LIBERATE TECHNOLOGIES
Form 10-K/A
September 16, 2003

QuickLinks -- Click here to rapidly navigate through this document

SECURITIES AND EXCHANGE COMMISSION

WASHINGTON, D.C. 20549

FORM 10-K/A

Amendment No. 1

**FOR ANNUAL AND TRANSITION REPORTS PURSUANT
TO SECTIONS 13 OR 15(d) OF THE SECURITIES EXCHANGE ACT OF 1934**

(MARK ONE)

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

FOR THE FISCAL YEAR ENDED MAY 31, 2002

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 000-26565

LIBERATE TECHNOLOGIES

(Exact Name of Registrant as Specified in Its Charter)

DELAWARE (State or Other Jurisdiction of Incorporation or Organization)	**94-3245315** (I.R.S. Employer Identification No.)
2 Circle Star Way, San Carlos, California (Address of Principal Executive Offices)	**94070-6200** (Zip Code)

(650) 701-4000
Registrant's Telephone Number, Including Area Code

SECURITIES REGISTERED PURSUANT TO SECTION 12(b) OF THE ACT: NONE
SECURITIES REGISTERED PURSUANT TO SECTION 12(g) OF THE ACT:

COMMON STOCK, $0.01 PAR VALUE PER SHARE
(Title of Class)

Indicate by check mark whether the Company (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 Company was required to file such reports), and (2) has been subject to such filing requirements for the past 90 days. Yes o No ý

Indicate by check mark if disclosure of delinquent filers pursuant to Item 405 of Regulation S-K is not contained herein, and will not be contained, to the best of the Company's knowledge, in definitive proxy or information statements incorporated by reference in Part III of this Form 10-K or any amendment to this Form 10-K. o

Indicate by check mark whether the registrant is an accelerated filer (as defined in Exchange Act Rule 12b-2). Yes ý No o

As of November 30, 2002, the aggregate market value of the voting stock held by non-affiliates of the Company was approximately $125 million based on the last reported sale price of the Company's common stock. As of July 31, 2003, there were 104,006,079 shares of common stock outstanding (including shares held by affiliates).

EXPLANATORY NOTE

This amended Annual Report on Form 10-K/A amends all Items of our report on Form 10-K filed on August 8, 2002 to reflect the restatement of our consolidated financial statements as of, and for the fiscal year ended May 31, 2002, as well as developments in our business and operations since the date of our earlier report. For a discussion of the reasons for our restatement, see Item 1, "Business."

Except as specifically noted, this report is written from the perspective of the date of filing. Please read this report in conjunction with our amended reports on Form 10-Q/A for the quarterly periods ended November 30, 2001 and February 28, 2002, our reports on Form 10-Q for the quarterly periods ended August 31, 2002, November 30, 2002, and February 28, 2003 and our Annual Report on Form 10-K for the fiscal year ended May 31, 2003, which we are filing concurrently with this report.

LIBERATE TECHNOLOGIES

Annual Report on Form 10-K/A, Amendment No. 1
For The Fiscal Year Ended May 31, 2002

TABLE OF CONTENTS

PART I.

Item 1. Business

This Annual Report on Form 10-K/A of Liberate Technologies ("Liberate," "we," "us," or "our") amends our Form 10-K filed with the Securities and Exchange Commission (the "SEC") on August 8, 2002 to reflect the restatement of our consolidated financial statements as of, and for the fiscal year ended May 31, 2002. This report also describes developments in our business and operations since we filed our original report.

The discussion in this report, which is filed on behalf of Liberate and its wholly owned subsidiaries, contains statements that involve expectations or intentions (such as those relating to future business or financial results, new products or features, anticipated deployments, or management strategies.) These statements are forward-looking and are subject to risks and uncertainties, so actual results may vary materially. We assume no obligation to update any forward-looking statements. You should consider our forward-looking statements in light of the risks discussed below, our consolidated financial statements, related notes, and the other financial information appearing elsewhere in this report and our other filings with the SEC.

In this report, we sometimes use the words "fiscal" or "FY" followed by a year to refer to our fiscal years, which end on May 31 of the specified year. We also sometimes use "Q1," "Q2," "Q3," and "Q4" to refer to our fiscal quarters, which end on August 31, November 30, the last day of February, and May 31 of each fiscal year.

