REALNETWORKS INC
Form 10-Q
November 10, 2008

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

FORM 10-Q

(Mark One)

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

For the Quarterly Period Ended September 30, 2008

OR

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

For the transition period from to

Commission file number 0-23137

RealNetworks, Inc.

(Exact name of registrant as specified in its charter)

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

(206) 674-2700

(Registrant s telephone number, including area code)

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

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

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

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

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

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

Deferred revenue, non-current portion	1,138	2,663
Accrued loss on excess office facilities, non-current portion	3,864	7,311
Deferred rent	4,680	4,518
Deferred tax liabilities, net, non-current portion	15,178	22,060
Other long-term liabilities	10,644	13,683
Total liabilities	243,733	380,725
Minority interest in Rhapsody America ($83.7 million redemption value at September 30, 2008)	6,297	19,613
Shareholders equity:		
Preferred stock, $0.001 par value, no shares issued and outstanding Series A: authorized 200 shares		
Undesignated series: authorized 59,800 shares		
Common stock, $0.001 par value authorized 1,000,000 shares; issued and outstanding 140,204 shares in 2008 and 142,298 shares in 2007	140	142
Additional paid-in capital	655,872	653,904
Accumulated other comprehensive (loss) income	(43,488)	17,732
Retained earnings	199,946	203,326
Total shareholders equity	812,470	875,104
Total liabilities and shareholders equity	$ 1,062,500	$ 1,275,442

See accompanying notes to unaudited condensed consolidated financial statements.

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

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

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

See accompanying notes to unaudited condensed consolidated financial statements.

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

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

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

See accompanying notes to unaudited condensed consolidated financial statements.

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

Note 1. Summary of Significant Accounting Policies

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

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

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

On August 20, 2007, RealNetworks and MTV Networks, a division of Viacom International Inc. (MTVN), created Rhapsody America LLC (Rhapsody America) to jointly own and operate a business-to-consumer digital audio music service. RealNetworks held a 51% interest in Rhapsody America as of September 30, 2008. Rhapsody America s financial position and operating results have been consolidated into RealNetworks financial statements since its formation in August 2007. The minority interest s proportionate share of income (loss) is included in Minority interest in Rhapsody America in the unaudited condensed consolidated statements of operations and comprehensive income (loss). MTVN s proportionate share of equity is included in Minority interest in Rhapsody America in the unaudited condensed consolidated balance sheets.

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

The unaudited condensed consolidated financial statements reflect all adjustments, consisting only of normal, recurring adjustments that, in the opinion of the Company s management, are necessary for a fair presentation of the results of operations for the periods presented. Operating results for the quarter and nine months ended September 30, 2008 are not necessarily indicative of the results that may be expected for any subsequent quarter or for the year ending December 31, 2008. Certain information and disclosures normally included in financial statements prepared in conformity with accounting principles generally accepted in the United States of America have been condensed or omitted pursuant to the rules and regulations of the Securities and Exchange Commission (SEC).

These unaudited condensed consolidated financial statements should be read in conjunction with the audited consolidated financial statements and related notes included in the Company s Annual Report on Form 10-K for the year ended December 31, 2007.

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

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

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

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

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

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

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

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

Note 2. Recent Accounting Pronouncements

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

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

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

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

Note 3. Stock-Based Compensation

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

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

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

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

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

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

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

No stock-based compensation was capitalized as part of the cost of an asset during the quarter and nine months ended September 30, 2008 or 2007. As of September 30, 2008, $40.5 million of total unrecognized compensation cost, net of estimated forfeitures, related to stock options, is expected to be recognized over a weighted-average period of 2.6 years.

Note 4. Rhapsody America

Formation

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

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