 51% of the limited liability company membership interests of Rhapsody America and MTVN owns, through a wholly owned subsidiary, the remaining 49%. We are entitled to appoint the general manager to manage the day-to-day operations of Rhapsody America. Rhapsody America is governed by a limited liability company agreement which, among other things, requires unanimous approval of the members for certain actions, including but not limited to the following:

- authorizing the annual operating budget and making capital expenditures in excess of a certain percentage over the budgeted amount for capital expenditures;
- making any unbudgeted loan or investment not in the ordinary course of business in excess of a certain amount;
- entering into certain material agreements;
- the issuance, sale or repurchase of Rhapsody America s membership interests;
- declaring of or making any distribution by Rhapsody America;
- engaging in any business other than the business (and reasonable extensions thereof) contemplated in the business plan of Rhapsody America;
- merging, consolidating or reorganizing Rhapsody America; acquiring or selling assets not in the ordinary course of business in excess of a certain amount; or acquiring or selling businesses valued in excess of a certain amount;
- commencement or settlement of any material litigation other than in the ordinary course of business;
- entering into any transaction with a value in excess of a certain amount with our affiliates or affiliates of MTVN; and
- the appointment of a new general manager if the existing general manager is required to resign as a result of Rhapsody America not meeting certain financial tests.

If we are not able to agree with MTVN on any of the foregoing items, or if the members are unable to agree on any other significant operational or financial matter requiring approval of the members, the business, results of operations and financial condition of Rhapsody America may be adversely affected and, consequently, our business may suffer.

If there is a change in management or change of control of MTVN or any other event occurs that adversely impacts our relationship with MTVN, the business, results of operations and financial condition of Rhapsody America may be adversely affected. MTVN s investments or activities generally may from time to time conflict with our interests or

those of Rhapsody America. MTVN may have economic or other business interests or goals that are inconsistent with our or Rhapsody America s business interests or goals.

The integration strategy we plan to implement with respect to the assets that have been combined in Rhapsody America may fail or be less successful than anticipated and the management of these assets creates operational complexities.

Our realization of the anticipated benefits of Rhapsody America will depend on our ability to integrate the assets contributed by us and MTVN and retain the personnel transferred to Rhapsody America. Neither we nor the current management of Rhapsody America have extensive experience in managing and operating complex joint ventures of this nature and the integration and operational activities may strain our internal resources, distract us from managing our day-to-day operations, and impact our ability to retain key employees in Rhapsody America. Our business, results of operations and financial condition could be materially and adversely affected if we are unable to successfully integrate and manage these assets.

The nature of our and MTVN s contributions of services and assets to Rhapsody America required detailed cost allocation agreements that will be complex for us to implement and manage and may result in significant costs that could adversely affect our operating results. For example, the advertising commitment from MTVN includes direct and integrated marketing services and programs, some of which may be difficult to value and may not generate expected returns. In addition, we are required to provide various support services, including facilities, information technology systems, personnel and overhead, to Rhapsody America. The allocation of these support service costs is based on various measures depending on the service provided, much of which must be tracked and then accounted for and reported to Rhapsody America on a periodic basis. Tracking and reporting these costs require significant internal resources and many of the allocation methodologies are complicated, which may result in inaccuracies in the total charges to be billed to Rhapsody America. In addition, the variable nature of these costs to be allocated to Rhapsody America may result in fluctuations in the period-over-period results of our Music business.

We and MTVN have certain contractual rights relating to the purchase and sale of MTVN s membership interest in Rhapsody America that may be settled in part through the issuance of additional shares of our capital stock, which would dilute our other stockholders voting and economic interests in us, and may require us to pay MTVN a price that exceeds the appraised value of their proportionate interest in Rhapsody America.

Pursuant to the terms of the Rhapsody America limited liability company agreement, we have a right to purchase from MTVN, and MTVN has a right to require us to purchase, MTVN s membership interest in Rhapsody America. These call and put rights are exercisable upon the occurrence of certain events and during certain periods in each of 2012, 2013 and 2014 and every two years thereafter and may be settled, in part, in shares of our capital stock, subject to specified limitations. If a portion of the purchase price for MTVN s membership interest is payable in shares of our capital stock, such shares could consist of our common stock representing up to 15% of the outstanding shares of our common stock immediately prior to the transaction, and shares of our non-voting stock representing up to an additional 4.9% of the outstanding shares of our common stock immediately prior to the transaction. If we pay a portion of the purchase price for MTVN s membership interest in shares of our common stock and non-voting stock, our other stockholders voting and economic interests in us will be diluted, and MTVN will become one of our significant stockholders. In addition, if MTVN exercises its right to require us to purchase its membership interests in Rhapsody America in certain situations, we may be required to pay MTVN a price that provides a return to MTVN over the appraised value of MTVN s proportionate interest in Rhapsody America.

Future growth of our online music, games and media software and services businesses may not keep pace with recently realized growth rates; any slowdown in growth would negatively impact our overall operating results.

Our revenue for online music, games and media services businesses has grown substantially in recent years. A slowdown in the growth of these businesses would have a negative impact on our total revenue and consolidated operating results. Moreover, these businesses compete in new and rapidly evolving markets and face substantial competitive threats. Our prospects for future growth in these businesses must be considered in light of the risks, expenses and difficulties frequently encountered in new and fiercely competitive markets.

The success of our subscription services businesses depends upon our ability to increase subscription revenue.

Our operating results could be adversely impacted by the loss of subscription revenue. Internet subscription businesses are a relatively new media delivery model and we cannot predict with accuracy our long-term ability to maintain or increase subscription revenue. Subscribers may cancel their subscriptions to our services for many

reasons, including a perception that they do not use the services sufficiently or that the service does not provide enough value, a lack of attractive or exclusive content generally or as compared to competitive service offerings (including Internet piracy), or because customer service issues are not satisfactorily resolved. In recent periods, we have seen an increase in the number of gross customer cancellations of our subscription services due in part to an increasingly large subscriber base. As our subscription business evolves, we have increased our focus on free-to-consumer products and services. In addition, certain subscription based products and services with mobile carriers and broadband service providers are sold on a flat-fee or revenue-share basis. It is not clear what the long-term impact of this evolution will have on our subscription revenue.

