

REALNETWORKS INC
Form 10-Q
November 10, 2008

Table of Contents

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

FORM 10-Q

(Mark One)

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

For the Quarterly Period Ended September 30, 2008

OR

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

For the transition period from to

Commission file number 0-23137

RealNetworks, Inc.

(Exact name of registrant as specified in its charter)

Washington

(State of incorporation)

91-1628146

(I.R.S. Employer Identification Number)

2601 Elliott Avenue, Suite 1000

Seattle, Washington

(Address of principal executive offices)

98121

(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 No

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

Large accelerated filer Accelerated filer Non-accelerated filer Smaller reporting company

(Do not check if a smaller reporting company)

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

The number of shares of the registrant's Common Stock outstanding as of October 31, 2008 was 135,061,961.

TABLE OF CONTENTS

	Page
<u>Part I. Financial Information</u>	
<u>Item 1. Financial Statements</u>	3
<u>Item 2. Management's Discussion and Analysis of Financial Condition and Results of Operations</u>	20
<u>Item 3. Quantitative and Qualitative Disclosures About Market Risk</u>	36
<u>Item 4. Controls and Procedures</u>	37
<u>Part II. Other Information</u>	
<u>Item 1. Legal Proceedings</u>	37
<u>Item 1A. Risk Factors</u>	38
<u>Item 2. Unregistered Sales of Equity Securities and Use of Proceeds</u>	48
<u>Item 3. Default Upon Senior Securities</u>	48
<u>Item 4. Submission of Matters to a Vote of Security Holders</u>	48
<u>Item 5. Other Information</u>	48
<u>Item 6. Exhibits</u>	48
<u>Signature</u>	49

EX-31.1

EX-31.2

EX-32.1

EX-32.2

Table of Contents**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, 2008	December 31, 2007
ASSETS		
Current assets:		
Cash and cash equivalents	\$ 305,143	\$ 476,697
Short-term investments	101,173	79,932
Trade accounts receivable, net of allowances for doubtful accounts and sales returns	70,427	84,674
Deferred costs, current portion	8,221	6,408
Prepaid expenses and other current assets	42,795	33,845
Total current assets	527,759	681,556
Equipment, software, and leasehold improvements, at cost:		
Equipment and software	131,254	109,621
Leasehold improvements	30,795	30,632
Total equipment, software, and leasehold improvements, at cost	162,049	140,253
Less accumulated depreciation and amortization	98,877	83,756
Net equipment, software, and leasehold improvements	63,172	56,497
Restricted cash equivalents and investments	14,734	15,509
Equity investments	9,277	9,976
Other assets	17,821	10,161
Deferred tax assets, net	35,564	40,913
Other intangible assets, net	78,656	107,677
Goodwill	315,517	353,153
Total assets	\$ 1,062,500	\$ 1,275,442
LIABILITIES AND SHAREHOLDERS EQUITY		
Current liabilities:		
Accounts payable	\$ 34,384	\$ 56,160
Accrued and other liabilities	111,507	114,136
Deferred revenue, current portion	42,376	39,564
Related party payable	15,663	17,241
Convertible debt		100,000
Accrued loss on excess office facilities, current portion	4,299	3,389
Total current liabilities	208,229	330,490

Edgar Filing: REALNETWORKS INC - Form 10-Q

Deferred revenue, non-current portion	1,138	2,663
Accrued loss on excess office facilities, non-current portion	3,864	7,311
Deferred rent	4,680	4,518
Deferred tax liabilities, net, non-current portion	15,178	22,060
Other long-term liabilities	10,644	13,683
Total liabilities	243,733	380,725
Minority interest in Rhapsody America (\$83.7 million redemption value at September 30, 2008)	6,297	19,613
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 140,204 shares in 2008 and 142,298 shares in 2007	140	142
Additional paid-in capital	655,872	653,904
Accumulated other comprehensive (loss) income	(43,488)	17,732
Retained earnings	199,946	203,326
Total shareholders' equity	812,470	875,104
Total liabilities and shareholders' equity	\$ 1,062,500	\$ 1,275,442

See accompanying notes to unaudited condensed consolidated financial statements.

Table of Contents

REALNETWORKS, INC. AND SUBSIDIARIES
UNAUDITED CONDENSED CONSOLIDATED STATEMENTS OF OPERATIONS
AND COMPREHENSIVE INCOME (LOSS)

(In thousands, except per share data)

	Quarters Ended		Nine Months Ended	
	September 30,		September 30,	
	2008	2007	2008	2007
Net revenue (A)	\$ 151,955	\$ 145,095	\$ 452,166	\$ 410,738
Cost of revenue (B)	62,164	56,644	173,202	151,786
Gross profit	89,791	88,451	278,964	258,952
Operating expenses:				
Research and development	31,076	26,528	85,147	75,012
Sales and marketing	55,080	52,812	161,730	152,593
Advertising with related party	15,153	7,747	31,733	7,747
General and administrative	15,453	16,750	50,874	51,167
Restructuring costs			686	
Subtotal operating expenses	116,762	103,837	330,170	286,519
Antitrust litigation benefit, net				(60,747)
Total operating expenses, net	116,762	103,837	330,170	225,772
Operating (loss) income	(26,971)	(15,386)	(51,206)	33,180
Other income (expenses):				
Interest income, net	2,865	7,290	11,198	24,457
Equity in net loss of investments	(226)		(424)	(132)
Gain on sale of equity investments, net			222	132
Minority interest in Rhapsody America	12,337	6,466	29,129	6,466
Gain on sale of interest in Rhapsody America	7,405	7,946	14,502	7,946
Other income, net	818	38	1,636	990
Other income, net	23,199	21,740	56,263	39,859
Income (loss) before income taxes	(3,772)	6,354	5,057	73,039
Income taxes	(728)	(2,012)	(8,436)	(27,409)
Net income (loss)	\$ (4,500)	\$ 4,342	\$ (3,379)	\$ 45,630

Edgar Filing: REALNETWORKS INC - Form 10-Q

Basic net income (loss) per share	\$ (0.03)	\$ 0.03	\$ (0.02)	\$ 0.30
Diluted net income per share	\$ (0.03)	\$ 0.03	\$ (0.02)	\$ 0.27
Shares used to compute basic net income per share	141,975	149,667	142,611	154,670
Shares used to compute diluted net income per share	141,975	163,094	142,611	169,840
Comprehensive income (loss):				
Net income (loss)	\$ (4,500)	\$ 4,342	\$ (3,379)	\$ 45,630
Unrealized holding losses on short-term and equity investments, net of income taxes	(1,841)	(3,228)	(2,130)	(8,947)
Foreign currency translation gains (losses)	(38,759)	1,206	(59,090)	(453)
Comprehensive income (loss)	\$ (45,100)	\$ 2,320	\$ (64,599)	\$ 36,230
(A) Components of net revenue:				
License fees	\$ 28,394	\$ 23,869	\$ 82,762	\$ 67,918
Service revenue	123,561	121,226	369,404	342,820
	\$ 151,955	\$ 145,095	\$ 452,166	\$ 410,738
(B) Components of cost of revenue:				
License fees	\$ 11,137	\$ 8,436	\$ 31,139	\$ 24,610
Service revenue	51,027	48,208	142,063	127,176
	\$ 62,164	\$ 56,644	\$ 173,202	\$ 151,786

See accompanying notes to unaudited condensed consolidated financial statements.

Table of Contents

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

	Nine Months Ended	
	September 30,	
	2008	2007
Cash flows from operating activities:		
Net (loss) income	\$ (3,379)	\$ 45,630
Adjustments to reconcile net income (loss) to net cash used in operating activities:		
Depreciation and amortization	38,032	32,865
Stock-based compensation	17,475	17,291
Loss on disposal of equipment, software, and leasehold improvements	157	275
Equity in net loss of investments	198	132
Gain on sale of equity investments, net	(222)	(132)
Excess tax benefit from stock option exercises	(108)	
Accrued loss on excess office facilities	(2,537)	(3,540)
Unrealized gain on trading securities		(5,426)
Purchase of trading securities		(270,000)
Deferred income taxes	2,640	(13,224)
Minority interest	(29,129)	(6,466)
Gain on sale of interest in Rhapsody America	(14,502)	(7,946)
Other	111	72
Net change in certain operating assets and liabilities, net of acquisitions:		
Trade accounts receivable	12,696	(9,755)
Prepaid expenses and other assets	(26,066)	(11,572)
Accounts payable	(16,766)	(3,349)
Accrued and other liabilities	386	28,334
Net cash used in operating activities	(21,014)	(206,811)
Cash flows from investing activities:		
Purchases of equipment, software, and leasehold improvements	(24,807)	(19,051)
Purchases of short-term investments	(151,378)	(117,762)
Proceeds from sales and maturities of short-term investments	130,136	154,251
Purchases of other intangible assets	(1,808)	(2,723)
Decrease in restricted cash equivalents and investments, net	776	1,800
Payment of acquisition costs, net of cash acquired	(10,192)	(25,316)
Purchase of equity investments	(4,500)	
Proceeds from sales of equity investments	1,225	1,615
Net cash used in investing activities	(60,548)	(7,186)
Cash flows from financing activities:		
	8,834	14,058

Edgar Filing: REALNETWORKS INC - Form 10-Q

Net proceeds from sale of common stock under employee stock purchase plan and exercise of stock options		
Payments of convertible debt obligations	(100,000)	
Excess tax benefit from stock option exercises	108	
Net proceeds from sales of interest in Rhapsody America	31,640	15,007
Repurchase of common stock	(23,062)	(142,150)
Net cash used in financing activities	(82,480)	(113,085)
Effect of exchange rate changes on cash and cash equivalents	(7,512)	(412)
Net decrease in cash and cash equivalents	(171,554)	(327,494)
Cash and cash equivalents, beginning of period	476,697	525,232
Cash and cash equivalents, end of period	\$ 305,143	\$ 197,738
Supplemental disclosure of cash flow information:		
Cash paid for income taxes	\$ 11,170	\$ 28,750
Supplemental disclosure of non-cash investing and financing activities:		
Accrued acquisition costs	\$	\$ 310
Accrued acquisition consideration		8,596
See accompanying notes to unaudited condensed consolidated financial statements.		

Table of Contents

REALNETWORKS, INC. AND SUBSIDIARIES
NOTES TO UNAUDITED CONDENSED CONSOLIDATED FINANCIAL STATEMENTS
Quarters and Nine Months Ended September 30, 2008 and 2007

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, 2008. 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 condensed consolidated statements of operations and comprehensive income (loss). MTVN's proportionate share of equity is included in Minority interest in Rhapsody America in the unaudited condensed consolidated balance sheets.

The Company acquired 99.7% of WiderThan Co., Ltd. (WiderThan) during the quarter ended December 31, 2006. The Company acquired substantially all of the remaining shares of WiderThan during the quarter 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 quarter and nine months ended September 30, 2007 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 quarter and nine months ended September 30, 2008 are not necessarily indicative of the results that may be expected for any subsequent quarter or for the year ending December 31, 2008. 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, 2007.

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.

Table of Contents

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 unaudited condensed consolidated statement of operations.

Note 2. Recent Accounting Pronouncements

In December 2007, the FASB issued SFAS No. 141R, *Business Combinations* (SFAS 141R), which establishes principles and requirements for how an acquirer recognizes and measures in its financial statements the identifiable assets acquired, the liabilities assumed, and any noncontrolling interest in an acquiree, including the recognition and measurement of goodwill acquired in a business combination. The requirements of SFAS 141R are effective for the Company for periods beginning after December 15, 2008. Early adoption is prohibited. The Company is in the process of evaluating this guidance and therefore has not yet determined the impact that SFAS 141R will have on the Company's financial position or results of operations upon adoption.

In December 2007, the FASB issued SFAS No. 160, *Noncontrolling Interest in Consolidated Financial Statements*, an amendment of ARB No. 51 (SFAS 160), which will change the accounting and reporting for minority interests, which will be recharacterized as noncontrolling interests and classified as a component of equity within the consolidated balance sheets. SFAS 160 requires that changes in a parent's ownership interest while the parent retains its controlling financial interest shall be accounted for as equity transactions. As a result, beginning in 2009, the gain on sales of interest in Rhapsody America will no longer be recorded in the statement of operations, but will be

reflected as a component of shareholders equity. The requirements of SFAS 160 are effective for the Company for periods beginning after December 15, 2008. Early adoption is prohibited. The Company is in the process of evaluating all the impacts of this guidance and therefore has not yet determined the full impact that SFAS 160 will have on the Company's financial position or results of operations upon adoption.