Restatement of Liberate's Financial Statements for the Fiscal Year Ended May 31, 2002 and Revision of Liberate's Financial Statements for the Quarter Ended August 31, 2002

On October 15, 2002, we announced that we would restate our financial results for our fourth quarter and fiscal year ended May 31, 2002 and delay the filing of our quarterly report on Form 10-Q for the quarter ended August 31, 2002. We made this determination after discovering facts calling into question the appropriateness and timing of revenue recognition for a single-transaction license fee of approximately $1.8 million. Our audit committee, which is composed of independent outside directors, retained independent counsel to review the revenue reported during our fiscal year ended May 31, 2002. On November 21, 2002, we announced that we had discovered facts that called into question the appropriateness and timing of revenue recognition for various transactions (including the originally identified transaction) that accounted for a total of approximately $10 million in revenue during our 2002 fiscal year and the first quarter of our 2003 fiscal year. While our audit committee's investigation was pending, we were not able to file our quarterly reports on Form 10-Q, and as a result, our stock was delisted from the Nasdaq National Market in January 2003 and currently trades through the Pink Sheets system.

Our audit committee's investigation is complete, and as a result of its findings, we are restating our financial statements for the fiscal year ended May 31, 2002. We are also restating our financial statements for the quarters ended November 30, 2001, February 28, 2002, and May 31, 2002. We are including the restated results for these quarters in this report and we are filing amended quarterly reports on Form 10-Q/A for the quarters ended November 30, 2001 and February 28, 2002. We are also revising the preliminary results and financial statements for the quarter ended August 31, 2002 that we disclosed in a press release dated September 26, 2002 and are including those revised results in a quarterly report on Form 10-Q for the quarter ended August 31, 2002.

Our audit committee and its independent advisors concluded that our historical financial statements had overstated our revenue by $2.2 million in Q2 FY02; $1.8 million in Q3 FY02; and $5.9 million in Q4 FY02. The total revenue overstatement for fiscal 2002 was $9.9 million, so that our revenue for that year should have been reported as $70.5 million. Expenses for FY02 were understated by $216,000, reflecting increases of approximately $646,000 related to cost of service revenues which were partially offset by a decrease in research and development expense of $229,000 and a decrease in income tax provisions of $201,000. Our reported net loss for fiscal 2002 was understated by $10.1 million, and should have been reported as $335.1 million rather than $325.0 million.

In addition, our audit committee and its independent advisors concluded that our preliminary earnings report for Q1 FY03 issued on September 26, 2002 had overstated our revenue by $901,000 and that revenue for that quarter should have been reported as $9.4 million rather than $10.3 million. Expenses for that quarter were overstated by $1.2 million. As a result, our reported net loss for that quarter should have been $249.3 million rather than $249.6 million.

Of the $9.9 million of revenue overstatements for fiscal 2002 and the $901,000 of revenue overstatements for Q1 FY03, as noted above, we are deferring approximately $6.8 million to Q2 FY03 and subsequent quarters.

The principal reason that we overstated our revenues was that certain Liberate employees failed to disclose material facts pertaining to commercial transactions to the employees responsible for revenue recognition. If we had been aware of these facts at the appropriate time, we would not have recognized revenue on certain transactions or would have deferred the recognition of such revenue.

As part of the adjustments necessary to correct the overstatement of our revenues, we have adjusted other items on our balance sheets such as accounts receivable, deferred revenues, prepaid expenses, other assets, and accrued liabilities, as well as items on our statements of operations such as cost of service revenues, research and development, bad debt expense, and income tax provision. See Financial Statements, Note 3.

As a result of our audit committee's investigation and restatement of our financial statements, we carried out an evaluation of the design and operation of our internal controls and procedures under the supervision and with the participation of our senior management, including our new chief executive officer and new chief financial officer, and adopted additional policies designed to strengthen our controls and procedures. See Item 14, "Controls and Procedures."

Business Overview

We are a leading provider of digital infrastructure software and services for cable networks. Our software supports a wide variety of services, including digital television and provisioning of voice and high-speed data communications.

Our digital television platform lets cable network operators deploy compelling features such as video-on-demand, enhanced electronic programming guides, and interactive content. Those features help operators reduce churn, increase consumer satisfaction, and promote new video services and program packages. Our Operations Support Systems platform lets cable network operators provision, manage, and monitor high-speed internet and cable telephony services offered via cable modems, increasing customer satisfaction and decreasing costs.

