REALNETWORKS INC
Form 10-Q
November 09, 2006

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

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

For the Quarterly Period Ended September 30, 2006

OR

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

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

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

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

The number of shares of the registrant s Common Stock outstanding as of October 31, 2006 was 161,595,952.

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FOR THE QUARTER ENDED SEPTEMBER 30, 2006
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PART I. FINANCIAL INFORMATION

Item 1. Financial Statements

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

	September 30, 2006	December 31, 2005
ASSETS		
Current assets:		
Cash and cash equivalents	$ 693,057	$ 651,971
Short-term investments	151,745	129,356
Trade accounts receivable, net of allowances for doubtful accounts and sales returns	24,481	16,721
Deferred tax assets, net, current portion	7,046	54,204
Prepaid expenses and other current assets	11,488	11,933
Total current assets	887,817	864,185
Equipment, software and leasehold improvements, at cost:		
Equipment and software	65,551	56,402
Leasehold improvements	29,139	27,964
Total equipment, software and leasehold improvements	94,690	84,366
Less accumulated depreciation and amortization	60,235	51,228
Net equipment, software and leasehold improvements	34,455	33,138
Restricted cash equivalents	17,300	17,300
Equity investments	26,269	46,163
Other assets	4,177	2,397
Deferred tax assets, net, non-current portion	15,967	19,147
Goodwill	132,789	123,330
Other intangible assets, net	7,386	7,337
Total assets	$ 1,126,160	$ 1,112,997
LIABILITIES AND SHAREHOLDERS EQUITY		
Current liabilities:		
Accounts payable	$ 14,905	$ 11,397
Accrued and other liabilities	72,105	112,340
Deferred revenue, current portion	25,469	25,021
Accrued loss on excess office facilities, current portion	4,053	4,623
Total current liabilities	116,532	153,381

Deferred revenue, non-current portion	340	276
Accrued loss on excess office facilities, non-current portion	11,323	13,393
Deferred rent	4,472	4,018
Convertible debt	100,000	100,000
Other long-term liabilities	1,679	196
Total liabilities	234,346	271,264
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 161,108 shares in 2006 and 166,037 shares in 2005	161	166
Additional paid-in capital	760,347	805,067
Deferred stock compensation		(19)
Accumulated other comprehensive income	15,597	26,724
Retained earnings	115,709	9,795
Total shareholders equity	891,814	841,733
Total liabilities and shareholders equity	$ 1,126,160	$ 1,112,997

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
(In thousands, except per share data)

	Quarters ended September 30,		Nine Months ended September 30,	
	2006	2005	2006	2005
Net revenue (A)	$ 93,676	$ 82,233	$ 269,687	$ 241,491
Cost of revenue (B)	28,389	24,695	81,788	74,273
Gross profit	65,287	57,538	187,899	167,218
Operating expenses:				
Research and development	18,344	16,354	55,127	45,381
Sales and marketing	37,560	30,745	111,604	93,809
General and administrative	14,043	7,037	41,586	21,120
Loss on excess office facilities			738	
Subtotal operating expenses	69,947	54,136	209,055	160,310
Antitrust litigation expenses (benefit), net	(61,861)	3,531	(159,554)	11,925
Total operating expenses, net	8,086	57,667	49,501	172,235
Operating income (loss)	57,201	(129)	138,398	(5,017)
Other income (expense), net:				
Interest income, net	10,618	2,904	27,978	7,499
Equity in net loss of MusicNet				(1,068)
Gain on sale of equity investments		11,740	2,286	19,330
Other, net	242	124	432	(276)
Other income, net	10,860	14,768	30,696	25,485
Net income before income taxes	68,061	14,639	169,094	20,468
Income tax provision	(25,908)	(3,457)	(63,180)	(3,763)
Net income	$ 42,153	$ 11,182	$ 105,914	$ 16,705
Basic net income per share	$ 0.26	$ 0.07	$ 0.66	$ 0.10
Diluted net income per share	$ 0.24	$ 0.06	$ 0.59	$ 0.09
Shares used to compute basic net income per share	160,578	170,797	160,466	170,761
Shares used to compute diluted net income per share	178,913	184,180	178,551	184,276
Comprehensive income:				
Net income	$ 42,153	$ 11,182	$ 105,914	$ 16,705
Unrealized holding gains (losses) on investments, net of tax	28	16,321	(12,887)	21,831
Adjustments for gains reclassified to net income		(4,052)		(4,052)

Foreign currency translation gains (losses)	388	(109)	1,760	(1,400)
Comprehensive income	$ 42,569	$ 23,342	$ 94,787	$ 33,084
(A) Components of net revenue:				
License fees	$ 22,528	$ 19,596	$ 68,014	$ 60,605
Service revenue	71,148	62,637	201,673	180,886
	$ 93,676	$ 82,233	$ 269,687	$ 241,491
(B) Components of cost of revenue:				
License fees	$ 9,675	$ 8,666	$ 28,865	$ 24,888
Service revenue	18,714	16,029	52,923	49,385
	$ 28,389	$ 24,695	$ 81,788	$ 74,273

See accompanying notes to unaudited condensed consolidated financial statements

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

	Nine Months Ended September 30,	
	2006	**2005**
Cash flows from operating activities:		
Net income	$ 105,914	$ 16,705
Adjustments to reconcile net income to net cash provided by operating activities:		
Depreciation and amortization	12,480	11,869
Stock-based compensation	12,332	109
Equity in net losses of MusicNet		1,068
Changes in accrued loss on excess office facilities and content agreement	(2,640)	(6,230)
Loss on disposal of equipment	76	250
Gain on sale of equity investments	(2,286)	(19,330)
Deferred income taxes	56,508	3,324
Other	73	48
Net change in certain operating assets and liabilities, net of balances acquired	(48,496)	6,127
Net cash provided by operating activities	133,961	13,940
Cash flows from investing activities:		
Purchases of equipment and leasehold improvements	(9,316)	(10,728)
Purchases of intangible assets		(1,000)
Purchases of short-term investments	(177,868)	(121,540)
Proceeds from sales and maturities of short-term investments	156,006	127,790
Decrease in restricted cash equivalents		2,095
Proceeds from sale of equity investments	2,286	19,530
Purchases of cost based investments	(834)	(647)
Payment of acquisition costs, net of cash acquired	(7,086)	(14,705)
Net cash provided by (used in) investing activities	(36,812)	795
Cash flows from financing activities:		
Net proceeds from sale of common stock under employee stock purchase plan and exercise of stock options	41,976	4,926
Repayment of long-term note payable		(648)
Repurchase of common stock	(98,869)	(29,275)
Net cash used in financing activities	(56,893)	(24,997)
Effect of exchange rate changes on cash and cash equivalents	830	(492)
Net increase (decrease) in cash and cash equivalents	41,086	(10,754)
Cash and cash equivalents at beginning of period	651,971	219,426

Cash and cash equivalents at end of period	$ 693,057	$ 208,672
Supplemental disclosure of non-cash investing and financing activities:		
Cash paid for income taxes	$ 14,181	$
Non-cash consideration in business combinations:		
Accrued acquisition payments	$ 2,079	$
Accrued acquisition costs	$	$ 1
Long-term notes payable acquired in business combination	$	$ 863

See accompanying notes to unaudited condensed consolidated financial statements

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

NOTE 1 SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES

(a) Description of Business

RealNetworks, Inc. and subsidiaries (RealNetworks or Company) is a leading creator of digital media services and software, such as Rhapsody, RealArcade and RealPlayer. Consumers use the Company s services and software to find, play, purchase and manage free and premium digital content, including music, games and video. Broadcasters, network operators, media companies and enterprises use the Company s products and services to create, secure and deliver digital media to PCs, mobile phones and other consumer electronics devices.

Inherent in the Company s business are various risks and uncertainties, including the 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, among other things, the acceptance of the Company s technology, products and services and the ability to generate related revenue.

(b) Basis of Presentation

The accompanying unaudited condensed consolidated financial statements include the accounts of the Company, its wholly-owned subsidiaries, and an entity in which the Company has a variable interest (see item (d) below for a further discussion of the variable interest entity). All significant intercompany balances and transactions have been eliminated in consolidation.

These 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, 2006 are not necessarily indicative of the results that may be expected for any subsequent quarter or for the year ending December 31, 2006. 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, 2005.

(c) Cash, Cash Equivalents and Short-Term Investments

Cash, cash equivalents and short-term investments are comprised of the following (in thousands):

	September 30, 2006	December 31, 2005
Cash and cash equivalents	$ 693,057	$ 651,971
Short-term investments	151,745	129,356
Total cash, cash equivalents and short-term investments	$ 844,802	$ 781,327
Restricted cash equivalents	$ 17,300	$ 17,300

Restricted cash equivalents at September 30, 2006 represent (a) cash equivalents pledged as collateral against a $10.0 million letter of credit in connection with a lease agreement for the Company s corporate headquarters, and (b) cash equivalents pledged as collateral against a $7.3 million letter of credit with a bank which represents collateral on the lease of a building located near the Company s corporate headquarters.

The majority of short-term investments mature within twelve months from the date of purchase. Investments with maturities beyond one year may be classified as short-term based on their highly liquid nature and because such marketable securities represent the investment of cash that is available for current operations.

The Company has classified as available-for-sale all marketable debt and equity securities for which there is a determinable fair market value and on which the Company has no restrictions to sell within the next 12 months.

Available-for-sale securities are carried at fair value, with unrealized gains and losses reported as a component of shareholders equity, net of applicable income taxes. Realized gains and losses and declines in value judged to be other-than-temporary on available-for-sale securities are included in other

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income (expense), net. The cost basis for determining realized gains and losses on available-for-sale securities is determined using the specific identification method.

(d) Equity Investments

The Company has certain equity investments that are accounted for under the cost method of accounting. The cost method is used to account for equity investments in companies in which the Company holds less than a 20 percent voting interest, does not exercise significant influence and for which the related securities do not have a quoted market price.

The Company has certain equity investments in which the Company holds less than a 20 percent voting interest in companies that are publicly traded. The investments are accounted for at market value. Changes in the market value of the investments are recognized as unrealized gains (losses), net of tax and are recorded in the accompanying unaudited condensed consolidated balance sheets as a component of Accumulated Other Comprehensive Income.

The Company s equity investment in MusicNet, Inc. (MusicNet) was accounted for under the equity method of accounting. Under the equity method of accounting, the Company s share of the investee s earnings or loss was included in the Company s consolidated operating results. In certain cases where the Company had loaned the investee funds, the Company may have recorded more than its relative equity share of the investee s losses. During the quarter ended June 30, 2005, the Company disposed of all of its preferred shares and convertible notes in MusicNet to a private equity firm, Baker Capital, in connection with the sale of all of the capital stock of MusicNet. There was no investment in MusicNet during 2006.

During the quarter ended March 31, 2006, the Company established Beijing RealNetworks Technology Co., Ltd, a Wholly Owned Foreign Entity (WOFE) which operates an Internet retail website in the People s Republic of China (PRC) in cooperation with a PRC affiliate. The results of operations of the WOFE have been included in the Company s consolidated results since the establishment date of the WOFE. The PRC regulates the WOFE s business through regulations and license requirements restricting: (i) the scope of foreign investment in the Internet, retail and delivery sectors; (ii) Internet content; and (iii) the sale of certain media products. In order to meet the PRC local ownership and regulatory licensing requirements, the WOFE s business is operated through a PRC affiliate which is owned by nominee shareholders who are PRC nationals and are RealNetworks employees. The WOFE does not own any capital stock of the PRC affiliate, but is the primary beneficiary of future losses or profits through contractual rights. As a result, the Company consolidates the results of the PRC affiliate in accordance with Financial Accounting Standards Board Interpretation No. 46R, Consolidation of Variable Interest Entities (FIN 46R). The net assets and operating results for the PRC affiliate were not significant during the quarter and nine months ended September 30, 2006.

(e) Other Assets

Other assets primarily consist of offering costs and other long-term deposits. The Company incurred the offering costs as a result of its convertible debt offering in 2003. These costs are deferred and are being amortized using the straight-line method, which approximates the effective interest method, over a 5-year period.

(f) Goodwill and Other Intangible Assets, net

Goodwill represents the excess of the purchase price over the fair value of identifiable tangible and intangible assets acquired and liabilities assumed in business combinations accounted for under the purchase method. Goodwill and intangible assets not subject to amortization are tested annually for impairment, and are tested for impairment more frequently if events and circumstances indicate that the asset might be impaired. Other intangible assets, net primarily consist of trade names, technology and patents that were acquired through certain of the Company s acquisitions, as well as other purchased technology. The intangible assets are amortized using the straight-line method over their estimated period of benefit, ranging from one to five years. The Company evaluates the recoverability of intangible assets periodically and takes into account events or circumstances that warrant revised estimates of useful lives or that may indicate that impairment exists. All of the Company s intangible assets are subject to amortization. No impairments of intangible assets have been identified during any of the periods presented.

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(g) Revenue Recognition

The Company recognizes revenue in accordance with the following authoritative literature: SEC Staff Accounting Bulletin No. 104, Revenue Recognition in Financial Statements (SAB 104); Emerging Issues Task Force (EITF) 00-21 Revenue Arrangements with Multiple Deliverables (EITF 00-21); Statement of Position (SOP) 97-2, Software Revenue Recognition (SOP 97-2); SOP 98-9 Software Revenue Recognition with Respect to Certain Arrangements (SOP 98-9); SOP 81-1, Accounting for Performance of Construction-Type and Certain Production-Type Contracts (SOP 81-1); and EITF 99-19 Reporting Revenue Gross as a Principal versus Net as an Agent (EITF 99-19). In general, 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.

The Company has arrangements whereby customers pay one price for multiple products and services. In some cases, these arrangements involve a combination of products and services. For arrangements with multiple deliverables, revenue is recognized upon the delivery of the separate units in accordance with EITF 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 99-19. In most arrangements, the Company contracts directly with its end user customers, is the primary obligor and carries all collectibility risk. Revenue in these arrangements is recorded 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 those instances, in accordance with EITF 99-19, the Company reports the revenue on a net basis.

The Company recognizes revenue in connection with its software products pursuant to the requirements of SOP 97-2, as amended by SOP 98-9. If the Company provides consulting services that are considered essential to the functionality of the software products, both the software product revenue and services revenue are recognized under contract accounting in accordance with the provisions of SOP 81-1. Revenue from these arrangements is recognized under the percentage of completion method based on the ratio of direct labor hours incurred to total projected labor hours. Revenue from software license agreements with original equipment manufacturers (OEM) is recognized when the OEM delivers its product incorporating the Company s software to the end user.

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

(h) Net Income 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.

The share count used to compute basic and diluted net income per share is calculated as follows (in thousands):

	Quarters Ended September 30,		Nine Months Ended September 30,	
	2006	2005	2006	2005
Weighted average common shares outstanding	160,578	170,797	160,466	170,761
Shares used to compute basic net income per share	160,578	170,797	160,466	170,761
Dilutive potential common shares				
Stock options	7,585	2,633	7,335	2,765
Convertible debt	10,750	10,750	10,750	10,750

Shares used to compute diluted net income per share	178,913	184,180	178,551	184,276

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Approximately 9.2 million and 7.6 million shares of common stock potentially issuable from stock options for the quarter and nine months ended September 30, 2006, respectively, and 24.1 million shares of common stock for both the quarter and nine months ended September 30, 2005, respectively, are excluded from the calculation of diluted net income per share because the exercise price per share was greater than the average per share market price of the common stock for the respective period.

(i) Derivative Financial Instruments

During the quarter ended September 30, 2006, the Company entered into foreign currency forward contracts to manage the foreign currency risk of certain intercompany balances denominated in a foreign currency. Although these instruments are effective as a hedge from an economic perspective, they do not meet the criteria for hedge accounting under Statement of Financial Accounting Standards No. 133, Accounting for Derivative Instruments and Hedging Activities (SFAS 133), as amended.