Table of Contents

In April 2008, the FASB issued FSP No. 142-3, *Determination of the Useful Life of Intangible Assets* (FSP 142-3). FSP 142-3 amends the factors that should be considered in developing renewal or extension assumptions used to determine the useful life of a recognized intangible asset under FASB Statement No. 142, *Goodwill and Other Intangible Assets*. FSP 142-3 is effective for financial statements issued for fiscal years beginning after December 15, 2008. Early adoption is prohibited. The Company is currently evaluating the impact FSP No. 142-3 may have on the Company's financial position or results of operations upon adoption.

In May 2008, the FASB issued SFAS No. 162, *The Hierarchy of Generally Accepted Accounting Principles*, (SFAS 162). This Statement identifies the sources of accounting principles and the framework for selecting the principles to be used in the preparation of financial statements of nongovernmental entities that are presented in conformity with U.S. GAAP (the GAAP hierarchy). While the effective date of this pronouncement has not yet been determined, the Company is currently assessing the impact SFAS 162 may have on the Company's financial position or results of operations upon adoption.

Note 3. Stock-Based Compensation

The Company accounts for stock-based compensation in accordance with SFAS No. 123R revised 2004, *Share-Based Payment* (SFAS 123R). 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 123R. The Company recognized compensation cost related to stock options granted prior to the adoption of SFAS 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 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:

	Quarters		Nine Months	
	Ended September 30, 2008	2007	Ended September 30, 2008	2007
Expected dividend yield	0%	0%	0%	0%
Risk-free interest rate	2.95%	4.44%	2.65%	4.56%
Expected life (years)	4.2	4.1	4.2	4.1
Volatility	45%	42%	45%	42%

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

	Quarters		Nine Months	
	Ended September 30, 2008	2007	Ended September 30, 2008	2007
Cost of service revenue	\$ 696	\$ 208	\$ 1,592	\$ 520
Research and development	2,247	1,740	6,307	5,153
Sales and marketing	1,458	2,395	4,798	6,985
General and administrative	1,554	1,641	4,778	4,633

Total stock-based compensation expense	\$ 5,955	\$ 5,984	\$ 17,475	\$ 17,291
--	----------	----------	-----------	-----------

No stock-based compensation was capitalized as part of the cost of an asset during the quarter and nine months ended September 30, 2008 or 2007. As of September 30, 2008, \$40.5 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 2.6 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:

Table of Contents

RealNetworks contributed its Rhapsody service subscribers, 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 51. MTVN made payments of \$17.0 million and \$31.4 million during the quarter and nine months ended September 30, 2008, respectively. As a result, RealNetworks realized and recorded gains of \$8.7 million and \$16.0 million, as all of the SAB 51 gain criteria were met. As of September 30, 2008, \$56.4 million in payments have been made on the note since the formation of Rhapsody America.

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 sheets as of September 30, 2008 and December 31, 2007. MTVN's contribution included identifiable intangible assets with estimated fair values as of the date of formation 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 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 agreed to during the initial formation of Rhapsody America, RealNetworks and MTVN provided additional funding of \$17.4 and \$16.7 million, respectively, in the quarter ended December 31, 2007, for future operations.

Call/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 evaluated the terms of the call and put rights under applicable accounting literature, including SFAS No. 133, *Accounting for Derivatives and Hedging Activities*, and SFAS No. 150, *Accounting for Certain Financial Instruments with Characteristics of Both Liabilities and Equity*, and concluded that neither of these rights represent freestanding financial instruments or derivatives that should be accounted for separately.

These call and put rights are exercisable upon the occurrence of certain events any time after January 1, 2011 and during certain periods in each of 2012, 2013 and 2014 and every two years thereafter and are not exercisable any time

prior to January 1, 2011. 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 its 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

Table of Contents

stock, such shares could consist of common stock representing up to 15% of the outstanding shares of RealNetworks common stock immediately prior to the transaction and shares of 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 shareholders' voting and economic interests in RealNetworks could be diluted and MTVN will become one of RealNetworks significant shareholders.

The redemption prices of MTVN's interest in Rhapsody America under both the call and put rights are calculated based on the provisions within the limited liability agreement, are impacted by the total appraised value of Rhapsody America and assume repayment of the \$230 million five-year note payable from MTVN. Once the call right becomes exercisable, the redemption price of MTVN's interest in Rhapsody America under the call right will be equal to the greater of \$230 million or the appraised value of MTVN's interest in Rhapsody America at the redemption date. Once the put right becomes exercisable, the redemption price of MTVN's interest in Rhapsody America under the put right will be equal to, upon the occurrence of certain events, the appraised value of MTVN's interest in Rhapsody America at the redemption date or will be based on a formula that is intended to approximate the appraised value at the redemption date. The hypothetical current redemption price of MTVN's interest in Rhapsody America under the put right at September 30, 2008 is \$83.7 million. The current redemption price has been adjusted under the formula in the limited liability agreement for the remaining outstanding amounts due of \$173.6 million on the note payable as of September 30, 2008.

Note 5. Fair Value Measurements

Effective January 1, 2008, the Company implemented SFAS No. 157, *Fair Value Measurement* (SFAS 157), for its financial assets and liabilities that are re-measured and reported at fair value at each reporting period, and non-financial assets and liabilities that are re-measured and reported at fair value at least annually. In accordance with the provisions of FSP No. FAS 157-2, *Effective Date of FASB Statement No. 157*, the Company elected to defer implementation of SFAS 157 as it relates to its non-financial assets and non-financial liabilities that are recognized and disclosed at fair value in the financial statements on a nonrecurring basis until January 1, 2009. The Company is evaluating the impact, if any, SFAS 157 will have on its non-financial assets and liabilities that are recognized or disclosed at fair value on a nonrecurring basis.

The adoption of SFAS 157 with respect to financial assets and liabilities and non-financial assets and liabilities that are re-measured and reported at fair value at least annually did not have an impact on the financial results of the Company in the third quarter of 2008. The Company will continue to evaluate the impact, if any, that the implementation of this standard will have on its financial statements as it relates to its non-financial assets and liabilities.

SFAS No. 157 establishes a hierarchy that prioritizes fair value measurements based on the types of inputs used for the various valuation techniques (market approach, income approach and cost approach). The levels of the hierarchy are described below:

Level 1: Observable inputs such as quoted prices in active markets for identical assets or liabilities

Level 2: Inputs other than quoted prices that are observable for the asset or liability, either directly or indirectly; these include quoted prices for similar assets or liabilities in active markets and quoted prices for identical or similar assets or liabilities in markets that are not active

Level 3: Unobservable inputs that reflect the reporting entity's own assumptions

The following table presents information about the Company's financial assets that have been measured at fair value as of September 30, 2008 and indicates the fair value hierarchy of the valuation inputs utilized to determine such fair value.

**Fair Value Measurements as of
September 30, 2008**

(in thousands)	Total	Level 1	Level 2	Level 3
Cash equivalents				
Money market funds	\$ 138,490	\$ 138,490	\$	\$
Corporate notes and bonds	91,876	91,876		
Short-term investments				
Corporate notes and bonds	24,186	24,186		
U.S. government agency securities	76,987	76,987		
Equity investments				
Publicly traded investments	4,654	4,654		
Total	\$ 336,193	\$ 336,193	\$	\$

Investments in marketable securities classified as short-term investments and equity investments of public companies are measured at fair value using quoted market prices and are classified within Level 1 of the valuation hierarchy. The Company carries its equity investments in private companies at cost and are excluded from the provisions of SFAS 157. The Company has consistently applied these valuation techniques in all periods presented.

Table of Contents**Note 6. Cash, Cash Equivalents, Trading Securities, Short-Term Investments, and Restricted Cash Equivalents and Investments**

Cash, cash equivalents, trading securities, short-term investments, and restricted cash equivalents and investments as of September 30, 2008 consist of the following (in thousands):

	Amortized Cost	Gross Unrealized Gains	Gross Unrealized Losses	Estimated Fair Value
Cash and cash equivalents:				
Cash	\$ 74,777	\$	\$	\$ 74,777
Money market mutual funds	138,490			138,490
Corporate notes and bonds	91,876			91,876
Total cash and cash equivalents:	305,143			305,143
Short-term investments:				
Corporate notes and bonds	25,097	1	(912)	24,186
U.S. Government agency securities	76,919	119	(51)	76,987
Total short-term investments:	102,016	120	(963)	101,173
Total cash, cash equivalents and short-term investments	\$ 407,159	\$ 120	\$ (963)	\$ 406,316
Restricted cash equivalents and investments	\$ 14,734	\$	\$	\$ 14,734

Cash, cash equivalents, short-term investments, and restricted cash equivalents as of December 31, 2007 consist of the following (in thousands):

	Amortized Cost	Gross Unrealized Gains	Gross Unrealized Losses	Estimated Fair Value
Cash and cash equivalents:				
Cash	\$ 105,615	\$	\$	\$ 105,615
Money market mutual funds	198,148			198,148
Corporate notes and bonds	172,934			172,934
Total cash and cash equivalents	476,697			476,697
Short-term investments:				
Corporate notes and bonds	43,552		(981)	42,571
U.S. Government agency securities	37,296	65		37,361

Total short-term investments	80,848	65	(981)	79,932
Total cash, cash equivalents, and short-term investments	\$ 557,545	\$ 65	\$ (981)	\$ 556,629
Restricted cash equivalents and investments	\$ 15,509	\$	\$	\$ 15,509

At September 30, 2008 and December 31, 2007, restricted cash equivalents and investments represent cash equivalents and short-term investments pledged as collateral against two letters of credit for a total of \$14.7 million and \$15.5 million, respectively, in connection with two lease agreements.

Realized gains or losses on sales of available-for-sale securities for the quarters ended September 30, 2008 and 2007 were not significant.

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.

The contractual maturities of available-for-sale investments at September 30, 2008 are as follows (in thousands):

	Amortized Cost	Estimated Fair Value
Within one year	\$ 93,848	\$ 93,908
Between one year and five years	8,168	7,265
Total available-for-sale investments	\$ 102,016	\$ 101,173

Table of Contents**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	Sales
	Accounts	Returns
	Receivable	
Balances, December 31, 2007	\$ 1,117	\$ 1,338
Additions charged to expenses/revenue	525	2,599
Amounts written off	(323)	(2,797)
Balances, September 30, 2008	\$ 1,319	\$ 1,140

As of September 30, 2008, one domestic and one international customer accounted for approximately 11% and 15% of trade accounts receivable, respectively. No one customer accounted for more than 10% of total revenue during the quarter or nine months ended September 30, 2008. As of December 31, 2007, one international customer accounted for 19% of trade accounts receivable. The same international customer accounted for 13% of total revenue during the quarter and nine months ended September 30, 2007.

Note 8. Equity Investments

As of September 30, 2008 and December 31, 2007, the carrying value of equity investments in publicly traded companies primarily relates to J-Stream Inc. (J-Stream), a Japanese media services company, of 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, 2008		December 31, 2007	
	Cost	Carrying	Cost	Carrying
		Value		Value
Publicly traded investments	\$ 855	\$ 4,654	\$ 933	\$ 8,085
Privately held investments	5,364	4,623	2,740	1,891
Total equity investments	\$ 6,219	\$ 9,277	\$ 3,673	\$ 9,976

Note 9. Other Intangible Assets

Other intangible assets at September 30, 2008 consist of the following (in thousands):

	Gross	Accumulated	
	Amount	Amortization	Net
Customer relationships	\$ 70,404	\$ 21,228	\$ 49,176
Developed technology	44,159	23,418	20,741
Patents, trademarks and tradenames	13,099	6,935	6,164
Service contracts and other	6,029	3,454	2,575
Total other intangible assets	\$ 133,691	\$ 55,035	\$ 78,656

Edgar Filing: REALNETWORKS INC - Form 10-Q

Other intangible assets at December 31, 2007 consist of the following (in thousands):

	Gross Amount	Accumulated Amortization	Net
Customer relationships	\$ 80,435	\$ 15,273	\$ 65,162
Developed technology	48,173	18,539	29,634
Patents, trademarks and tradenames	13,833	5,000	8,833
Service contracts and other	6,815	2,767	4,048
Total other intangible assets	\$ 149,256	\$ 41,579	\$ 107,677

Table of Contents

Amortization expense related to other intangible assets during the quarter and nine months ended September 30, 2008 was \$6.5 million and \$20.4 million, respectively. Amortization expense related to other intangible assets during the quarter and nine months ended September 30, 2007 was \$6.1 million and \$17.5 million, respectively.