Corporate Background

We began our operations in late 1995 as a division of Oracle, developing client and server software for the consumer, enterprise, and educational markets. We incorporated in Delaware in April 1996 when Oracle spun off our division as Network Computer, Inc. ("NCI"). NCI's initial focus was selling software to original equipment manufacturers of network computer products for enterprise customers. In August 1997, NCI merged with a Netscape Communications subsidiary, Navio Communications, Inc., which was developing internet application and server software for the consumer market. NCI was the surviving entity in the merger. After the merger, we changed our strategic direction and restructured our operations to focus our development and marketing efforts on products targeted primarily at the

consumer device market, targeting sales to a limited number of large network operators and consumer device manufacturers. In May 1999, we changed our name from NCI to Liberate Technologies.

Between our incorporation and our initial public offering, we raised a significant amount of capital by selling small equity positions to a number of investors, including some major network operators. In order to continue funding our operations, we issued shares of our stock to the public in July 1999. In January 2000, we effected a two-for-one split of our stock. We raised additional capital in February 2000 through a secondary public offering, and again in July 2000 when Cisco Systems invested $100.0 million through a private placement. In July 2002, we subsequently repurchased 3,963,780 shares of our stock from Cisco Systems for $10.0 million.

We have made three acquisitions since becoming a publicly traded company. In March 2000, we acquired the VirtualModem assets of SourceSuite LLC, a company based in Canada. In June 2000, we acquired MoreCom, Inc, a company based in Horsham, Pennsylvania. In August 2002, we acquired Sigma Systems Group (Canada). Because we acquired Sigma Systems after the end of our 2002 fiscal year, we have not included Sigma System's operating results in our fiscal 2002 financial statements.

Through the end of fiscal 2002, we operated in one segment and generated revenues from licenses, royalties, and services. Our 2002 fiscal year started on June 1, 2001 and ended on May 31, 2002.

Products and Services

We provide a range of infrastructure software and services for cable and telecommunications networks. Our products include:

Digital television platforms. We offer technologies that are specifically engineered to deliver interactive TV services for digital television. We use our knowledge of digital TV technology to facilitate the delivery of digital services over digital cable networks.

Operations Support Systems (OSS). We have developed and acquired technologies that automate many of the processes related to provisioning, deploying, and managing high-speed internet and telephony services over cable networks. With the acquisition of Sigma Systems in August 2002, we added OSS capabilities to our product offerings.

Our software platform includes a range of interactive television client and server products, interactive television infrastructure services, developer tools, and OSS products. We also offer a variety of services designed to facilitate deployment of our software.

Interactive Television Client and Server Products

Our client software products and their accompanying server software products form the core of our offerings. The client components, collectively called Liberate TV Navigator , can run on digital set-top boxes of various types such as cable, digital terrestrial broadcast, and digital subscriber lines (DSL) enabling interactive and enhanced services. These products have been deployed primarily in digital cable networks. We also provide a variety of server software products to support Liberate TV Navigator software and other set-top box clients. Collectively, these products comprise a software suite called Liberate Connect .

Interactive Television Services Infrastructure

We have developed products that provide common functionality needed by various types of services delivered via cable networks and digital set-top boxes. In some cases, these products also give the operator greater control over how services are delivered and who can access them.

Several of our products are aimed at communications between individuals or between an application service provider and a consumer. Liberate Message software provides a messaging system

that delivers data between various points on a network, either between set-top boxes or between servers and set-top boxes. Liberate TV Ticker software captures live data and manages its broadcast to set-top boxes for services such as an information ticker or other services that uses near-real-time broadcast data (such as a games leader-board.) Liberate TV Info software collects television-programming-related data and delivers it to the set-top box. Liberate Imprint software incorporates both client and server elements in order to collect information about aggregate subscriber usage patterns. Such information helps network operators target and personalize their offerings for subscribers.

Operations Support Systems

The Liberate Service Management Portfolio is a set of products that lets network operators integrate with existing back-office systems to automate the provisioning of high-speed internet services, circuit-switched cable telephony, and voice-over-IP offerings. The Service

Management Portfolio stores and uses domain knowledge, including configurable business rules, technology models, service definitions, process workflows, embedded protocols, and data mapping translations. This stored information helps network operators efficiently deploy and operate voice and data services over increasingly large and complex networks.

