REALNETWORKS INC
Form 10-Q
August 09, 2010

UNITED STATES SECURITIES AND EXCHANGE COMMISSION
Washington, D.C. 20549
FORM 10-Q

(Mark One)

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

For the Quarterly Period Ended June 30, 2010

OR

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

For the transition period from __________ to __________

Commission file number 0-23137

RealNetworks, Inc.
(Exact name of registrant as specified in its charter)

Washington	**91-1628146**
(State of incorporation)	*(I.R.S. Employer Identification Number)*
2601 Elliott Avenue, Suite 1000 **Seattle, Washington**	**98121**
(Address of principal executive offices)	*(Zip Code)*

(206) 674-2700
(Registrant s telephone number, including area code)

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

Indicate by check mark whether the registrant has submitted electronically and posted on its corporate Web site, if any, every Interactive Data File required to be submitted and posted pursuant to Rule 405 of Regulation S-T (§232.405 of this chapter) during the preceding 12 months (or for such shorter period that the registrant was required to submit and post such files). Yes o No o

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 o	Accelerated filer þ	Non-accelerated filer o (Do not check if a smaller reporting company)	Smaller reporting company o

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

The number of shares of the registrant s Common Stock outstanding as of July 30, 2010 was 135,592,883.

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PART I. FINANCIAL INFORMATION

Item 1. Financial Statements

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

	June 30, 2010	December 31, 2009
ASSETS		
Current assets:		
Cash and cash equivalents	$ 156,155	$ 277,030
Short-term investments	157,065	107,870
Trade accounts receivable, net of allowances for doubtful accounts and sales returns	43,805	60,937
Deferred costs, current portion	4,541	5,192
Prepaid expenses and other current assets	30,001	30,624
Total current assets	391,567	481,653
Equipment, software, and leasehold improvements, at cost:		
Equipment and software	142,978	151,951
Leasehold improvements	25,308	31,041
Total equipment, software, and leasehold improvements, at cost	168,286	182,992
Less accumulated depreciation and amortization	121,616	125,878
Net equipment, software, and leasehold improvements	46,670	57,114
Restricted cash equivalents and investments	10,000	13,700
Equity method investments	24,223	50
Available for sale securities	17,587	19,503
Other assets	3,746	4,030
Deferred costs, non-current portion	13,516	10,182
Deferred tax assets, net, non-current portion	8,822	10,001
Other intangible assets, net	7,804	10,650
Total assets	$ 523,935	$ 606,883
LIABILITIES AND SHAREHOLDERS EQUITY		
Current liabilities:		
Accounts payable	$ 27,662	$ 32,703
Accrued and other liabilities	88,521	124,934
Deferred revenue, current portion	20,740	31,374
Related party payable Rhapsody	459	
Related party payable MTVN		11,216
Accrued loss on excess office facilities, current portion	762	3,228
Total current liabilities	138,144	203,455
Deferred revenue, non-current portion	879	1,933

Accrued loss on excess office facilities, non-current portion	4,047	
Deferred rent	3,768	4,464
Deferred tax liabilities, net, non-current portion	719	961
Other long-term liabilities	12,293	13,006
Total liabilities	159,850	223,819
Noncontrolling interest in Rhapsody		7,253
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 135,587 shares in 2010 and 135,057 shares in 2009	136	135
Additional paid-in capital	690,521	671,606
Accumulated other comprehensive loss	(46,577)	(38,614)
Retained deficit	(279,995)	(257,316)
Total shareholders equity	364,085	375,811
Total liabilities and shareholders equity	$ 523,935	$ 606,883

See accompanying notes to unaudited condensed consolidated financial statements.

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

	Quarters Ended June 30,		Six Months Ended June 30,	
	2010	**2009**	**2010**	**2009**
Net revenue (A)	$ 88,884	$ 135,725	$ 217,484	$ 276,498
Cost of revenue (B)	29,149	55,614	78,308	111,635
Gross profit	59,735	80,111	139,176	164,863
Operating expenses:				
Research and development	27,583	28,923	62,258	57,482
Sales and marketing	27,382	42,273	65,209	85,958
Advertising with related party		6,865	1,065	14,288
General and administrative	14,590	19,338	29,511	42,169
Impairment of goodwill		175,583		175,583
Restructuring and other charges	4,792		10,407	794
Loss on excess office facilities	7,082		7,082	
Total operating expenses	81,429	272,982	175,532	376,274
Operating loss	(21,694)	(192,871)	(36,356)	(211,411)
Other income (expenses):				
Interest income, net	551	754	931	1,937
Equity in net loss of Rhapsody and other investments	(5,427)	(269)	(5,427)	(924)
Gain (loss) on sale of equity investments, net	(50)	68	(50)	205
Gain on deconsolidation of Rhapsody			10,929	
Other income (expense), net	994	(449)	1,093	406
Total other income (expenses), net	(3,932)	104	7,476	1,624
Loss before income taxes	(25,626)	(192,767)	(28,880)	(209,787)
Income taxes benefit (expense)	(281)	(1,210)	3,291	(2,759)
Net loss	(25,907)	(193,977)	(25,589)	(212,546)
Net loss attributable to noncontrolling interest in Rhapsody		5,648	2,910	12,081
Net loss attributable to common shareholders	$ (25,907)	$ (188,329)	$ (22,679)	$ (200,465)
Basic net income (loss) per share available to common shareholders	$ (0.19)	$ (1.40)	$ (0.14)	$ (1.51)
Diluted net income (loss) per share available to common shareholders	$ (0.19)	$ (1.40)	$ (0.14)	$ (1.51)