As of September 30, 2008, estimated future amortization of other intangible assets is as follows (in thousands):

2008 (remaining three months)	\$ 6,130
2009	23,063
2010	16,961
2011	11,898
2012	10,705
Thereafter	9,899
Total	 \$ 78,656

Note 10. Goodwill

Changes in goodwill are as follows (in thousands):

Balance, December 31, 2007	\$ 353,153
Increases due to current year acquisitions	1,817
Decreases for the reduction of liabilities assumed related to the acquisition of Sony NetServices GmbH	(538)
Effects of foreign currency translation	(38,915)
Balance, September 30, 2008	 \$ 315,517

Note 11. Accrued and Other Liabilities

Accrued and other liabilities consist of (in thousands):

	September 30, 2008	December 31, 2007
Royalties and other fulfillment costs	\$ 48,654	\$ 37,554
Employee compensation, commissions and benefits	19,849	21,639
Sales, VAT and other taxes payable	12,580	18,156
Legal fees and contingent legal fees	2,676	3,439
Other	27,748	33,348
Other	 \$ 111,507	 \$ 114,136

Note 12. Loss on Excess Office Facilities

The accrued loss of \$8.2 million for estimated future losses on excess office facilities located near the Company's corporate headquarters in Seattle Washington at September 30, 2008, is shown net of expected future sublease income of \$5.7 million, which was committed under sublease contracts at the time of the estimate. The Company regularly evaluates the market for office space in the cities where it has operations. If the market for such space declines further in future periods, the Company may have to revise its estimates further, which may result in additional losses on excess office facilities.

Edgar Filing: REALNETWORKS INC - Form 10-Q

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

Accrued loss on excess office facilities, December 31, 2007	\$ 10,700
Less amounts amortized from the accrued loss on excess office facilities	(2,537)
Accrued loss on excess office facilities, September 30, 2008	8,163
Less current portion	(4,299)
Accrued loss on excess office facilities, non-current portion	\$ 3,864

Table of Contents**Note 13. Repurchase of Common Stock**

In May 2008, the Company's Board of Directors authorized a new share repurchase program for the repurchase of up to an aggregate of \$50.0 million of its outstanding common stock. During the quarter ended September 30, 2008, the Company purchased 3.6 million shares of its common stock at an average cost of \$6.36 per share for an aggregate value of \$23.0 million. The Company purchased a total of 3.8 million shares of its common stock at an average cost of \$6.39 per share for an aggregate value of \$24.5 million under the May 2008 repurchase program and \$25.5 million remained authorized as of September 30, 2008.

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):

	Quarters Ended		Nine Months Ended	
	September 30,		September 30,	
	2008	2007	2008	2007
Weighted average common shares outstanding used to compute basic net income per share	141,975	149,667	142,611	154,670
Dilutive potential common shares:				
Stock options and restricted stock		2,677		4,420
Convertible debt		10,750		10,750
Shares used to compute diluted net income per share	141,975	163,094	142,611	169,840

During the quarter and nine months ended September 30, 2008, 32.1 million 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 quarter 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.

Note 15. Commitments and Contingencies

Borrowing Arrangements. The Company's subsidiary, WiderThan, has entered into lines of credit with two Korean domestic banks with an aggregate maximum available limit of \$2.4 million at interest rates of approximately 1.6% 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 \$0.8 million bearing interest at 7.3%. During the quarter and nine months ended September 30, 2008, the Company did not draw on these lines of credit and there were no balances outstanding as of September 30, 2008 or December 31, 2007.

The Company's subsidiary, WiderThan, uses corporate charge cards issued by a Korean domestic bank with an aggregate line of credit of up to \$4.1 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), which 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 quarter and nine months ended September 30, 2008, the Company did not draw on the letter of credit and there was no balance outstanding as of September 30, 2008 or December 31, 2007.

Table of Contents

The Company's subsidiary, WiderThan, has purchased guarantees amounting to \$0.5 million from Seoul Guarantee Insurance which guarantees payments for one year under certain supply contracts the Company has with a customer in Korea.

Purchase Obligations. As of September 30, 2008, the Company has commitments with third party vendors to pay \$11.8 million and \$23.4 million through the years ended May 31, 2009 and 2010, respectively. These commitments are ordinary course expenses relating to the Company's on-going business operations.

Litigation. On September 30, 2008, the Company filed a declaratory action against Disney Enterprises, Inc., Paramount Pictures Corp., Sony Pictures Entertainment, Inc., Twentieth Century Fox Film Corp., NBC Universal, Inc., Warner Bros. Entertainment, Inc., and Viacom, Inc. and the DVD Copy Control Association (DVD CCA) in the Northern District of California relating to the Company's RealDVD product, which, among other things, allows consumers to store a copy of DVDs that they own on their computers. On the same day, various movie studios filed suit against the Company in the Central District of California. The Company's suit asks the court to find that the RealDVD product does not breach the license agreement that the Company entered into with the DVD CCA. The movie studios' suit alleges that by offering the RealDVD product, RealNetworks has violated the Digital Millennium Copyright Act. The movie studios' suit was subsequently transferred to the Northern District of California. On October 3, 2008, the Studios obtained a temporary restraining order (TRO) requiring the Company to cease distribution of its RealDVD product. The TRO was extended on October 7, 2008. The Court scheduled a preliminary injunction hearing to address the movie studios' claim that RealDVD should not be sold pending a final judicial determination of the underlying claims between the parties. The Company believes that RealDVD complies with the law, and the Company intends to vigorously defend the preliminary injunction request and, if necessary, pursue its declaratory judgment action.

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, in some of which the Company is a participant. Additionally, the CRB is currently holding hearings that will determine mechanical royalty rates associated with the statutory license for digital phonorecord deliveries, including tethered downloads. These rates are also subject to industry-wide settlement negotiations. A partial settlement with respect to on-demand streaming and tethered downloads was recently reached between the Digital Media Association (DiMA), the Recording Industry Association of America (RIAA) and the National Music Publishers Association (NMPA), among others. This settlement was recently published by the CRB in an administrative judicial proceeding supervised by the U.S. Copyright Office. This settlement is still subject to comment by industry participants and is not yet final. Finally, the Company is involved in a proceeding in the Southern District of New York that will determine a royalty rate for the public performance of music contained in the American Society of Composers, Authors and Publishers (ASCAP) catalogue. In April 2008, the district court issued a preliminary ruling that sets forth, among other things, a methodology to be used to calculate the royalties owed to ASCAP. The methodology to be used to calculate the royalties is incomplete and contains elements that require negotiation and agreement by the parties in addition to further hearings and decisions by the district court. On July 16, 2008, the court issued its ruling relating to the application of the new rates. The Company is working with ASCAP to make a final determination of amounts due under the court's ruling. The Company believes it has sufficiently accrued for expected royalties. It is too soon to tell what ultimate effect the district court's preliminary ruling will have on the Company or what additional royalty amounts, if any, might ultimately be payable to ASCAP.

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 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 on July 26, 2007, and invalidated all claims on grounds of obviousness. Friskit has appealed the court's ruling, and the court heard oral argument on October 7, 2008.

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 other legal proceedings or claims that the Company believes will have, individually or taken together, a material adverse effect on the Company's business,

Table of Contents

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* (SFAS 131), 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 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 includes the Company's Chief Executive Officer, Chief Financial Officer, Chief Operating Officer 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 131. 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 the aspects of its music business not included as part of Rhapsody America. 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-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.

The 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 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 quarter ended September 30, 2008 is as follows (in thousands):

	Music	Consumer	Technology Products and Solutions	Reconciling Amounts	Consolidated
Net revenue	\$ 41,591	\$ 58,731	\$ 51,633	\$	\$ 151,955
Cost of revenue	23,787	14,790	23,587		62,164

Edgar Filing: REALNETWORKS INC - Form 10-Q

Gross profit	17,804	43,941	28,046		89,791
Operating expenses	42,355	44,476	29,719	212	116,762
Operating income (loss)	(24,551)	(535)	(1,673)	(212)	(26,971)
Total non-operating income, net	19,742			3,457	23,199
Income (loss) before income taxes	\$ (4,809)	\$ (535)	\$ (1,673)	\$ 3,245	\$ (3,772)

16

Table of Contents

Segment income (loss) before income taxes for the nine months ended September 30, 2008 is as follows (in thousands):

	Music	Consumer	Technology Products and Solutions	Reconciling Amounts	Consolidated
Net revenue	\$ 116,840	\$ 181,121	\$ 154,205	\$	\$ 452,166
Cost of revenue	65,999	41,765	65,438		173,202
Gross profit	50,841	139,356	88,767		278,964
Operating expenses	107,978	126,137	94,683	1,372	330,170
Operating income (loss)	(57,137)	13,219	(5,916)	(1,372)	(51,206)
Total non-operating income, net	43,631			12,632	56,263
Income (loss) before income taxes	\$ (13,506)	\$ 13,219	\$ (5,916)	\$ 11,260	\$ 5,057

Segment income (loss) before income taxes for the quarter 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
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
--	--------------	-----------------	--	--------------------------------	---------------------

Edgar Filing: REALNETWORKS INC - Form 10-Q

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
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	\$ (18,894)	\$ 22,000	\$ (13,629)	\$ 83,652	\$ 73,039

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

	Quarters Ended		Nine Months Ended	
	September 30,		September 30,	
	2008	2007	2008	2007
United States	\$ 102,363	\$ 91,281	\$ 302,430	\$ 263,870
Europe	27,151	22,150	78,514	60,382
Republic of Korea	12,171	20,591	38,261	57,875
Rest of the World	10,270	11,073	32,961	28,611
Total net revenue	\$ 151,955	\$ 145,095	\$ 452,166	\$ 410,738

Table of Contents

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

	September 30, 2008	December 31, 2007
United States	\$ 196,293	\$ 186,665
Republic of Korea	172,221	235,728
Europe	81,339	87,181
Rest of the World	7,492	7,753
Total long-lived assets	\$ 457,345	\$ 517,327

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

	September 30, 2008	December 31, 2007
United States	\$ 560,902	\$ 576,994
Republic of Korea	173,306	228,153
Europe	75,220	79,410
Rest of the World	9,339	10,160
Total net assets	\$ 818,767	\$ 894,717

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

	September 30, 2008	December 31, 2007
Music	\$ 37,029	\$ 37,029
Consumer	129,158	129,621
Technology products and solutions	149,330	186,503
Total goodwill	\$ 315,517	\$ 353,153

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 quarter ended September 30, 2008, Rhapsody America received \$17.0 million in cash as a note payment and spent \$15.2 million in advertising with MTVN. During the nine months ended September 30, 2008, Rhapsody America received \$31.4 million in cash as a note payment and spent \$31.7 million in advertising with MTVN. During the year ended December 31, 2007, Rhapsody America received \$25.0 million in cash as a note payment and spent \$24.4 million in advertising with MTVN.

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 charged costs for the support services, revenue and related costs for the quarter and nine months ended September 30, 2008 were \$0.1 million and \$1.1 million, respectively. These amounts are included in the unaudited

condensed consolidated financial statements within the related party payable of \$15.7 million as of September 30, 2008.

Table of Contents

The Company also agreed to grant 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 and comprehensive income. 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 charged \$0.2 million to MTVN related to stock options since the formation of the venture. This amount was paid in full by MTVN prior to September 30, 2008.

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. Convertible Debt

During the quarter ended September 30, 2008, the Company repurchased \$100.0 million of its outstanding convertible debt. After the repurchase, no convertible debt remains outstanding.