At September 30, 2006, the following foreign currency contracts were outstanding and recorded at fair value (in thousands):

	Contract Amount (Local Currency)	Contract Amount (US Dollars)	Fair Value
Japanese Yen (YEN) (contracts to pay YEN/receive US$)	(YEN) 151,300	$ 1,293	$ 3

At December 31, 2005, the following foreign currency contracts were outstanding and recorded at fair value (in thousands):

	Contract Amount (Local Currency)	Contract Amount (US Dollars)	Fair Value
British Pounds (GBP) (contracts to receive GBP/pay US$)	(GBP) 1,000	$ 1,736	$ (15)
Euro (EUR) (contracts to pay EUR/receive US$)	(EUR) 1,260	$ 1,514	$ 23
Japanese Yen (YEN) (contracts to receive YEN/pay US$)	(YEN) 30,000	$ 251	$ 4

No derivative instruments designated as hedges for accounting purposes were outstanding at September 30, 2006 or December 31, 2005.

(j) Accumulated Other Comprehensive Income

The Company s accumulated other comprehensive income at September 30, 2006 and December 31, 2005 consisted of net unrealized gains on investments and the net amount of foreign currency translation adjustments. The tax effect of the foreign currency translation adjustments and unrealized gains and losses on investments has been taken into account if applicable. The components of accumulated other comprehensive income are as follows (in thousands):

	September 30, 2006	December 31, 2005
Unrealized gains on investments, net of taxes of $6,278 in 2006 and $13,592 in 2005	$ 15,829	$ 28,717
Foreign currency translation adjustments	(232)	(1,993)
Total accumulated other comprehensive income	$ 15,597	$ 26,724

(k) Stock-Based Compensation

On January 1, 2006, the Company adopted the provisions of, and began accounting for stock-based compensation in accordance with, the Financial Accounting Standards Board s (FASB) Statement of Financial Accounting Standards

No. 123 revised 2004, Share Based Payment (SFAS 123R), which replaced SFAS No. 123, Accounting for Stock-Based Compensation (SFAS 123) and supersedes APB Opinion No. 25, Accounting for Stock Issued to Employees (APB 25). Under the fair value provisions of this 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, consistent with that used for pro forma disclosures under SFAS 123. The Company utilized the modified prospective transition method, which requires that stock-based compensation expense be recorded for all new and unvested stock options and employee stock purchase plan shares that are ultimately expected to vest as the requisite service is rendered beginning on January 1, 2006, the first day of the Company s 2006 fiscal year. Stock-based compensation expense for awards granted prior to January 1, 2006 is based on the grant date fair-value as determined under the pro forma provisions of SFAS 123.

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. For the quarter and

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nine months ended September 30, 2006, 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. Prior to the adoption of SFAS 123R, expected stock price volatility was estimated using only historical volatility. 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 or four years. The Company has not paid dividends in the past.

In accordance with SFAS 123R the Company presents excess tax benefits from the exercise of stock-based compensation awards as a financing activity in the Condensed Consolidated Statement of Cash Flows for quarters in which a tax benefit is recorded. No such benefit was recorded for the quarter or nine months ended September 30, 2006 and as a result there were no differences in net cash provided by (used in) operating and financing activities due to the implementation of SFAS 123R.

The Company recognizes 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 Financial Accounting Standards Board (FASB) Interpretation No. 28, Accounting for Stock Appreciation Rights and Other Variable Stock Option or Award Plans (FIN 28). 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. At September 30, 2006, the Company had options outstanding under six stock-based compensation plans. The Company issues new shares of its common stock to satisfy stock option exercises.

During the quarter and nine months ended September 30, 2006, the Company recognized approximately $5.0 million and $12.3 million, respectively, related to stock-based compensation. The amounts are classified in the Company s unaudited condensed consolidated statements of operations as follows (in thousands):

	Quarter Ended September 30, 2006	Nine Months Ended September 30, 2006
Cost of revenue	$ 57	$ 148
Research and development	1,878	4,565
Sales and marketing	1,920	4,713
General and administrative	1,166	2,906
Total stock-based compensation	$ 5,021	$ 12,332

No stock-based compensation was capitalized as part of the cost of an asset as of September 30, 2006. As of September 30, 2006, $20.8 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 approximately two years.

Prior to the adoption of SFAS 123R, the Company measured compensation expense for its employee stock-based compensation plans using the intrinsic value method prescribed by APB 25. The Company applied the disclosure provisions of SFAS 123 as amended by SFAS No. 148, Accounting for Stock-Based Compensation Transition and Disclosure as if the fair-value-based method had been applied in measuring compensation expense. Under APB 25, when the exercise price of the Company s employee stock options was equal to the market price of the underlying stock on the date of the grant, no compensation expense was recognized.

The following table presents the impact of the Company s adoption of SFAS 123R on selected line items from the unaudited condensed consolidated statement of operations for the quarter and nine months ended September 30, 2006 (in thousands, except per share amounts):

	Quarter Ended September 30, 2006		Nine Months Ended September 30, 2006	
	As Reported Following	If Reported Following	As Reported Following	If Reported Following

	SFAS 123(R)	APB 25	SFAS 123(R)	APB 25
Operating income	$ 57,201	$ 62,222	$ 138,398	$ 150,730
Income before income taxes	68,061	73,082	169,094	181,426
Net income	$ 42,153	$ 45,263	$ 105,914	$ 113,713
Basic net income per share	$ 0.26	$ 0.28	$ 0.66	$ 0.71
Diluted net income per share	$ 0.24	$ 0.25	$ 0.59	$ 0.64

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The following table illustrates the effect on net income and net income per share if the Company had applied the fair value recognition provisions of SFAS 123 to stock-based employee compensation during the quarter and nine months ended September 30, 2005 (in thousands, except per share data):

	Quarter Ended September 30, 2005	Nine Months Ended September 30, 2005
Net income as reported	$ 11,182	$ 16,705
Plus: stock-based employee compensation expense included in reported net income, net of related tax effects	25	109
Less: stock-based employee compensation expense determined under fair value based methods for all awards, net of related tax effects	(3,720)	(10,134)
Pro forma net income	$ 7,487	$ 6,680
Net income per share:		
Basic as reported	$ 0.07	$ 0.10
Diluted as reported	$ 0.06	$ 0.09
Basic pro forma	$ 0.04	$ 0.04
Diluted pro forma	$ 0.04	$ 0.04

For further information related to the Company s equity compensation plans, refer to NOTE 10 EQUITY COMPENSATION PLANS.

(l) Reclassifications

Certain reclassifications have been made to the September 30, 2005 unaudited condensed consolidated financial statements, and footnotes thereto, to conform to the September 30, 2006 presentation.

(m) Recently Issued Accounting Pronouncements

In June 2006, the FASB issued Interpretation No. 48, Accounting for Uncertainty in Income Taxes An Interpretation of FASB Statement No. 109 (FIN 48), which prescribes a recognition threshold and measurement attribute for the financial statement recognition and measurement of a tax position taken or expected to be taken in a tax return. FIN 48 will be effective beginning the first fiscal quarter in 2007. The Company has not yet evaluated the impact of implementation of FIN 48 on its condensed consolidated financial statements.

In June 2006, the FASB ratified the consensus reached on Emerging Issues Task Force Issue No. 06-3, *How Taxes Collected from Customers and Remitted to Governmental Authorities Should Be Presented in the Income Statement (That Is, Gross Versus Net Presentation)* (EITF 06-3). The scope of EITF 06-3 includes any transaction-based tax assessed by a governmental authority that is imposed concurrent with or subsequent to a revenue-producing transaction between a seller and a customer. The scope does not include taxes that are based on gross receipts or total revenues imposed during the inventory procurement process. Gross versus net income statement classification of that tax is an accounting policy decision and a voluntary change would be considered a change in accounting policy requiring the application of SFAS No. 154, *Accounting Changes and Error Corrections* . The following disclosures will be required for taxes within the scope of this issue that are significant in amount: (1) the accounting policy elected for these taxes and (2) the amounts of the taxes reflected gross (as revenue) in the income statement on an interim and annual basis for all periods presented. The EITF 06-3 is effective for interim and annual periods beginning after December 15, 2006. The Company does not expect the adoption of EITF 06-3 to have a material impact on our condensed consolidated financial statements.

In September 2006, the FASB issued SFAS No. 157, *Fair Value Measurements* (SFAS 157), which defines fair value, establishes a framework for measuring fair value in generally accepted accounting principles, and expands disclosures about fair value measurements. SFAS 157 does not require any new fair value measurements, but provides

guidance on how to measure fair value by providing a fair value hierarchy used to classify the source of the information. SFAS 157 is effective for fiscal years beginning after November 15, 2007. The Company is currently assessing the potential impact that the adoption of SFAS 157 will have on its condensed consolidated financial statements.

In September 2006, the SEC issued SAB No. 108, *Financial Statements Considering the Effects of Prior Year Misstatements when Quantifying Misstatements in Current Year Financial Statements* (SAB 108). SAB 108 provides guidance on how prior year misstatements should be taken into consideration when quantifying misstatements in current year financial statements for purposes of determining whether the current year s financial statements are materially misstated. The impact of correcting all misstatements, including both the carryover and reversing effects of prior year misstatements, must be quantified on the current year financial statements. When a current year misstatement has been quantified, SAB No. 99, *Financial Statements Materiality* should be applied to determine whether the misstatement is material and should result in an adjustment to the financial statements. SAB 108 also discusses the implications of misstatements uncovered upon the application of SAB 108 in situations when a registrant has historically been using either the iron curtain approach or the rollover approach as described in the SAB. Registrants electing not to restate prior periods should reflect the effects of initially applying the guidance in their annual financial statements covering the first fiscal year ending after November 15, 2006. The Company is evaluating what impact the adoption of SAB 108 will have on its condensed consolidated financial statements.

NOTE 2 SEGMENT INFORMATION

The Company operates in two business segments for which the Company receives revenue from its customers: Consumer Products and Services and Technology Products and Solutions. The Company s Chief Operating Decision Maker is considered to be the Company s CEO Staff (CEOS), which is comprised of the Company s Chief Executive Officer, Chief Financial Officer, Executive Vice President 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 Consumer Products and Services segment and Technology Products and Solutions segment and, therefore, the Company reports these as operating segments as defined by Statement of Financial Accounting Standards No. 131, Disclosure About Segments of an Enterprise and Related Information (SFAS 131).

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The Company s customers consist primarily of business customers and individual consumers located in the United States and various foreign countries. Revenue by geographic region is as follows (in thousands):

	Quarters Ended September 30,		Nine Months Ended September 30,	
	2006	2005	2006	2005
United States	$ 69,433	$ 63,478	$ 201,675	$ 184,678
Europe	15,895	10,937	45,725	33,547
Rest of the world	8,348	7,818	22,287	23,266
Total net revenue	$ 93,676	$ 82,233	$ 269,687	$ 241,491

The Company s segment revenue is defined as follows:

Consumer Products and Services primarily includes revenue from: digital media subscription services such as Rhapsody, RadioPass, GamePass and SuperPass; sales and distribution of third party software and services; sales of digital content such as music and 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 the Company charges customers credit cards at the time of sale. Billing periods for subscription services typically occur monthly, quarterly or annually, depending on the service purchased.

Technology Products and Solutions primarily includes revenue from: sales of media delivery system software, including Helix system software and related authoring and publishing tools, both directly to customers and indirectly through OEM channels; support and maintenance services that we sell to customers who purchase our software products; broadcast hosting services; and consulting services we offer to our customers. These products and services are primarily sold to corporate, educational and governmental customers.

Net revenue by segment is as follows (in thousands):

	Quarters Ended September 30,		Nine Months Ended September 30,	
	2006	2005	2006	2005
Consumer Products and Services	$ 82,497	$ 71,750	$ 234,750	$ 206,549
Technology Products and Solutions	11,179	10,483	34,937	34,942
Total net revenue	$ 93,676	$ 82,233	$ 269,687	$ 241,491

Consumer Products and Services revenue is comprised of the following (in thousands):

	Quarters Ended September 30,		Nine Months Ended September 30,	
	2006	2005	2006	2005
Music	$ 30,375	$ 26,193	$ 89,411	$ 74,009
Media Software and Services	29,586	30,858	82,990	92,004
Games	22,536	14,699	62,349	40,536
Total Consumer Products and Services revenue	$ 82,497	$ 71,750	$ 234,750	$ 206,549

Long-lived assets, net by geographic region are as follows (in thousands):

	September 30, 2006	December 31, 2005
United States	$ 147,820	$ 149,247
Europe	26,134	14,256
Rest of world	676	302
Total long-lived assets, net	$ 174,630	$ 163,805

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

	September 30, 2006	December 31, 2005
Consumer Products and Services	$ 126,799	$ 117,340
Technology Products and Solutions	5,990	5,990
Total goodwill	$ 132,789	$ 123,330

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Reconciliation of segment operating income (loss) to net income (loss) before income taxes is as follows (in thousands):

For the Quarter Ended September 30, 2006	Consumer Products and Services	Technology Products and Solutions	Reconciling Amounts	Consolidated
Net revenue	$ 82,497	$ 11,179	$	$ 93,676
Cost of revenue	26,302	2,087		28,389
Gross profit	56,195	9,092		65,287
Antitrust litigation expense (benefit)			(61,861)	(61,861)
Other operating expenses	56,881	13,066		69,947
Operating income (loss)	(686)	(3,974)	61,861	57,201
Total non-operating income, net			10,860	10,860
Net income (loss) before income taxes	$ (686)	$ (3,974)	$ 72,721	$ 68,061

For the Nine Months Ended September 30, 2006	Consumer Products and Services	Technology Products and Solutions	Reconciling Amounts	Consolidated
Net revenue	$ 234,750	$ 34,937	$	$ 269,687
Cost of revenue	75,468	6,320		81,788
Gross profit	159,282	28,617		187,899
Antitrust litigation expense (benefit)			(159,554)	(159,554)
Loss on excess office facilities			738	738
Other operating expenses	167,223	41,094		208,317
Operating income (loss)	(7,941)	(12,477)	158,816	138,398
Total non-operating income, net			30,696	30,696
Net income (loss) before income taxes	$ (7,941)	$ (12,477)	$ 189,512	$ 169,094

For the Quarter Ended September 30, 2005	Consumer Products and Services	Technology Products and Solutions	Reconciling Amounts	Consolidated
Net revenue	$ 71,750	$ 10,483	$	$ 82,233
Cost of revenue	22,770	1,925		24,695
Gross profit	48,980	8,558		57,538
Antitrust litigation expense (benefit)			3,531	3,531
Other operating expenses	43,016	11,120		54,136

Operating income (loss)	5,964	(2,562)	(3,531)	(129)
Total non-operating income, net			14,768	14,768
Net income (loss) before income taxes	$ 5,964	$ (2,562)	$ 11,237	$ 14,639

For the Nine Months Ended September 30, 2005	Consumer Products and Services	Technology Products and Solutions	Reconciling Amounts	Consolidated
Net revenue	$ 206,549	$ 34,942	$	$ 241,491
Cost of revenue	68,133	6,140		74,273
Gross profit	138,416	28,802		167,218
Antitrust litigation expense (benefit)			11,925	11,925
Other operating expenses	125,049	35,261		160,310
Operating income (loss)	13,367	(6,459)	(11,925)	(5,017)
Total non-operating income, net			25,485	25,485
Net income (loss) before income taxes	$ 13,367	$ (6,459)	$ 13,560	$ 20,468

Operating expenses of both Consumer Products and Services and Technology Products and Solutions include costs directly attributable to those segments and an allocation of general and administrative expenses and other corporate overhead costs. General and administrative and other corporate overhead costs are allocated to the segments and are generally based on the relative headcount of each segment. The accounting policies used to derive segment results are generally the same as those described in Note 1.