Our digital content subscription business, and our online music services in particular, depend on our continuing ability to license compelling content on commercially reasonable terms.

We must continue to obtain compelling digital media content for our video, music, and games services in order to maintain and increase usage, subscription service revenue, and overall customer satisfaction for these products. In some cases, we pay substantial fees to obtain premium content. For instance, we pay substantial royalty fees to music labels to license content. Moreover, our online music service offerings now available through our Rhapsody America venture depend on music licenses from the major music labels and publishers, and the failure of any such parties to renew these licenses under terms that are acceptable to us would harm Rhapsody America s ability to offer successful music subscription services and therefore our operating results. If we cannot obtain premium digital content for any of our digital content subscription services on commercially reasonable terms, or at all, our business will be harmed.

RealPlayer 11 may not achieve consumer or market acceptance and may be subject to legal challenge.

We recently launched a new version of our media delivery software, RealPlayer 11. Consumers can use RealPlayer 11 to record and download videos from websites on the Internet with a single click on a Download this Video button that appears in the consumer s web browser when a video is playing. Consumers can also simultaneously download and record multiple videos in a number of popular formats and can save the videos to CDs with the free version of RealPlayer 11 and to DVDs with a premium version that can be purchased through our websites. We cannot predict the rate of adoption or level of usage of RealPlayer 11 or whether it will lead to increased sales of any of our consumer products or services.

There are other risks associated with the distribution of RealPlayer 11, including the risk that content owners may claim that the recording and downloading of their content with RealPlayer 11 infringes their intellectual property rights even though RealPlayer 11 automatically recognizes and will not download content protected by digital rights management. It is possible that content owners may allege infringement even though RealPlayer 11 has substantial non-infringing uses. Usage of downloaded content by consumers for other than personal use, including commercial use, may also lead to claims against us for infringement of copyright or other intellectual property rights of third parties. Although we believe RealPlayer 11 is legal, there is no assurance that a court would agree with our position. Responding to these potential claims may require us to enter into royalty and licensing agreements on unfavorable terms, require us to stop distributing or selling, or to redesign, RealPlayer 11, or to pay damages. If we are required to enter into such agreements or take such actions, our operating results may be adversely impacted.

Music publishing royalty rates for music subscription services offered through RealNetworks and Rhapsody America are not yet fully established; a determination of high royalty rates could negatively impact our operating results.

Publishing royalty rates associated with music subscription services in the U.S. and abroad are not fully established. Public performance licenses are negotiated individually, and we have not yet agreed to rates with all of the performing rights societies for all of our music subscription service activities, including those now conducted by Rhapsody America . We or Rhapsody America may be required to pay a rate that is higher than we expect, as the issue was recently submitted to a Rate Court by the American Society of Composers, Authors and Publishers (ASCAP) for judicial determination. We have license agreements with the Harry Fox Agency, an agency that represents music publishers, and with many independent music publishers to reproduce musical compositions as required in the creation and delivery of on-demand streams and tethered downloads, but these license agreements do not include final royalty rates. The license agreements anticipate industry-wide agreement on rates, or, if no industry-wide agreement can be reached, determination by a copyright royalty board (CRB), an administrative judicial proceeding supervised by the U.S. Copyright Office. If the rates agreed to or determined by a CRB or by Congress are higher than we expect, the increased expense could negatively impact our operating results. The publishing rates associated with our international music streaming services are also not yet determined and may be higher than our current estimates.

An appeal of, or other industry settlement relating to, the April 2007 Copyright Royalty Board decision regarding Internet radio royalties and minimum payments could result in material expenses that would harm our operating results and our ability to provide popular radio services.

In April 2007, the Copyright Royalty Board (CRB) issued a decision setting new royalty rates for the use of sound recordings in Internet radio from 2006 through 2010. These rates are still under appeal and are also subject to

industry-wide settlement negotiations, in some of which we are a participant. The appeal or other industry settlement, whether or not we directly participate in the settlement, may result in higher rates or other terms that are unfavorable to us, which could adversely impact our operating results and our ability to provide our radio services in the future.

Our music, games and media software and services businesses face substantial competitive challenges that may prevent us from being successful in those businesses.

Music. Our online music services now offered through our Rhapsody America venture face significant competition from traditional offline music distribution competitors and from other online digital music services, as well as online theft or piracy. Some of these competing online services have spent substantial amounts on marketing and have received significant media attention, including Apple s iTunes music download service, which it markets closely with its extremely popular iPod line of portable digital audio players and its recently introduced iPhone. Microsoft has also begun offering premium music services in conjunction with its Windows Media Player and also now markets a portable music player and related download software and music service called Zune. We also expect increasing competition from online retailers such as Amazon.com. Our current music service offerings now offered through Rhapsody America may not be able to compete effectively in this highly competitive market. Our online music services also face significant competition from free peer-to-peer services which allow consumers to directly access a wide variety of free content without securing licenses from content providers. Enforcement efforts have not effectively shut down these services and there can be no assurance that these services will ever be shut down. The ongoing presence of these free services substantially impairs the marketability of legitimate services like ours.