Table of Contents

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-looking statements. Forward-looking statements include statements with respect to:

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

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

plans, strategies and expected opportunities for growth, increased profitability and innovation in 2008 and future years;

the creation of new strategic partnerships and broadening of existing strategic partnerships and the advantages and growth we will achieve as a result of such partnerships (including in connection with our Games, Music and Technology Products and Solutions businesses);

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;

RealNetworks' intention to separate its games business, distribute shares of the newly created games company to its shareholders, the potential sale of up to 20% of the shares of the new games company in an initial public offering and the anticipated tax-free nature of the proposed transactions;

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;

the effects of legislation, regulations, administrative proceedings, court rulings, settlement negotiations and other factors that may impact music publishing royalty rates;

the potential outcomes and effects of claims and legal proceedings on our business, prospects, financial condition or results of operations;

our financial position and the availability of resources;

our expectations regarding acquisition activity in 2008 and our focus on the integration of completed acquisitions;

our relationships with our employees;

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*.*

Table of Contents

Overview

We are a leading creator of digital media services and software. Our mission is to deliver world class digital entertainment experiences – music, games or video – wherever and whenever consumers want them. 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 AT&T and Verizon in the U.S., Vodafone in Europe, and SK Telecom in 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 subscribers.

Our strategy is to continue to (1) develop technology that provides meaningful differentiation to our chosen markets in digital entertainment services; (2) build a direct relationship with, and grow, our worldwide user base; and (3) create strong business partnerships with device makers, media companies, service providers and other distribution channels in order to build a sustainable and profitable global business. We intend to continue to expand our products and services beyond the PC to mobile devices and to create compelling digital media experiences on a variety of entertainment 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 acquisition efforts principally to identify and acquire targets (1) with complementary technologies and products to ours in order to accelerate and supplement our research and development efforts, (2) to increase the distribution of our products and services into new geographies and (3) to gain significant new customers. For example, our Technology Products and Solutions business acquired WiderThan in 2006 to obtain a new set of products and technologies including ringback tone and music-on-demand businesses for mobile carriers. The WiderThan acquisition also expanded our geographic reach into South Korea and brought us a new strategic relationship with SK Telecom in South Korea. Subsequent to our acquisition of WiderThan, we acquired Sony NetServices in 2007 to expand our presence in Europe for our ringback tone and music-on-demand products and to enhance our strategic relationship with Vodafone. Similarly, in our Games business, we acquired Zylom in 2006 to expand our presence in Europe and Trymedia in April 2008 to expand the distribution of our casual games to a wide variety of new customers through Trymedia's existing syndication business.

We have recently focused our efforts on growing our Music and Consumer businesses through both internal initiatives, third party distribution and strategic acquisitions of businesses and technologies. Through our agreement with Verizon Wireless, we have expanded our Rhapsody subscription music service, which is provided through Rhapsody America, into the mobile carrier market. We have also increased our focus on free-to-consumer products and services, such as providing free music streaming for top music websites and downloadable games monetized through 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. We believe that the weakness of the economy and credit market turmoil will continue to negatively impact consumer and advertising spending, which in turn, may negatively affect our revenue in future periods. In addition, we expect our revenue to be impacted by the increased volatility in foreign exchange rates, particularly if the US dollar continues to gain strength against the euro and the Korean won.

Our Technology Products and Solutions business consists of system software license sales and application service provider (ASP) services, which include ringback tones, music-on-demand, video-on-demand and messaging services. Our traditional system software sales have been negatively impacted primarily by the competitive effects of Microsoft, which 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 the settlement of all antitrust disputes worldwide, and we also entered into two commercial agreements related to our digital music and casual games businesses. The settlement agreement contained cash payments to us totaling approximately \$761 million, the final installment of which we received in the quarter ended March 31, 2007, and the transactions under the commercial agreements have also concluded. While the payments we received under the settlement agreement have significantly enhanced our cash position and impact the comparability of our overall

results of operations in 2007 and the results of operations in 2008, we do not expect that the completion of Microsoft's obligations under the settlement agreement and the commercial agreements will materially impact our prospects or business strategies in future periods.

In response to the slowing growth of our system software sales business we began to shift our focus to growing our ASP services, which we significantly enhanced by acquiring WiderThan in 2006. We believe that the transition to an ASP business model will create a more stable, recurring, and scalable revenue stream compared with our traditional system software license sales model. In addition, we have continued to de-emphasize our systems integration business primarily because it has lower margins and does not generate consistent recurring revenue streams. This shift away from the systems integration business to our ASP business has resulted in declines in our Technology Products and Solutions revenue in the quarter ended September 30, 2008.

Table of Contents

On May 8, 2008 we announced that we intend to separate our casual games business into an independent company and to distribute shares of the newly created games company to our shareholders. We also announced that we may precede the spin-off with an initial public offering (IPO) and sale of up to 20% of the shares of the new games company. We expect that either a spin-off or an IPO and subsequent spin-off will be tax-free to our shareholders. In addition to final approval by the our board of directors, completion of the transaction will be subject to a number of factors, including the effectiveness of a registration statement, the receipt of a favorable letter ruling from the Internal Revenue Service, the receipt of an opinion of tax counsel, market conditions, as well as the execution of inter-company agreements and other matters. We do not expect to make any filings with the Securities and Exchange Commission relating to the separation of the games business in 2008.

In the quarter ended September 30, 2008, total revenue grew 5% as compared with the quarter ended September 30, 2007 due primarily to continued growth in subscribers to services offered by our Music and Consumer segments, which accounted for a majority of the increase. Consumer revenue growth during the quarter ended September 30, 2008 was also driven by the effects from the April 2008 acquisition of Trymedia.

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, Consumer Revenue 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;

Minority interest;

Accounting for gains on sale of subsidiary stock;

Accounting for income taxes; and

Accounting for taxes collected from customers.

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 music tracks, albums and games are recognized at the time the music or game is made available, digitally, to the end user.

Table of Contents

We recognize 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, 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 many arrangements, we contract directly with end user customers, are the primary obligor and carry all collectibility risk. In such arrangements we report the 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 the 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 costs in excess of total expected revenue are considered not recoverable and charged to operations in the period in which the determination is made.

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.

Table of Contents

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.

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 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 that 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 in this report.

Stock-Based Compensation. We account for stock-based compensation in accordance with Statement of Financial Accounting Standards (SFAS) No. 123R, *Share-Based Payment* (SFAS 123R). 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 in our common stock price 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. Prior to the adoption of SFAS No. 123R, we measured compensation expense for our employee stock-based compensation plans using the intrinsic value method prescribed by Accounting Principles Board Opinion (APB) No. 25, *Accounting for Stock Issued to Employees*. Under APB No. 25, when the exercise price of our employee stock options was equal to the market price of the underlying stock on the date of the grant, no compensation expense was recognized.

Minority Interests. We record minority interest expense (benefit) which reflects the portion of the earnings (losses) of majority-owned entities which are applicable to the minority interest partners in accordance with Accounting Research Bulletin No. 51, *Consolidated Financial Statements* (ARB No. 51). Redeemable minority interests that are redeemable at either fair value or are based on a formula that is intended to approximate fair value are accounted for in accordance with ARB No. 51. As of September 30, 2008 and December 31, 2007, our minority interests solely related to redeemable minority interests in Rhapsody America. Minority interest expense (benefit) is included in the unaudited condensed consolidated statements of operations and comprehensive income for 2008.

Table of Contents

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 *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. We have elected to reflect SAB No. 51 gains or losses in our consolidated statements of operations and comprehensive income.

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 basis 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 more likely than not, 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 and comprehensive income. Factors we consider in making such an assessment include, but are not limited to: past performance and our expectation of future taxable income, macroeconomic 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.

As of September 30, 2008, there have been no material changes to our uncertain tax positions disclosures as provided in Note 15 of our 2007 Annual Report on Form 10-K. We do not anticipate that the total unrecognized tax benefits will significantly change within the next twelve months.

We file numerous consolidated, combined, 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. We are currently under California Franchise Tax Board income tax audit for the consolidated group RealNetworks, Inc. and subsidiaries for the years ended December 31, 2005 and 2006. During the current quarter, an income tax audit by the United States Internal Revenue Service for our wholly-owned subsidiary WiderThan Americas, Inc. for the period ended December 31, 2005 was closed with no adjustments.

Accounting for Taxes Collected From Customers. We collect various types of taxes from our 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 our net revenue.

Revenue by Segment

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

	Quarters Ended September 30,			Nine Months Ended September 30,		
	2008	Change	2007	2008	Change	2007
Music	\$ 41,591	10%	\$ 37,658	\$ 116,840	8%	\$ 108,586
Consumer	58,731	8	54,166	181,121	17	155,393
Technology Products and Solutions	51,633	(3)	53,271	154,205	5	146,759
Total net revenue	\$ 151,955	5%	\$ 145,095	\$ 452,166	10%	\$ 410,738

Table of Contents

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

	Quarters Ended		Nine Months Ended	
	September 30, 2008	2007	September 30, 2008	2007
Music	27%	26%	26%	26%
Consumer	39	37	40	38
Technology Products and Solutions	34	37	34	36
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 mp3 store, Rhapsody service and our RealPlayer music store; and advertising from our music websites. These products and services are sold and provided primarily through our distribution partners and 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.

Prior to the quarter ended September 30, 2008, our Music revenue growth had slowed due primarily to continuing challenges facing our subscription music business, including low consumer awareness of subscription music services, Apple's dominance of the portable mp3 player business, limited distribution of music devices that are compatible with our subscription services, and the persistent availability of free, unlicensed music content from peer-to-peer services. In response, we have shifted our business strategy and marketing efforts toward new initiatives including the launches of our new online mp3 store and our Rhapsody subscription service with Verizon Wireless, as well as the development of music-discovery services for consumer music websites, such as Yahoo!, MTV.com and the iLike application on Facebook. These initiatives were launched on June 30, 2008 and contributed to an increase in the rate of growth of our Music revenue for the quarter ended September 30, 2008. Additionally, as part of a strategic relationship between Yahoo! and us, Yahoo! Music Unlimited subscribers that chose to migrate to Rhapsody's digital music service were converted from Yahoo! Music Unlimited subscribers to Rhapsody subscribers during the quarter ended September 30, 2008.

Music revenue increased 10% and 8% during the quarter and nine months ended September 30, 2008, respectively, compared with the quarter and nine months ended September 30, 2007. Growth in revenue from our Rhapsody subscription music service accounted for \$3.5 million and \$10.5 million of the increase for the quarter and nine months ended September 30, 2008, respectively. Subscriber and related revenue growth were primarily driven by our launch of a new distribution channel with Verizon Wireless and the one-time migration of Yahoo! Music Unlimited subscribers who chose to convert to Rhapsody. An increase in the number of digital music tracks sold during the quarter and nine months ended September 30, 2008, respectively, contributed approximately \$1.3 million and \$0.8 million to the increase. The increase in sales of digital music tracks was due primarily to the launch of our new mp3 store on June 30, 2008. These increases were offset by a decline in revenue from our RadioPass music subscription services of approximately \$1.2 million and \$4.0 million for the quarter and nine months ended September 30, 2008, respectively, due primarily to a decline in subscribers to these services. No other single factor contributed materially to the changes during the periods.

Consumer. Consumer revenue 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 8% and 17% during the quarter and nine months ended September 30, 2008, compared with the quarter and nine months ended September 30, 2007, respectively. Factors contributing to the

changes in revenue are discussed below in the sections included within Consumer revenue.

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. Application services revenue consists of ringback tones, music-on-demand, video-on-demand, and inter-carrier messaging services, and are primarily sold to wireless carriers. Software revenue consists 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.

Table of Contents

Technology Products and Solutions revenue decreased 3% during the quarter ended September 30, 2008, compared with the quarter ended September 30, 2007. The decrease during the quarter was due primarily to a decrease in systems integration revenue of approximately \$5.4 million. The decrease was partially offset by an increase in revenue from application services provided to wireless carriers, including ringback tones, music-on-demand, inter-carrier messaging, and video-on-demand services of approximately \$3.4 million during the quarter. Technology Products and Solutions revenue increased 5% during the nine months ended September 30, 2008, compared with the nine months ended September 30, 2007, due primarily to an increase in revenue from application services provided to wireless carriers of approximately \$20.6 million. This increase was offset by a decrease in systems integration revenue of approximately \$11.2 million as compared with the prior period. The increases in revenue from application services to wireless carriers during the quarter and nine months ended September 30, 2008 were due primarily to increased usage and users of the services we provide. The decline in systems integration revenue during the quarter and nine months was due primarily to a shift away from our lower-margin systems integration business to focus on our application service provider business. No other single factor contributed materially to the change during the periods.