The Liberate Service Management Portfolio software also includes five main applications:

- The Liberate Service Profile Manager application handles subscribers, maintains subscriber profiles, and manages order entry, order management, and service provisioning/activation requests.

- The Liberate Self-Service Manager lets subscribers select and activate their services directly over the Internet without a call center becoming involved. Furthermore, it allows subscribers to access their service profiles and billing information without the need to call a customer service representative.

- The Liberate Service Diagnostics Manager application lets customer service representatives and technical service representatives troubleshoot and diagnose service issues remotely and in real time, while the subscriber is on the phone.

- The Liberate Service Topology Manager application helps cable operators assess the impact of service orders and service changes on service-critical network resources. It also enables flow-through provisioning as well as the maintenance of network segmentation and combining plans.

The Liberate Service Creation Toolkit application lets a network operator's product managers define new broadband services and service bundles according to business needs.

Trademark Notice

Liberate®, the Liberate logo, and the various Liberate products and programs described above are registered trademarks and trademarks of Liberate Technologies. All other trademarks are the property of their respective owners.

Professional Services

Our Professional Services group provides design, development, deployment, integration, and support services to network operators. The Professional Services group works closely with our product development and technical support teams to design and install appropriate system elements. We also rely on technology partners and system integrators to provide our customers with products and technologies from others in the industry.

Research and Development

As of June 30, 2003, we had development offices in San Carlos, California and Ontario, Canada. Our total research and development expenses were $32.3 million in fiscal 2000, $51.2 million in fiscal 2001, and $44.6 million in fiscal 2002. These amounts exclude acquisition-related charges for purchased in-process research and development of $1.9 million in fiscal 2000 and $22.4 million in fiscal 2001.

Sales and Marketing

We typically license our server software directly to network operators and license our interactive client software to both network operators and consumer device manufacturers. We license our software primarily through our direct sales force and use indirect resellers in certain developing markets. We have direct sales professionals located in North America, Europe, and Asia.

Customers

Our customers are typically large network operators who introduce, market, and promote products and services based on our technology. For fiscal 2000, NTL accounted for 30%, Wind River Systems accounted for 19%, and AOL-Time Warner accounted for 12% of total revenues. For fiscal 2001, NTL accounted for 28%, Telewest accounted for 25%, and AOL accounted for 11% of total revenues. For fiscal 2002, Telewest accounted for 19% and NTL accounted for 16% of total revenues. In May 2000, NTL acquired the consumer cable and certain other operations of Cable and Wireless and the percentages for NTL for fiscal 2000 include amounts previously reported for Cable and Wireless.

Competition

We face intense competition in licensing software for networks and consumer devices. Our principal competitors in the interactive television software market include OpenTV, including Liberty Broadband Interactive Technologies, its controlling shareholder; Canal+ Technologies, a subsidiary of Thomson Multimedia; and Microsoft. In the OSS market, we compete primarily with Alopa Networks, Ceon, Core Networks, Imagine Broadband (IBL), Interactive Enterprises, JacobsRimell, and Lemur Networks. Other established and emerging companies in the television, computer software, and telecommunications sectors may also become competitors. The principal competitive factors in our industry include:

- The quality and breadth of product and service offerings;
- The speed of product integration and deployment into existing customers networks;
- The ability of our systems to operate in large-scale digital cable networks;
- The adequacy of financial resources and corporate stability;
- The competitiveness of product pricing;
- The possession of patents relating to important technologies; and
- The effectiveness of sales and marketing efforts.

Intellectual Property Rights and Proprietary Information

We have a portfolio of technologies and intellectual property that addresses various features of interactive networks and devices. We seek to safeguard our proprietary information and our other intellectual property through a combination of domestic and international copyrights, trademarks, patents, and trade secret protection, as well as through contractual protections such as proprietary information agreements and nondisclosure agreements. However, we cannot guarantee that these steps

will prevent misappropriation of our proprietary information, and we may not be able to detect unauthorized use and take appropriate steps to enforce our intellectual property rights.

As of June 30, 2003, we had 29 issued U.S. patents in the general area of interactive networking technologies, 34 pending U.S. patent applications, and 24 foreign patents.

We have registered "Liberate" and the Liberate logo in the United States and extensively throughout the world, and use our other product trademarks in association with these marks.