NOTE 3 ACQUISITION

On January 31, 2006, the Company acquired all of the outstanding securities of Zylom Media Group BV (Zylom) in exchange for approximately $7.9 million in cash payments. Included in the purchase price are $0.3 million in estimated acquisition-related expenditures consisting primarily of professional fees. The Company is also obligated to pay an additional $2.0 million, through individual payments of approximately $1.0 million on the first and second anniversaries of the acquisition date. In addition, the Company may be obligated to pay up to $10.9 million over a three-year period, dependent on whether certain performance criteria are achieved. Such amounts are not included in the initial aggregate purchase price and, to the extent earned, will be recorded as goodwill

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when it is probable that the individual payments will be made.

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

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

Cash paid at acquisition	$ 7,922
Additional future payments related to initial purchase price	2,000
Estimated direct acquisition costs	293
Total	$ 10,215

The aggregate purchase consideration has been allocated to the assets and liabilities acquired, including identifiable intangible assets, based on their respective estimated fair values as summarized below. The respective estimated fair values were determined by a third party appraisal at the acquisition date and resulted in excess purchase consideration over the net tangible and identifiable intangible assets acquired of $8.2 million. Goodwill in the amount of $8.2 million is not deductible for tax purposes. Pro forma results are not presented, because they are not material to the Company s overall financial statements.

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

Current assets	$ 1,830
Property and equipment	166
Technology/Games	570
Tradenames/Trademarks	560
Distributor/Customer Relationships	1,290
Non-compete agreements	180
Goodwill	8,168
Current liabilities	(1,781)
Net deferred tax liabilities	(768)
Net assets acquired	$ 10,215

Technology/Games and Tradenames/Trademarks have weighted average estimated useful lives of three years. Distributor and customer relationships have weighted average estimated useful lives of approximately five years. Non-compete agreements have a weighted average estimated useful life of four years.

NOTE 4 GOODWILL

Goodwill is the excess of the purchase price (including liabilities assumed and direct acquisition related costs) over the fair value of the tangible and identifiable intangible assets acquired through acquisitions of businesses.

Goodwill changed during 2006 as follows (in thousands):

Goodwill at December 31, 2005	$ 123,330
Acquisition of Zylom	8,168
Effects of foreign currency translation	1,291
Goodwill at September 30, 2006	$ 132,789

NOTE 5 EQUITY INVESTMENTS

The Company has made minority equity investments for business and strategic purposes through the purchase of voting capital stock of certain companies. The Company s investments in publicly traded companies are accounted for as available-for-sale, carried at current market value and are classified as long-term. The Company periodically evaluates whether declines in fair value, if any, of its investments are other-than-temporary. This evaluation consists of a review of qualitative and quantitative factors. For investments with publicly quoted market prices, these factors include the time period and extent of which the quoted market price is less than its accounting basis. The Company also considers other 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

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information regarding the investee companies. For investments in private companies with no quoted market price, the Company considers similar qualitative and quantitative factors and also considers the implied value from any recent rounds of financing completed by the investee. Based upon an evaluation of the facts and circumstances at September 30, 2006, the Company determined that there were no other-than-temporary declines in fair value for the quarter and nine months then ended.

As of September 30, 2006, the Company owned marketable equity securities of J-Stream, a Japanese media services company, representing approximately 10.6% of the investee s outstanding shares, accounted for as available-for-sale securities. The market value of these shares has increased from the Company s original cost of approximately $0.9 million, resulting in a carrying value of $22.7 million and $43.4 million at September 30, 2006 and December 31, 2005, respectively. The increase over the Company s cost basis, net of tax effects, was $15.5 million and $28.9 million at September 30, 2006 and December 31, 2005, respectively, and is reflected as a component of accumulated other comprehensive income. The market for this company s shares is relatively limited and the share price is volatile. Accordingly, there can be no assurance that a gain of this magnitude, or any gain, can be realized through the disposition of these shares.

NOTE 6 INVESTMENT IN MUSICNET

The Company s investment in MusicNet, a joint venture with several media companies to create a platform for online music subscription services, was accounted for under the equity method of accounting. During the quarter ended June 30, 2005, the Company disposed of all of its preferred shares and convertible notes in MusicNet to a private equity firm, Baker Capital, in connection with the sale of all of the capital stock of MusicNet. The Company received approximately $7.2 million of cash proceeds in connection with the closing of the transaction and received an additional $0.4 million in connection with the expiration of an escrow arrangement in August 2005. During the quarter ended June 30, 2006, the Company received an additional $2.3 million in cash due to the expiration of an indemnity escrow arrangement which expired on the one-year anniversary of the transaction date.

The Company recorded in its statement of operations its equity share of MusicNet s net loss through the date of disposition, which was not significant during the quarter ended September 30, 2005 and was $1.1 million for the nine months ended September 30, 2005. No amounts were recorded during 2006. For purposes of calculating the Company s equity in net loss of MusicNet, the convertible notes were treated on an as if converted basis due to the nature and terms of the convertible notes. As a result, the losses recorded by the Company represented approximately 36.1% of MusicNet s net losses through the date of disposition in 2005.

NOTE 7 LOSS ON EXCESS OFFICE FACILITIES

In October 2000, the Company entered into a 10-year lease agreement for additional office space located near its corporate headquarters in Seattle, Washington. Due to a subsequent decline in the market for office space in Seattle and the Company s re-assessment of its facilities requirements, the Company has accrued for estimated future losses on excess office facilities. The loss estimate currently includes $11.8 million of sublease income, which is committed under current sublease contracts. During the quarter ended March 31, 2006, the Company increased its loss estimate by $0.7 million due to building operating expenses that are not expected to be recovered under the terms of the existing sublease agreements. Although the Company believes its estimates are reasonable, additional losses may result if actual experience differs from projections.

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

Accrued loss at December 31, 2005	$ 18,016
Less amounts paid, net of sublease income	(3,378)
Revisions to estimates in accrued loss on excess office facilities in 2006	738
Accrued loss at September 30, 2006	$ 15,376

NOTE 8 CONVERTIBLE DEBT

During 2003, the Company issued $100 million aggregate principal amount of zero coupon convertible subordinated notes due July 1, 2010, pursuant to Rule 144A under the Securities Act of 1933, as amended. The notes

are subordinated to any Company senior debt, and are also effectively subordinated in right of payment to all indebtedness and other liabilities of its subsidiaries. The notes are convertible into shares of the Company s common stock based on an initial effective conversion price of approximately $9.30 per share if (1) the closing sale price of the Company s common stock exceeds $10.23, subject to certain restrictions, (2) the notes are called for redemption, (3) the Company makes a significant distribution to its shareholders or becomes a party to a transaction that would result in a change in control, or (4) the trading price of the notes falls below 95% of the value of common stock that the notes are convertible into, subject to certain restrictions; one of which allows the Company, at its discretion, to issue cash or common stock

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or a combination thereof upon conversion. On or after July 1, 2008, the Company has the option to redeem all or a portion of the notes that have not been previously purchased, repurchased or converted, in exchange for cash at 100% of the principal amount of the notes. The purchasers may require the Company to purchase all or a portion of the notes in cash on July 1, 2008 at 100% of the principal amount of the notes. As a result of this issuance, the Company received proceeds of $97.0 million, net of offering costs. The offering costs are included in other assets and are being amortized over a five-year period. Interest expense from the amortization of offering costs in the amount of $0.2 million and $0.5 million is recorded in interest income, net for the quarter and nine months ended September 30, 2006 and 2005, respectively. The net proceeds of the issuance are to be used for general corporate purposes, acquisitions, other strategic transactions including joint ventures, and other working capital requirements.

NOTE 9 REPURCHASE OF COMMON STOCK

In November 2005, the Company announced a share repurchase program to repurchase up to an aggregate of $100.0 million of the Company s outstanding common stock. During the quarter ended March 31, 2006, the Company repurchased approximately 9.5 million shares for an aggregate value of approximately $77.0 million at an average cost of $8.09 per share. From the inception of the November 2005 repurchase program through March 31, 2006, the Company repurchased 12.4 million shares under the November 2005 program for an aggregate value of $100.4 million (inclusive of transaction costs) at an average price of $8.11 per share. At March 31, 2006, no amounts authorized were outstanding under the November 2005 repurchase program.

In April 2006, the Company announced a new share repurchase program, in which the Company s Board of Directors authorized the repurchase of up to an aggregate of $100.0 million of the Company s outstanding common stock. During the quarter ended September 30, 2006, the Company repurchased approximately 0.2 million shares for an aggregate value of approximately $1.9 million at an average cost of $9.51 per share. Since the inception of the April 2006 repurchase program, the Company has repurchased approximately 2.3 million shares for an aggregate value of approximately $21.9 million at an average cost of $9.44 per share. At September 30, 2006, the remaining amount authorized under the April 2006 repurchase program was approximately $78.1 million.

NOTE 10 EQUITY COMPENSATION PLANS

The Company has options outstanding under six equity compensation plans (Plans) to compensate its employees and directors for past and future services. Of the Plans, the RealNetworks Inc. 2005 Stock Incentive Plan (2005 Plan) and the RealNetworks Inc. Director Compensation Stock Plan (Director Plan) remain active and are available for future grants. The Company has reserved 23.6 million shares under the 2005 Plan, which includes a total of 5.1 million shares cancelled from prior Plans and transferred to the 2005 Plan, and 0.4 million shares under the Director Plan. As of September 30, 2006, 8.8 million shares were available for grant under the 2005 Plan and 0.3 million shares were available for grant under the Director Plan. Generally, options vest based on continuous employment, over a four- or five-year period. The options expire in either seven, ten or twenty years from the date of grant and are exercisable at the fair market value of the common stock at the grant date. Shares that lapse due to forfeiture or expiration are available for re-issuance.

A summary of stock option related activity is as follows:

	Shares	Options Outstanding		Weighted Average
	Available for Grant	Number of Shares	Weighted Average Exercise Price	Fair Value-Grants
	in (000 s)	in (000 s)		
Balance at December 31, 2005	14,473	35,622	$ 6.95	
Options granted at common stock price	(8,629)	8,629	9.52	$ 4.30
Options exercised		(6,773)	6.04	
Options canceled	3,003	(3,003)	6.41	

Balance at September 30, 2006	8,847	34,475	$	7.82

The weighted average fair value of options granted during the nine months ended September 30, 2005 was $2.41. Pursuant to the provisions of the 2005 Stock Incentive Plan, Shares Available for Grant as of December 31, 2005 were adjusted to reflect an additional 3.1 million available shares which were cancelled from previously expired Plans during 2005.

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The fair value of options granted was determined using the Black-Scholes model. The following assumptions were used to perform the calculations:

	Quarters Ended September 30,		Nine Months Ended September 30,	
	2006	2005	2006	2005
Expected dividend yield	0%	0%	0%	0%
Risk-free interest rate	4.68-5.06%	3.17%	4.35-5.07%	2.83 3.17%
Expected life (years)	4.3	4.4	4.3	4.4
Volatility	49%	56%	48-49%	48-56%

The following table summarizes information about stock options outstanding at September 30, 2006:

	Options Outstanding			Options Exercisable	
Exercise Prices	Number of Shares (in 000 s)	Weighted Average Remaining Contractual Life (Years)	Weighted Average Exercise Price	Number of Shares (in 000 s)	Weighted Average Exercise Price
$0.02 $5.01	5,779	10.06	$ 4.19	2,493	$ 3.42
$5.03 $5.89	5,713	14.56	5.52	1,463	5.58
$5.90 $6.74	4,631	16.37	6.17	2,287	6.11
$6.75 $7.22	4,718	15.37	7.15	4,063	7.19
$7.24 $8.58	4,579	7.88	7.97	1,120	7.89
$8.69 $10.06	6,064	7.65	9.85	869	9.55
$10.06 $46.00	2,981	10.71	18.41	1,861	23.24
$46.19 $46.19	10	12.95	46.19	10	46.19
	34,475	11.72	$ 7.82	14,166	$ 8.52

At September 30, 2005, there were approximately 18.1 million exercisable options outstanding with a weighted average exercise price of $8.10.

The aggregate intrinsic value of options outstanding and options exercisable at September 30, 2006 was $120.1 million and $53.5 million, respectively. The aggregate intrinsic value represents the difference between the Company s closing stock price on the last day of trading during the quarter, which was $10.61 per share as of September 30, 2006, and the exercise price multiplied by the number of applicable options. The total intrinsic value of options exercised during the nine months ended September 30, 2006 and 2005 was $31.0 million and $4.4 million, respectively.

NOTE 11 GUARANTEES

In the ordinary course of business, the Company is not subject to potential obligations under guarantees that fall within the scope of FASB Interpretation No. 45, Guarantor s Accounting and Disclosure Requirements for Guarantees, Including Indirect Guarantees and Indebtedness of Others (FIN 45) an interpretation of FASB Statements No. 5, 57, and 107 and rescission of FASB interpretation No. 34, except for standard indemnification and warranty provisions that are contained within many of the Company s customer license and service agreements, and give rise only to the disclosure requirements prescribed by FIN 45.

Indemnification and warranty provisions contained within the Company s customer license and service agreements are generally consistent with those prevalent in the Company s industry. The duration of the Company s product warranties generally does not exceed 90 days following delivery of the Company s products. The Company has not incurred significant obligations under customer indemnification or warranty provisions historically and does not

expect to incur significant obligations in the future. Accordingly, the Company does not maintain accruals for potential customer indemnification or warranty-related obligations.

NOTE 12 LITIGATION

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

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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 seeks to enjoin the Company from the alleged infringing activity and to recover treble damages from the alleged infringement. The Company has filed its answer and a counterclaim against Friskit challenging the validity of the patents at issue. The trial court has also granted the Company s motion to transfer the action to the Northern District of California. The Company disputes Friskit s allegations in this action and intends to vigorously defend itself.

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

NOTE 13 SUBSEQUENT EVENT

On September 12, 2006, the Company entered into a definitive agreement to acquire all of the issued and outstanding common shares and American Depository Shares (ADSs) of WiderThan Co., Ltd. (WiderThan), through a cash tender offer for approximately $350.0 million. The tender offer was made pursuant to the Offer to Purchase and Letter of Transmittal, each filed with the Securities and Exchange Commission on September 29, 2006, as amended and supplemented. WiderThan, based in Seoul, South Korea, is a provider of integrated mobile music and entertainment solutions, including ringback tones and music-on-demand services. On October 31, 2006, the Company successfully completed the tender offer pursuant to which the Company acquired 2,840,329 common shares and 15,905,999 ADSs, together representing approximately 95% of WiderThan s outstanding common shares, including common shares underlying ADSs, for an aggregate value of $319.6 million.

The Company announced a subsequent offering period of ten business days, expiring on November 10, 2006, unless otherwise extended. During the subsequent offering period, holders of WiderThan common shares and ADSs that were not previously tendered in the offer may tender their common shares and ADSs on the same terms that applied prior to the initial expiration of the tender offer.

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

The discussion in this report contains forward-looking statements that involve risks and uncertainties. RealNetworks actual results could differ materially from those discussed below. Factors that could cause or contribute to such differences include, but are not limited to, those identified below, and those discussed in the section titled Risk Factors included elsewhere in this Report. You should also carefully review the risk factors set forth in other reports or documents that RealNetworks files from time to time with the Securities and Exchange Commission, particularly RealNetworks Annual Reports on Form 10-K, other Quarterly Reports on Form 10-Q and any Current Reports on Form 8-K. You should also read the following discussion and analysis in conjunction with our unaudited condensed consolidated financial statements and related notes included in this report.

Overview

RealNetworks, Inc. is a leading creator of digital media services and software, such as Rhapsody, RealArcade and RealPlayer. Consumers use our services and software to find, play, purchase and manage free and premium digital content, including music, games and video. Broadcasters, network operators, media companies and enterprises use our products and services to create, secure and deliver digital media to PCs, mobile phones and other consumer electronics devices.