Shares used to compute basic net income (loss) per share available to common shareholders	135,277	134,420	135,209	134,394
Shares used to compute diluted net income (loss) per share available to common shareholders	135,277	134,420	135,209	134,394
Comprehensive loss:				
Net loss	$ (25,907)	$ (193,977)	$ (25,589)	$ (212,546)
Unrealized holding (gains) losses on short-term and equity investments, net of income taxes	(3,160)	5,760	(1,609)	3,938
Foreign currency translation gains (losses)	(4,743)	9,207	(6,354)	1,218
Comprehensive loss	(33,810)	(179,010)	(33,552)	(207,390)
Net loss attributable to noncontrolling interest		5,648	2,910	12,081
Comprehensive loss attributable to common shareholders	$ (33,810)	$ (173,362)	$ (30,642)	$ (195,309)
(A) Components of net revenue:				
License fees	$ 16,644	$ 24,389	$ 40,816	$ 50,568
Service revenue	72,240	111,336	176,668	225,930
	$ 88,884	$ 135,725	$ 217,484	$ 276,498
(B) Components of cost of revenue:				
License fees	$ 5,668	$ 9,869	$ 13,217	$ 19,115
Service revenue	23,481	45,745	65,091	92,520
	$ 29,149	$ 55,614	$ 78,308	$ 111,635

See accompanying notes to unaudited condensed consolidated financial statements.

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

	Six Months Ended June 30, 2010	Six Months Ended June 30, 2009
Cash flows from operating activities:		
Net income (loss)	$ (25,589)	$ (212,546)
Adjustments to reconcile net income (loss) to net cash used in operating activities:		
Depreciation and amortization	13,973	15,522
Stock-based compensation	6,692	10,818
Gain on disposal of equipment, software, and leasehold improvements	(3)	(34)
Equity in net loss of Rhapsody and other investments	5,427	924
Loss (gain) on sale of equity investments, net	50	(205)
Impairment of goodwill		175,583
Excess tax benefit from stock option exercises	(18)	(9)
Gain on deconsolidation of Rhapsody	(10,929)	
Accrued loss on excess office facilities	6,470	
Deferred income taxes	(1,609)	(682)
Accrued restructuring and other charges	3,581	(3,675)
Other	22	24
Net change in certain operating assets and liabilities, net of acquisitions and disposals:		
Trade accounts receivable	7,649	5,716
Prepaid expenses and other assets	(7,336)	(2,268)
Accounts payable	(2,417)	(2,043)
Accrued and other liabilities	(52,300)	(5,366)
Net cash used in operating activities	(56,337)	(18,241)
Cash flows from investing activities:		
Purchases of equipment, software, and leasehold improvements	(9,507)	(7,608)
Purchases of short-term investments	(65,754)	(66,192)
Proceeds from sales and maturities of short-term investments	16,559	38,692
Decrease in restricted cash equivalents and investments, net	3,700	141
Payment of acquisition costs, net of cash acquired		(3,154)
Purchase of equity investments		(2,000)
Payment in connection with the restructuring of Rhapsody	(18,000)	
Repayment of temporary funding upon deconsolidation of Rhapsody	5,869	
Proceeds from sales of equity investments		205
Net cash used in investing activities	(67,133)	(39,916)
Cash flows from financing activities:		
Net proceeds from sale of common stock under employee stock purchase plan and exercise of stock options	1,272	819
Excess tax benefit from stock option exercises	18	9
Payments received on MTVN note	1,213	14,537

Capital contribution to Rhapsody from MTVN		5,000
Net cash provided by financing activities	2,503	20,365
Effect of exchange rate changes on cash and cash equivalents	92	2,316
Net decrease in cash and cash equivalents	(120,875)	(35,476)
Cash and cash equivalents, beginning of period	277,030	232,968
Cash and cash equivalents, end of period	$ 156,155	$ 197,492
Supplemental disclosure of cash flow information:		
Cash received from income tax refunds	$ 131	$ 5,942
Cash paid for income taxes	$ 1,818	$ 3,336

See accompanying notes to unaudited condensed consolidated financial statements.

REALNETWORKS, INC. AND SUBSIDIARIES
NOTES TO UNAUDITED CONDENSED CONSOLIDATED FINANCIAL STATEMENTS
Quarters and Six Months Ended June 30, 2010 and 2009

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 intercompany balances and transactions have been eliminated in consolidation. Certain reclassifications have been made to 2009 amounts to conform to the current presentation.

On August 20, 2007, RealNetworks and MTV Networks, a division of Viacom International Inc. (MTVN), created Rhapsody America LLC (Rhapsody) to jointly own and operate a business-to-consumer digital audio music service. RealNetworks held a 51% equity interest in Rhapsody and Rhapsody s financial position and operating results has been consolidated into RealNetworks financial statements prior to March 31, 2010. MTVN s proportionate share of income (loss) was included in noncontrolling interest in Rhapsody in the unaudited condensed consolidated statements of operations and comprehensive income (loss). MTVN s proportionate share of equity was included in noncontrolling interest in Rhapsody in the unaudited condensed consolidated balance sheets. On March 31, 2010, the Company and MTVN restructured Rhapsody, and RealNetworks held slightly less than 47.5% of the outstanding shares of capital stock of Rhapsody after the restructuring and as of June 30, 2010. Since March 31, 2010, RealNetworks has not held a controlling interest in Rhapsody and therefore, the Company has treated its ownership interest in Rhapsody as an equity method investment. Rhapsody s financial position as of March 31, 2010 and its operating results beginning April 1, 2010 are no longer consolidated with RealNetworks consolidated financial statements.