Consumer Revenue

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

	Quarters Ended September 30,			Nine Months Ended September 30,		
	2008	Change	2007	2008	Change	2007
Games	\$ 34,200	19%	\$ 28,820	\$ 100,943	30%	\$ 77,617
Media Software and Services	24,531	(3)	25,346	80,178	3	77,776
Total consumer products and services revenue	\$ 58,731	8%	\$ 54,166	\$ 181,121	17%	\$ 155,393

Games. Games revenue primarily includes revenue from: the sale of individual games through our RealArcade service and our Games related websites; our GamePass and FunPass subscription service; and advertising through RealArcade and our Games related websites and distribution of third-party software products.

Games revenue increased 19% and 30% during the quarter and nine months ended September 30, 2008, respectively, compared with the quarter and nine months ended September 30, 2007. Revenue associated with our Trymedia acquisition, which was consummated on April 1, 2008, accounted for approximately \$4.0 million and \$8.1 million of the increases during the quarter and nine months ended September 30, 2008, respectively. Increases in subscription revenue generated through our RealArcade service and our websites accounted for approximately \$1.7 million and \$8.5 million of the increases during the quarter and nine months ended September 30, 2008, respectively. Increases in the number of subscribers to our FunPass product accounted for a significant portion of the increase in subscription revenue for both the quarter and nine months ended September 30, 2008. Revenue associated with the distribution of third-party products increased approximately \$1.0 million and \$2.9 million during the quarter and nine months ended September 30, 2008, respectively, due primarily to an increased focus on the distribution of these products. The increases for the quarter ended September 30, 2008 were offset by a decrease in sales of individual games of approximately \$1.4 million. No other single factor contributed materially to the change during the periods.

While our Games revenue grew during the quarter and nine months ended September 30, 2008 compared with the quarter and nine months ended September 30, 2007, our Games revenue growth slowed in 2008, and revenue for the quarter ended September 30, 2008 declined by 2% from the quarter ended June 30, 2008. The slowing revenue growth, as well as the decline in revenue from the quarter ended June 30, 2008 are primarily attributed to a decline in sales of individual games.

Media Software and Services. Media Software and Services revenue primarily includes revenue from: our SuperPass and stand-alone premium video subscription services; premium versions of RealPlayer such as 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 3% during the quarter ended September 30, 2008, compared with the quarter ended September 30, 2007. This decrease was due primarily to a decrease in subscribers to, and related revenue from, our SuperPass subscription service totaling approximately \$1.9 million, offset by an increase in the number of licenses sold for our premium versions of RealPlayer totaling approximately \$0.7 million. Media Software and Services revenue increased 3% during the nine months ended September 30, 2008, compared with the nine months ended September 30, 2007. This increase was due primarily to an increase in revenue of approximately \$5.3 million from distribution of third-party products related to our campaign to encourage consumers to

Table of Contents

upgrade to RealPlayer 11 and a \$2.8 million increase in the number of licenses sold for premium versions of RealPlayer. The increase for the nine months was offset by a decrease in subscribers to our SuperPass service, and related subscription revenue, totaling approximately \$4.2 million. No other single factor contributed materially to the change during the periods.

Media Software and Services revenue for the quarter ended September 30, 2008, decreased sequentially from the quarter ended June 30, 2008, by approximately \$4.7 million. This decrease was due primarily to a decline in revenue from distribution of third-party products related to the end of the upgrade cycle for our new version of RealPlayer. The upgrade cycle was substantially completed during the quarter ended June 30, 2008.

Geographic Revenue

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

	Quarters Ended September 30,			Nine Months Ended September 30,		
	2008	Change	2007	2008	Change	2007
United States	\$ 102,363	12%	\$ 91,281	\$ 302,430	15%	\$ 263,870
Europe	27,151	23	22,150	78,514	30	60,382
Republic of Korea	12,171	(41)	20,591	38,261	(34)	57,875
Rest of the world	10,270	(7)	11,073	32,961	15	28,611
Total net revenue	\$ 151,955	5%	\$ 145,095	\$ 452,166	10%	\$ 410,738

Revenue in the U.S. increased 12% and 15% for the quarter and nine months ended September 30, 2008, respectively, compared with the quarter and nine months ended September 30, 2007. The increases were due primarily to growth in our Consumer and Music segments, including the acquisition of Trymedia in April 2008. Trymedia contributed approximately \$4.0 million and \$8.1 million of the increases during the quarter and nine months ended September 30, 2008, respectively. See *Revenue by Segment - Games and Music* above for further discussion of these changes.

Revenue in Europe increased 23% and 30% during the quarter and nine months ended September 30, 2008, respectively, compared with the quarter and nine months ended September 30, 2007. The increases were due primarily to the continued growth of our Games and Technology Products and Solutions businesses in Europe. The growth in our Games business was due primarily to increased subscription revenue of approximately \$1.5 million and \$4.9 million of revenue in Europe during the quarter and nine months ended September 30, 2008, respectively. The growth in our Technology Products and Solutions business was due primarily to increased subscribers and increased usage of our application services to wireless carriers that accounted for approximately \$0.9 million and \$9.2 million of revenue in Europe during the quarter and nine months ended September 30, 2008, respectively. See *Revenue by Segment - Games and Technology Products and Solutions* above for further discussion of these changes.

Revenue in the Republic of Korea decreased 41% and 34% for the quarter and nine months ended September 30, 2008, respectively, compared with the quarter and nine months ended September 30, 2007. These decreases were due primarily to a decline in revenue from our systems integration business of approximately \$5.0 million and \$9.6 million during the quarter and nine months ended September 30, 2008, respectively. See *Revenue by Segment - Technology Products and Solutions* above for further discussion of these changes.

License and Service Revenue

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

	Quarters Ended September 30,			Nine Months Ended September 30,		
	2008	Change	2007	2008	Change	2007
License fees	\$ 28,394	19%	\$ 23,869	\$ 82,762	22%	\$ 67,918

Edgar Filing: REALNETWORKS INC - Form 10-Q

Service revenue	123,561	2	121,226	369,404	8	342,820
Total net revenue	\$ 151,955	5%	\$ 145,095	\$ 452,166	10%	\$ 410,738

28

Table of Contents

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

	Quarters Ended		Nine Months Ended	
	September 30, 2008	2007	September 30, 2008	2007
License fees	19%	16%	18%	17%
Service revenue	81	84	82	83
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; our media delivery system software; premium versions of our RealPlayer and related products; messaging gateways to mobile carriers; and sales and distribution of third-party products. License fees include revenue from all of our reporting segments.

License revenue increased 19% and 22% during the quarter and nine months ended September 30, 2008, respectively, compared with the quarter and nine months ended September 30, 2007. The increases were due primarily to revenue generated from our Trymedia acquisition totaling approximately \$4.0 million and \$8.0 million, respectively. An increase in the number of licenses sold for our premium versions of RealPlayer totaling approximately \$2.8 million also contributed to the increase during the nine months ended September 30, 2008. No other single factor contributed materially to the change during the periods.

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 2% and 8% during the quarter and nine months ended September 30, 2008, respectively, compared with the quarter and nine months ended September 30, 2007. The respective increases during the quarter and nine months ended September 30, 2008, were due primarily to increased subscription revenue from our Music and Games businesses totaling approximately \$4.0 million and \$15.0 million, respectively, increased revenue from greater distribution of third-party products from our Consumer segment totaling approximately \$1.8 million and \$8.2 million, respectively, and increased revenue from application services of approximately \$3.4 million and \$20.6 million, respectively. These increases were offset by a decrease in system integration revenue of approximately \$5.4 million and \$11.2 million, as well as a decrease in subscription revenue from our Media Software and Services business of approximately \$1.9 million and \$4.2 million during the quarter and nine months ended September 30, 2008, respectively. 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, 2008, was \$43.5 million compared with \$42.2 million at December 31, 2007. The change in deferred revenue was due primarily to an increase in unearned music subscription revenue. No other single factor contributed materially to the change during the period.

Cost of Revenue by Segment

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

	Quarters Ended			Nine Months Ended		
	September 30, 2008	Change	2007	September 30, 2008	Change	2007

Edgar Filing: REALNETWORKS INC - Form 10-Q

Music	\$ 23,787	14%	\$ 20,891	\$ 65,999	11%	\$ 59,570
Consumer	14,790	43	10,326	41,765	45	28,890
Technology products and solutions	23,587	(7)	25,427	65,438	3	63,326
Total cost of revenue	\$ 62,164	10%	\$ 56,644	\$ 173,202	14%	\$ 151,786

Table of Contents

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

	Quarters Ended		Nine Months Ended	
	September 30, 2008	September 30, 2007	September 30, 2008	September 30, 2007
Music	57%	55%	56%	55%
Consumer	25	19	23	19
Technology products and solutions	46	48	42	43
Total cost of revenue	41%	39%	38%	37%

Cost of Music. Cost of Music revenue consists 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 Music revenue increased 14% and 11% during the quarter and nine months ended September 30, 2008, respectively, compared with the quarter and nine months ended September 30, 2007, due primarily to increased costs to provide content including royalties of approximately \$1.7 million and \$5.9 million, respectively, related to an increase in the number of subscribers to our music subscription services. No other single factor contributed materially to the change during the periods.

Cost of Consumer. Cost of Consumer revenue consists 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 Consumer revenue increased 43% and 45% during the quarter and nine months ended September 30, 2008, respectively, compared with the quarter and nine months ended September 30, 2007. The increase during the quarter ended September 30, 2008 was due primarily to cost of revenue associated with revenue attributable to the acquisition of Trymedia, which accounted for approximately \$2.5 million of the increase. During the nine months ended September 30, 2008, cost of revenue associated with the acquisition of Trymedia accounted for approximately \$4.9 million of the increase. Increases in costs related to subscriber growth in our Consumer subscription services contributed an additional \$3.8 million during the nine months ended September 30, 2008. No other single factor contributed materially to the changes during the periods. The increase of costs of content were primarily responsible for the increase of costs as a percentage of revenue. Cost of Consumer revenue as a percentage of Consumer revenue for the quarter and nine months ended September 30, 2008, was negatively impacted by the acquisition of Trymedia. Trymedia's gross margins are generally lower than our other Consumer segment products.

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. Cost of Technology Products and Solutions revenue decreased 7% during the quarter ended September 30, 2008, compared with the quarter ended September 30, 2007. The decrease in costs was related to a decrease in costs of systems integration revenue of approximately \$4.1 million. This decrease was partially offset by an increase in cost of revenue from application services provided to wireless carriers of approximately \$2.0 million. Cost of Technology Products and Solutions revenue increased 3% during the nine months ended September 30, 2008, compared with the nine months ended September 30, 2007, due primarily to an increase in cost of revenue from application services provided to wireless carriers of approximately \$8.9 million. This increase was offset by a decrease in cost of system integration revenue of approximately \$7.8 million as compared with the prior period. No other single factor contributed materially to the changes during the periods.

Cost of License and Service Revenue

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

	Quarters Ended September 30,			Nine Months Ended September 30,		
	2008	Change	2007	2008	Change	2007
License fees	\$ 11,137	32%	\$ 8,436	\$ 31,139	27%	\$ 24,610
Service revenue	51,027	6	48,208	142,063	12	127,176
Total cost of revenue	\$ 62,164	10%	\$ 56,644	\$ 173,202	14%	\$ 151,786

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

	Quarters Ended September 30,		Nine Months Ended September 30,	
	2008	2007	2008	2007
License fees	39%	35%	38%	36%
Service revenue	41	40	38	37
Total cost of revenue	41%	39%	38%	37%

Table of Contents

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 increased 32% and 27% during the quarter and nine months ended September 30, 2008, respectively, compared with the quarter and nine months ended September 30, 2007, due primarily to increased costs of content related to revenue associated with the acquisition of Trymedia which totaled approximately \$2.3 million and \$4.8 million, respectively. These increases accounted for substantially all of the change for the quarter and the nine months ended September 30, 2008.