Over the last several years, we have focused on the development of our consumer businesses through both internal initiatives and strategic acquisitions of businesses and technologies. These efforts have resulted in increases in the number of subscribers to our music and games subscription offerings and increased sales of our digital music and games content. This shift in focus and the increases in subscribers and sales of digital media content have resulted in a significantly higher percentage of our total revenue arising from our consumer businesses. Our Consumer Products and Services segment accounted for approximately 88% and 87% of our total revenue for the quarter and nine months ended September 30, 2006, respectively. In addition, we have increased our focus on free-to-consumer products and services, such as Rhapsody 25, our Rhapsody.com website and our RealArcade game service, which generate advertising revenue and are designed to increase the exposure of our paid digital music and games products and services to consumers. Our Technology Products and Solutions revenue in dollar terms has remained relatively consistent over the last several years; however, it has decreased as a percentage of total revenue.

In the quarter ended September 30, 2006, we recorded the highest total quarterly revenue in our history due to the significant growth in our Consumer Products and Services segment. This growth, as compared to the same quarter in 2005, was driven primarily by increased revenue from our Games and Music businesses, including increased sales resulting from our acquisition of Zylom in January 2006. Media Software and Services revenue declined for the quarter and nine months ended September 30, 2006 from the same periods ended September 30, 2005, primarily due to a decline in subscribers to our SuperPass subscription service and a decline in our stand-alone subscription products. Although total revenue for the quarter and nine months ended September 30, 2006 grew approximately 14% and 12% over the respective periods in 2005, our quarterly sequential revenue growth rate has fluctuated in recent periods.

In October 2005, we entered into an agreement to settle all of our antitrust disputes worldwide with Microsoft. Upon settlement of the legal disputes, we also entered into two commercial agreements with Microsoft that provide for collaboration in digital music and casual games. The remaining contractual payments to be made subsequent to the quarter ended September 30, 2006 by Microsoft to us over the remaining term of the commercial agreements, or through 2007, are approximately $122.3 million in cash and services in support of our music and games businesses. Microsoft can earn credits at pre-determined market rates for music subscribers and users delivered to us through its MSN network during the contract period which will be netted against the quarterly contractual payments in the music agreement. Pursuant to these commercial agreements we received a payment of approximately $62.3 million during the quarter ended September 30, 2006 and received a total of approximately $160.7 million during the nine months ended September 30, 2006.

On September 12, 2006, we entered into a definitive agreement to acquire WiderThan Co., Ltd. (WiderThan), through a cash tender offer for approximately $350.0 million. WiderThan is a provider of integrated mobile music and entertainment solutions, including ringback tones and music-on-demand services. On October 31, 2006, we successfully completed the tender offer pursuant to which we acquired approximately 95% of WiderThan s

outstanding common shares and American Depository shares. We believe the acquisition of WiderThan will enhance our mobile entertainment products and services, and increase our revenue in our Technology Products and Solutions segment as well as increase our revenue arising from our international operations. We will include WiderThan s results of operations from the date of the acquisition in our consolidated financial statements for the quarter ending December 31, 2006.

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We manage our business, and correspondingly report revenue, based on our two operating segments: Consumer Products and Services and Technology Products and Solutions.

Consumer Products and Services primarily includes revenue from: digital media subscription services such as Rhapsody, RadioPass, GamePass and SuperPass; sales and distribution of third party software and services; sales of digital content such as music and game downloads; sales of premium versions of our RealPlayer and related products; and advertising.

Technology Products and Solutions includes revenue from: sales of our media delivery system software, including Helix system software and related authoring and publishing tools, both directly to customers and indirectly through original equipment manufacturer (OEM) channels; support and maintenance services that we sell to customers who purchase our software products; broadcast hosting services; and consulting services we offer to our customers.

Critical Accounting Policies and Estimates

The preparation of our financial statements requires us to make estimates and assumptions that affect the reported amount of assets and liabilities and disclosure of contingent assets and liabilities at the date of the financial statements and the reported amounts of revenues 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;

Stock-based compensation;

Estimating sales returns and the allowance for doubtful accounts;

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 goodwill;

Accounting for income taxes; and

Determining the loss on a purchase commitment.

Revenue Recognition. As described below, significant management judgments and estimates must be made and used in connection with the revenue recognized in any accounting period. Material differences may result in the amount and timing of our revenue for any period if our management made different judgments or utilized different estimates.

We recognize revenue in accordance with the following authoritative literature: Staff Accounting Bulletin No. 104, Revenue Recognition in Financial Statements (SAB 104); Emerging Issues Task Force (EITF) 00-21 Revenue Arrangements with Multiple Deliverables (EITF 00-21); Statement of Position (SOP) 97-2, Software Revenue Recognition (SOP 97-2); SOP 98-9 Software Revenue Recognition with Respect to Certain Arrangements (SOP 98-9); SOP 81-1, Accounting for Performance of Construction-Type and Certain Production-Type Contracts (SOP 81-1); and EITF 99-19 Reporting Revenue Gross as a Principal versus Net as an Agent (EITF 99-19). In general, we recognize revenue when there is persuasive evidence of an arrangement, the fee is fixed or determinable, the products 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 individual games are recognized at the time the music or game is made available, digitally, to the end user.

We have arrangements whereby customers pay one price for multiple products and services. In some cases, these arrangements involve a combination of products and services. For arrangements with multiple deliverables, revenue is recognized upon the delivery of the separate units in accordance with EITF 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

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items. Management applies 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 99-19. In most arrangements, we contract directly with our end user customers, are the primary obligor and carry all collectibility risk. Revenue in these arrangements is recorded 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 those instances, in accordance with EITF 99-19, we report the revenue on a net basis.

We recognize revenue in connection with our software products pursuant to the requirements of SOP 97-2, as amended by SOP 98-9. If we provide consulting services that are considered essential to the functionality of the software products, both the software product revenue and services revenue are recognized under contract accounting in accordance with the provisions of SOP 81-1. Revenue from these arrangements is recognized under the percentage of completion method based on the ratio of direct labor hours incurred to total projected labor hours. Revenue from software license agreements with original equipment manufacturers (OEM) is recognized when the OEM delivers its product incorporating our software to the end user.

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 owed for our domestic and international music services. Material differences may result in the amount and timing of our expense for any period if our 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 our management bases its 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.

Stock-Based Compensation. We account for stock-based compensation in accordance with Statement of Financial Accounting Standards, Share-Based Payment (SFAS 123R). Under the provisions of SFAS 123R, which we adopted as of January 1, 2006, stock-based compensation cost is estimated at the grant date based on the award s fair-value as calculated by the Black-Scholes option-pricing model and is recognized as expense over the requisite service period, which is the vesting period. The Black-Scholes model requires various highly judgmental assumptions including volatility and expected option life. If any of the assumptions used in the Black-Scholes model change significantly, stock-based compensation expense may differ materially in the future from the amounts recorded in our condensed 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 123R, we measured compensation expense for our employee stock-based compensation plans using the intrinsic value method prescribed by APB Opinion No. 25 (APB 25). Under APB 25, when the exercise price of the Company s employee stock options was equal to the market price of the underlying stock on the date of the grant, no compensation expense was recognized.

Sales Returns and the Allowance for Doubtful Accounts. 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 and other allowances. Similarly, we must make estimates of the uncollectibility of our accounts receivable. We specifically analyze the age of accounts receivable and analyze historical bad debts, customer credit-worthiness and current economic trends when evaluating the adequacy of the allowance for doubtful accounts. Significant judgments and

estimates must be made and used in connection with establishing allowances for sales returns and the allowance for doubtful accounts in any accounting period. Material differences may result in the amount and timing of our revenue for any period if we were to make different judgments or utilize different estimates.

Accrued Loss On Excess Office Facilities. We made significant estimates in determining the appropriate amount of accrued loss on excess office facilities. If we made different estimates, our loss on excess office facilities could be significantly different from that recorded, which could have a material impact on our operating results. We have revised our original estimate four times in the last four years, increasing the accrual for loss on excess office facilities each time. The first two revisions were the result of changes in the market for commercial real estate where we operate. The third revision, which took place in 2003, resulted from adding an additional

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tenant at a sublease rate lower than the rate used in previous estimates. The fourth revision, which took place during the quarter ended March 31, 2006, resulted from incremental increases in the building operating expenses which were greater than the amounts previously estimated as not recoverable. The significant factors we considered in making our estimates are discussed in the section entitled Loss on Excess Office Facilities.

Impairment of Investments. As part of the process of preparing our consolidated financial statements 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. See Other Income (Expense), Net in the following pages for a discussion of the factors we considered in evaluating whether declines in fair value of our investments were other-than-temporary and the factors we considered in estimating the fair value of investments in private companies.

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

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

significant negative industry, economic or company specific trends;

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

loss of key personnel.

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

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

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

other assets.

In 2005, we reduced our valuation allowance by $220 million, as we determined at year-end that it is more likely than not that the results of our future operations, as a result of the settlement with Microsoft, will generate sufficient taxable income to realize certain of our deferred tax assets. As of September 30, 2006, we have a valuation allowance of $36.6 million relating primarily to net operating losses that are restricted under Internal Revenue Code Section 382 and losses not yet realized for tax purposes on certain equity investments.

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Determining the loss on a purchase commitment. We may from time-to-time enter into purchase commitments that commit us to the purchase of certain products and services. We periodically evaluate, based on market conditions, product plans and other factors, the future benefit of these purchase commitments. If it is determined that the purchase commitments do not have a future benefit, then a reserve is established for the amount of the commitment in excess of the estimated future benefit. Significant judgments and estimates must be made to determine such reserves.

Revenue by Segment

We operate our business in two segments: Consumer Products and Services and Technology Products and Solutions. Revenue by segment is as follows:

	Quarters Ended September 30,			Nine Months Ended September 30,		
	2006	2005	Change	2006	2005	Change
	(Dollars in thousands)					
Consumer Products and Services	$ 82,497	$ 71,750	15%	$ 234,750	$ 206,549	14%
Technology Products and Solutions	11,179	10,483	7	34,937	34,942	(0)
Total net revenue	$ 93,676	$ 82,233	14%	$ 269,687	$ 241,491	12%

	Quarters Ended September 30,		Nine Months Ended September 30,	
	2006	2005	2006	2005
	(As a percentage of total net revenue)			
Consumer Products and Services	88%	87%	87%	86%
Technology Products and Solutions	12	13	13	14
Total net revenue	100%	100%	100%	100%

Consumer Products and Services. Consumer Products and Services primarily includes revenue from: digital media subscription services such as Rhapsody, RadioPass, GamePass and SuperPass and stand-alone subscriptions; sales and distribution of third party software and services; sales of digital content such as music and 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. Billing periods for subscription services typically occur monthly, quarterly or annually, depending on the service purchased. Consumer Products and Services revenue increased in the quarter and nine months ended September 30, 2006 primarily due to increased revenue from: (1) increased sales of individual PC-based and mobile games, including increased sales resulting from our acquisition of Zylom; (2) growth in the number of subscribers to our Rhapsody and GamePass subscription services; (3) increased advertising revenue; and (4) increased revenue related to the distribution of third party products. Additional factors contributing to the increase are discussed below in the sections included within Consumer Products and Services revenue. We believe the growth in our music and games subscription services is due in part to the continued shift in our marketing and promotional efforts to these services as well as product improvements and increasing consumer acceptance and adoption of digital media products and services. While revenue and the aggregate number of subscribers related to our digital media subscription services have increased on a year-over-year basis, the number of subscribers and revenue growth for individual subscription services has fluctuated on a sequential quarterly basis. We cannot predict with accuracy how these subscription offerings will perform in the future, at what rate digital media subscription service revenue and number of subscribers will grow, if at all, or the nature or potential impact of anticipated competition.

Technology Products and Solutions. Technology Products and Solutions primarily includes revenue from: sales of media delivery system software, including Helix system software and related authoring and publishing tools, both directly to customers and indirectly through OEM channels; support and maintenance services that we sell to customers who purchase our software products; broadcast hosting services; and consulting services we offer to our customers. These products and services are primarily sold to corporate, educational and governmental customers. Technology Products and Solutions revenue increased in the quarter ended September 30, 2006 due primarily to an increase in sales of upgrade and support services related to our system software products and an increase in sales through original equipment manufacturers (OEMs). This increase was partially offset by a decreases in revenue from the licensing of custom versions of our software and a decrease in sales of our system software products. Technology Products and Services revenue decreased slightly in the nine months ended September 30, 2006 due primarily to a decrease in revenue from sales of our system software products, which was partially offset by an increase in revenue from the licensing of custom versions of our software. We believe that sales of our business software products were substantially affected by Microsoft s continuing practice of bundling its competing Windows Media Player and server software for free with its Windows operating system products. No

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assurance can be given when, or if, we will experience increased sales of our Technology Products and Solutions to customers in these markets.

Consumer Products and Services Revenue

A further analysis of our Consumer Products and Services revenue is as follows:

	Quarters Ended September 30,			Nine Months Ended September 30,		
	2006	2005	Change	2006	2005	Change
	(Dollars in thousands)					
Music	$ 30,375	$ 26,193	16%	$ 89,411	$ 74,009	21%
Media Software and Services	29,586	30,858	(4)	82,990	92,004	(10)
Games	22,536	14,699	53	62,349	40,536	54
Total Consumer Products and Services revenue	$ 82,497	$ 71,750	15%	$ 234,750	$ 206,549	14%

Music. Music revenue primarily includes revenue from: our Rhapsody and RadioPass subscription services; sales of digital music content through our Rhapsody service and our RealPlayer music store; and advertising from our music websites. The increase in Music revenue during the quarter ended September 30, 2006 was due primarily to an increase in revenue from: (1) the increased number of subscribers to our Rhapsody subscription service, including our Rhapsody To Go service; (2) advertising on our music related web properties; and (3) the distribution of our Rhapsody radio product through internet service providers. These increases were partially offset by a decrease in revenue associated with our RadioPass subscription service and the online sale of individual tracks through our Rhapsody subscription service and through our RealPlayer Music Store. The increase in Music revenue during the nine months ended September 30, 2006 is due primarily to an increase in revenue from: (1) growth in subscribers to our Rhapsody subscription service, including our Rhapsody To Go service; (2) advertising on our music related web properties; (3) the distribution of our Rhapsody radio product through internet service providers; and (4) the online sale of individual tracks through our Rhapsody subscription service and our RealPlayer Music Store. These increases were partially offset by a decrease in revenue associated with our RadioPass subscription service. We believe the growth of our Music revenue during the first nine months of 2006 was due primarily to the broader acceptance of paid online music services and increased focus of our marketing efforts on our music offerings. While revenue and the aggregate number of subscribers related to our digital media subscription services have increased on a year-over-year basis, the number of subscribers and revenue growth for individual subscription services has fluctuated on a sequential quarterly basis. We cannot predict with accuracy how these subscription offerings will perform in the future, at what rate digital media subscription service revenue and number of subscribers will grow, if at all, or the nature or potential impact of anticipated competition.

Media Software and Services. Media Software and Services revenue primarily includes revenue from: our SuperPass and stand-alone premium video subscription services; RealPlayer Plus and related products; sales and distribution of third-party software products; and all advertising other than that related directly to our Music and Games businesses. The decrease in revenue in the quarter and nine months ended September 30, 2006 was due primarily to the decrease in revenue from: (1) our SuperPass subscription service, resulting from a decrease in the number of subscribers; (2) discontinuation of certain stand-alone subscription services; and (3) certain of our premium and third-party consumer license products. These decreases were partially offset by an increase in revenue from advertising on our non-Music and non-Games related web properties and the increased revenue related to the distribution of certain third-party products. We believe that the decreases were due primarily to a shift in our marketing and promotional efforts towards our music and games subscription services, which we believe represent a greater growth opportunity for us.

Games. Games revenue primarily includes revenue from: the sale of individual games through our RealArcade service and our games related websites including GameHouse, Mr. Goodliving and Zylom; our GamePass

subscription service; and advertising through RealArcade and our games related websites. The increase in Games revenue during the quarter and nine months ended September 30, 2006 was due primarily to an increase in revenue from: (1) increased sales of individual games through our RealArcade service and our websites, including Zylom (subsequent to our acquisition of Zylom in January 2006); (2) growth in the number of subscribers to our GamePass subscription service; and (3) increased advertising on our Games related web properties. In addition, during the nine months ended September 30, 2006, Games revenue increased due to increased sales of games for mobile phones, primarily through our Mr. Goodliving product offerings (subsequent to our acquisition of Mr. Goodliving in May 2005). Additionally, we believe the growth in our Games revenue is due to the increased focus of our marketing efforts on our Games business and the addition of new game titles to our RealArcade and GamePass offerings.