Employees

As of May 31, 2002, we had 512 employees. As of June 30, 2003, we had 268 employees, reflecting the effects of recent restructurings as well as the addition of Sigma Systems employees in August 2002. None of our employees is represented by a collective bargaining agreement and we have never experienced a work stoppage.

Equity Investments

In fiscal 2001, we began making investments in companies in the field of interactive television and other markets. As of May 31, 2002, we had invested $17.1 million in our portfolio of companies. The carrying value of our equity investments was $10.4 million as of May 31, 2002 and zero as of May 31, 2003. See Consolidated Financial Statements ("Financial Statements"), Notes 2, 10, and 19.

Risk Factors

Any of the following risks could seriously harm our business, financial condition, and results of operations, causing the price of our stock to decline.

Demand for information-oriented set-top boxes and advanced digital voice, data, and video services may not develop rapidly.

Because the market for advanced digital voice, data, and video services (including interactive television) and information-oriented set-top boxes is newly emerging, the potential size of the market opportunity and the timing of its development are uncertain. As a result, our profit potential is unknown.

Sales of our technology and services depend upon the commercialization and broad acceptance by consumers and businesses of advanced digital voice, data, and video services. This will depend in turn on many factors, including the development of compatible devices, content, and applications of interest to significant numbers of consumers and the emergence of industry standards that facilitate the distribution of such content and applications. Because demand for these types of products and services has fluctuated, and our revenues have recently declined markedly, we do not anticipate that we will be able to achieve our prior revenue growth rates. If our market does not develop, develops slowly, or develops in a different direction than we hope, our revenues will not grow quickly, and may decline.

Because the market for interactive television is newly emerging, the relative value of system components such as infrastructure, operating systems, middleware, applications, and content has yet to be widely tested commercially. We have focused on developing and marketing our interactive television software platform and infrastructure applications that let our customers handle subscriber management services. Content and applications may become a relatively more valuable part of an interactive television system, while platforms and infrastructure to enable interactive television and manage subscribers may become less valuable, which could lead to relatively lower margins for our business.

6

Our success depends on a limited number of network operators introducing and promoting products and services incorporating our technology.

Our success depends on large network operators introducing and promoting products and services based on or using our technology. There are, however, only a limited number of these large network operators worldwide, some of whom have elected not to adopt our products. Mergers or other business combinations among these network operators could reduce the number of potential customers, disrupt our existing business relationships, and cause demand for our products and services to decline.

Our network operator customers are not contractually obligated to introduce or promote our technology, or to achieve any specific introduction schedules. Our agreements are not exclusive, so network operators who license our technology may enter into similar agreements with one or more of our competitors.

Because the large-scale deployment of products and services incorporating our technology is complex, time-consuming, and expensive, network operators are cautious about proceeding with these deployments. The customization process for new customers typically requires a lengthy and significant commitment of resources by our customers and us, and it is difficult for us to predict the timing of those purchases.

We currently derive, and expect to continue to derive, a significant portion of our revenues from a limited number of customers. See Item 1, "Business Customers" and Financial Statements, Note 15. The specific customers may vary from period to period. As a result, if we do not sell our products and services to one or more customers in any particular period, or a large customer purchases fewer of our products or services, defers or cancels orders, fails to meet its payment obligations, or terminates its relationship with us, our revenues could decline significantly.

Several of our largest customers have significant debt burdens and are restructuring. These customers have decreased their use of our products and services, and corporate changes may put future business or payments at risk. The telecommunication industry in which our customers operate continues to experience consolidation, and some of our customers have been acquired by or merged into other companies. Continuing industry consolidation among our customers may result in a loss of customers for our products and may cause our revenues to decline further.

Our internal inquiry into the restatement of our financial statements could interfere with the conduct of our business.

In October 2002, when we discovered facts calling into question the appropriateness and timing of revenue recognition, the audit committee of our board of directors initiated an inquiry to review the appropriateness and timing of revenue recognition, correct the accounting treatment where appropriate, take proper remedial action, and assess controls and procedures for financial reporting. We have incurred, and may continue to incur, significant accounting and legal expenses in connection with this inquiry and the related litigation. The inquiry has also required significant time and attention from our senior management, and is likely to require further diversion of management attention to address matters identified in the inquiry. The continued diversion of our financial and management resources to this inquiry has harmed and may continue to harm our business and our operating results.