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 six months ended June 30, 2010 are not necessarily indicative of the results that may be expected for any subsequent quarter or for the year ending December 31, 2010. 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, 2009.

Revenue Recognition. The Company recognizes revenue when persuasive evidence of an arrangement exists, delivery has occurred, the sales price is fixed or determinable, and collection is probable. Physical products are considered delivered to the customer once they have been shipped and title and risk of loss have been transferred. For online sales, the products or services are considered delivered at the time the products or services are made available, digitally, to the end user.

The Company recognizes revenue on a gross or net basis. In most arrangements, the Company contracts directly with end user customers, is the primary obligor and carries all collectability risk. In such arrangements, the Company recognizes 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 collectability risk. In such instances, the Company recognizes revenue on a net basis.

In the Company s direct to consumer business segments, which include Games, Media Software and Services (MSS), and prior to April 1, 2010, included Music, the Company derives revenue through (1) subscriptions, (2) sales of content downloads, software and licenses and (3) the sale of advertising and the distribution of third-party products on its websites and in the Company s games.

Beginning in the quarter ended June 30, 2010, revenue from the Company s Rhapsody joint venture is no longer consolidated within its financial statements and the Company is no longer recording any operating or other financial results for the former Music segment.

Consumer subscription products are paid in advance, typically for monthly, quarterly or annual duration. Subscription revenue is recognized ratably over the related subscription time period. Revenue from sales of content downloads, software and licenses is recognized at the time the product is made available, digitally, to the end user. Revenue generated from advertising on the Company s websites and from advertising and the distribution of third-party products included in the Company s products is recognized as revenue at the time of delivery.

The Company s business-to-business Technology Products and Solutions (TPS) segment generates revenue by providing services that enable wireless carriers to deliver audio and video content to their customers and through sales of software licenses and products and related support and other services.

Revenue generated from services provided to wireless carriers that enable the delivery of audio and video content to their customers is recognized as the services are provided. Setup fees to build these services are recognized ratably upon launch of the service over the remaining expected term of the service.

Accounting for Gains on Sale of Subsidiary Stock. Effective January 1, 2009, the Company adopted Statement of Financial Accounting Standards No. 160, *Non-controlling Interests in Consolidated Financial Statements, an amendment to ARB No. 51* (SFAS 160) which was primarily codified into FASB ASC 810 *Consolidation* (ASC 810). Current guidance requires that the difference between the carrying amount of the parent s investment in a subsidiary and the underlying net book value to be recorded as an equity transaction. The Company elected to recognize any such gain in its consolidated statement of operations prior to January 1, 2009.

Noncontrolling Interests. The Company records noncontrolling interest expense (benefit) which reflects the portion of the earnings (losses) of majority-owned entities which are applicable to the noncontrolling interest partners in the consolidated statement of operations. Redeemable noncontrolling interests that are redeemable at either fair value or are based on a formula that is intended to approximate fair value follow the Company s historical disclosure only policy for the redemption feature. Redeemable noncontrolling interests that are redeemable at either a fixed price or are based on a formula that is not akin to fair value are reflected as an adjustment to income attributable to common shareholders based on the difference between accretion as calculated using the terms of the redemption feature and the accretion entry for a hypothetical fair value redemption feature with the remaining amount of accretion to redemption value recorded directly to equity. Noncontrolling interest expense (benefit) is included within the consolidated statements of operations and comprehensive income (loss). The Company applied this accounting policy to the noncontrolling interest in Rhapsody that was held by MTVN for periods beginning when Rhapsody was formed in August 2007 through the quarter ended March 31, 2010. Due to the completion of the restructuring of Rhapsody on March 31, 2010, which resulted in the Company holding approximately 47.5% of the outstanding shares of capital stock of Rhapsody, this accounting policy will no longer apply with respect to the Company s investment as the Company no longer consolidates Rhapsody and no longer reports a noncontrolling interest.

Note 2. Recent Accounting Pronouncements

With the exception of those discussed below, there have been no recent accounting pronouncements or changes in accounting pronouncements during the six months ended June 30, 2010, to be implemented by the Company in future periods as compared to the recent accounting pronouncements described in the Company s Annual Report on Form 10-K for the year ended December 31, 2009, that are of significance, or potential significance to the Company.

In September 2009, the FASB ratified Accounting Standards Update (ASU) 2009-13 (ASU 2009-13) (previously Emerging Issues Task Force (EITF) Issue No. 08-1, *Revenue Arrangements with Multiple Deliverables* (EITF 08-1)). ASU 2009-13 supersedes EITF 00-21 and addresses criteria for separating the consideration in multiple-element arrangements. ASU 2009-13 will require companies to allocate the overall consideration to each deliverable by using a best estimate of the selling price of individual deliverables in the arrangement in the absence of vendor-specific objective evidence or other third-party evidence of the selling price. ASU 2009-13 will be effective prospectively for revenue arrangements entered into or materially modified in fiscal years beginning on or after June 15, 2010 and early adoption is permitted. The Company is currently evaluating the potential impact, if any, of the adoption of ASU 2009-13 on its consolidated results of operations and financial condition and whether it will adopt the standard early.