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Geographic Revenue

	Quarters Ended September 30,			Nine Months Ended September 30,		
	2006	2005	Change	2006	2005	Change
	(Dollars in thousands)					
United States	$ 69,433	$ 63,478	9%	$ 201,675	$ 184,678	9%
Europe	15,895	10,937	45	45,725	33,547	36
Rest of the World	8,348	7,818	7	22,287	23,266	(4)
Total net revenue	$ 93,676	$ 82,233	14%	$ 269,687	$ 241,491	12%

	Quarters Ended September 30,		Nine Months Ended September 30,	
	2006	2005	2006	2005
	(As a percentage of total net revenue)			
United States	74%	77%	75%	76%
Europe	17	13	17	14
Rest of the World	9	10	8	10
Total	100%	100%	100%	100%

Revenue generated in the United States increased for the quarter and nine months ended September 30, 2006 primarily due to the growth of our Music and Games businesses and increased revenue from distribution of third party products. See Consumer Products and Services Revenue *Games* and *Music* above for further discussion of the changes.

Revenue generated in Europe increased for the quarter and nine months ended September 30, 2006 primarily due to the continued growth of our games business in Europe. The growth in our European games business was driven primarily by additional revenue from our Mr. Goodliving and Zylom product offerings subsequent to our acquisitions in May 2005 and January 2006, respectively. This increase was partially offset by a decrease in subscribers to our SuperPass subscription service. Revenue generated in Rest of the World increased for the quarter ended September 30, 2006 primarily due to an increase from the distribution of third party products, which was partially offset by a decrease in revenue from our SuperPass subscription service due to a decrease in subscribers. Revenue generated in Rest of the World decreased for the nine months ended September 30, 2006 primarily due to a decrease in subscribers to our SuperPass subscription service, which was partially offset by an increase in revenue from the distribution of third party products. Overall international revenue, which includes revenue from Europe and Rest of the World, increased as a percentage of overall revenue for the quarter and nine months ended September 30, 2006 driven mainly by the growth in our European games business.

Revenue

In accordance with SEC regulations, we present our revenue based on License Fees and Service Revenue as set forth below.

	Quarters Ended September 30,			Nine Months Ended September 30,		
	2006	2005	Change	2006	2005	Change
	(Dollars in thousands)					
License fees	$ 22,528	$ 19,596	15%	$ 68,014	$ 60,605	12%
Service revenue	71,148	62,637	14	201,673	180,886	11
Total net revenue	$ 93,676	$ 82,233	14%	$ 269,687	$ 241,491	12%

	Quarters Ended September 30,		Nine Months Ended September 30,	
	2006	2005	2006	2005
	(As a percentage of total net revenue)			
License fees	24%	24%	25%	25%
Service revenue	76	76	75	75
Total net revenue	100%	100%	100%	100%

License Fees. License fees primarily includes revenue from: sales of content such as game downloads and digital music tracks; sales of our media delivery system software; sales of premium versions of our RealPlayer Plus and related products; and sales of third-party products. License fees includes revenue from both our Consumer Products and Services and Technology Products and Solutions segments. The increase in license fees in the quarter and nine months ended September 30, 2006 was primarily due to an increase in revenue from the sale of individual games through our RealArcade service and our websites, including Zylom (which we acquired in January 2006). In addition, during the nine months ended September 30, 2006, license fee revenue increased due to the sale of individual games for mobile phones, primarily through our Mr. Goodliving product offerings (subsequent to our acquisition of Mr. Goodliving in May 2005) and the online sale of individual tracks through our Rhapsody music subscription service and our RealPlayer Music Store. The increase in license fee revenue was partially offset by a decrease in sales of our system software. See Revenue by

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Segment Consumer Products and Services and Revenue by Segment Technology Products and Solutions above for further explanation of changes.

Service Revenue. Service revenue primarily includes revenue from: digital media subscription services such as SuperPass, Rhapsody, RadioPass, GamePass and stand-alone subscriptions; 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 both our Consumer Products and Services and Technology Products and Solutions segments. The increase in service revenue in the quarter and nine months ended September 30, 2006 was primarily attributable to an increase in revenue from: (1) the increase in the number of subscribers to our music and games subscription services; (2) advertising through our web properties; (3) increases in the revenue related to the distribution of certain third-party products; and (4) consulting services provided to our corporate customers. These increases were partially offset by a decrease in revenue related to: (1) the decrease in the number of subscribers to our SuperPass subscription service; (2) sales of stand-alone subscription services and (3) the decrease in the number of subscribers to our RadioPass subscription service. Our subscription services accounted for approximately $50.9 million and $47.3 million of service revenue during the quarters ended September 30, 2006 and 2005, respectively, and $146.2 million and $139.6 million for the nine months ended September 30, 2006 and 2005, respectively. The increase in revenue related to our subscription services was primarily due to an increase in the number of subscribers to our Rhapsody and GamePass subscription services. These increases were partially offset by a decrease in revenue resulting from a decrease in the number of subscribers to our SuperPass, RadioPass and stand-alone subscription service.

Deferred Revenue

Deferred revenue is comprised of the unrecognized revenue related to unearned subscription services, support contracts, prepayments under OEM arrangements and other prepayments for which the earnings process has not been completed. Deferred revenue at September 30, 2006 was $25.8 million compared to $25.3 million at December 31, 2005. The increase in deferred revenue was primarily due to an increase in prepayments related to support and maintenance services related to certain of our server software products. This increase was partially offset by a decrease in the aggregate number of subscribers and the related prepayments for our SuperPass subscription service, a decrease in sales and related prepayments to standalone subscription services, and an overall decrease in prepayment receipts related to certain of our Technology Products and Solutions customers. The slower rate of prepayment receipts has been largely due to the decrease in the number of new contracts in our Technology Products and Solutions business segment in recent periods, which historically represented a significant portion of deferred revenue. We believe the decrease in the number of new contracts in our Technology Products and Solutions business segment results primarily from the conditions described in Revenue by Segment Technology Products and Solutions above.

Cost of Revenue by Segment

	Quarters Ended September 30,			Nine Months Ended September 30,		
	2006	2005	Change	2006	2005	Change
	(Dollars in thousands)					
Consumer Products and Services	$ 26,303	$ 22,770	16%	$ 75,469	$ 68,133	11%
Technology Products and Solutions	2,086	1,925	8	6,319	6,140	3
Total cost of revenue	$ 28,389	$ 24,695	15%	$ 81,788	$ 74,273	10%

Cost of Revenue as a percent of Segment Revenue

	Quarters Ended September 30,	Nine Months Ended September 30,

	2006	2005	2006	2005
Consumer Products and Services	32%	32%	32%	33%
Technology Products and Solutions	19%	18%	18%	18%
Total cost of revenue	30%	30%	30%	31%

Cost of Consumer Products and Services. Cost of Consumer Products and Services revenue includes cost of content, delivery of the content included in our digital media subscription service offerings, royalties paid on sales of games, music and other third-party products, amounts paid for licensed technology, costs of product media, duplication, manuals, packaging materials, and fees paid to third-party vendors for order fulfillment and support services. The increase in dollars of Cost of Consumer Products and Services revenue for the quarter and nine months ended September 30, 2006 resulted primarily from: (1) an increase in content costs associated with the increase in our music subscription revenue; and (2) an increase in licensing costs associated with the increase in sales of

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online games through RealArcade and our other partner sites. In addition, the increase for the nine month period ended September 30, 2006 resulted from an increase in licensing costs associated with increased sales of individual tracks online. The Cost of Consumer Products and Services as a percentage of revenue for the quarter ended September 30, 2006 was consistent with the same period in 2005. The decrease in Cost of Consumer Products and Services for the nine months ended September 30, 2006 as a percentage of Consumer Products and Services revenue was primarily due to: (1) the renegotiation of certain content agreements with more favorable financial terms; (2) the discontinuation of certain content offerings; and (3) a shift in revenue mix to higher margin products such as advertising. The decrease was partially offset by increases related to content costs associated with our music subscription services and an increase in licensing costs associated with the online sale of individual tracks.

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 third-party vendors for order fulfillment, cost of in-house and contract personnel providing support and consulting services, and expenses incurred in providing our streaming media hosting services. Cost of Technology Products and Solutions revenue in dollar terms for the quarter and nine months ended September 30, 2006 increased primarily from increased customer support costs. Cost of Technology Products and Solutions revenue as a percentage of Technology Products and Solutions revenue for the quarter and nine months ended September 20, 2006 was consistent with the same period in 2005.

Cost of Revenue

	Quarters Ended September 30,			Nine Months Ended September 30,		
	2006	2005	Change	2006	2005	Change
	(Dollars in thousands)					
License fees	$ 9,675	$ 8,666	12%	$ 28,865	$ 24,888	16%
Service revenue	18,714	16,029	17	52,923	49,385	7
Total cost of revenue	$ 28,389	$ 24,695	15%	$ 81,788	$ 74,273	10%

Cost of Revenue as a percent of Revenue

	Quarters Ended September 30,		Nine Months Ended September 30,	
	2006	2005	2006	2005
License fees	43%	44%	42%	41%
Service revenue	26%	26%	26%	27%
Total cost of revenue	30%	30%	30%	31%

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, costs of product media, duplication, manuals, packaging materials, and fees paid to third-party vendors for order fulfillment. The increase in cost of license fees in dollar terms for the quarter ended September 30, 2006 is primarily due to increased licensing costs associated with the increase in the online sale of games through RealArcade and our partner sites. The decrease in cost of license fees as a percentage of license revenue for the quarter ended September 30, 2006 was primarily due to decreased licensing costs associated with the decrease in online sales of individual songs through our Rhapsody subscription service and our RealPlayer Music Store. The increases in cost of license fees in dollar terms and as a percentage of license revenue for the nine months ended September 30, 2006 were primarily due to increased licensing costs associated with the increase in the online sale of games through RealArcade and our other partner sites and the online sale of individual songs through our Rhapsody subscription service and our RealPlayer Music Store.

Cost of Service Revenue. Cost of service revenue includes the cost of content and delivery of the content included in our digital media subscription service offerings, cost of in-house and contract personnel providing support and consulting services, and expenses incurred in providing our streaming media hosting services. The increase of cost of

service revenue in dollars for the quarter and nine months ended September 30, 2006 was primarily due to an increase in content costs associated with the increase in revenue from our Rhapsody subscription services. The cost of service revenue as a percentage of service revenue for the quarter ended September 30, 2006 was consistent with the same period in 2005. The decrease in cost of service revenue as a percentage of service revenue for the nine months ended September 30, 2006 was due primarily to the renegotiation of certain content agreements and the discontinuation of certain content offerings related to our SuperPass and stand-alone subscription services. This decrease was partially offset by an increase in costs of content included in our digital media subscription services, primarily Rhapsody, due to an increase in paying subscribers.

Our digital media subscription services, including Rhapsody, are a growing portion of our business and, to date, have been characterized by higher costs of revenue than our other products and services, primarily due to the cost of licensing media content to

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provide these services. As a result, if our digital media subscription services continue to grow as a percentage of net revenue, our cost of service revenue may grow at an increased rate relative to net revenue, which will result in reductions in our gross margin percentages in the future.

Operating Expenses

Research and Development

	Quarters Ended September 30,			Nine Months Ended September 30,		
	2006	2005	Change	2006	2005	Change
			(Dollars in thousands)			
Research and development	$18,344	$16,354	12%	$55,127	$45,381	21%
As a percentage of total net revenue	20%	20%		20%	19%	

Research and development expenses consist primarily of salaries and related personnel costs, expense associated with stock option awards and employee purchases of stock through our employee stock purchase plan (ESPP) 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. The increases in research and development expenses for the quarter and nine months ended September 30, 2006 were primarily due to: (1) increases in headcount and the related expenses, partially attributable to our acquisitions of Mr. Goodliving and Zylom; and (2) expenses associated with stock option awards and stock purchased through our ESPP program due to our adoption of SFAS 123R on January 1, 2006. These increases were partially offset by a gain from the recovery of a previously cancelled purchase commitment in excess of the expected residual value.

Sales and Marketing

	Quarters Ended September 30,			Nine Months Ended September 30,		
	2006	2005	Change	2006	2005	Change
			(Dollars in thousands)			
Sales and marketing	$37,560	$30,745	22%	$111,604	$93,809	19%
As a percentage of total net revenue	40%	37%		41%	39%	

Sales and marketing expenses consist primarily of salaries and related personnel costs, expense associated with stock option awards and employee purchases of stock through our ESPP, sales commissions, credit card fees, subscriber acquisition costs, consulting fees, trade show expenses, advertising costs and costs of marketing collateral. Sales and marketing expense increased in the quarter and nine months ended September 30, 2006 in dollars and as a percentage of total net revenue primarily due to: (1) increased advertising costs, including costs associated with our ongoing direct marketing programs; (2) expenses associated with stock option awards and stock purchased through our ESPP due to our adoption of SFAS 123R on January 1, 2006; (3) increases in sales and marketing personnel and the related costs in order to support the continued growth in our Consumer Products and Services business and (4) increases in costs from our acquisitions of Mr. Goodliving and Zylom. We expect that our sales and marketing expenses will increase as we continue to grow our consumer businesses and as we continue to shift the focus of our marketing efforts to our Consumer Products and Services businesses.

General and Administrative

	Quarters Ended September 30,			Nine Months Ended September 30,		
	2006	2005	Change	2006	2005	Change
			(Dollars in thousands)			
General and administrative	$14,043	$7,037	100%	$41,586	$21,120	97%
As a percentage of total net revenue	15%	9%		15%	9%	

General and administrative expenses consist primarily of salaries and related personnel costs, expense associated with stock option awards and employee purchases of stock through our ESPP, charitable contributions, fees for professional, temporary services and contractor costs and other general corporate costs. General and administrative expenses increased in the quarter and nine months ended September 30, 2006 in dollars and as a percentage of total net revenue primarily due to: (1) increased headcount and the related

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costs; (2) increased litigation defense costs, including the costs of our jury trial for the successful defense of the Ethos patent claim (excluding antitrust litigation expenses); (3) charitable contributions resulting from our practice of donating 5% of our annual net income to charity; and (4) the expense associated with stock option awards and stock purchased through our ESPP due to our adoption of SFAS 123R on January 1, 2006.

Antitrust Litigation Expenses (Benefit), Net

Antitrust litigation expenses (benefit), net of ($61.9) million and ($159.6) million for the quarter and nine months ended September 30, 2006, respectively, and $3.5 million and $11.9 million for the quarter and nine months ended September 30, 2005, respectively, consist of 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, net of payments received from Microsoft. 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 United States litigation. The amounts for antitrust litigation expenses (benefit), net reflected the impact of payments received of $62.3 million and $160.7 million in the quarter and nine months ended September 30, 2006, respectively. Only the benefit and costs that are directly attributable to these antitrust complaints are included in antitrust litigation expenses (benefit), net.

Other Income (Expense), Net

	Quarters Ended September 30,			Nine Months Ended September 30,		
	2006	2005	Change	2006	2005	Change
	(Dollars in thousands)					
Interest income, net	$ 10,618	$ 2,904	266%	$ 27,978	$ 7,499	273%
Equity in net loss of MusicNet			n/a		(1,068)	n/a
Gain on sale of equity investments		11,740	n/a	2,286	19,330	(88)
Other, net	242	124	95	432	(276)	257
Other income, net	$ 10,860	$ 14,768	(26)%	$ 30,696	$ 25,485	20%

Other income (expense), net consists primarily of interest earnings on our cash, cash equivalents and short-term investments, which are net of interest expense due to the amortization of offering costs related to our convertible debt, gains related to the sales of certain of our equity investments, and equity in net loss of MusicNet, Inc. Other income (expense), net decreased in the quarter ended September 30, 2006 primarily due to the gain on sales of a portion of our equity investments during 2005, which was partially offset by an increase in interest income during 2006 resulting from our overall higher investment balances and a general increase in our effective interest rates in 2006. Other income (expense), net increased in the nine months ended September 30, 2006 primarily due to an increase in interest income resulting from our overall higher investment balances and a general increase in our effective interest rates, which was partially offset by the gain on sales of a larger portion of our equity investments during 2005.