Media Software and Services. Our media software and services (primarily our SuperPass subscription service) face competition from existing competitive alternatives and other free emerging services and technologies, such as user generated content services like YouTube and alternative streaming media playback technologies including Microsoft Windows Media Player and Adobe Flash. Content owners are increasingly marketing their content on their own websites rather than licensing to other distributors such as us. We face competition in these markets from traditional media outlets such as television, radio, CDs, DVDs, videocassettes and others. We also face competition from emerging Internet media sources and established companies entering into the Internet media content market, including Time Warner s AOL subsidiary, Microsoft, Apple, Adobe, Yahoo! and broadband ISPs. We expect this competition to become more intense as the market and business models for Internet video content mature and more competitors enter these new markets. Competing services may be able to obtain better or more favorable access to compelling video content than us, may develop better offerings than us and may be able to leverage other assets to promote their offerings successfully.

Games. Our RealArcade, GameHouse, and Zylom branded services compete with other online distributors of downloadable casual PC games. Some of these distributors have high volume distribution channels and greater financial resources than we do, including Yahoo! Games, MSN Gamezone, Pogo.com, and Shockwave. We expect competition to intensify in this market from these and other competitors and no assurance can be made that we will be able to continue to grow our revenue. Our GameHouse, Zylom, and Mr. Goodliving content development studios compete with other developers and publishers of downloadable PC and mobile games. Our development studios compete primarily with other developers of downloadable and mobile casual PC games and must continue to develop popular and high-quality game titles to maintain our competitive position and help maintain the growth of our games business.

We may not be successful in maintaining and growing our distribution of digital media products.

We cannot predict whether consumers will continue to download and use our digital media products consistent with past usage, especially in light of the fact that Microsoft bundles its competing Windows Media Player with its Windows operating system. Our inability to maintain continued high volume distribution of our digital media products could hold back the growth and development of related revenue streams from these market segments, including the distribution of third-party products, and therefore could harm our business and our prospects.

The success of music services offered through Rhapsody America depend, in part, on interoperability with our customers music playback hardware.

In order for the digital music services offered through Rhapsody America to continue to grow we must design services that interoperate effectively with a variety of hardware products, including portable digital audio players, mobile handsets, home stereos and PCs. We and Rhapsody America depend on significant cooperation with manufacturers of these products and with software manufacturers that create the operating systems for such hardware devices to achieve our objectives. To date, Apple has not agreed to design its popular iPod line of portable digital

audio players or its new iPhone to function with our music services. If we cannot successfully design our service to interoperate with the music playback devices that our customers own, our business will be harmed.

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Risks Related to Our Technology Products and Solutions Business

Recent acquisitions in our Technology Products and Solutions business could expose us to new risks, disrupt our business and adversely impact our results of operations.

In November 2006, we announced the final results of our tender offer for WiderThan Co., Ltd. (WiderThan) pursuant to which we acquired 99.7% of the outstanding common shares and American Depository Shares of WiderThan. We acquired the remaining 0.3% of WiderThan during the three months ended June 30, 2007. We also acquired Sony NetServices GmbH (SNS) and Exomi Oy (Exomi) in May 2007 and June 2007, respectively. The integration of these acquisitions, particularly WiderThan, is continuing and may divert the attention of management and other key personnel from other core business operations, which could adversely impact our financial performance in the near term. Moreover, the integration of WiderThan s operations into the Company will require expansions to our system of internal controls over financial reporting. Any failure to successfully operate and integrate WiderThan could have an adverse effect on our results of operations.

Our businesses may be adversely affected by developments affecting the South Korean economy amid increased tensions with North Korea.

With the acquisition of WiderThan, we generate a material portion of our revenue from operations in the Republic of Korea (South Korea). On a consolidated basis, during each of the three and nine months ended September 30, 2007 we derived 14% of our revenue from our operations in South Korea and expect that we will generate a significant portion of our revenue from South Korea in the remainder of 2007. Operating in this market subjects us to risks that were not previously relevant to us, including risks associated with the general state of the economy in South Korea and the potential instability of the Democratic People s Republic of Korea (North Korea).

Relations between South Korea and North Korea have been tense throughout Korea s modern history. The level of tension between the two Koreas has fluctuated and may increase or change abruptly as a result of current and future events, including ongoing contacts at the highest levels of the governments of South Korea and North Korea. Any further increase in tensions, which may occur, for example, if high-level contacts break down or military hostilities occur, could have a material adverse effect on our business, financial condition, and results of operations.

Our traditional system software business has been negatively impacted by the effects of our competitors and our settlement agreement with Microsoft may not improve sales of our system software products.

We believe that our traditional system software sales have been negatively impacted primarily by the competitive effects of Microsoft, which markets and often bundles its competing technology with its market leading operating systems and server software. In December 2003, we filed suit against Microsoft in U.S. District Court to redress what we believed were illegal, anticompetitive practices by Microsoft. In October 2005, we entered into a settlement agreement with Microsoft regarding these claims and we also entered into two commercial agreements related to our digital music and casual games businesses. Although the settlement agreement contained a substantial cash payment to us and a series of technology agreements between the two companies, Microsoft will continue to be an aggressive competitor with our traditional systems software business. We cannot be sure whether the portions of the settlement agreement designed to limit Microsoft s ability to leverage its market power will be effective and we cannot predict when, or if, we will experience increased demand for our system software products.

A majority of the revenue that we generate in South Korea is dependent upon our relationship with SK Telecom, the largest wireless carrier in Korea; any deterioration of this relationship could materially harm our business.

We offer our mobile entertainment services to consumers in South Korea through SK Telecom, the largest wireless carrier in South Korea. In the near term, we expect that we will continue to generate a material portion of our total revenue through SK Telecom. If SK Telecom fails to market or distribute our applications or terminates its business contracts with us, or if our relationship with SK Telecom deteriorates in any significant way, we may be unable to replace the affected business arrangements with acceptable alternatives, which could have a material negative impact on our revenue and operating results. Also, if we are unable to continue our service development in conjunction with SK Telecom, our ability to develop, test, and introduce new services will be materially harmed.

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Contracts with our carrier customers subject us to significant risks that could negatively impact our revenue from application services.