In September 2009, the FASB ratified ASU 2009-14 (ASU 2009-14) (previously EITF No. 09-3, *Certain Revenue Arrangements That Include Software Elements)*. ASU 2009-14 modifies the scope of Software Revenue Recognition to exclude (a) non-software components of tangible products and (b) software components of tangible products that are sold, licensed, or leased with tangible products when the software components and non-software components of the tangible product function together to deliver the tangible product s essential functionality. ASU 2009-14 has an effective date that is consistent with ASU 2009-13. The Company is currently evaluating the potential impact, if any, of the adoption of ASU 2009-14 on its consolidated results of operations and financial condition and whether it will adopt the standard early.

Note 3. Stock-Based Compensation

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. The Company recognizes compensation cost related to options granted 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 employee behavior in the future. 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 never paid dividends.

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

	Quarters Ended June 30,		Six Months Ended June 30,	
	2010	2009	2010	2009
Expected dividend yield	0%	0%	0%	0%
Risk-free interest rate	1.65%	1.76%	1.91%	1.64%
Expected life (years)	4.0	4.2	4.0	4.2
Volatility	62%	63%	62%	63%

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

	Quarters Ended June 30,		Six Months Ended June 30,	
	2010	2009	2010	2009
Cost of revenue	$ 228	$ 363	$ 459	$ 993
Research and development	693	2,234	2,290	4,058
Sales and marketing	811	1,199	1,807	2,265
General and administrative	1,039	1,800	2,136	3,502
Total stock-based compensation expense	$ 2,771	$ 5,596	$ 6,692	$ 10,818

No stock-based compensation was capitalized as part of the cost of an asset during the quarters or six months ended June 30, 2010 or 2009. As of June 30, 2010, $17.8 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 2.2 years.

Note 4. Rhapsody Joint Venture

Restructuring of Rhapsody

As described in Note 1, Summary of Significant Accounting Policies, the Company initially formed in August 2007 a joint venture with MTVN to own and operate a business-to-consumer digital audio music service known as Rhapsody. Prior to March 31, 2010, the Company owned 51% of the outstanding equity interests of Rhapsody and MTVN owned the remaining 49%. On March 31, 2010, restructuring transactions involving Rhapsody were completed, and Rhapsody was converted from a limited liability company to a corporation. Following the completion of the restructuring transactions, RealNetworks owned slightly less than 47.5%, MTVN owned 47.5%, and two minority stockholders held slightly more than 5% of the outstanding shares of capital stock of Rhapsody. RealNetworks contributed $18.0 million in cash, the Rhapsody brand and certain other assets, including content licenses, in exchange for shares of convertible preferred stock of Rhapsody, carrying a $10.0 million preference upon certain liquidation events. As part of the transactions, RealNetworks repurchased the international radio business that was previously contributed to Rhapsody by

RealNetworks. MTVN contributed a $33.0 million advertising commitment in exchange for shares of common stock of Rhapsody, and MTVN s previous obligation to provide advertising of approximately $111 million as of December 31, 2009 was cancelled. In addition, the put and call rights held by RealNetworks and MTVN and MTVN s rights to receive a preferred return in connection with the exercise of RealNetworks put right were terminated. RealNetworks is also obligated to provide certain operational transition services to Rhapsody until December 31, 2010, unless earlier terminated by Rhapsody. Rhapsody will be initially governed by a Board of Directors with two directors appointed by each of the Company and MTVN and one independent director appointed by mutual agreement of the Company and MTVN.

RealNetworks no longer has a controlling interest in Rhapsody and therefore, the operating results of Rhapsody are accounted for under the equity method of accounting for investments, and the Company s proportionate share of the income or loss is recognized as a component of other income and expense, net in the Company s consolidated statements of operations in periods subsequent to March 31, 2010. Since March 31, 2010, Rhapsody has been classified as an equity method investment, and RealNetworks removed all Rhapsody related assets and liabilities that were previously consolidated from its unaudited condensed consolidated balance sheet. The removal of these assets and liabilities and the creation of the equity method investment resulted in a one-time net gain of $10.9 million recorded in other income and expense, net in the Company s unaudited condensed consolidated statement of operations for the quarter ended March 31, 2010, at which time the Company determined the fair value of its retained equity interest of approximately 47.5% to be approximately $29.7 million. During the quarter ended June 30, 2010, the Company recorded its share of losses in the operations of Rhapsody of approximately $5.4 million. These losses reduced the original carrying value of the equity investment accordingly to approximately $24.2 million. As a result of the deconsolidation of Rhapsody s operations from the Company s financial statements, the Company will no longer record any operating or financial results for its Music segment for periods subsequent to March 31, 2010. The Company now reports its share of Rhapsody s income or losses as Equity in net loss of Rhapsody and other equity method investments in Other income.