Our investment in MusicNet, a joint venture with several media companies to create a platform for online music subscription services, was accounted for under the equity method of accounting. In the quarter ended June 30, 2005, we disposed of all of our preferred shares and convertible notes in MusicNet to a private equity firm, Baker Capital, in connection with the sale of all of the capital stock of MusicNet. We received approximately $7.2 million of cash proceeds in connection with the closing of the transaction and received an additional $0.4 million in connection with the expiration of an escrow arrangement in August 2005. During the quarter ended June 30, 2006, we received an additional $2.3 million in cash due to the expiration of an indemnity escrow arrangement which expired on the one-year anniversary of the transaction date.

We recorded in our statement of operations our equity share of MusicNet s net loss through the date of disposition, which was $1.1 million for the quarter ended March 31, 2005. No amounts were recorded for the quarter or six months ended September 30, 2006. For purposes of calculating our equity in net loss of MusicNet, the convertible notes were treated on an as if converted basis due to the nature and terms of the convertible notes. As a result, the losses we recorded represented approximately 36.1% of MusicNet s net losses through the date of disposition in 2005. We did not hold an ownership interest in MusicNet during 2006.

We have made minority equity investments for business and strategic purposes through the purchase of voting capital stock of several companies. 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. This evaluation consists of 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

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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 and also consider the implied value from any recent rounds of financing completed by the investee. Based upon an evaluation of the facts and circumstances at September 30, 2006, we determined that there were no other-than-temporary declines in fair value for the quarter or nine months then ended.

As of September 30, 2006, we owned marketable equity securities of J-Stream, a Japanese digital media services company. We own approximately 10.6% of the outstanding shares and this investment is accounted for as an available-for-sale security. The market value of these shares has significantly increased from our original cost of approximately $0.9 million, resulting in a carrying value of $22.7 million and $43.4 million at September 30, 2006 and December 31, 2005, respectively. The increase over our cost basis, net of tax effects is $15.5 million and $28.9 million at September 30, 2006 and December 31, 2005, respectively, and is reflected as a component of accumulated other comprehensive income. The market for this company s shares is relatively limited and the share price is volatile. Although the carrying value of our investment in J-Stream was approximately $22.7 million at September 30, 2006, there can be no assurance that a gain of this magnitude, or any gain, can be realized through the disposition of these shares.

Income Taxes

We recognized income tax expense of $25.9 million and $63.2 million for the quarter and nine months ended September 30, 2006, respectively, and $3.5 million and $3.8 million for the quarter and nine months ended September 30, 2005, respectively. We must assess the likelihood that our deferred tax assets will be recovered from future taxable income. In making this assessment, all available evidence must be considered including the current economic climate, our expectations of future taxable income and our ability to project such income and the appreciation of our investments and other assets. In 2005, we reduced our valuation allowance by $220 million, as we determined at year-end that it is more likely than not that the results of our future operations, as a result of the settlement with Microsoft, will generate sufficient taxable income to realize certain of our deferred tax assets. As of September 30, 2006, we have a valuation allowance of $36.6 million relating primarily to net operating losses that are restricted under Internal Revenue Code Section 382, and losses not yet realized for tax purposes on certain equity investments. We estimate that our effective tax rate for fiscal year 2006 will be approximately 37%.

Recently Issued Accounting Pronouncements

In June 2006, the Financial Accounting Standards Board (FASB) issued FASB Interpretation No. 48, Accounting for Uncertainty in Income Taxes An Interpretation of FASB Statement No. 109 (FIN 48), which prescribes a recognition threshold and measurement attribute for the financial statement recognition and measurement of a tax position taken or expected to be taken in a tax return. FIN 48 will be effective beginning the first quarter in 2007. We have not yet evaluated the impact of implementation of FIN 48 on our condensed consolidated financial statements.

In June 2006, the FASB ratified the consensus reached on Emerging Issues Task Force Issue No. 06-3, *How Taxes Collected from Customers and Remitted to Governmental Authorities Should Be Presented in the Income Statement (That Is, Gross Versus Net Presentation)* (EITF 06-3). The scope of EITF 06-3 includes any transaction-based tax assessed by a governmental authority that is imposed concurrent with or subsequent to a revenue-producing transaction between a seller and a customer. The scope does not include taxes that are based on gross receipts or total revenues imposed during the inventory procurement process. Gross versus net income statement classification of that tax is an accounting policy decision and a voluntary change would be considered a change in accounting policy requiring the application of SFAS No. 154, *Accounting Changes and Error Corrections* . The following disclosures will be required for taxes within the scope of this issue that are significant in amount: (1) the accounting policy elected for these taxes and (2) the amounts of the taxes reflected gross (as revenue) in the income statement on an interim and annual basis for all periods presented. The EITF 06-3 is effective for interim and annual periods beginning after December 15, 2006. We do not expect the adoption of EITF 06-3 to have a material impact on our condensed consolidated financial statements.

In September 2006, the FASB issued SFAS No. 157, *Fair Value Measurements* (SFAS 157), which defines fair value, establishes a framework for measuring fair value in generally accepted accounting principles, and expands

disclosures about fair value measurements. SFAS 157 does not require any new fair value measurements, but provides guidance on how to measure fair value by providing a fair value hierarchy used to classify the source of the information. SFAS 157 is effective for fiscal years beginning after November 15, 2007. We are currently assessing the potential impact that the adoption of SFAS 157 will have on our condensed consolidated financial statements.

In September 2006, the SEC issued SAB No. 108, *Financial Statements Considering the Effects of Prior Year Misstatements when Quantifying Misstatements in Current Year Financial Statements* (SAB 108). SAB 108 provides guidance on how prior year misstatements should be taken into consideration when quantifying misstatements in current year financial statements for purposes of determining whether the current year s financial statements are materially misstated. The impact of correcting all misstatements, including both the carryover and reversing effects of prior year misstatements, must be quantified on the current year financial statements. When a current year misstatement has been quantified, SAB No. 99, *Financial Statements Materiality* should be applied to determine whether the misstatement is material and should result in an adjustment to the financial statements. SAB 108 also discusses the implications of misstatements uncovered upon the application of SAB 108 in situations when a registrant has historically been using either the iron curtain approach or the rollover approach as described in the SAB. Registrants electing not to restate prior periods should reflect the effects of initially applying the guidance in their annual financial statements covering the first fiscal year ending after November 15, 2006. We are evaluating what impact the adoption of SAB 108 will have on our condensed consolidated financial statements.

Liquidity and Capital Resources

Net cash provided by operating activities was $134.0 million and $13.9 million for the nine months ended September 30, 2006 and 2005, respectively. Net cash provided by operating activities in 2006 was primarily the result of net income of $105.9 million, which includes cash receipts of $160.7 million from Microsoft related to the Antitrust Litigation Settlement, and non-cash expenses including depreciation and amortization of $12.5 million, deferred taxes of $56.5 million and stock-based compensation of $12.3 million. These non-cash expenses were offset by: (1) a net decrease in certain operating assets and liabilities of $48.5 million, due primarily to the timing of cash receipts or payments at the beginning and end of the period, which includes a decrease in accrued legal fees related to the Antitrust Litigation Settlement of $14.0 million, a decrease in accrued donations of $14.1 million, a decrease in accrued income taxes of $9.0 million, and a decrease in accrual of a loss on purchase commitment of $6.6 million; and (2) payments related to the accrued loss on excess office facilities and content agreement of $3.4 million, which was partially offset by a $0.7 million increase in the accrual. Net cash provided by operating activities in 2005 was primarily the result of: (1) net income of $16.7 million; (2) net increase in certain operating assets and liabilities of $6.1 million, which includes a decrease in deferred revenue of $3.3 million, due primarily to the timing of cash receipts or payments at the beginning and end of the period; (3) depreciation and amortization of $11.9 million; (4) payments related to the accrued loss on excess office facilities of $4.0 million; (5) payments related to the accrued loss on content agreement of $2.2 million; and (6) equity in net losses of MusicNet of $1.1 million.

Net cash used in investing activities was $36.8 million in the nine months ended September 30, 2006 and net cash provided by investing activities was $0.8 million for the nine months ended September 30, 2005. Net cash used in investing activities in 2006 was primarily due to net purchases of short-term investments of $21.9 million, cash payments related to our acquisition of Zylom net of cash acquired of $7.1 million, and purchases of equipment and leasehold improvements of $9.3 million. Net cash provided by

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investing activities in 2005 was primarily due to: (1) net sales and maturities of short-term investments of $6.3 million; (2) proceeds of $7.6 million from the sale of our equity investment in MusicNet; and (3) proceeds of $11.9 million from the sale of a portion of our investment in J-Stream, which were partially offset by cash payments, net of cash acquired, of $14.7 million related to the acquisition of Mr. Goodliving, and purchases of equipment and leasehold improvements of $10.7 million.

Net cash used in financing activities was $56.9 million and $25.0 million in the nine months ended September 30, 2006 and 2005, respectively. Net cash used in financing activities during 2006 was due to repurchases of our common stock of $98.9 million, which was partially offset by the proceeds from the exercise of stock options of $42.0 million. Net cash used in financing activities in 2005 was primarily due to proceeds from the exercise of stock options partially offset by a cash payment related to the repayment of a long-term note payable in connection with the acquisition of Mr. Goodliving.

In November 2005, our Board of Directors authorized a share repurchase program for the repurchase of up to an aggregate value of $100 million of our outstanding common stock. The repurchases were made from time to time, depending on market conditions, share price and other factors. Repurchases were made in the open market or through private transactions in accordance with Securities and Exchange Commission requirements and we entered into a Rule 10(b)5-1 plan designed to facilitate the repurchase of the authorized repurchase amount. During the quarter ended March 31, 2006, we repurchased approximately 9.5 million shares for an aggregate value of approximately $77.0 million at an average cost of $8.09 per share. From the inception of the November 2005 repurchase program through March 31, 2006, we had repurchased 12.4 million shares for an aggregate value of $100.4 million (inclusive of transaction costs) at an average price of $8.11 per share. As of March 31, 2006, we had repurchased all authorized amounts under the November 2005 repurchase program.

In April 2006, our Board of Directors authorized a new share repurchase program for the repurchase of up to an aggregate of $100.0 million of our outstanding common stock. The repurchases may be made from time to time, depending on market conditions, share price, trading volume and other factors. Repurchases may be made in the open market or through private transactions, in accordance with Securities and Exchange Commission requirements and we entered into a Rule 10(b)5-1 plan designed to facilitate the repurchase of the authorized repurchase amount. The repurchase program does not require us to acquire a specific number of shares and may be terminated under certain conditions. During the quarter ended September 30, 2006, we repurchased approximately 0.2 million shares for an aggregate value of approximately $1.9 million at an average cost of $9.51 per share. Since the inception of the April 2006 repurchase program, we have repurchased approximately 2.3 million shares for an aggregate value of approximately $21.9 million at an average cost of $9.44 per share. At September 30, 2006, the remaining amount authorized under the April 2006 repurchase program was approximately $78.1 million. We currently intend to continue our stock repurchase program depending on market conditions and other factors until we reach the $100.0 million limit authorized by our Board of Directors, which will be a further use of cash.

On September 12, 2006, we entered into a definitive agreement to acquire all of the issued and outstanding common shares and American Depository Shares (ADSs) of WiderThan, through a cash tender offer for approximately $350.0 million. On October 31, 2006, we successfully completed the tender offer pursuant to which we acquired approximately 95% of WiderThan s outstanding common shares, including common shares underlying ADSs, for an aggregate value of $319.6 million which will be a further use of cash subsequent to the quarter ended September 30, 2006.

We announced a subsequent offering period of ten business days, expiring on November 10, 2006, unless otherwise extended. During the subsequent offering period, holders of WiderThan common shares and ADSs that were not previously tendered in the offer may tender their common shares and ADSs on the same terms that applied prior to the initial expiration of the tender offer. The subsequent tender offer may result in a further use of cash subsequent to the quarter ended September 30, 2006.

We currently have no planned significant capital expenditures for the remainder of 2006 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.

At September 30, 2006, we had approximately $862.1 million in cash, cash equivalents, short-term investments and restricted cash equivalents. Our principal commitments 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 twelve months.

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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 would 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 eleven primary functional currencies: the United States dollar, the Japanese yen, the British pound, the Euro, the Mexican peso, the Brazilian real, the Australian dollar, the Hong Kong dollar, the Singapore dollar, the Korean won and the Chinese yuan. 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. For foreign currency exposures we do hedge, these transactions do not meet the criteria for hedge accounting under Statement of Financial Accounting Standards No. 133 Accounting for Derivative Instruments and Hedging Activities , as amended. We invoice our international customers primarily in U.S. dollars, except in Japan, Germany, France, the United Kingdom, Australia and China, where we invoice our customers primarily in yen, euros (for Germany and France), pounds, Australian dollars and Chinese yuan, 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 in either of the quarters or six months ended September 30, 2006 and 2005.

Off-Balance Sheet Agreements

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

Item 3. Quantitative and Qualitative Disclosures About Market Risk

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

Interest Rate Risk. Our exposure to interest rate risk from changes in market interest rates relates primarily to our short-term investment portfolio. We do not hold derivative financial instruments or equity investments in our short-term investment portfolio. Our short-term investments consist of high quality securities as specified in our investment policy guidelines. 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 falling 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 has been no material change in our investment methodology regarding our cash equivalents and short-term investments in 2006, and as such, the descriptions under the captions Interest Rate Risk remain unchanged from those included in our Annual Report on Form 10-K for the year ended December 31, 2005.

Investment Risk. As of September 30, 2006, we had investments in voting capital stock of both publicly-traded and privately-held technology companies for business and strategic purposes. Some of these securities do not have a quoted market price. Our investments in publicly-traded companies are 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. This evaluation consists of a review of qualitative and quantitative factors. Equity price fluctuations of plus or minus 10% of prices at September 30, 2006 would have had an impact of

approximately $2.3 million on the value of our investments in publicly-traded companies at September 30, 2006, related primarily to our investment in J-Stream, a publicly-traded Japanese company.

Foreign Currency Risk. International revenue accounted for approximately 26% and 25% of total net revenue for the quarter and nine months ended September 30, 2006, respectively. Our international subsidiaries incur most of their expenses in their respective local currencies. Accordingly, all foreign subsidiaries use their local currency as their functional currency.

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Our exposure to foreign exchange rate fluctuations arises 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.

We manage a portion of these risks 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. We may, however, 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 for the quarters or nine months ended September 30, 2006 and 2005.

Item 4. Controls and Procedures

(a) *Evaluation of Disclosure Controls and Procedures.* Based on their 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 sufficiently effective to ensure that information required to be disclosed by the Company in reports that it files or submits under the Exchange Act (1) is recorded, processed, summarized and reported within the time periods specified in Securities and Exchange Commission rules and forms, and (2) is accumulated and communicated to the Company s management, including its principal executive officer and principal financial officer, as appropriate to allow timely decisions regarding required disclosure.

(b) *Changes in Internal Controls.* There have not been any changes in the Company s internal control over financial reporting (as such term is defined in Rule 13a-15(f) and 15d-15(f) under the Exchange Act) during the fiscal quarter ended September 30, 2006 that have materially affected, or are reasonably likely to materially affect, the Company s internal control over financial reporting.