In connection with the restatement and related inquiry, our audit committee and executive management have added or revised controls and procedures that could change the timing, amount, and characterization of future revenues. By adding additional types of review to our processes, could cause us to operate less efficiently, recognize less revenue, or defer significant amounts of revenue to future periods.

The diversion of management and financial resources resulting from the SEC's inquiry into the restatement of our financial statements could harm our business.

When we announced that we would restate our financial statements, we contacted the SEC and provided them with additional information regarding our findings. In February 2003, we learned that the SEC had initiated a formal, non-public investigation into the events and circumstances that led to the restatement of our financial statements. We have been cooperating with the SEC and will continue to do so.

Conducting our internal investigation and responding to the SEC investigation have required significant time and attention from management and are likely to further occupy management's attention and resources in the future. If the SEC elects to pursue an enforcement action, the defense may be costly and require additional management resources. If we are unsuccessful in defending against such an action, we may face penalties or fines that could seriously harm our business and cause our stock price to decline further.

Securities class-action litigation and shareholder derivative litigation could result in substantial costs and occupy substantial management attention and resources.

Beginning on October 17, 2002, five securities class-action lawsuits were filed in the United States District Court for the Northern District of California against us and certain officers and directors (collectively, the "Class Action Defendants"), which were subsequently consolidated into a single action (the "Class Action"). The law firm of Schiffrin & Barroway has been named to represent the lead plaintiff. The Class Action is based on our announcements in October and November 2002 that we would restate our financial results for fiscal 2002 and that we were investigating other periods. The Class Action generally alleges, among other things, that members of the purported class were damaged when they acquired our securities because, as a result of accounting irregularities, our previously issued financial statements were materially false and misleading, and caused the prices of our securities to be inflated artificially. The Class Action further alleges that, as a result of this conduct, the Class Action Defendants violated Section 10(b) and 20(a) of the Securities Exchange Act of 1934, and SEC Rule 10b-5, promulgated thereunder. The Class Action seeks unspecified monetary damages and other relief from all Class Action Defendants.

In addition, on or about October 29, 2002, a shareholder derivative action was filed in the California Superior Court for the County of San Mateo, naming us as a nominal party and naming certain of our officers and directors as defendants (collectively, the "Derivative Defendants"). A second shareholder derivative action was filed on or about November 6, 2002. On February 26, 2003, these actions were consolidated into a single action. The law firm of Robbins Umeda & Fink was named as lead counsel. The Derivative Action is based on substantially the same facts and circumstances as the Class Action and generally alleges that the Derivative Defendants failed to adequately oversee our financial reporting, and thus are liable for breach of their fiduciary duties, abuse of control, gross mismanagement, and waste of corporate assets. The Derivative Action also alleges that certain current or former officers and directors are liable for unjust enrichment. The Derivative Action seeks unspecified monetary damages and other relief.

We have retained Skadden, Arps, Slate, Meagher & Flom as our legal counsel in the SEC investigation, Class Action, and Derivative Action. The cost of participating and defending against these actions is substantial and will require the continuing diversion of management's attention and corporate resources.

Because of the restatement and the related litigation and SEC investigation, our financial statements and public filings could receive heightened scrutiny from the SEC and current or potential plaintiffs. While the disclosures contained in this report and our other reports filed concurrently with the SEC represent Liberate's best efforts to correct inaccuracies related to our past revenue

recognition, we may not be able to detect all errors, notwithstanding the adoption of new controls and procedures. If we become aware of other errors or inaccuracies in our financial statements or public disclosures, we may be required to restate our financial statements again and may be subject to further litigation or investigations.

We cannot predict or determine the outcome or resolution of the Class Action, the Derivative Action or the SEC investigation, or estimate the amounts of, or potential range of, loss with respect to these proceedings. In addition, the timing of the final resolution of these proceedings is uncertain. The possible resolutions of these proceedings could include judgments against us or settlements that could require substantial payments by us, which could have a material adverse impact on our financial position, results of operations, and cash flows.

We have agreed to indemnify our directors and officers to the fullest extent allowed by Delaware law. As a consequence, we are advancing expenses (including reasonable attorneys' fees) incurred by directors and officers in connection with the Class Action, the Derivative Action, and the SEC investigation although these payments are subject to reimbursement if such expenses are ultimately found to be non-indemnifiable. Additionally, we may ultimately be obligated to pay indemnifiable judgments, penalties, fines, and amounts paid in settlement actually and reasonably incurred by them in connection with these proceedings.