As mentioned above, MTVN s preferred return rights were terminated in connection with the restructuring of Rhapsody. Prior to the restructuring, if the appraised value of Rhapsody at a redemption date was less than $436.3 million, then the exercise price of the put would have included a preferred return to MTVN. The Company previously elected to accrete any excess of the redemption value over the carrying amount as an adjustment to income attributable to common shareholders, and adjusted earnings per share for the current quarter s accretion of the difference between accretion as calculated using the terms of the redemption feature and the accretion entry for a hypothetical fair value redemption feature. Due to the termination of MTVN s preferred return rights at the completion of the restructuring, the Company decreased the noncontrolling interest on the unaudited condensed consolidated balance sheet at March 31, 2010, by $10.4 million as part of the deconsolidation transactions, of which $3.7 million was an adjustment to income attributable to common shareholders for the purposes of calculating earnings per share for the quarter ended March 31, 2010. The Company increased the noncontrolling interest on the unaudited condensed consolidated balance sheet for the quarter and six months ended June 30, 2009, by $0.4 million and $1.8 million, respectively, which was an adjustment to income attributable to common shareholders for the purposes of calculating earnings per share. See Note 13, Earnings Per Share, for more information on this item.

Noncontrolling interest rollforward

Activity in noncontrolling interest and equity attributable to common shareholders is as follows (in thousands):

	Noncontrolling interest	Total Equity
Balances, December 31, 2008	$ 378	$ 553,558
Net loss	(12,081)	(200,465)
Contribution and other transactions with owners	13,475	7,237
Accretion of MTVN s equity interest in Rhapsody	5	(5)
Accretion of MTVN s preferred return in Rhapsody	1,850	(1,850)
		3,938

Unrealized holding losses on short-term and equity investments, net of taxes				
Foreign currency translation losses				1,218
Stock-based transactions and compensation expense, net of taxes				11,464
Balances, June 30, 2009	$	3,627	$	375,095

	Noncontrolling interest	Total Equity
Balances, December 31, 2009	$ 7,253	$ 375,811
Net loss	(2,910)	(22,679)
Contribution and other transactions with owners	616	619
Reversal of MTVN s accretion equity interest in Rhapsody	(6,736)	6,736
Reversal of MTVN s preferred return in Rhapsody	(3,700)	3,700
Deconsolidation	5,477	
Unrealized holding losses on short-term and equity investments, net of taxes		(1,609)
Foreign currency translation losses		(6,354)
Stock-based transactions and compensation expense, net of taxes		7,861
Balances, June 30, 2010	$	$ 364,085

Note 5. Fair Value Measurements

The Company measures certain financial assets at fair value on a recurring basis, including cash equivalents, short-term investments, and equity investments. The fair value of these financial assets was determined based on three levels of inputs:

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

Items Measured at Fair Value on a Recurring Basis

The following table presents information about the Company s financial assets that have been measured at fair value (in thousands) on a recurring basis as of June 30, 2010 and December 31, 2009 and indicates the fair value hierarchy of the valuation inputs utilized to determine such fair value.

	Fair Value Measurements as of June 30, 2010			
	Total	Level 1	Level 2	Level 3
	(In thousands)			
Cash equivalents				
Money market funds	$ 61,251	$ 61,251	$	$
Corporate notes and bonds	40,996	40,996	$	$
Short-term investments				
Corporate notes and bonds	104,403	104,403		
U.S. government agency securities	52,662	52,662		
Restricted cash equivalents and investments	10,000	10,000		
Available for sale securities	17,587	17,587		
Total	$ 286,899	$ 286,899	$	$

Fair Value Measurements as of December 31, 2009

	Total	Level 1	Level 2	Level 3
		(In thousands)		
Cash equivalents				
Money market funds	$ 223,909	$ 223,909	$	$
Short-term investments				
Corporate notes and bonds	73,462	73,462		
U.S. government agency securities	34,408	34,408		
Restricted cash equivalents and investments	13,700	13,700		
Available for sale securities	19,503	19,503		
Total	$ 364,982	$ 364,982	$	$

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 no fair value is derived. The Company has consistently applied these valuation techniques in all periods presented.

Items Measured at Fair Value on a Nonrecurring Basis

Certain assets and liabilities of the Company are measured at estimated fair value on a non-recurring basis. These instruments are subject to fair value adjustments only in certain circumstances (for example, when there is evidence of impairment). The Company performed a valuation using Level 3 inputs of its investment in the Rhapsody joint venture as of March 31, 2010. The Company performed the analysis as a result of the restructuring and related deconsolidation of Rhapsody, which is further described in Note 4, Rhapsody Joint Venture. The fair value analysis used multiple valuation models and was based on assumptions of future results made by management, including operating and cash flow projections.

The Company also performed a valuation using Level 3 inputs of its reporting units to test its goodwill for potential impairment as of June 30, 2009, resulting in goodwill impairment charges of $175.6 million during the quarter and six months ended June 30, 2009. The first step determined if there was an indication of impairment by comparing the estimated fair value of each reporting unit to its carrying value including existing goodwill. Goodwill is considered impaired if the carrying value of a reporting unit exceeds the estimated fair value. The second step calculated the implied fair value of goodwill by allocating the fair value of the reporting unit to all assets and liabilities other than goodwill and comparing it to the carrying amount of goodwill. The fair value analyses used multiple valuation models and were based on assumptions of future results made by management, including operating and cash flow projections.