We derive a material portion of our revenue from carrier application services. Many of our carrier application services contracts provide for revenue sharing arrangements but we have little control over the pricing decisions of our carrier customers. Furthermore, most of these contracts do not provide for guaranteed minimum payments or usage levels. Moreover, since most of our carrier customer contracts are non-exclusive, it is possible that our wireless carriers could purchase similar application services from third parties, and cease to use our services in the future. As a result, our revenue derived under these agreements may be substantially reduced depending on the pricing and usage decisions of our carrier customers.

In addition, none of our carrier application services contracts obligates our carrier customers to market or distribute any of our applications. As a result, revenue related to our application services are, to a large extent, dependent upon the marketing and promotion activities of our carrier customers. The loss of carrier customers or a reduction in marketing or promotion of our applications would likely result in the loss of future revenues from our carrier application services.

Finally, many of our carrier contracts are short term and allow for early termination by the carrier with or without cause. These contracts are therefore subject to renegotiation of pricing or other key terms that could be adverse to our interests, and leave us vulnerable to non-renewal by the carriers. If our carrier contracts are terminated, not renewed, or renegotiated in a manner less favorable to us, our application services revenue would be negatively impacted.

Our carrier customers could begin developing some or all of our carrier applications services on their own, which could result in the loss of future revenues.

Most of our carrier customers do not offer internally-developed application services that compete with ours. If, however our carrier customers begin developing these application services internally, we could be forced to lower our prices or increase the amount of service we provide in order to maintain our business with those carrier customers. This could result in the loss of future revenues from our carrier application services or the reduction of margins related to such revenues.

The mobile entertainment market is highly competitive.

The market for mobile entertainment services, including ringback tone and music-on-demand solutions, is highly competitive. Current and potential future competitors include major media companies, Internet portal companies, content aggregators, wireless software providers and other pure-play wireless entertainment publishers. In connection with music-on-demand in particular, we may in the future compete with companies such as Apple, Microsoft, Napster, and Yahoo! which currently provide music-on-demand services for online or other non-mobile platforms. In addition, the major music labels may demand more aggressive revenue sharing arrangements or seek an alternative business model less favorable to us. Increased competition has in the past resulted in pricing pressure, forcing us to lower the selling price of our services. If we are not as successful as our competitors in our target markets, our sales could decline, our margins could be negatively impacted and we could lose market share, any of which could materially harm our business.

Our Helix open source initiative is subject to risks associated with open source technology.

Although we have invested substantial resources in the development of the underlying technology within our Helix DNA Platform and the Helix Community process, the market and industry may not accept these technologies and, therefore, we may not derive royalty or support revenue from them. Moreover, the introduction of the Helix DNA Platform open source and community source licensing schemes may adversely affect sales of our commercial system software products to mobile operators, broadband providers, corporations, government agencies, educational institutions and other business and non-business organizations.

Our patents may not improve our business prospects.

Our primary strategy with regard to patents is to use our patent portfolio to increase licensing and usage of our Helix products. We do not know whether our patents will ultimately be deemed enforceable, valid, or infringed. Accordingly, we cannot predict whether our patent strategy will be successful or will improve our financial results. Moreover, we may be forced to litigate to determine the validity and scope of our patents. Any such litigation could be costly and may not achieve the desired results.

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Risks Related to Our Business in General

Our operating results are difficult to predict and may fluctuate, which may contribute to fluctuations in our stock price.

As a result of the rapidly changing markets in which we compete, our operating results may fluctuate from period-to-period. In past periods, our operating results have been affected by personnel reductions and related charges, charges relating to losses on excess office facilities, and impairment charges for certain of our equity investments. Our operating results may be adversely affected by similar or other charges or events in future periods, which could cause the trading price of our stock to decline. Certain of our expense decisions (for example, research and development and sales and marketing efforts) are based on predictions regarding business and the markets in which we compete. To the extent that these predictions prove inaccurate, our revenue may not be sufficient to offset these expenditures, and our operating results may be harmed. In addition, we recently acquired the operations of WiderThan. We have limited experience managing these assets which may make it more difficult for us to accurately predict our operating results.

Our settlement agreement with Microsoft may not improve our business prospects.

In October 2005, we entered into a settlement agreement with Microsoft regarding claims of monopolistic activity which we had made against them. In connection with the settlement, we also entered into two commercial agreements with Microsoft related to our digital music and casual games businesses. The settlement agreement consists of a series of substantial cash payments, all of which have been received by us, and a series of technology agreements between the two companies. We cannot be sure that we will be able to apply the proceeds of the settlement in a way that will improve our operating results or otherwise increase the value of our shareholders investments in our stock.

Our products and services must compete with the products and services of strong or dominant competitors.

Our software and services must compete with strong existing competitors and new competitors that may enter with competitive new products, services, and technologies. These market conditions have in the past resulted in, and could likely continue to result in the following consequences, any of which could adversely affect our business, our operating results and the trading price of our stock:

- reduced prices, revenue and margins;
- increased expenses in responding to competitors;
- loss of current and potential customers, market share and market power;
- lengthened sales cycles;
- degradation of our stature and reputation in the market;
- changes in our business and distribution and marketing strategies;
- changes to our products, services, technology, licenses and business practices, and other disruption of our operations;
- strained relationships with partners; and
- pressure to prematurely release products or product enhancements.

Many of our current and potential competitors have longer operating histories, greater name recognition, more employees and significantly greater resources than we do. Our competitors across the breadth of our product lines include a number of large and powerful companies, such as Microsoft, Apple, and Yahoo!.

Failure to develop and introduce new products and services that achieve market acceptance could result in a loss of market opportunities and negatively affect our operating results.