PART II. OTHER INFORMATION

Item 1. Legal Proceedings

In August 2005, a lawsuit was filed against us 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 our 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 us from the allegedly infringing activity and to recover treble damages for the alleged infringement. In October 2005, our co-defendant moved to transfer the lawsuit from the District of Maryland to the Northern District of California. We dispute the plaintiff s allegations in the action and intend to vigorously defend ourselves.

In June 2003, a lawsuit was filed against us and Listen.com, Inc. (Listen) in federal district court for the Northern District of Illinois by Friskit, Inc. (Friskit), alleging that certain features of our 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 seeks to enjoin us from the alleged infringing activity and to recover treble damages from the alleged infringement. We have filed our answer and a counterclaim against Friskit challenging the validity of the patents at issue. The trial court has also granted our motion to transfer the action to the Northern District of California. We dispute Friskit s allegations in this action and

intend to vigorously defend ourselves.

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From time to time we are, and expect to continue to be, subject to legal proceedings and claims in the ordinary course of our 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 us to spend significant financial and managerial resources. We are not aware of any legal proceedings or claims that we believe will have, individually or taken together, a material adverse effect on our business, prospects, financial condition or results of operations. However, we may incur substantial expenses in defending against third party claims and certain pending claims are moving closer to trial. We expect that our 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 us, we may incur substantial monetary liability, and/or be required to change its business practices. Either of these could have a material adverse effect on our financial position and results of operations.

Item 1A. ***Risk Factors***

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

Risks Related To Completed and Potential Acquisitions

Our recent acquisition of WiderThan could expose us to new risks, disrupt our business and adversely impact our results of operations.

On October 30, 2006, we announced the results of our tender offer for WiderThan pursuant to which we acquired approximately 95% of the outstanding common shares and American Depository Shares of WiderThan. We expect to acquire additional securities of WiderThan during the subsequent offering period which is scheduled to expire on November 10, 2006.

As a result of this acquisition, we will be entering new markets, both technologically and geographically. WiderThan provides ringback tones, music-on-demand and other mobile entertainment services to wireless carriers in more than 25 countries. Because the acquisition has just recently occurred, we do not yet know the specific risks that the combined business will face. We expect, however, that such risks will include, but not be limited to:

- the loss or deterioration of WiderThan s relationship with SK Telecom, the largest wireless carrier in Korea, which provided approximately 65% of WiderThan s revenues in 2005 and which owns certain intellectual property utilized by WiderThan in its music-on-demand carrier application service;
- intense competition for mobile entertainment services;
- the dynamics of the wireless carrier market and WiderThan s reliance on carrier customers;
- changes in government regulation in the various countries in which WiderThan operates, and the regulatory environment of the media and wireless communications industries in particular;
- foreign currency fluctuations;
- economic changes in the various countries in which WiderThan operates, specifically, Korea, which was the source of approximately 65% of WiderThan s revenues in 2005; and
- increased tensions with North Korea.

In addition, our acquisition of WiderThan may divert the attention of management and other key personnel from our core business operations, which could adversely impact our financial performance in the near term. Moreover, the integration of WiderThan s operations into the Company will require expansions to our system of internal controls over financial reporting. Any failure to successfully operate and integrate WiderThan could have an adverse effect on our results of operations.

Potential acquisitions involve 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. The failure to adequately 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. Financial risks related to acquisitions may harm our financial position, reported operating results or stock price.

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 or personnel of the acquired company and difficulties in retaining key management or employees of the acquired company;
- entrance into unfamiliar markets or industry segments;
- impairment of relationships with employees, affiliates, advertisers or content providers of our business or the acquired business; and
- the assumption of known and unknown liabilities of the acquired company, including intellectual property claims.

Risks Related to Our Consumer Products and Services Business

Our online consumer businesses have grown substantially in recent periods and these businesses compete in rapidly evolving markets, which makes their prospects difficult to evaluate.

Our Consumer Products and Services segment in the quarter and nine months ended September 30, 2006 represented approximately 88% and 87% of total revenue, respectively. These consumer businesses compete in new and rapidly evolving markets and face substantial competitive threats. Our prospects must be considered in light of the risks, expenses and difficulties frequently encountered by businesses in new and fiercely competitive markets. Our Consumer Products and Services revenue and subscriber and user base have grown substantially in the past two years and it is unlikely that we will be able to sustain our recent growth rates.

Our online consumer businesses have generally lower margins than our traditional software license business.

The gross margin for our Consumer Products and Services segment is lower than the gross margins in our Technology Products and Solutions segment. The cost of third party content, in particular, is a substantial percentage of net revenue and is unlikely to decrease significantly over time as a percentage of net revenue. Our Consumer Products and Services businesses represent a substantial majority of our revenue and include our music subscriptions and sales, video subscription services and games subscription and sales as well as advertising revenue across our web properties. If our Consumer Products and Services revenue continues to grow as a percentage of our overall revenue, our margins may further decrease which may affect our ability to sustain profitability. We are also increasingly acquiring music subscribers through wholesale relationships with broadband service providers and other distribution partners, such as our agreement with Comcast for the distribution of our radio products. Our gross margins could be negatively impacted if usage of our radio products by these subscribers significantly exceeds our forecasts.

Our subscription levels may vary due to seasonality.

Our subscription businesses are rapidly evolving and we are still determining the impact of seasonality on these businesses, including our music and games subscription businesses. In addition, some of the most popular premium content that we have offered in our premium video subscription services is seasonal or periodic in nature and we are experimenting with different types of content to determine what consumers prefer. We have limited experience with these types of offerings and cannot predict how the seasonal or periodic nature of these offerings will impact our subscriber growth rates for these products, future subscriber retention levels or our quarterly financial results.

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The success of our subscription services businesses depends upon our ability to add new subscribers and minimize subscriber churn.

Our operating results could be adversely impacted by subscriber churn. Internet subscription businesses are a relatively new media delivery model and we cannot predict with accuracy our long-term ability to retain subscribers or add new subscribers. Subscribers may cancel their subscriptions to our services for many reasons, including a perception that they do not use the services sufficiently or that the service does not provide enough value, a lack of attractive or exclusive content generally or as compared to competitive service offerings (including Internet piracy), or because customer service issues are not satisfactorily resolved. In addition, the costs of marketing and promotional activities necessary to add new subscribers and the costs of obtaining content that customers desire may adversely impact our margins and operating results. In recent periods, we have seen an increase in the number of gross customer cancellations of our subscription services due in part to our increasingly large subscriber base. We are also increasingly acquiring music subscribers through alternative marketing channels, including direct marketing and third party distribution. We believe that subscribers obtained through these channels are likely to have higher cancellation rates.

Our digital content subscription businesses depend on our continuing ability to license compelling content on commercially reasonable terms.

We must continue to obtain compelling digital media content for our video, music and games subscription services in order to maintain and increase subscription service revenue and overall customer satisfaction for these products. In some cases, we pay substantial fees to obtain premium content. In particular, we pay substantial royalty fees to the music labels to license content. If we cannot obtain premium digital content for any of our digital content subscription services on commercially reasonable terms, or at all, our business will be harmed.

Our online music services depend upon our licensing agreements with the major music label and music publishing companies.

Our online music service offerings depend on music licenses from the major music labels and publishers. The current license agreements are for relatively short terms and we cannot be sure that the music labels will renew the licenses on commercially viable terms, or at all. Due to the increasing importance of our music services to our overall revenue, the failure of any major music label or publisher to renew these licenses under terms that are acceptable to us will harm our ability to offer successful music subscription services and would harm our operating results. In addition, the failure of the major music labels to agree to new or innovative license terms or arrangements may harm our ability to offer consumers compelling digital music products and services.

Music publishing royalty rates for music subscription services 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. We may be required to pay a rate that is higher than we expect, as the issue was recently submitted to a Rate Court by ASCAP for judicial determination. We have a license agreement with the Harry Fox Agency, an agency that represents music publishers, to reproduce musical compositions as required in the creation and delivery of on-demand streams and tethered downloads, but this license agreement does not include a rate. The license agreement anticipates industry-wide agreement on rates, or, if no industry-wide agreement can be reached, determination by a copyright royalty board (CARB), an administrative judicial proceeding supervised by the United States Copyright Office. If the rates agreed to or determined by a CARB or by Congress are higher than we expect, this 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.

Our consumer businesses face substantial competitive challenges that may prevent us from being successful in those businesses.

Music. Our online music services face significant competition from traditional offline music distribution competitors and from other online digital music services. Some of these competing online services have spent substantial amounts on marketing and have received significant media attention, including Apple s iTunes music

download service, which it markets closely with its extremely popular iPod line of portable digital audio players, Napster s music subscription service and Yahoo!, which offers certain of its competing music subscription products at a lower price than our similar products. Microsoft has also begun offering premium music services in conjunction with its Windows Media Player and MSN services and also now markets a portable music player and related download software called Zune. We also expect increasing competition from media companies such as MTV, and from online retailers such as Amazon.com, which is also reportedly planning to develop and market a digital music player and a related digital

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music subscription service. Our current music service offerings may not be able to compete effectively in this highly competitive market, particularly if new or existing competitors continue to price their competing digital music products and services lower than ours or increase the costs of customer acquisition through their marketing efforts. Our online music services also face significant competition from free peer-to-peer services which allow consumers to directly access an expansive array of free content without securing licenses from content providers. Enforcement efforts have not effectively shut down these services and there can be no assurance that these services will ever be shut down. The ongoing presence of these free services substantially impairs the marketability of legitimate services like ours.

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

Games. Our RealArcade service competes with other online distributors of downloadable casual PC games. Some of these distributors have high volume distribution channels and greater financial resources than us, including Yahoo! Games, MSN Gamezone, Pogo.com and Shockwave. We expect competition to intensify in this market from these and other competitors and no assurance can be made that we will be able to continue to grow our revenue. We also own and operate GameHouse, a developer and distributor of downloadable casual PC games, and we recently acquired Mr. Goodliving, a developer and publisher of mobile games primarily in the European market. Game development is a new business for us, and we may not be able to successfully develop and market software games in the future. GameHouse competes primarily with other developers of downloadable casual PC games and must continue to develop popular and high-quality game titles to maintain its competitive position. In addition, certain competitors of our RealArcade service also distribute and promote games developed by GameHouse. These distributors may not continue to distribute and promote our games in the same manner as a result of our ownership of GameHouse. Mr. Goodliving faces intense competition from a wide variety of mobile game developers and publishers, many of which are larger and devote substantially more resources to the mobile games business than we do. We also recently acquired Zylom, a developer and distributor of casual PC games in Europe. Combining Zylom s European business with our European games business could result in cannibalization of customer revenue and in developers distributing their games through alternative sources.

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

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

Our consumer businesses depend upon effective digital rights management solutions.

Our consumer businesses depend upon effective digital rights management solutions that control accessibility to digital content. These solutions are important to address concerns of content providers regarding online piracy. We cannot be certain that we can develop, license or acquire such solutions, or that content licensors, electronic device makers or consumers will accept them. In addition, consumers may be unwilling to accept the use of digital rights management technologies that limit their use of content, especially with large amounts of free content readily available. If digital rights management solutions are not effective, or are perceived as not effective, content providers may not be willing to include content in our services, which would harm our business and operating results. If our

digital rights management technology is compromised or otherwise malfunctions, we could be subject to lawsuits seeking compensation for any harm caused and our business could be harmed.

Our Harmony Technology may not achieve consumer or market acceptance.

Our Harmony technology enables consumers to securely transfer purchased music to portable digital music devices, including certain versions of the market leading iPod line of digital music players made by Apple Computer, as well as certain devices that use Microsoft Windows Media DRM. Harmony is designed to enable consumers to transfer music purchased from our RealPlayer Music Store to a wide variety of portable music devices, rather than being restricted to a specific portable device. We do not know whether consumers will accept Harmony or whether it will lead to increased sales of any of our consumer products or services or increased

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usage of our media player products. There are other risks associated with our Harmony technology, including the risk that Apple will continue to modify its technology to break the interoperability that Harmony provides to consumers, which Apple has done in connection with the release of certain new products. This could result in substantial costs or lower customer satisfaction.

The success of our music services depend, in part, on interoperability with our customer s music playback hardware.

In order for our digital music services to continue to grow we must design services that interoperate effectively with a variety of hardware products, including home stereos, car stereos, portable digital audio players, mobile handsets and PCs. We 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 to function with our music services and users of our music services must rely on our Harmony technology for interoperability with iPods. If we cannot successfully design our service to interoperate with the music playback devices that our customers own, either through relationships with manufacturers or through our Harmony technology, our business will be harmed.

Risks Related to Our Technology Products and Solutions Business

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

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

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

There are a number of risks associated with our Helix Community initiative, including risks associated with market and industry acceptance, development processes and software licensing practices, and business models. The broader media technology and product industry may not adopt the Helix DNA Platform and/or the Helix Community as a development platform for media delivery and playback products and third parties may not enhance, develop or introduce technologies or products based on Helix DNA technology. While we have invested substantial resources in the development of the underlying technology within the Helix DNA technology and the Helix Community process itself, the market and industry may not accept them and we may not derive royalty or support revenue from them. The introduction of the Helix DNA Platform open source and community source licensing schemes may adversely affect sales of our commercial system software products to mobile operators, broadband providers, corporations, government agencies, educational institutions and other business and non-business organizations. In those areas where adoption of the Helix Community and Helix DNA occurs, our community and open source approach means that we no longer exercise sole control over many aspects of the development of the Helix DNA technology.

Sales of our commercial system products could be negatively affected by open source technologies.

Competitive technologies to our commercial system software products have been made available under open source license terms. The introduction of such technologies under broadly available open source software license terms may adversely affect sales of our commercial system software products to mobile operators, broadband providers, corporations, government agencies, educational institutions and other business organizations.

Our recently issued Click-to-Stream patent and our other patents may not improve our business prospects.

We recently announced that we have been granted a fundamental patent for streaming media technology and applications. The patent (known as Click-to-Stream) covers the core methods used when consumers select links to stream audio-visual media via web browsers and other media players. Our primary strategy is to use our patent

portfolio, including the Click-to-Stream patent, to increase licensing and usage of our Helix products. We do not know if the Click-to-Stream patent or any of our other patents will ultimately be deemed enforceable, valid or infringed. Accordingly, we cannot predict whether our patent strategy will be successful or will improve

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our financial results. Moreover, we may be forced to litigate to determine the validity and scope of our patents, including the Click to-Stream patent. Any such litigation could be costly and may not achieve the desired results.

Our mobile digital media products and services are new and innovative and might not be successful.

Mobile operators may select technology from our competitors or our mobile consumer services might not generate significant revenue. In order for our investments in the development of mobile products to be successful, consumers must adopt and use mobile devices for consumption of digital media and utilize our products and services. To date, consumers have not widely adopted these mobile digital media products and services.

Risks Related to Our Business in General

We have a history of losses, and we cannot be sure that we will be able to sustain profitability in the future.

With the exception of 2005 and the first nine months of 2006, we have incurred losses in every year since our inception. Our profit in 2005 and the first nine months of 2006 was primarily related to cash payments from Microsoft related to our antitrust litigation settlement and commercial agreements. Due to our cost structure, we may not generate sufficient revenue to be profitable on a quarterly or annual basis in the future.

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

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

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

In 2003, we filed suit against Microsoft in the U.S. District Court for the Northern District of California, alleging that Microsoft violated U.S. and California antitrust laws. In our lawsuit, we alleged that Microsoft had illegally used its monopoly power to restrict competition, limit consumer choice and attempt to monopolize the field of digital media. In October 2005, we entered into a settlement agreement with Microsoft regarding these claims and we also entered into two commercial agreements with Microsoft related to our digital music and casual games businesses. The settlement agreement consists of a series of substantial cash payments to us and a series of technology agreements between the two companies. We cannot be sure that we will be able to apply the proceeds of the settlement in a way that will improve our operating results or otherwise increase the value of our shareholders investments in our stock. Under the music and games agreements, Microsoft is scheduled to pay us approximately $122.3 million over the next two quarters. Microsoft can earn credits at pre-determined market rates for subscribers and users delivered to us through marketing and promotional efforts of its MSN network of websites, which will be applied against the quarterly contractual payments in the music agreement. The rate at which Microsoft may deliver subscribers and users to us and the rate at which Microsoft may earn the related credits is unpredictable and we do not know whether these agreements will have a substantial impact on our music and games businesses. In addition, our music and games agreements are fixed-term arrangements that require joint collaborative efforts to be successful and may not result in a sustainable favorable impact on our business or financial results during or beyond the term of the agreements.