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 6% and 12% during the quarter and nine months ended September 30, 2008, respectively, compared with the quarter and nine months ended September 30, 2007. The respective increases were due primarily to increased content costs resulting from increased subscribers to our Music and Consumer subscription services totaling approximately \$2.1 million and \$9.6 million as well as costs associated with increased sales of application services of approximately \$2.0 million and \$8.9 million. These increases were offset by decreased costs resulting from decreased systems integration revenue of approximately \$4.1 million and \$7.8 million. No other single factor contributed materially to the changes 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):

	Quarters Ended			Nine Months Ended		
	2008	September 30, Change	2007	2008	September 30, Change	2007
Research and development	\$31,076	17%	\$26,528	\$85,147	14%	\$75,012
As a percentage of total net revenue	20%		18%	19%		18%

Research and development expenses, including non-cash stock-based compensation, increased 17% and 14% during the quarter and nine months ended September 30, 2008, respectively, compared with the quarter and nine months ended September 30, 2007. These increases were due primarily to an overall increases in personnel and related costs from our acquisitions of Trymedia (acquired in April 2008) and Game Trust (acquired in October 2007). Trymedia accounted for approximately \$1.6 million and \$3.0 million of the increased costs during the quarter and nine months, respectively. Game Trust accounted for approximately \$0.8 million and \$2.5 million of the increased costs during the quarter and nine months, respectively. No other single factor contributed materially to the increases during the periods. The increases in research and development expenses as a percentage of total net revenue for the quarter and nine months ended September 30, 2008 were due primarily to a higher growth rate of total research and development expenses.

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):

	Quarters Ended September 30,			Nine Months Ended September 30,		
	2008	Change	2007	2008	Change	2007
Sales and marketing	\$55,080	4%	\$52,812	\$161,730	6%	\$152,593
As a percentage of total net revenue	36%		36%	36%		37%

Sales and marketing expenses, including non-cash stock-based compensation, increased 4% and 6% during the quarter and nine months ended September 30, 2008, respectively, compared with the quarter and nine months ended September 30, 2007. An additional \$5.0 million and \$10.5 million was spent to promote our new mp3 store and Rhapsody, our music subscription product, during the quarter and nine months ended September 30, 2008, respectively. These increases were offset by reduced personnel and

Table of Contents

related costs of approximately \$2.0 million and \$3.9 million, respectively, arising from a reduction in sales and marketing headcount. These changes accounted for substantially all of the total increase in sales and marketing expenses during the quarter and nine months ended September 30, 2008, respectively. No other single factor contributed materially to the increases during the periods. The decrease in sales and marketing expenses as a percentage of total net revenue for the nine months ended September 30, 2008 was due to higher growth rate of 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):

	Quarters Ended September 30,			Nine Months Ended September 30,		
	2008	Change	2007	2008	Change	2007
General and administrative	\$ 15,453	(8)%	\$ 16,750	\$ 50,874	(1)%	\$ 51,167
As a percentage of total net revenue	10%		12%	11%		12%

General and administrative expenses, including non-cash stock-based compensation, decreased 8% and 1% during the quarter and nine months ended September 30, 2008, respectively, compared with the quarter and nine months ended September 30, 2007. Decreases in personnel related costs of approximately \$0.7 million accounted for substantially all of the decrease in general and administrative expenses during the quarter ended September 30, 2008. No other single factor contributed materially to the decreases during the periods. The decreases in general and administrative expenses as a percentage of total net revenue were due to a higher growth rate of 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 quarter and nine months ended September 30, 2008, Rhapsody America spent \$15.2 million and \$31.7 million in advertising with MTVN, respectively. During the quarter and nine months ended September 30, 2007, Rhapsody America spent \$7.7 million in advertising with MTVN.

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 consists 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 and nine months ended September 30, 2008. 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.

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):

	Quarters Ended September 30,			Nine Months Ended September 30,		
	2008	Change	2007	2008	Change	2007
Interest income, net	\$ 2,865 (226)	(61)% n/a	\$ 7,290	\$ 11,198 (424)	(54)% 221	\$ 24,457 (132)

Equity in net loss of investments						
Gain on sale of equity investments, net		n/a		222	68	132
Minority interest in Rhapsody America	12,337	91	6,466	29,129	350	6,466
Gain on sale of interest in Rhapsody America	7,405	(7)	7,946	14,502	83	7,946
Other income, net	818	2,053	38	1,636	65	990
Other income, net	\$ 23,199	7%	\$ 21,740	\$ 56,263	41%	\$ 39,859

Table of Contents

Other income, net increased during the quarter ended September 30, 2008 due primarily to a gain from minority interest in Rhapsody America offset by a decrease in yields from our investments. The increase for the nine months ended September 30, 2008, was due primarily to the minority interest in Rhapsody America as well as the gains recognized on the sale of interest in Rhapsody America, which were offset in part by a decrease in interest income due to a decrease in yields from our investments.

Income Taxes

During the quarters ended September 30, 2008 and 2007, we recognized income tax expense of \$0.7 million and \$2.0 million, respectively, related to U.S. and foreign income taxes. During the nine months ended September 30, 2008 and 2007, we recognized income tax expense of \$8.4 million and \$27.4 million, respectively, related to U.S. and foreign income taxes. The decreases in income tax expense were a result of changes in income before income tax. The increases in tax expense as a percentage of pre-tax income during the quarter and nine months ended September 30, 2008, were the result of our lower net income combined with losses not benefited in certain foreign jurisdictions.

As of September 30, 2008, there have been no material changes to the Company's uncertain tax positions disclosures as provided in Note 15 of the 2007 Annual Report on Form 10-K. We do not anticipate that total unrecognized tax benefits will significantly change within the next twelve months.

We file numerous consolidated, combined, 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. We are currently under California Franchise Tax Board income tax audit for the consolidated group RealNetworks, Inc. and subsidiaries for the years ended December 31, 2005 and 2006. During the current quarter, an income tax audit by the United States Internal Revenue Service for our wholly-owned subsidiary WiderThan Americas, Inc. for the period ended December 31, 2005 was closed with no adjustments.

New Accounting Pronouncements

In December 2007, the FASB issued SFAS No. 141R, *Business Combinations* (SFAS 141R), which establishes principles and requirements for how an acquirer recognizes and measures in its financial statements the identifiable assets acquired, the liabilities assumed, and any noncontrolling interest in an acquiree, including the recognition and measurement of goodwill acquired in a business combination. The requirements of SFAS 141R are effective for the Company for periods beginning after December 15, 2008. Early adoption is prohibited. We are in the process of evaluating this guidance and therefore have not yet determined the impact that SFAS 141R will have on our financial position or results of operations upon adoption.

In December 2007, the FASB issued SFAS No. 160, *Noncontrolling Interest in Consolidated Financial Statements, an amendment of ARB No. 51* (SFAS 160), which will change the accounting and reporting for minority interests, which will be recharacterized as noncontrolling interests and classified as a component of equity within the consolidated balance sheets. SFAS 160 requires that changes in a parent's ownership interest while the parent retains its controlling financial interest shall be accounted for as equity transactions. As a result, beginning in 2009, the gain on sales of interest in Rhapsody America will no longer be recorded in the statement of operations, but will be reflected as a component of shareholders equity. The requirements of SFAS 160 are effective for the Company for periods beginning after December 15, 2008. Early adoption is prohibited. We are in the process of evaluating all the impacts of this guidance and therefore have not yet determined the full impact that SFAS 160 will have on our financial position or results of operations upon adoption.

In April 2008, the FASB issued FSP No. 142-3, *Determination of the Useful Life of Intangible Assets* (FSP 142-3). FSP 142-3 amends the factors that should be considered in developing renewal or extension assumptions used to determine the useful life of a recognized intangible asset under FASB Statement No. 142, *Goodwill and Other Intangible Assets*. FSP 142-3 is effective for financial statements issued for fiscal years beginning after December 15, 2008. Early adoption is prohibited. We are currently evaluating the impact FSP No. 142-3 may have on our financial position or results of operations upon adoption.

In May 2008, the FASB issued SFAS No. 162, *The Hierarchy of Generally Accepted Accounting Principles*, (SFAS 162). This Statement identifies the sources of accounting principles and the framework for selecting the principles to be used in the preparation of financial statements of nongovernmental entities that are presented in

conformity with U.S. GAAP (the GAAP hierarchy). While the effective date of this pronouncement has not yet been determined, the Company is currently assessing the impact SFAS 162 may have on our financial position or results of operations upon adoption.

Table of Contents**Liquidity and Capital Resources**

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

	September 30, 2008	December 31, 2007
Working capital	\$ 319,530	\$ 351,066
Cash, cash equivalents, and short-term investments	406,316	556,629
Restricted cash	14,734	15,509

Cash, cash equivalents, and short-term investments decreased primarily due to the repayment of our \$100.0 million convertible debt obligation, the use of cash in operations, repurchases made on our common stock of approximately \$23.0 million as well as the purchases of equipment, software and leasehold improvements of approximately \$24.8 million.

The following summarizes cash flows (in thousands):

	Nine Months Ended September 30,	
	2008	2007
Cash used in operating activities	\$(21,014)	\$(206,811)
Cash used in investing activities	(60,548)	(7,186)
Cash used in financing activities	(82,480)	(113,085)

Cash used in operating activities consisted of net income adjusted for certain non-cash items including depreciation, amortization, stock-based compensation, purchases of trading securities, deferred income taxes, minority interest, gain on sale of interest in Rhapsody America, and the effect of changes in certain operating assets and liabilities, net of acquisitions.

Cash used in operating activities in the nine months ended September 30, 2008 was \$21.0 million and consisted of a net loss of \$3.4 million, adjustments for non-cash items provided by operations of \$12.1 million and cash used in activities related to certain operating assets and liabilities, net of acquisitions of \$29.8 million. Adjustments for non-cash items primarily consisted of \$38.0 million of depreciation and amortization expense, \$17.5 million of stock-based compensation and \$2.6 million of deferred income taxes, partially offset by \$29.1 million of minority interest and \$14.5 million of gain on sale of interest in Rhapsody America.

Changes in certain operating assets and liabilities, net of acquisitions, in the nine months ended September 30, 2008, primarily consisted of an increase of \$26.1 million in prepaid expenses and other assets due primarily to increases in deferred costs and prepaid royalties, and a decrease in accounts payable of \$16.8 million due primarily to a decrease in payments to third party content providers, partially offset by a decrease in accounts receivable of \$12.7 million related to decreases in revenue associated with our systems integration business.

Cash used in operating activities in the nine months ended September 30, 2007, was \$206.8 million and consisted of net income of \$45.6 million, \$270.0 million related to purchases of trading securities, adjustments for non-cash items provided by operations of \$17.4 million and cash provided by activities related to certain operating assets and liabilities, net of acquisitions of \$3.7 million. Adjustments for non-cash items primarily consisted of \$5.4 million related to the unrealized gain on trading securities, \$13.2 million of deferred income taxes, \$6.5 million of minority interest and \$7.9 million of gain on sale of interest in Rhapsody America, partially offset by \$32.9 million of depreciation and amortization, and \$17.3 million of stock based compensation.

Changes in certain operating assets and liabilities, net of acquisitions, in the nine months ended September 30, 2007, primarily consisted of an increase of \$28.3 million in accrued and other liabilities due primarily to increases in deferred revenue and accrued royalties payable, partially offset by a decrease in prepaid and other assets of

\$11.6 million related to increases in deferred costs and prepaid royalties, an increase in accounts receivable of \$9.8 million due to increases in revenue associated with our application service provider business, and a decrease in accounts payable of \$3.3 million.

In the nine months ended September 30, 2008, investing activities used cash primarily for purchases of equipment, software, and leasehold improvements of \$24.8 million and acquisition costs of \$10.2 million, net of cash acquired from the acquisition of Trymedia, and the payment of anniversary and performance costs relating to the acquisition of Zylom, which were previously accrued. Purchases net of sales and maturities of short-term investments used cash of \$21.2 million during 2008. In the nine months ended September 30, 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.

Table of Contents

Financing activities used cash for the repurchase of our common stock of \$23.1 million and \$142.2 million during the nine months ended September 30, 2008 and 2007, respectively, in addition to the payments on our convertible debt obligations of \$100.0 million during the nine months ended September 30, 2008. These uses of cash were offset by the proceeds of sales of interests in Rhapsody America of \$31.6 million in 2008 and \$15.0 million in 2007, as well as sales of common stock under our employee stock purchase plan and exercise of stock options of \$8.8 million in 2008 and \$14.1 million in 2007.