The process of developing new, and enhancing existing, products and services is complex, costly and uncertain. Our business depends on providing products and services that are attractive to subscribers and consumers, which, in

part, is subject to unpredictable and volatile factors beyond our control, including end-user preferences and competing products and services. Any failure by us to timely respond to or accurately anticipate consumers changing needs and emerging technological trends could significantly harm our current market share or result in the loss of market opportunities. In addition, we must make long-term investments, develop or obtain appropriate intellectual property and commit significant resources before knowing whether our predictions will accurately reflect consumer demand for our products and services. Therefore, our operating results could be negatively impacted.

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We are experiencing greater fluctuations in revenue due to seasonality than at any time in our past, and we expect this trend to continue.

We are increasingly experiencing seasonality in our business, particularly with respect to the fourth quarter of our fiscal year. Our music, games and media software and services businesses, which include advertising revenue, make up a large percentage of our revenue, and the fourth quarter has traditionally been the seasonally strongest quarter for internet advertising. In addition, as we have begun partnering more closely with device manufacturers for our consumer music services, we expect sales of these devices to follow typical consumer buying patterns with a majority of consumer electronics being sold in the fourth quarter. Finally, WiderThan s historical business has seen a concentration of system sales, deployments, and consulting revenue in the fourth quarter. These factors may result in increasing seasonality in our business and we cannot predict with accuracy how these factors will impact our quarterly financial results.

Microsoft is one of our strongest competitors, and employs highly aggressive tactics against us.

Microsoft is one of our principal competitors in the development and distribution of digital media and media distribution technology. Microsoft s market power in related markets such as personal computer operating systems, office software suites and web browser software gives it unique advantages in the digital media markets. Despite the settlement of our antitrust litigation with Microsoft, we expect that Microsoft will continue to compete vigorously in the digital media markets in the future. Microsoft s dominant position in certain parts of the computer and software markets, and its aggressive activities have had, and in the future will likely continue to have, adverse effects on our business and operating results.

If our products are not able to support the most popular digital media formats, our business will be substantially impaired.

We may not be able to license technologies, like codecs or digital rights management technology, that obtain widespread consumer and developer use, which would harm consumer and developer acceptance of our products and services. In addition, our codecs and formats may not continue to be in demand or as desirable as other third-party codecs and formats, including codecs and formats created by Microsoft or industry standard formats created by MPEG.

We depend upon our executive officers and key personnel, but may be unable to attract and retain them, which could significantly harm our business and results of operations.

Our success depends on the continued employment of certain executive officers and key employees, particularly Robert Glaser, our founder, Chairman of the Board and Chief Executive Officer. The loss of the services of Mr. Glaser or other key executive officers or employees could harm our business.

Our success is also dependent upon our ability to identify, attract and retain highly skilled management, technical, and sales personnel, both in our domestic operations and as we expand internationally. Qualified individuals are in high demand and competition for such qualified personnel in our industry is intense, and we may incur significant costs to retain or attract them. There can be no assurance that we will be able to attract and retain the key personnel necessary to sustain our business or support future growth.

Our industry is experiencing consolidation that may cause us to lose key relationships and intensify competition.

The Internet and media distribution industries are undergoing substantial change, which has resulted in increasing consolidation and formation of strategic relationships. Acquisitions or other consolidating transactions could harm us in a number of ways, including the loss of customers if competitors or users of competing technologies consolidate with our current or potential customers, or our current competitors become stronger, or new competitors emerge from consolidations. Any of these events could put us at a competitive disadvantage, which could cause us to lose customers, revenue and market share. Consolidation in our industry, or in related industries such as broadband carriers, could force us to expend greater resources to meet new or additional competitive threats, which could also harm our operating results.

Industry consolidation could also cause the loss of strategic relationships if our strategic partners are acquired by or enter into relationships with a competitor. Because we rely on strategic relationships with third parties, including relationships providing for content acquisition and distribution of our products, the loss of current strategic relationships (due to industry consolidation or otherwise), the inability to find other strategic partners, our failure to

effectively manage these relationships or the failure of our existing relationships to achieve meaningful positive results could harm our business.

Acquisitions involve costs and risks that could harm our business and impair our ability to realize potential benefits from acquisitions.

As part of our business strategy, we have acquired technologies and businesses in the past, including the acquisition of Game Trust, Inc. in October 2007, and expect that we will continue to do so in the future. The failure to adequately manage the costs and address the financial, legal and operational risks raised by acquisitions of technology and businesses could harm our business and prevent us from realizing the benefits of the acquisitions.

Acquisition-related costs and financial risks related to completed and potential future acquisitions may harm our financial position, reported operating results, or stock price. Previous acquisitions have resulted in significant expenses, including amortization of purchased technology and amortization of acquired identifiable intangible assets, which are reflected in our operating expenses. New acquisitions and any potential future impairment of the value of purchased assets could have a significant negative impact on our future operating results.

Acquisitions also involve operational risks that could harm our existing operations or prevent realization of anticipated benefits from an acquisition. These operational risks include:

- difficulties and expenses in assimilating the operations, products, technology, information systems, and/or personnel of the acquired company;
- retaining key management or employees of the acquired company;
- entrance into unfamiliar markets, industry segments, or types of businesses;
- operating and integrating acquired businesses in remote locations;
- integrating and managing businesses based in countries in which we have little or no prior experience;
- diversion of management time and other resources from existing operations to integration activities for acquired businesses;
- impairment of relationships with employees, affiliates, advertisers or content providers of our business or acquired business; and
- assumption of known and unknown liabilities of the acquired company, including intellectual property claims.

Our strategic investments may not be successful and we may have to recognize expenses in our income statement in connection with these investments.

We have made, and in the future we may continue to make, strategic investments in other companies, including joint ventures. These investments often involve immature and unproven businesses and technologies and involve a high degree of risk. We could lose the entire amount of our investment. No assurance can be made that we will realize the anticipated benefits from any of our strategic investments.