We have notified our various insurance carriers of the Class Action, the Derivative Action, and the SEC investigation, however our insurance may not cover our defense costs, any settlement, any judgment rendered against us, or amounts we are required to pay to any indemnified person in connection with the Class Action, the Derivative Action, the SEC investigation, or any other matter.

More generally, securities class-action litigation has often been brought against a company following declines in the market price of its securities. This risk is especially acute for us because technology companies have experienced greater than average stock price declines in recent years and, as a result, have been subject to a greater than average number of securities class-action claims. Due to the significant decline of our stock price, we may in the future face additional litigation, which could result in substantial additional costs and further diversion of management attention and resources.

The circumstances surrounding the restatement of our financial statements could make it difficult for us to hire and retain key personnel.

The announced restatement of our financial statements and the ensuing litigation, delisting by Nasdaq, and restructuring of our workforce have created substantial uncertainty regarding our ability to focus on our business operations and remain competitive with other companies in our industry. Because of this uncertainty, we may have difficulty motivating and retaining key personnel or replacing key personnel who leave Liberate, which could seriously harm our ability to generate revenue, attract and retain customers, manage day-to-day operations, and deliver our products and services.

The restatement of our financial statements and ensuing litigation may raise concerns among our customers regarding our long-term stability, which could seriously harm our future sales.

Our customers typically integrate our technology into the core of their networks and systems, and our customers may distribute our technology widely among their end-users. Because of this extensive integration, customers who purchase our products or services make a significant long-term investment in our technology and rely on us to provide ongoing support. The restatement of our financial statements and the ensuing litigation and SEC investigation may create instability, or the perception of instability, in our business, which could lead customers and potential customers to believe that we are, or may in the future be, unable to provide necessary support for our products. If our customers or potential customers believe that our business is unstable, we may lose significant sales opportunities to our competitors, which could seriously harm our business and results of operations.

Many of our controls and procedures are untested and the failure or circumvention of our controls and procedures could seriously harm our business.

As part of our internal inquiry into the appropriateness and timing of revenue recognition in our previously filed financial statements, we reviewed our internal controls and disclosure controls and procedures in order to determine whether they were effective and whether they had been circumvented. Although we have now adopted additional policies designed to strengthen our controls and procedures with the goal of improving our method of obtaining, recording, and reporting information, our controls and procedures may not be able to prevent error or fraud in the future. Certain aspects of our controls are new and untested, and faulty judgments, simple errors or mistakes, or the failure of our personnel to adhere to established controls and procedures may make it impossible for us to detect all inaccuracies. If our controls and procedures do not detect inaccuracies or fraud in the future, we could face additional litigation and investigations.

The delisting of our stock from the Nasdaq National Market may harm the price and liquidity of our stock and may lead to increased volatility of our stock price.

On October 22, 2002, we announced that we had received a Nasdaq Staff Determination indicating that we did not comply with the timely filing requirements for continued listing and that our securities were therefore subject to delisting from the Nasdaq National Market. Following a hearing before a Nasdaq Listing Qualifications Panel on November 22, 2002, we were granted a grace period until January 14, 2003 to file our amended annual report on Form 10-K/A, our delayed report on Form 10-Q for the quarter ended August 31, 2002, and any other delinquent filings. Because the internal inquiry and review had not concluded by that date, we failed to meet the conditions, and Nasdaq delisted our common stock on January 17, 2003. We subsequently withdrew our appeal of this ruling. Delisting can result in a lower stock price, more volatility in our stock price, more restrictions on our ability to borrow or otherwise raise capital, and significantly less liquidity of our common stock, potentially resulting in lower market prices and fewer opportunities to trade our stock.

Our recent workforce restructurings may harm morale and performance of our personnel and may harm our sales.

In order to reduce costs, we significantly restructured our organization in fiscal 2002 and fiscal 2003, in part through substantial reductions in our workforce. There have been and may continue to be substantial costs associated with the workforce reductions, including severance and other employee-related costs, and our restructuring plan may result in unanticipated consequences, such as poor employee morale, attrition beyond our planned reduction, or a significant loss of customers and revenue. As a result of these reductions, we may not be prepared to respond to new challenges or to take advantage of new opportunities.