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 June 30, 2010 consist of the following (in thousands):

	Amortized Cost	Gross Unrealized Gains	Gross Unrealized Losses	Estimated Fair Value
Cash and cash equivalents:				
Cash	$ 53,908	$	$	$ 53,908
Money market mutual funds	61,251			61,251
Corporate notes and bonds	40,996			40,996
Total cash and cash equivalents:	156,155			156,155
Short-term investments:				
Corporate notes and bonds	103,759	665	(21)	104,403
U.S. Government agency securities	52,420	243	(1)	52,662
Total short-term investments:	156,179	908	(22)	157,065
Total cash, cash equivalents and short-term investments	$ 312,334	$ 908	$ (22)	$ 313,220
Restricted cash equivalents and investments	$ 10,000	$	$	$ 10,000

Cash, cash equivalents, short-term investments, and restricted cash equivalents as of December 31, 2009 consist of the following (in thousands):

	Amortized	Gross Unrealized	Gross Unrealized	Estimated

	Cost	Gains	Losses	Fair Value
Cash and cash equivalents:				
Cash	$ 53,121	$	$	$ 53,121
Money market mutual funds	223,909			223,909
Total cash and cash equivalents	277,030			277,030
Short-term investments:				
Corporate notes and bonds	72,731	732	(1)	73,462
U.S. Government agency securities	34,560	5	(157)	34,408
Total short-term investments	107,291	737	(158)	107,870
Total cash, cash equivalents and short-term investments	$ 384,321	$ 737	$ (158)	$ 384,900
Restricted cash equivalents and investments	$ 13,700	$	$	$ 13,700

At December 31, 2009, restricted cash equivalents and investments represent cash equivalents and short-term investments pledged as collateral against two letters of credit for a total of $13.7 million in connection with two lease agreements. During the quarter ended June 30, 2010, the Company completed its obligation with one of the two lease agreements, and as a result, $3.7 million was reclassified into cash and cash equivalents.

Realized gains or losses on sales of available-for-sale securities for the quarters and six months ended June 30, 2010 and 2009 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 June 30, 2010 are as follows (in thousands):

	Amortized Cost	Estimated Fair Value
Within one year	$ 58,626	$ 58,730
Between one year and five years	97,553	98,335
Total available-for-sale investments	$ 156,179	$ 157,065

Note 7. Allowance for Doubtful Accounts Receivable and Sales Returns

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

	Allowance For	
	Doubtful Accounts Receivable	Sales Returns
Balances, December 31, 2009	$ 2,912	$ 1,012
Additions charged to expenses	1,449	1,995
Amounts written off	(724)	(2,064)
Balances, June 30, 2010	$ 3,637	$ 943

Two customers accounted for 12% and 10% of trade accounts receivable, respectively, as of June 30, 2010. As of December 31, 2009, the same two customers accounted for 18% and 10% of trade accounts receivable. No one customer accounted for more than 10% of total revenue during the quarters and six months ended June 30, 2010 and 2009.

Note 8. Equity Method Investments and Available for Sale Securities

As of June 30, 2010 and December 31, 2009, the carrying value of the Company s equity interest in publicly traded companies primarily relates to J-Stream Inc., a Japanese media services company, and LoEn Entertainment, Inc., a Korean digital music distribution company. These investments are classified as available for sale. The market for these investments is relatively limited and the share price is volatile. On March 31, 2010, the Company restructured its investment in Rhapsody, and as a result, the Company treats its investment in Rhapsody as an equity method investment since March 31, 2010. See Note 4, Rhapsody Joint Venture, above for further discussion of the restructuring transactions. Although the carrying value of the equity method investments and available for sale securities was $41.8 million at June 30, 2010, there can be no assurance that any gain can be realized through the disposition of these shares.

Summary of investments is as follows (in thousands):

	June 30, 2010		December 31, 2009	
	Cost	Carrying Value	Cost	Carrying Value

Available for sale securities	$ 10,765	$ 17,587	$ 10,765	$ 19,503
Equity method investments	29,650	24,223	500	50
Total investments	$ 40,415	$ 41,810	$ 11,265	$ 19,553

Note 9. Other Intangible Assets

Other intangible assets consist of the following (in thousands):

	Gross Amount	Accumulated Amortization	Net
Customer relationships	$ 29,397	$ 22,528	$ 6,869
Developed technology	28,008	27,096	912
Patents, trademarks and tradenames	5,455	5,432	23
Service contracts and other	5,904	5,904	
Total other intangible assets, June 30, 2010	$ 68,764	$ 60,960	$ 7,804
Total other intangible assets, December 31, 2009	$ 78,128	$ 67,478	$ 10,650

Amortization expense related to other intangible assets during the quarter and six months ended June 30, 2010 was $1.2 million and $2.5 million, respectively. Amortization expense related to other intangible assets during the quarter and six months ended June 30, 2009 was $2.2 million and $4.5 million, respectively.

As of June 30, 2010, estimated future amortization of other intangible assets is as follows (in thousands):

2010 (remaining six months)	$ 1,922
2011	2,186
2012	1,938
2013	1,541
2014	153
Thereafter	64
Total	$ 7,804

The Company reviews long-lived assets for impairment whenever events or changes in circumstances indicate the carrying amount of such assets may not be recoverable. Recoverability of these assets is measured by comparing their carrying amount to future undiscounted cash flows the assets are expected to generate. If long-lived assets are considered to be impaired, the impairment to be recognized equals the amount by which the carrying value of the assets exceeds their fair market value. The Company did not record any impairments to long-lived assets during the quarters or six months ended June 30, 2010 or 2009.