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

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

- reduced prices, revenue and margins;
- increased expenses in responding to competitors;

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

lengthened sales cycles;

degradation of our stature in the market and reputation;

changes in our business and distribution and marketing strategies;

changes to our products, services, technology, licenses and business practices, and other disruption of our operations;

strained relationships with partners; and

pressure to prematurely release products or product enhancements.

Many of our current and potential competitors have longer operating histories, greater name recognition, more employees and significantly greater resources than we do. Our competitors across the breadth of our product lines include a number of large and powerful companies, such as Microsoft, Apple Computer, and Yahoo!. Some of our competitors have in the past and may in the future enter into collaborative arrangements with each other that enable them to better compete with our business.

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

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

Any development delays or cost overruns may affect our operating results.

We have experienced delays and cost overruns in our development efforts in the past and we may encounter such problems in the future. Delays and cost overruns could affect our ability to respond to technological changes, evolving industry standards, competitive developments or customer requirements. Also, our products may contain undetected errors that could cause increased development costs, loss of revenue, adverse publicity, reduced market acceptance of our products or services or lawsuits by customers.

Our business is dependent in part on third party vendors whom we do not control.

Certain of our products and services are dependent in part on the licensing and incorporation of technology from third party vendors. If the technology of these vendors fails to perform as expected or if a key vendor does not continue to support its technology, then we may incur substantial costs in replacing the products and services, or we may fall behind in our development schedule while we search for a replacement. These costs or the potential delay in the development of our products and services could harm our business and our prospects.

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

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

We depend on key personnel who may not continue to work for us.

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

leave, we could face substantial difficulty in hiring qualified successors and could experience a loss in productivity while any such successor obtains the necessary training and experience. If we do not succeed in retaining and motivating existing personnel, our business and prospects could be harmed.

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

The Internet and media distribution industries are undergoing substantial change, which has resulted in increasing consolidation and formation of strategic relationships. Acquisitions or other consolidating transactions could harm us in a number of ways, including:

the loss of strategic relationships if our strategic partners are acquired by or enter into relationships with a competitor (which could cause us to lose access to distribution, content, technology and other resources);

the loss of customers if competitors or users of competing technologies consolidate with our current or potential customers; and

our current competitors could become stronger, or new competitors could form, from consolidations.

Any of these events could put us at a competitive disadvantage, which could cause us to lose customers, revenue and market share. Consolidation in our industry, or in related industries such as broadband carriers, could force us to expend greater resources to meet new or additional competitive threats, which could also harm our operating results.

Our recent acquisitions create unique challenges for us and if we fail to integrate and successfully operate the acquired companies, our business will be harmed.

We acquired Listen in 2003 and the operations associated with Listen have remained in San Francisco. This is our first experience operating and integrating a substantial acquired business in a remote location. We also acquired GameHouse in 2004, Mr. Goodliving in 2005 and Zylom in 2006. The acquisition of GameHouse is our first attempt to operate and manage a content creation business and we may not be successful in operating this type of business. Mr. Goodliving is a game developer and also competes in the mobile games market which is a new business for us and is a highly competitive market. No assurance can be made that we will be able to leverage Mr. Goodliving s European assets and distribution network to compete successfully in the global mobile games market.

Our two most recent acquisitions, Mr. Goodliving and Zylom, are based in Finland and the Netherlands, respectively. These acquisitions represent our first attempts at acquiring and integrating businesses abroad. We have no prior experience in managing businesses in these countries and in certain cases we will have to adjust our operating procedures to conform to local cultural and legal issues, many of which are unfamiliar to us. No assurance can be made that we will be able to successfully manage businesses in these countries.

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Acquisition-related costs could cause significant fluctuation in our net income (loss).

Previous acquisitions have resulted in significant expenses, including amortization of purchased technology, charges for in-process research and development 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.

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

We have made, and in the future we may continue to make, strategic investments in other companies, including joint ventures. These investments often involve immature and unproven businesses and technologies, and involve a high degree of risk. We could lose the entire amount of our investment. We also may be required to record on our financial statements significant charges from reductions in the value of our strategic investments, and, potentially from the net losses of the companies in which we invest. We have taken these charges in the past, and these charges could adversely impact our reported operating results in the future. No assurance can be made that we will realize the anticipated benefits from any strategic investment.

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

Access to the Internet through devices other than a personal computer, 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. Manufacturers of these types of products are increasingly investing in digital media-related applications. If a substantial number of alternative device manufacturers do not license and incorporate our technology into their devices, we may fail to capitalize on the opportunity to deliver digital media to non-PC devices which could harm our business prospects. We do not believe that complete standards have emerged with respect to non-PC wireless and cable-based systems and if our technologies are not adopted, our results could suffer. If we do not successfully make our products and technologies compatible with emerging standards and the most popular devices used to access digital media, we may miss market opportunities and our business and results will suffer.

If we are not successful in maintaining, managing and adding to our strategic relationships, our business and operating results will be adversely affected.

We rely on strategic relationships with third parties in connection with our business, including relationships providing for content acquisition and distribution of our products. The loss of current strategic relationships, the inability to find other strategic partners, our failure to effectively manage these relationships or the failure of our existing relationships to achieve meaningful positive results could harm our business. We may not be able to replace these relationships with others on acceptable terms, or at all, or find alternative sources for resources that these relationships provide.

Our business and operating results will suffer if our systems or networks fail, become unavailable, unsecure 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. Also, any compromise of our ability to transmit data securely could damage our business, hurt our ability to distribute products and services and collect revenue. We have on occasion experienced system errors and failures that cause 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, intentional actions to disrupt our systems and networks and many other causes. The vulnerability of our computer and communications infrastructure is enhanced because it is located at a single leased facility in Seattle, Washington, an area that is at heightened risk of earthquake, flood, and volcanic events. We 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.

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We rely on the continued reliable operation of third parties systems and networks and, if these systems and networks fail to operate or operate poorly, our business and operating results will be harmed.

Our operations are in part dependent upon the continued reliable operation of the information systems and networks of third parties. If these third parties do not provide reliable operation, our ability to service our customers will be impaired and our business, reputation and operating results could be harmed.

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

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

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

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

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

We may be unable to adequately protect our proprietary rights.

Our ability to compete partly depends on the superiority, uniqueness and value of our technology, including both internally developed technology and technology licensed from third parties. To protect our proprietary rights, we rely on a combination of patent, trademark, copyright and trade secret laws, confidentiality agreements with our employees and third parties, and protective contractual provisions. Despite these efforts, any of the following occurrences may reduce the value of our intellectual property:

Our applications for patents and trademarks relating to our business may not be granted and, if granted, may be challenged or invalidated;

Issued patents and trademarks may not provide us with any competitive advantages;

Our efforts to protect our intellectual property rights may not be effective in preventing misappropriation of our technology;

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

Another party may obtain a blocking patent and we would need to either obtain a license or design around the patent in order to continue to offer the contested feature or service in our products.

We may be forced to litigate to defend our intellectual property rights, or to defend against claims by third parties against us relating to intellectual property rights.

Disputes regarding the ownership of technologies and rights associated with streaming media, digital distribution and online businesses are common and likely to arise in the future. We may be forced to litigate to enforce or defend our intellectual property rights, to protect our trade secrets or to determine the validity and scope of other parties proprietary rights. Any such litigation could be very costly and could distract our management from focusing on operating our business. The existence and/or outcome of any such litigation could harm our business.

From time to time we receive claims and inquiries from third parties alleging that our internally developed technology or technology we license from third parties 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. We are now investigating a number of such pending claims, some of which are described in Part I of this report under the heading Legal Proceedings.

Interpretation of existing laws that did not originally contemplate the Internet could harm our business and operating results.

The application of existing laws governing issues such as property ownership, copyright and other intellectual property issues to the Internet is not clear. Many of these laws were adopted before the advent of the Internet and do not address the unique issues associated with the Internet and related technologies. In many cases, the relationship of these laws to the Internet has not yet been interpreted. New interpretations of existing laws may increase our costs, require us to change business practices or otherwise harm our business.

It is not yet clear how laws designed to protect children that use the Internet may be interpreted, and such laws may apply to our business in ways that may harm our business.

The Child Online Protection Act and the Child Online Privacy Protection Act impose civil and criminal penalties on persons distributing material harmful to minors (e.g., obscene material) over the Internet to persons under the age of 17, or collecting personal information from children under the age of 13. We do not knowingly distribute harmful materials to minors or collect personal information from children under the age of 13. The manner in which these Acts may be interpreted and enforced cannot be fully determined, and future legislation similar to these Acts could subject us to potential liability if we were deemed to be non-compliant with such rules and regulations, which in turn could harm our business.

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 post 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 legal liability for the provision of third-party products, services or content.

We periodically enter into arrangements to offer third-party products, services, content or advertising under our brands or via distribution on our websites or in our products or service offerings. We may be subject to claims concerning these products, services, content or advertising by virtue of our involvement in marketing, branding, broadcasting or providing access to them. Our agreements with these third parties may not adequately protect us from these potential liabilities. It is also possible that, if any information provided directly by us contains errors or is

otherwise negligently provided to users, third parties could make claims against us, including, for example, claims for intellectual property infringement. Investigating and defending any of these types of claims is

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expensive, even if the claims do not result in liability. If any of these claims result in liability, we could be required to pay damages or other penalties, which could harm our business and our operating results.

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

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

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

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

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

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

We donate a portion of our net income to charity.

In periods where we achieve profitability, we intend to donate 5% of our annual net income to charitable organizations, which will reduce our net income for those periods. The non-profit RealNetworks Foundation manages our charitable giving efforts.

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

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

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

elect or defeat the election of our directors;

amend or prevent amendment of our articles of incorporation or bylaws;

effect or prevent a merger, sale of assets or other corporate transaction; and

control the outcome of any other matter submitted to the shareholders for vote.

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

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

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

adopt a plan of merger;

authorize the sale, lease, exchange or mortgage of assets representing more than 50% of the book value of our assets prior to the transaction or on which our long-term business strategy is substantially dependent;

authorize our voluntary dissolution; or

take any action that has the effect of any of the above.

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

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

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

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

We have evaluated our internal controls in order to allow management to report on, and our registered independent public accounting firm to attest to, our internal controls, as required by Section 404 of the Sarbanes-Oxley Act of 2002. We have performed the system and process evaluation and testing required in an effort to comply with the management certification and auditor attestation requirements of Section 404. The requirements and processes associated with Section 404 are relatively new and still evolving and we cannot be certain that the measures we have taken will be sufficient to meet the Section 404 requirements as changes occur to the guidance and our reporting environment or that we will be able to implement and maintain adequate controls over financial reporting processes and reporting in the future. Moreover, we cannot be certain that the costs associated with such measures will not exceed our estimates, which could impact our overall level of profitability. Any failure to meet the Section 404 requirements or to implement required new or improved controls, or difficulties or unanticipated costs encountered in their implementation, could cause investors to lose confidence in our reported financial information or could harm our financial results, which could have a negative effect on the trading price of our stock.

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

The trading price of our common stock has been highly volatile. For example, during the 52-week period ended September 30, 2006, the price of our common stock ranged from $11.20 to $5.63 per share. Our stock price could be subject to wide fluctuations in response to factors such as actual or anticipated variations in quarterly operating results, changes in financial estimates, recommendations by securities analysts, changes in the competitive environment, as well as any of the other risk factors described above.

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

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

Special Note Regarding Forward-Looking Statements

We have made forward-looking statements in this document, all of which are subject to risks and uncertainties. When we use words such as may , anticipate, expect, intend, plan, believe, seek and estimate or similar making forward-looking statements. Forward-looking statements include information concerning our possible or assumed future business success or financial results. Such forward-looking statements include, but are not limited to, statements as to our expectations regarding:

the impact of our acquisition of WiderThan on our digital entertainment product and service offerings and our international presence and revenue;

increasing competition to our video content services;

future competitive activities of Microsoft in the overall market for digital media and media distribution products and services;

future cash payments from Microsoft related to our antitrust settlement;

anticipated increased cancellation rates of subscribers to our internet subscription services who we obtain through alternative marketing channels;

increasing competition to our online music services from media companies, online retailers and Internet portals;

increasing competition to our online game distribution business;

the growth of our business in China;

the impact on our gross margins if revenue from our digital media subscription services continues to grow as a percentage of our net revenue;

the increase of our sales and marketing expenses in dollars and as a percentage of total net revenue as we grow our consumer business and shift our marketing efforts to consumer products and services;

our future activities under our stock repurchase program;

future capital needs and expenditures;

plans for future acquisitions of technologies and businesses;

the future impact of a sudden change in market interest rates on our operating results and cash flows; and

the impact and duration of current litigation in which we are involved.

You should note that an investment in our common stock involves certain risks and uncertainties that could affect our future business success or financial results. Our actual results could differ materially from those anticipated in these forward-looking statements as a result of certain factors, including those set forth in Risk Factors and elsewhere

in our Quarterly Report on Form 10-Q.

We believe that it is important to communicate our expectations to our investors. However, there may be events in the future that we are not able to predict accurately or over which we have no control. Before you invest in our common stock, you should be aware that the occurrence of the events described in the Risk Factors and elsewhere in our Quarterly Report on Form 10-Q could

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materially and adversely affect our business, financial condition and operating results. We undertake no obligation to publicly update any forward-looking statements for any reason, even if new information becomes available or other events occur in the future.

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

(a) Between July 1, 2006 and September 30, 2006, the Company has issued and sold unregistered securities as follows:

(1) On September 30, 2006, the Company issued an aggregate of 2,332 shares of Common Stock to three non-employee directors as compensation for board service during the second quarter of 2006 pursuant to the RealNetworks, Inc. Director Compensation Stock Plan. The aggregate value of the shares was approximately $24,753. The shares were issued in reliance on Section 4(2) under the Securities Act of 1933, as amended, on the basis that the transactions did not involve a public offering.

(b) Not applicable

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

Below is a summary of share repurchases for the quarter ended September 30, 2006. See Note 9 of our Notes to Unaudited Condensed Consolidated Financial Statements for information regarding our share repurchase plan.

Period	Total Number of Shares Purchased	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(1)
7/1/2006 7/31/2006	200	$ 9.51	200	$ 78,117
Total	200	$ 9.51	200	

(1) In April 2006, the Company announced a share repurchase program in which the Company s Board of Directors authorized the repurchase of up to an aggregate of $100.0 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 for Security Holders

None

Item 5. Other Information

None

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Item 6. Exhibits

Exhibits Required by Item 601 of Regulation S-K:

Exhibit Number	Description
2.1	Combination Agreement dated as of September 12, 2006, by and between RealNetworks, RN International Holdings B.V. and WiderThan Co., Ltd. (incorporated by reference from Exhibit 2.1 to RealNetworks Current Report on Form 8-K filed with the Securities and Exchange Commission on September 14, 2006).
2.2	Form of Shareholder Tender and Voting Agreement dated as of September 12, 2006, by and between RealNetworks, RN International Holdings B.V., WiderThan Co., Ltd. and certain shareholders of WiderThan Co., Ltd. (incorporated by reference to the Schedule 13D filed with respect to WiderThan Co., Ltd. securities by RealNetworks with the Securities and Exchange Commission on September 22, 2006).
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

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SIGNATURES

Pursuant to the requirements of the Securities Exchange Act of 1934, the Registrant has duly caused this Report to be signed on its behalf by the undersigned, thereunto duly authorized, on November 8, 2006.

REALNETWORKS, INC.

By: /s/ Michael Eggers

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

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