In May 2008, our Board of Directors authorized a new share repurchase program for the repurchase of up to an aggregate of \$50.0 million of our outstanding common stock. During the quarter ended September 30, 2008, we purchased 3.6 million shares of our common stock at an average cost of \$6.36 per share for an aggregate value of \$23.0 million. We purchased a total of 3.8 million shares of our common stock at an average cost of \$6.39 per share for an aggregate value of \$24.5 million under the May 2008 repurchase program and \$25.5 million remained authorized as of September 30, 2008.

We currently have no planned significant capital expenditures for 2008 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.

As of September 2008, we have commitments with third party vendors to pay \$11.5 million and \$23.4 million through the years ended May 31, 2009 and 2010, respectively. These commitments are ordinary course expenses relating to our on-going business operations.

During the quarter ended September 30, 2008, we repurchased \$100.0 million of our outstanding convertible debt. After the repurchase, no convertible debt remains outstanding.

Our contractual obligations include office leases and contractual payments due to content and other service providers. 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 quarters ended September 30, 2008 and 2007.

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.

Table of Contents**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 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 during the quarter ended September 30, 2008. Based on our cash, cash equivalents, short-term investments, and restricted cash equivalents at September 30, 2008, a hypothetical 10% increase/decrease in interest rates would increase/decrease our annual interest income and cash flows by approximately \$0.2 million.

Investment Risk. As of September 30, 2008, 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. Based upon an evaluation of the facts and circumstances during the quarters and nine month periods ended September 30, 2008 and 2007, we determined that no additional other-than-temporary decline in fair value had occurred and therefore no impairment charges were recorded.

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.

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 quarter and nine months ended September 30, 2008 and 2007.

Table of Contents**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 quarter ended September 30, 2008 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**

On September 30, 2008, we filed a declaratory action against Disney Enterprises, Inc., Paramount Pictures Corp., Sony Pictures Entertainment, Inc., Twentieth Century Fox Film Corp., NBC Universal, Inc., Warner Bros. Entertainment, Inc., and Viacom, Inc. and the DVD Copy Control Association (DVD CCA) in the Northern District of California relating to our RealDVD product, which, among other things, allows consumers to store a copy of DVDs that they own on their computers. On the same day, various movie studios filed suit against us in the Central District of California. Our suit asks the court to find that our RealDVD product does not breach the license agreement that we entered into with the DVD CCA. The movie studios' suit alleges that by offering the RealDVD product, we have violated the Digital Millennium Copyright Act. The movie studios' suit was transferred to the Northern District of California. On October 3, 2008, the movie studios obtained a temporary restraining order (TRO) requiring us to cease distribution of our RealDVD product. The TRO was extended on October 7, 2008. The Court scheduled a preliminary injunction hearing to address the movie studios' claim that RealDVD should not be sold pending a final judicial determination of the underlying claims between the parties. We believe that RealDVD complies with the law, and we intend to vigorously defend the preliminary injunction request and, if necessary, pursue our declaratory judgment action.

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, in some of which we are a participant. Additionally, the CRB is currently holding hearings that will determine mechanical royalty rates associated with the statutory license for digital phonorecord deliveries, including tethered downloads. These rates are also subject to industry-wide settlement negotiations. A partial settlement with respect to on-demand streaming and tethered downloads was recently reached between the Digital Media Association (DiMA), the Recording Industry Association of America (RIAA) and the National Music Publishers Association (NMPA), among others. This settlement was recently published by the Copyright Royalty Board (CRB) in an administrative judicial proceeding supervised by the U.S. Copyright Office. However, this settlement is still subject to comment by industry participants and so is not yet final. Finally, we are involved in a proceeding in the Southern District of New York that will determine a royalty rate for the public performance of music contained in the ASCAP catalogue. In April 2008, the district court issued a preliminary ruling that sets forth, among other things, a methodology to be used to calculate the royalties owed to ASCAP. The methodology to be used to calculate the royalties is incomplete and contains elements that require negotiation and agreement by the parties in addition to further hearings and decisions by the district court. On July 16, 2008, the court issued its ruling relating to the application of the new rates. We are working with ASCAP to make a final determination of amounts due under the court's ruling. We believe we have sufficiently accrued for expected royalties. It is too soon to tell what ultimate effect the district court's preliminary ruling will have on us or what additional royalty amounts, if any, might ultimately be payable to ASCAP. Any of these three proceedings may result in higher rates or other terms that are unfavorable to us. Due to the uncertainties previously described, we are unable to

reasonably estimate the amount of possible additional liabilities associated with the resolution of these matters beyond what has been previously recorded.

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 and in Note 15 to the financial statements included in this report, even if not meritorious, could force the Company to spend significant financial and managerial resources. The Company is not aware of any other 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.

Table of Contents**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 Recently Announced Separation of Our Games Business

We recently announced our intention to separate our global games business into an independent company and to distribute shares of the newly created games company to our shareholders. We also indicated that we may precede the spin-off with an initial public offering and sale of up to 20% of the shares of the games company. If such transactions are further delayed or not completed, our stock price and business may be adversely affected.

On May 8, 2008, we announced our intention to separate our global games business into an independent company and distribute shares of the newly created games company to our shareholders. We also indicated that we may precede the spin-off with an initial public offering and sale of up to 20% of the shares of the new games company. As a result of current conditions in the capital markets, however, we do not expect to make any filing with the Securities and Exchange Commission relating to the spin-off of the games company by the end of 2008. Moreover, we may not complete such transactions, each of which is subject to a number of factors including, among others, market conditions, the final approval of our board of directors, the effectiveness of a registration statement, the receipt of a favorable letter ruling from the Internal Revenue Service and the execution of inter-company agreements.

If the transactions are further delayed or not completed, our stock price could decline, we will have incurred significant expenses which we will be unable to recover and we will not be able to recover the significant diversion of management and employee attention that we will have incurred in preparing for the transactions. In addition, our business and operations may be harmed to the extent there is customer or employee uncertainty surrounding the future direction of our product and service offerings and strategy for our Games business.

Our games business represents a significant portion of our business and a spin-off or initial public offering of the games business may cause our operating results to suffer and may cause our revenues, income and stock price to decline.

The games business represents a significant portion of our business that is currently reported as a component of our Consumer segment in our consolidated financial statements. For the fiscal years ended 2007, 2006 and 2005, the games business represented approximately 19%, 22% and 17% of our revenues, respectively. Following the spin-off, the games business will no longer be a division of RealNetworks and its financial results, including its revenues and income, will no longer be included in RealNetworks' consolidated financial statements. Accordingly, our historical consolidated financial information will not necessarily be comparable with our financial position, results of operations and cash flows after the games business ceases to be a division. We are unable to predict what the market price of our common stock will be after the spin-off or the potential initial public offering and the market price of our common stock could be volatile for several months after either transaction. Moreover, even if such transactions are consummated, we cannot assure you that we will be able to successfully achieve the intended benefits of either transaction or that they will result in any increase in value for our shareholders.

In connection with the proposed spin-off and potential initial public offering, we intend to prepare separate, audited historical annual financial statements and unaudited historical quarterly financial statements for our games business on a stand-alone basis. The operating results and financial data reflected in the stand-alone financial statements of our games business could differ from the operating results and financial data reported by us on a consolidated basis due to adjustments made during the preparation and/or audit of the stand-alone financial statements.

The separation and possible initial public offering of the games business is a substantial undertaking that may disrupt our ongoing business and may increase expenses, which may affect our results of operations or financial condition.

The planning and implementation of the separation of the games business from RealNetworks and the possible initial public offering and spin-off of the games company will require substantial dedication of management resources, and we expect to incur significant expenses related to the transactions. We have not yet made any adjustments to our

historical financial information to reflect the significant changes that may occur in our cost structure, funding and operations as a result of these transactions. In addition, the

Table of Contents

efforts required to implement these transactions may disrupt our ongoing business activities, may result in employee distraction and may harm our business and our ability to attract, retain and motivate key employees. Additionally, perceived uncertainties as to our future direction may result in difficulties in recruiting and retaining employees and may also have a negative impact on our relationships with our customers, suppliers, vendors and partners and may result in the loss of business opportunities. If any of the foregoing occurs, our results of operations or financial condition would suffer.

Risks Related to Our Music and Consumer Businesses

Our music and consumer businesses face substantial competitive challenges that may prevent us from being successful in, and negatively impact future growth in, those businesses.

Many of our current and potential competitors in our music and consumer businesses 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 in these businesses include a number of large and powerful companies, such as Microsoft and Apple. To effectively compete in the markets for our music and consumer businesses, we may experience the following consequences, any of which would adversely affect our operating results and the trading price of our stock:

reduced prices or margins,

loss of current and potential customers, market share and market power,

changes to our products, services, technologies, licenses or business practices or strategies,

lengthened sales cycles,

pressure to prematurely release products or product enhancements, or

degradation in our stature and reputation in the market.

In addition, we face the following risks relating to our music, media software and solutions and games businesses:

Music. Our online music services now offered through our Rhapsody America joint venture with MTVN 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 popular iPod line of portable digital audio players and its iPhone. Microsoft has also begun offering premium music services in conjunction with its Windows Media Player and also 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 as well as other providers of free, ad-supported music services. 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, unlicensed content. 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. Rhapsody America may not be able to compete effectively in this highly competitive and rapidly evolving market, which may negatively impact the future growth of our Music business.

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, NBC Universal, Microsoft, Apple, Adobe, Yahoo! and broadband ISPs. We expect

this competition to continue to be 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. If we are unable to compete successfully, the future growth of our Media Software and Services business will be negatively impacted. In addition, our overall ability to sell subscription services depends in part on the use of RealNetworks' formats on the Internet, and declines in the use of our formats may negatively affect our subscription revenue and increase costs of obtaining new subscribers.

Table of Contents

Games. Our RealArcade, GameHouse, and Zylom branded services compete with other online aggregators and distributors of online and downloadable casual PC games. Some of these competitors have high volume distribution channels and greater financial resources than we do. Our games business also competes with many other smaller companies which may be able to adjust to market conditions faster than us. 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 development studios compete primarily with other developers of online, 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.

The success of our subscription services businesses depends upon our ability to increase subscription revenue and to license compelling content on commercially reasonable terms.

Our operating results could be adversely impacted by the loss of subscription revenue, including the revenue generated from the online music services offered by our Rhapsody America joint venture. 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 with 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. In addition, we must continue to obtain compelling digital media content for our video, music, and games services in order to maintain and increase usage and overall customer satisfaction for these products. Our online music service offerings available through our Rhapsody America venture depend on music licenses from the major music labels and publishers, and the failure to renew these licenses under terms that are commercially reasonable and acceptable to us would harm Rhapsody America's ability to generate revenues from its subscription services.

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 be on our subscription revenue.

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. On July 16, 2008, a court issued a ruling that sets forth how royalties are to be calculated, and we are working with the American Society of Composers, Authors and Publishers to make a final determination of amounts owed under the court's ruling. While we believe we have sufficiently accrued for expected royalties to be paid as of September 30, 2008, the court's ruling remains subject to appeal and may be challenged by other participants. We have license agreements to reproduce musical compositions with the Harry Fox Agency, an agency that represents music publishers, and with many independent music publishers as required in the creation and delivery of on-demand streams and tethered downloads, but these license agreements generally do not include final royalty rates. The license agreements anticipate industry-wide agreement on rates, which was recently reached between the Digital Media Association (DiMA), the Recording Industry Association of America (RIAA) and the National Music Publishers Association (NMPA), among others. This settlement was recently published by the Copyright Royalty Board (CRB) following an administrative judicial proceeding supervised by the U.S. Copyright Office. However, this settlement is still subject to comment by industry participants and so is not yet final. If these rates are set at a level 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. However, these rates are subject to ongoing industry-wide settlement negotiations, in some of which we are a participant. These rates are also currently under appeal. The appeal or other industry-wide settlement of these rates, whether or not we directly participate, may result in 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. Based on recent progress in the industry-wide settlement negotiations, Congress passed the Webcaster Settlement Act of 2008, which extended Sound Exchange's authority to negotiate on behalf of sound recording owners in the industry-wide settlements until February 15, 2009.