We need to develop relationships and technical standards with manufacturers of non-PC media and communication devices to grow our business.

Access to the Internet through devices other than a personal computer (PC), such as personal digital assistants, cellular phones, television set-top devices, game consoles, Internet appliances and portable music and games devices has increased dramatically and is expected to continue to increase. If a substantial number of alternative device manufacturers do not license and incorporate our technology into their devices, we may fail to capitalize on the opportunity to deliver digital media to non-PC devices which could harm our business prospects. If we do not successfully make our products and technologies compatible with emerging standards and the most popular devices used to access digital media, we may miss market opportunities and our business and results will suffer.

Our business and operating results will suffer if our systems or networks fail, become unavailable, unsecured or perform poorly so that current or potential users do not have adequate access to our products, services and websites.

Our ability to provide our products and services to our customers and operate our business depends on the continued operation of our information systems and networks. A significant or repeated reduction in the performance, reliability or availability of our information systems and network infrastructure could harm our ability to conduct our business, and harm our reputation and ability to attract and retain users, customers, advertisers and content providers. We have on occasion experienced system errors and failures that caused interruption in availability of products or content or an increase in response time. Problems with our systems and networks could result from our failure to

adequately maintain and enhance these systems and networks, natural disasters and similar events, power failures, HVAC failures, intentional actions to disrupt our systems and networks and many other causes. The vulnerability of a large portion of our computer and communications infrastructure is enhanced because much of it is located at a single leased facility in Seattle, Washington, an area that is at heightened risk of earthquake, flood, and volcanic events. Many of our services do not currently have fully redundant systems or a formal disaster recovery plan, and we may not have adequate business interruption insurance to compensate us for losses that may occur from a system outage.

Our network is subject to security risks that could harm our business and reputation and expose us to litigation or liability.

Online commerce and communications depend on the ability to transmit confidential information and licensed intellectual property securely over private and public networks. Any compromise of our ability to transmit and store such information and data securely, and any costs associated with preventing or eliminating such problems, could damage our business, hurt our ability to distribute products and services and collect revenue, threaten the proprietary or confidential nature of our technology, harm our reputation, and expose us to litigation or liability. We also may be required to expend significant capital or other resources to alleviate problems caused by such breaches or attacks. Any successful attack or breach of our security could hurt consumer demand for our products and services, expose us to consumer class action lawsuits, and harm our business.

The growth of our business is dependent in part on successfully implementing our international expansion strategy.

A key part of our strategy is to develop localized products and services in international markets through subsidiaries, branch offices and joint ventures, if we do not successfully implement this strategy, we may not recoup our international investments and we may fail to develop or maintain worldwide market share. In addition, our recent acquisitions of Exomi, SNS, WiderThan, Zylom, and Mr. Goodliving have increased our revenue from our international operations. Our international operations involve risks inherent in doing business on an international level, including difficulties in managing operations due to distance, language, and cultural differences, different or conflicting laws and regulations, taxes, and exchange rate fluctuations. Any of these factors could harm operating results and financial condition. Our foreign currency exchange risk management program reduces, but does not eliminate, the impact of currency exchange rate movements.

As part of our international expansion strategy, we intend to grow our business in The People s Republic of China (PRC). PRC government regulates our business in PRC through regulations and license requirements restricting (i) the scope of foreign investment in the Internet, retail and delivery sectors, (ii) Internet content and (iii) the sale of certain media products. In order to meet PRC local ownership and regulatory licensing requirements, our business in PRC is operated through a PRC subsidiary which acts in cooperation with PRC companies owned by nominee shareholders who are PRC nationals. Although we believe this structure complies with existing PRC laws, it involves unique risks. There are substantial uncertainties regarding the interpretation of PRC laws and regulations, and it is possible that PRC government will ultimately take a view contrary to ours. If any of our PRC entities were found to be in violation of existing or future PRC laws or regulations or if interpretations of those laws and regulations were to change, the business could be subject to fines and other financial penalties, have its licenses revoked or be forced to shut down entirely.

We may be unable to adequately protect our proprietary rights and may face risks associated with third-party claims relating to our intellectual property.

Our ability to compete partly depends on the superiority, uniqueness and value of our technology, including both internally developed technology, and technology licensed from third parties. To protect our proprietary rights, we rely on a combination of patent, trademark, copyright and trade secret laws, confidentiality agreements with our employees and third parties, and protective contractual provisions. As disputes regarding the ownership of technologies and rights associated with streaming media, digital distribution, and online businesses are common and likely to arise in the future, we may be forced to litigate to enforce or defend our intellectual property rights or to determine the validity and scope of other parties proprietary rights. Any such litigation would likely be costly, distract our management, and the existence and/or outcome of any such litigation could harm our business.

Despite our efforts to protect our proprietary rights, any of the following would likely reduce the value of our intellectual property:

- our applications for patents and trademarks relating to our business may not be granted and, if granted, may be challenged or invalidated;
- our efforts to protect our intellectual property rights may not be effective in preventing misappropriation of our technology;

- our efforts may not prevent the development and design by others of products or technologies similar to, competitive with, or superior to those we develop; or

- another party may obtain a blocking patent, thus requiring us to either obtain a license or design around the patent in order to continue to offer the contested feature or service in our products.

From time to time we receive claims and inquiries from third parties alleging that our technology may infringe the third parties proprietary rights, especially patents. Third parties have also asserted and most likely will continue to assert claims against us alleging infringement of copyrights, trademark rights, trade secret rights or other proprietary rights, or alleging unfair competition or violations of privacy rights. Currently we are investigating or litigating a variety of such pending claims, some of which are described in Part II of this report under the heading Legal Proceedings.

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We may be subject to market risk and legal liability in connection with the data collection capabilities of our products and services.