Note 10. Goodwill

In accordance with SFAS 142, goodwill is required to be tested for impairment annually and also if there is an event or change in conditions that would more likely than not reduce the fair value of a reporting unit below its carrying value. The Company performs its annual goodwill impairment test during its fiscal fourth quarter.

The Company considered whether a triggering event had occurred during the quarter ended June 30, 2009 in assessing whether an interim impairment analysis of goodwill was warranted. The Company noted its market capitalization, before adjusting for a reasonable control premium, was below its carrying value. In addition, the Company observed that the trading price per share of the Company s common stock had negatively diverged from the broader market during 2009. The Company also noted, more broadly, a continuation of macroeconomic instability as well as continued illiquidity in the overall credit market. As a result, the Company concluded that due to the sustained divergence in the Company s market capitalization and continued macroeconomic instability, an interim impairment analysis of goodwill as of June 30, 2009 was warranted.

The Company determined as part of its interim testing of impairment that the implied fair value of goodwill was zero for each of its reporting units. As a result, the Music, Technology Products and Solutions, Games, and Media Software and Services reporting units recorded impairments of $37.0 million, $50.5 million, $41.2 million and

$46.8 million, respectively, during the quarter ended June 30, 2009. No impairments were recognized in either the quarter or six months ended June 30, 2010.

Note 11. Accrued and Other Liabilities

Accrued and other liabilities consist of (in thousands):

	June 30, 2010	December 31, 2009
Royalties and other fulfillment costs	$ 31,224	$ 53,693
Employee compensation, commissions and benefits	22,770	20,077
Sales, VAT and other taxes payable	15,019	16,907
Legal fees and contingent legal fees	1,873	5,251
Other	17,635	29,006
Total	$ 88,521	$ 124,934

Note 12. Loss on Excess Office Facilities

In June 2010, the Company completed a business and operational reorganization which led to the reduction of its use of office space in its corporate headquarters in Seattle, Washington and one of its offices in Europe. As a result, the Company recorded losses of $7.1 million during the quarter ended June 30, 2010. These losses represented approximately $5.5 million of rent and contractual operating expenses over the remaining life of the lease, and approximately $1.6 million for the write-down of leasehold improvements to their estimated fair value. The Company regularly evaluates the market for office space. If the market for such space changes further in future periods, the Company may have to revise its estimates which may result in future gains or losses on excess office facilities.

The Company is also continuing to pay against the accrued loss on excess office facilities originally recorded in 2001 associated with the 10-year lease of additional office space near its corporate headquarters in Seattle, Washington.

The total accrued loss of $4.8 million for estimated future losses on excess office facilities at June 30, 2010, is shown net of expected future sublease income of $0.9 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.

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

Accrued loss on excess office facilities, December 31, 2009	$ 3,228
Additional accrued loss on excess office facilities resulting from its June 2010 restructuring	7,082
Less write-down of leasehold improvements	(1,552)
Less amounts paid, net of sublease income	(3,949)
Accrued loss on excess office facilities, June 30, 2010	$ 4,809
Less current portion	(762)
Accrued loss on excess office facilities, non-current portion	$ 4,047

Note 13. Earnings Per Share

For periods beginning August 2007 through the quarter ended March 31, 2010, basic net income (loss) available to common shareholders per share is computed by dividing net income (loss) attributable to common shareholders less any accretion from MTVN s preferred return in Rhapsody by the weighted average number of common shares outstanding during the period. Diluted net income (loss) available to common shareholders per share is computed by dividing net income (loss) attributable to common shareholders less any accretion from MTVN s preferred return in

Rhapsody by the weighted average number of common and dilutive potential common shares outstanding during the period. On March 31, 2010, the restructuring transactions involving Rhapsody were completed. After the completion of the restructuring transactions, MTVN no longer holds a preferred return in Rhapsody. Therefore, the total amount of the previously recognized accretion of $3.7 million was reversed in the quarter ended March 31, 2010. For periods subsequent to March 31, 2010, no adjustment to net income (loss) available to common shareholders was required.

Basic and diluted net income available to common shareholders per share are calculated as follows (in thousands):

	Quarters Ended June 30, 2010	Quarters Ended June 30, 2009	Six Months Ended June 30, 2010	Six Months Ended June 30, 2009
Net income (loss) available to common shareholders:				
Net income (loss) attributable to common shareholders	$ (25,907)	$ (188,329)	$ (22,679)	$ (200,465)
Less accretion of MTVN s preferred return in Rhapsody		(416)	3,700	(1,850)
Net income (loss) available to common shareholders	$ (25,907)	$ (188,745)	$ (18,979)	$ (202,315)
Weighted average common shares outstanding used to compute basic net income (loss) per share available to common shareholders	135,277	134,420	135,209	134,394
Dilutive potential common shares:				
Stock options and restricted stock				
Shares used to compute diluted net income (loss) per share available to common shareholders	135,277	134,420	135,209	134,394
Basic net income (loss) per share available to common shareholders	$ (0.19)	$ (1.40)	$ (0.14)	$ (1.51)
Diluted net income (loss) per share available to common shareholders	$ (0.19)	$ (1.40)	$ (0.14)	$ (1.51)

During the quarter and six months ended June 30, 2010, 18.4 million and 18.6 million shares of common stock, respectively, potentially issuable from stock options were excluded from the calculation of diluted net income per share because of their antidilutive effect. During the quarter and six months ended June 30, 2009, 38.7 million and 38.9 million shares of common stock, respectively, potentially issuable from stock options were excluded from the calculation of diluted net income per share because of their antidilutive effect.