Table of Contents***Our RealDVD PC application is currently the subject of pending litigation, and we could incur significant expenses or be further prevented from selling RealDVD.***

On September 30, 2008, we announced the availability of RealDVD, a PC application that allows consumers to store, manage and play their DVDs on their computers. On the same day, we filed a motion for declaratory judgment against the DVD Copy Control Association and Disney Enterprises, Inc., Paramount Pictures Corp., Sony Pictures Entertainment, Inc., Twentieth Century Fox Film Corp., NBC Universal, Inc., Warner Bros., Entertainment, Inc. and Viacom, Inc. seeking a determination that, among other things, our RealDVD product complies with the DVD Copy Control Association's license agreement. Various movie studios filed suit against us alleging that RealDVD violates the Digital Millennium Copyright Act and also asked for and were granted a temporary restraining order preventing us from selling RealDVD until a full preliminary injunction hearing could be held. Although we believe that our RealDVD product fully complies with the DVD Copy Control Association's license agreement and enables consumers to exercise their legitimate, fair use rights to store a copy of DVDs that they own on their computers, we may not ultimately prevail on our claims. These claims could be costly and time-consuming to assert and defend and could require us to pay significant litigation expenses or damages or result in a preliminary or permanent injunction against the sale of RealDVD, any of which would harm our operating results.

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 and the popularity of the Adobe Flash format. 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 sales of our subscription services, and therefore could harm our business and our prospects.

We face risks with respect to certain matters in the governance and management of our Rhapsody America joint venture and the integration and operation of assets that have been combined to form Rhapsody America.

We and 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 key operational activities, such as adopting a budget and authorizing certain capital expenditures, and for significant company events, such as mergers, asset sales, distributions, affiliate transactions and issuance, sale and repurchase of membership interests of Rhapsody America. If we are not able to agree with MTVN on any of those items, if the members are unable to agree on any other significant operational or financial matter requiring approval of the members, or if there is any event that adversely impacts our relationship with MTVN, the business, results of operations and financial condition of Rhapsody America may be adversely affected and, consequently, our business may suffer. In addition, MTVN may have or develop economic or other business interests or goals that are inconsistent with our or Rhapsody America's business interests or goals.

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. The nature of our and MTVN's contributions of services and assets to Rhapsody America required detailed cost allocation agreements that are complex to implement and manage and may result in significant costs that could adversely affect our operating results. The allocation of these support service costs is based on various measures depending on the service provided, and require significant internal resources. 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 shareholders' voting and economic interests in us, and may require us to pay MTVN a price that exceeds the appraised value of its 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, through the issuance of 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 represent up to 15% of the outstanding shares of our common stock immediately prior to the transaction. In addition, we may also be obligated to issue shares

Table of Contents

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 shareholders' voting and economic interests in us will be diluted, and MTVN will become one of our significant shareholders. In certain situations, if MTVN exercises its right to require us to purchase its membership interests in Rhapsody America, 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.

Risks Related to Our Technology Products and Solutions Business

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 generate a material portion of our revenue from operations in the Republic of Korea (South Korea), primarily from our mobile entertainment services offered 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 significant portion of our total revenue from South Korea, particularly through SK Telecom. In recent periods, revenue from SK Telecom has declined within our systems integration business and may continue to decline in future periods. 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. Furthermore, our relationship with SK Telecom may be affected by the general state of the economy of South Korea. Failure to maintain our relationship with SK Telecom 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 could be materially harmed.

Contracts with our carrier customers subject us to significant risks that could negatively impact our revenue or otherwise harm our operating results.

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. Because most of our carrier customer contracts are nonexclusive, 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 could 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. Despite the lack of marketing commitments, revenue related to our application services is, to a large extent, dependent upon the marketing and promotion activities of our carrier customers. In addition, 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. The loss of carrier customers, a reduction in marketing or promotion of our applications, or the termination, non-renewal or renegotiation of contract terms that are less favorable to us would likely result in the loss of future revenues from our carrier application services.

Finally, certain of our carrier contracts obligate us to indemnify the carrier customer for certain liabilities and losses incurred by them, including liabilities resulting from third party claims for damages that arise out of the use of our technology. These indemnification terms provide us with certain procedural safeguards, including the right to control the defense of the indemnified party. We have accepted tenders of indemnification from two of our carrier customers related to one pending patent infringement proceeding, and we are vigorously defending them. This pending proceeding or future claims against which we may be obligated to defend our carrier customers could result in paying amounts pursuant to these obligations that could materially harm our operating results.

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 current providers of music-on-demand

services for online or other non-mobile platforms, some of which have greater financial resources than we do. In addition, the major music labels may demand more aggressive revenue sharing arrangements or impose an alternative business model less favorable to us. In addition, while most of our carrier customers do not

Table of Contents

offer internally developed application services that compete with ours, if 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. Increased competition has in the past resulted in pricing pressure, forcing us to lower the selling price of our services.

Our traditional system software licensing business has been negatively impacted by competitive factors, and we may not experience improved 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. Although the settlement agreement we entered into with Microsoft relating to our claims regarding Microsoft's anticompetitive practices contained a substantial cash payment to us and a series of technology agreements, 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 in a way that improves our operating results or shareholder return on an investment in our stock.

Risks Related to Our Business in General

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

The trading price for our common stock has been volatile, ranging from \$4.89 to \$7.61 per share during the 52-week period ended September 30, 2008. As a result of the rapidly changing markets in which we compete, our operating results may fluctuate from period-to-period, which may continue to contribute to the volatility of our stock price. 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, including, but not limited to:

- our inability to realize SAB No. 51 gains within the statement of operations upon adoption of SFAS 160 in 2009,

- impairments of goodwill and other long-lived assets,

- integrating and operating newly acquired businesses and assets,

- the seasonality of our business, which has experienced increased revenues in the fourth quarter of our fiscal year, and

- the general difficulty in forecasting our operating results and metrics, which could result in actual results that differ significantly from expected results.

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. Fluctuations in our operating results, particularly when experienced beyond what we expected, could cause the trading price of our stock to continue to fluctuate.

New products and services may not achieve market acceptance or may be subject to legal challenge that could 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. For example, we launched a new version of our media delivery software, RealPlayer 11, that consumers can use 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. 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. 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. Furthermore, new products and services may be subject to legal challenge. For example, although we believe RealPlayer 11 is legal, there are risks

Table of Contents

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. 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 our products or services, or to pay damages.

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, including 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.

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 and expect that we will continue to do so in the future. Since late 2006 through the second quarter of 2008, we completed the acquisition of substantially all of WiderThan Co., Ltd. and the acquisitions of Sony NetServices GmbH, Exomi Oy, Game Trust, Inc. and Trymedia. 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.

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

Access to the Internet through devices other than a 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 and services into their devices, we may fail to capitalize on the opportunity to deliver digital media to non-PC devices which could harm

Table of Contents

our business prospects. In addition, in order for our services, in particular, the digital music services offered through Rhapsody America, to continue to grow, we must design services that interoperate effectively with a variety of hardware devices. To achieve this interoperability, 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 do not successfully make our products and technologies compatible with emerging standards and the most popular devices used to access digital media or successfully design our service to interoperate with the music playback devices that our customers own, we may miss market opportunities and our business and results will suffer.

We may be unable to adequately protect our proprietary rights or leverage our patent portfolio, 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 patent portfolio and other 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. However, our efforts to protect our intellectual property rights may not assure our ownership rights in our intellectual property, protect or enhance the competitive position of our products and services or effectively prevent misappropriation of our technology. As disputes regarding the validity and scope of patents or 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 patents and other intellectual property rights or to determine the validity and scope of other parties' proprietary rights, enter into royalty or licensing agreements on unfavorable terms or redesign our product features and services. Any such dispute would likely be costly and distract our management, and the outcome of any such dispute could fail to improve our business prospects or otherwise harm our business.

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 Note 15 to the financial statements included in this report.

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 hurt customer demand for our products, 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, which expenditures could adversely affect our operating results.

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

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.

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 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 or from our Internet commerce activities.

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. The collection and remittance of VAT subjects us to additional currency fluctuation risks.

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.

An impairment in the carrying value of our goodwill or other intangible assets could adversely affect our financial condition and results of operations.

Pursuant to SFAS No. 142, *Goodwill and Other Intangible Assets*, we are required to annually test goodwill and intangible assets with indefinite lives, including the goodwill associated with past acquisitions and any future acquisitions, to determine if impairment has occurred. Additionally, interim reviews must be performed whenever events or changes in circumstances indicate that impairment may have occurred. If the testing performed indicates that impairment has occurred, we are required to record a non-cash impairment charge for the difference between the carrying value of the goodwill or other intangible assets and the implied fair value of the goodwill or other intangible assets in the period the determination is made. The testing of goodwill and other intangible assets for impairment requires us to make significant estimates about our future performance and cash flows, as well as other assumptions. These estimates can be affected by numerous factors, including changes in economic, industry or market conditions, changes in business operations, changes in competition or potential changes in the share price of our common stock and market capitalization. Changes in these factors, or changes in actual performance compared with estimates of our future performance, could affect the fair value of goodwill or other intangible assets, which may result in an impairment charge. We cannot accurately predict the amount and timing of any impairment of assets. Should the value

of goodwill or other intangible assets become impaired, there could be an adverse effect on our financial condition and results of operations.

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

Our directors and executive officers beneficially own more than 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.

Table of Contents

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 more than one third of our common stock himself. 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.

In addition, Mr. Glaser has special rights under our articles of incorporation to appoint or remove members of the strategic transaction committee at his discretion that could make it more difficult for RealNetworks to be sold or to complete another change of control transaction without Mr. Glaser's consent.

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, 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.

Table of Contents**Item 2. Unregistered Sales of Equity Securities and Use of Proceeds**

(a) Not applicable

(b) Not applicable

(c) Purchases of Equity Securities by the Issuer and Affiliated Purchasers (in thousands, except per share amounts):

Period	Total Number of Shares Repurchased (In thousands)	Average Price Paid Per Share	Total Number of Shares Purchased as Part of Publicly Announced Plans or Programs	Approximate Dollar Value of Shares that May Yet Be Purchased Under the Plans or Programs
7/1/2008 - 7/31/2008	884	\$ 6.78	884	\$ 6.78
8/1/2008 - 8/31/2008	1,191	6.63	1,191	6.63
9/1/2008 - 9/30/2008	1,536	5.90	1,536	5.90
Total	3,611	\$ 6.36	3,611	\$ 6.36

In May 2008 the Board of Directors of the company authorized a new share repurchase program for the repurchase of up to an aggregate of \$50.0 million of the Company's outstanding common stock. All of the repurchases in the table above were made through that program.

Item 3. Default Upon Senior Securities

None

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

None

Item 5. Other Information

None

Item 6. Exhibits

Exhibits Required by Item 601 of Regulation S-K

Exhibit Number	Description
10.1	Offer Letter dated July 1, 2008 between RealNetworks, Inc. and John Giamatteo (incorporated by reference from Exhibit 10.1 to RealNetworks, Inc.'s Quarterly Report on Form 10-Q for the quarterly period ended June 30, 2008 filed with the Securities and Exchange Commission on August 11, 2008)
10.2	Offer Letter dated October 28, 2008 between RealNetworks, Inc. and John Barbour (incorporated by reference from Exhibit 10.1 to RealNetworks, Inc.'s Current Report on Form 8-K filed with the Securities and Exchange Commission on November 3, 2008)

- 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

Table of Contents

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 7, 2008.

REALNETWORKS, INC.

By: /s/ Michael Eggers

Michael Eggers

Title: Senior Vice President, Chief Financial Officer and Treasurer
(Principal Financial and Accounting Officer)

49

Table of Contents

INDEX TO EXHIBITS

Exhibit Number	Description
10.1	Offer Letter dated July 1, 2008 between RealNetworks, Inc. and John Giamatteo (incorporated by reference from Exhibit 10.1 to RealNetworks, Inc.'s Quarterly Report on Form 10-Q for the quarterly period ended June 30, 2008 filed with the Securities and Exchange Commission on August 11, 2008)
10.2	Offer Letter dated October 28, 2008 between RealNetworks, Inc. and John Barbour (incorporated by reference from Exhibit 10.1 to RealNetworks, Inc.'s Current Report on Form 8-K filed with the Securities and Exchange Commission on November 3, 2008)
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