Many of our products are interactive Internet applications that by their very nature require communication between a client and server to operate. To provide better consumer experiences and to operate effectively, our products send information to our servers. Many of the services we provide also require that a user provide certain information to us. We have an extensive privacy policy concerning the collection, use and disclosure of user data involved in interactions between our client and server products. Any failure by us to comply with our posted privacy policy and existing or new legislation regarding privacy issues could impact the market for our products and services, subject us to litigation, and harm our business.

We account for employee stock options using the fair value method, which may have a material adverse affect on our results of operations.

On January 1, 2006, we adopted the provisions of, and started accounting for stock-based compensation in accordance with, the Financial Accounting Standards Board s Statement of Financial Accounting Standard (SFAS) No. 123R revised 2004, *Share Based Payment*, which requires a company to recognize, as an expense, the fair value of stock options and other stock-based compensation. We are required to record an expense for our stock-based compensation plans using the fair value method as described in SFAS No. 123R, which results in the recognition of significant and ongoing accounting charges, for which we recorded an expense of $6.0 million and $5.0 million during the three months ended September 30, 2007 and 2006, respectively, and $17.3 million and $12.3 million during the nine months ended September 30, 2007 and 2006, respectively, in our condensed consolidated statement of operations. Stock options are also a key part of the compensation packages that we offer our employees. If we are forced to curtail our broad-based option program due to these additional charges, it may become more difficult for us to attract and retain employees.

We may be subject to assessment of sales and other taxes for the sale of our products, license of technology or provision of services.

Currently we do not collect sales or other taxes on the sale of our products, license of technology, or provision of services in states and countries other than those in which we have offices or employees. Our business would be harmed if one or more states or any foreign country were to require us to collect sales or other taxes from past sales or income related to products, licenses of technology, or provision of services.

Effective July 1, 2003, we began collecting Value Added Tax, or VAT, on sales of electronically supplied services provided to European Union residents, including software products, games, data, publications, music, video and fee-based broadcasting services. There can be no assurance that the European Union will not make further modifications to the VAT collection scheme, the effects of which could require significant enhancements to our systems and increase the cost of selling our products and services into the European Union. The collection and remittance of VAT subjects us to additional currency fluctuation risks.

The Internet Tax Freedom Act, or ITFA, which Congress extended until November 2007, among other things, imposed a moratorium on discriminatory taxes on electronic commerce. The imposition by state and local governments of various taxes upon Internet commerce could create administrative burdens for us and could decrease our future sales.

We may be subject to additional income tax assessments.

We are subject to income taxes in the U.S. and numerous foreign jurisdictions. Significant judgment is required in determining our worldwide provision for income taxes, income taxes payable, and net deferred tax assets. In the ordinary course of business, there are many transactions and calculations where the ultimate tax determination is uncertain. Although we believe our tax estimates are reasonable, the final determination of tax audits and any related litigation could be materially different than that which is reflected in our historical financial statements. An audit or litigation can result in significant additional income taxes payable in the U.S. or foreign jurisdictions which could have a material adverse effect on our financial condition and results of operations.

We donate a portion of our net income to charity.

In periods where we achieve profitability, we intend to donate 5% of our annual net income to charitable organizations, which would reduce our net income for those periods.

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Risks Related to the Securities Markets and Ownership of Our Common Stock

Our directors and executive officers beneficially own approximately one third of our stock, which gives them significant control over certain major decisions on which our shareholders may vote, may discourage an acquisition of us, and any significant sales of stock by our officers and directors could have a negative effect on our stock price.

Our executive officers, directors and affiliated persons beneficially own more than one third of our common stock. Robert Glaser, our Chief Executive Officer and Chairman of the Board, beneficially owns the majority of that stock. As a result, our executive officers, directors and affiliated persons will have significant influence to:

- elect or defeat the election of our directors;
- amend or prevent amendment of our articles of incorporation or bylaws;
- effect or prevent a merger, sale of assets or other corporate transaction; and
- control the outcome of any other matter submitted to the shareholders for vote.

Management s stock ownership may discourage a potential acquirer from making a tender offer or otherwise attempting to obtain control of RealNetworks, which in turn could reduce our stock price or prevent our shareholders from realizing a premium over our stock price.

Provisions of our charter documents, Shareholder Rights Plan, and Washington law could discourage our acquisition by a third-party.

Our articles of incorporation provide for a strategic transaction committee of the board of directors. Without the prior approval of this committee, and subject to certain limited exceptions, the board of directors does not have the authority to:

- adopt a plan of merger;
- authorize the sale, lease, exchange or mortgage of assets representing more than 50% of the book value of our assets prior to the transaction or on which our long-term business strategy is substantially dependent;
- authorize our voluntary dissolution; or
- take any action that has the effect of any of the above.

RealNetworks has also entered into an agreement providing Mr. Glaser with certain contractual rights relating to the enforcement of our charter documents and Mr. Glaser s roles and authority within RealNetworks.

We have adopted a shareholder rights plan that provides that shares of our common stock have associated preferred stock purchase rights. The exercise of these rights would make the acquisition of RealNetworks by a third-party more expensive to that party and has the effect of discouraging third parties from acquiring RealNetworks without the approval of our board of directors, which has the power to redeem these rights and prevent their exercise.

Washington law imposes restrictions on some transactions between a corporation and certain significant shareholders. The foregoing provisions of our charter documents, shareholder rights plan, our agreement with Mr. Glaser, our zero coupon convertible subordinated notes and Washington law, as well as our charter provisions that provide for a classified board of directors and the availability of blank check preferred stock, could have the effect of making it more difficult or more expensive for a third-party to acquire, or of discouraging a third-party from attempting to acquire, control of us. These provisions may therefore have the effect of limiting the price that investors might be willing to pay in the future for our common stock.

We are exposed to potential risks from legislation requiring companies to evaluate controls under Section 404 of the Sarbanes-Oxley Act of 2002.