Note 14. Commitments and Contingencies

Borrowing Arrangements. The Company s subsidiary, WiderThan, has entered into lines of credit with a Korean domestic bank with an aggregate maximum available limit of $0.8 million at interest rates of approximately 6% over the rate earned on the underlying deposits. During the quarter or six months ended June 30, 2010, the Company did not draw on the line of credit and there was no balance outstanding as of June 30, 2010 or December 31, 2009.

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.

WiderThan has a letter of credit of up to $1.0 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 or six months ended June 30, 2010, the Company did not draw on the letter of credit and there was no balance outstanding as of June 30, 2010 or December 31, 2009.

WiderThan has purchase guarantees amounting to $0.9 million from Seoul Guarantee Insurance which guarantees payments for one year under certain supply contracts the Company has with a customer in Korea.

Litigation. On April 25, 2007, a lawsuit was filed by Greenville Communications, LLC in the U.S. District Court for the Northern District of Mississippi against a number of cell phone carriers, including the Company s partners T-Mobile USA, Inc. and Alltel Corporation, alleging that they infringe its patents by providing ringback tone services. The Company agreed to indemnify T-Mobile and Alltel against the claims based on an indemnity that is claimed to be owed by the Company s subsidiary, WiderThan. On August 27, 2007, the Company s motion to transfer this matter to the U.S. District Court for the District of New Jersey was granted. The parties briefed claim construction, but the case was subsequently stayed pending reexamination of the patents at issue. In December

2009, the U.S. Patent and Trademark Office (PTO) issued notice of its intent to issue reexamination certificates for the patents in suit. The Court lifted the stay on the litigation on January 29, 2010 and discovery has resumed. The Company disputes the plaintiff s allegations regarding both the validity of its patents and its claims of infringement against the Company s partners.

The Company has also been involved in a proceeding in the U.S. District Court for the Southern District of New York to 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 and subsequently issued additional rulings. After working with ASCAP to make a final determination of amounts due under the court s rulings, the Company reached a partial agreement with ASCAP on January 12, 2009. The Company believes it has sufficiently accrued for expected royalties under the agreement, but the Company and ASCAP appealed some aspects of the court s rulings that underlie the agreement, which appeal remains pending before the U.S. Court of Appeals for the Second Circuit.

From time to time the Company is, and expects to continue to be, subject to legal proceedings and claims in the ordinary course of 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, 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 15. Segment Information

The Company reports four business segments 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, Executive Vice President and certain 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 TPS, MSS, Games, and, prior to April 1, 2010, Music segments and, therefore, the Company reports these as operating segments. The accounting policies used to derive segment results are generally the same as those described in Note 1, Summary of Business and Summary of Significant Accounting Policies.

The TPS segment includes revenue and costs from: sales of application services such as ringback tones, music on demand, video on demand, messaging, and information services; sales of media delivery system software and licenses, including Helix system software and related authoring and publishing tools, directly to customers and indirectly through original equipment manufacturer channels; sales of support and maintenance services to customers who purchase software products; sales of broadcast hosting services; and sales of consulting and professional services. These products and services are primarily sold to corporate customers.

The MSS segment primarily includes revenue from sales of the Company s SuperPass premium subscription service; sales of 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 Games and former Music businesses. Beginning with the quarter ended June 30, 2010, MSS revenue also includes sales of the RadioPass subscription service that the Company repurchased from Rhapsody in connection with the restructuring transactions that were completed on March 31, 2010.

The Games segment primarily includes revenue from the sale of individual games on the Company s websites RealArcade.com, GameHouse.com and Zylom.com; the sale of games subscription services; advertising through the Company s games websites; the sale of games through syndication on partner sites; and sales of games through wireless carriers.

For periods prior to April 1, 2010, the Music segment primarily includes the operations of Rhapsody. The revenue and costs from these businesses include: digital music subscription services, such as Rhapsody and RadioPass, and sales of digital music content 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. Billings for subscription services typically occur monthly, quarterly or annually, depending on the term of the service purchased. As a result of the deconsolidation of Rhapsody s operations from the Company s financial statements effective following the restructuring of Rhapsody on March 31, 2010, the Company will not record any operating or financial results for its Music segment for periods subsequent to March 31, 2010. The Company now reports its share of Rhapsody s income or losses as Equity in net loss of Rhapsody and other equity method investments in Other income.

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.

Segment net income (loss) attributable to common shareholders for the quarter ended June 30, 2010 is as follows (in thousands):

	Technology Products and Solutions	**Media Software and Services**	**Games**	**Music**	**Reconciling Amounts**	**Consolidated**
Net revenue	$ 41,122	$ 19,617	$ 28,145	$	$	$ 88,884
Cost of revenue	17,526	4,243	7,380			29,149
Gross profit	23,596	15,374	20,765			59,735
Loss on excess office facilities					7,082	7,082
Restructuring and other charges					4,792	4,792
Operating expenses	25,663	16,132	27,784		(24)	69,555
Operating income (loss)	(2,067)	(758)	(7,019)		(11,850)	(21,694)
Total non-operating income, net					(3,932)	(3,932)
Income (loss) before income taxes	(2,067)	(758)	(7,019)		(15,782)	(25,626)
Income taxes					(281)	(281)
Net income (loss)	(2,067)	(758)	(7,019)		(16,063)	(25,907)