We have evaluated our internal controls in order to allow management to report on, and our registered independent public accounting firm to attest to, our internal controls, as required by Section 404 of the Sarbanes-Oxley Act of 2002. We have performed the system and process evaluation and testing required in an effort to comply with the

management certification and auditor attestation requirements of Section 404. The requirements and processes associated with Section 404 are still evolving and we cannot be certain that the measures we have taken will be sufficient to meet the Section 404 requirements as changes occur to the guidance and our reporting environment or that we will be able to implement and maintain adequate controls over financial reporting processes and reporting in the future. Moreover, we cannot be certain that the costs associated with such measures will not exceed our estimates, which could impact our overall level of profitability. Any failure to meet the Section 404 requirements or to implement required new or improved controls, or difficulties or unanticipated costs encountered in their implementation, could cause investors to lose confidence in our reported financial information or could harm our financial results, which could have a negative effect on the trading price of our stock.

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Certain material weaknesses in internal controls of WiderThan were identified as of December 31, 2005; if we fail to remediate and maintain an effective system of internal controls at WiderThan we may be unable to accurately report our financial results or reduce our ability to prevent or detect fraud, and investor confidence may be affected.

In connection with the audit of WiderThan s 2005 financial statements, the management of WiderThan identified certain material weaknesses, as defined by the Public Company Accounting Oversight Board s Auditing Standard No. 2, as of December 31, 2005, as follows:

- WiderThan did not retain accounting staff with sufficient depth and skill in the application of U.S. GAAP commensurate with the reporting requirements of a U.S. registrant;

- WiderThan did not have effective controls over establishing and maintaining accounting policies related to revenue recognition; and

- WiderThan did not maintain effective controls, including monitoring, over the financial close and reporting process. Specifically, WiderThan relied heavily on the use of spreadsheet programs during the financial close process and did not have adequately designed controls to ensure the completeness, accuracy, and restricted access to such spreadsheets.

In making its assessment of the effectiveness of internal control over financial reporting as of December 31, 2006 management excluded WiderThan, as permitted by the SEC, because it was acquired on October 31, 2006. We are in the process of integrating the finance operations of WiderThan into our finance department; however, there is no certainty that the identified material weaknesses will be remediated in a timely manner or controls will be implemented to prevent a material misstatement in the consolidated financial statements. Moreover, we cannot be certain that the costs associated with such measures will not exceed our estimates, which could impact our overall level of profitability. Any failure to remediate these material weaknesses could cause investors to lose confidence in our reported financial information or could harm our financial results.

Our stock price has been volatile in the past and may continue to be volatile.

The trading price of our common stock has been highly volatile. For example, during the 52-week period ended September 30, 2007, the price of our common stock ranged from $5.45 to $12.08 per share. Our stock price could be subject to wide fluctuations in response to factors such as actual or anticipated variations in quarterly operating results, changes in financial estimates, recommendations by securities analysts, changes in the competitive environment, as well as any of the other risk factors described above.

Financial forecasting of our operating results will be difficult because of the changing nature of our products and business, and our actual results may differ from forecasts.

As a result of the dynamic markets in which we compete, it is difficult to accurately forecast our operating results and metrics. Our inability or the inability of the financial community to accurately forecast our operating results could result in our reported net income (loss) in a given quarter to differ from expectations, which could cause a decline in the trading price of our common stock.

Item 2. Unregistered Sales of Equity Securities and Use of Proceeds

None

Item 3. Default Upon Senior Securities

None

Item 4. Submission of Matters to a Vote of Security Holders

None

Item 5. Other Information

None

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Item 6. Exhibits

Exhibits Required by Item 601 of Regulation S-K

Exhibit Number	Description
10.1	Transaction, Contribution and Purchase Agreement dated as of August 20, 2007 among Rhapsody America LLC, RealNetworks, Inc., RealNetworks Digital Music of California, Inc., Viacom International Inc. and DMS Holdco Inc.
10.2	Limited Liability Company Agreement of Rhapsody America LLC dated as of August 20, 2007 among RealNetworks, Inc., RealNetworks Digital Music of California, Inc., Viacom International Inc. and DMS Holdco Inc.
10.3	Stockholder Agreement by and between Viacom International Inc. and RealNetworks, Inc. dated as of August 20, 2007
31.1	Certification of Robert Glaser, Chairman and Chief Executive Officer of RealNetworks, Inc., Pursuant to Exchange Act Rules 13a-14(a) and 15d-14(a), as Adopted Pursuant to Section 302 of the Sarbanes-Oxley Act of 2002
31.2	Certification of Michael Eggers, Senior Vice President, Chief Financial Officer and Treasurer of RealNetworks, Inc., Pursuant to Exchange Act Rules 13a-14(a) and 15d-14(a), as Adopted Pursuant to Section 302 of the Sarbanes-Oxley Act of 2002
32.1	Certification of Robert Glaser, Chairman and Chief Executive Officer of RealNetworks, Inc., Pursuant to 18 U.S.C. Section 1350, as Adopted Pursuant to Section 906 of the Sarbanes-Oxley Act of 2002
32.2	Certification of Michael Eggers, Senior Vice President, Chief Financial Officer and Treasurer of RealNetworks, Inc., Pursuant to 18 U.S.C. Section 1350, as Adopted Pursuant to Section 906 of the Sarbanes-Oxley Act of 2002

Portions of this exhibit are omitted and were filed separately with the Securities and Exchange Commission pursuant to the Company s application requesting confidential treatment under Rule 24b-2 of the Securities Exchange Act of 1934, as

amended.

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SIGNATURE

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, on November 8, 2007.

REALNETWORKS, INC.

By: /s/ Michael Eggers
Michael Eggers
Title: Senior Vice President, Chief Financial Officer and Treasurer
(Principal Financial and Accounting Officer)

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