Some of the employees who were terminated may possess specific knowledge or skills that may prove to have been important to our operations. In that case, their absence may create significant difficulties for our operations. Reductions in workforce may also subject us to the risk of litigation, which may harm our operations and may cause us to incur significant unanticipated expenses. We may need to further reduce our expenses in the future, which could seriously disrupt our business operations and harm morale and performance of our personnel.

In December 2002, we terminated the employment of Donald Fitzpatrick, our former chief operating officer, who was responsible for the Sales and Professional Services division. In 2003, we also terminated the employment of the sales vice presidents who had reported to Mr. Fitzpatrick and other members of our sales force employed during the periods being restated. This significant level of turnover and our resulting need to rebuild our sales force may seriously harm our revenues in current and future quarters.

Moreover, we have had significant recent turnover among key members of senior management, and may have additional turnover in the future. Our recent restructurings and general cost reductions may create uncertainties for our employees. If we have difficulty motivating and retaining key personnel, it could seriously harm our ability to manage day-to-day operations, develop and deliver technologies, attract and retain customers, attract and retain other employees, and generate revenues.

Because of the large number of employees whose positions were eliminated in fiscal 2002 and 2003, we may be subject to unanticipated claims or litigation related to employment, employee benefits, or termination. The types of claims could divert the attention and resources of management and could harm our financial condition.

Service revenues may continue to constitute a significant percentage of total revenues, which is likely to reduce our gross margins.

Our customers often need substantial professional services to integrate our products into their networks. Service revenues typically have a lower gross margin than do license and royalty revenues, and in the past our services gross margins have been negative. If we are unable to maintain good utilization rates for our professional services staff and adequately price our fixed-fee service contracts, our service margins are likely to remain low.

Our success depends on set-top box manufacturers introducing and promoting products that incorporate or operate with our technology.

Our interactive television client technology operates on digital television set-top boxes manufactured by other companies. No set-top box manufacturer is obligated to introduce or promote set-top boxes incorporating or operating with our technology, to achieve any specific production schedule, or to license from us exclusively. A manufacturer or its customers could choose to support and use only applications and content developed to operate directly with a particular set-top box, which could eliminate the need for our interactive television software platform. As an example, many industry analysts have predicted that North American cable operators will focus on video-on-demand services, which in isolation could operate with set-top boxes that do not require our software. Moreover, although we have focused on developing our interactive television software platform to operate with set-top boxes, consumers may in the future receive interactive television through multi-purpose home entertainment devices or advanced game consoles, using software platforms other than ours. If our technology is not broadly integrated with these devices, or if these devices do not achieve broad acceptance with retailers and consumers, our revenues will not grow quickly and may decline.

A continued downturn in macroeconomic conditions could further reduce sales of our products and services or result in collection difficulties.

Economic growth in the United States and internationally has slowed significantly and the prospects for near-term economic growth worldwide are uncertain. The global telecommunications industry has been particularly hard hit, with many industry participants publicly reporting decreased revenues and earnings, significant financial restructuring efforts, and reduced capital expenditures, all of which affect their ability to purchase our products and services. Many of our customers rely on debt-based financing and subscriber revenues to fund their capital expenditures, so economic conditions that reduce either of these sources of financing may slow or stop their use of our products and services, or make it more difficult for us to collect receivables. Some of our largest customers are restructuring their debts and have reduced their use of our products and services. Some of our smaller customers may not be able to continue their operations or afford to pay for our products. As a result, we may experience a substantial reduction in revenue if our customers change the timing of their orders, decrease their capital spending, or experience adverse financial conditions.

If we do not meet our financial goals or if our operating results do not improve, our stock price could decline.

We have withdrawn our guidance regarding future revenues and earnings, including our previous projections for profitability. We expect our future revenues to continue to depend significantly on a small number of relatively large orders for our products and services. We have found it difficult to forecast the timing and amount of specific sales because our sales process is complex and our sales cycle is long. Licensing our products on a site or enterprise basis (as some of our customers have requested) does not generate predictable royalty revenues on a per-subscriber basis, but rather one-time license revenues that would be hard for us to forecast. In some cases, we recognize revenues from services based on the percentage of completion of a services project. Our ability to recognize these revenues may be delayed if we are unable to meet service milestones on a timely basis. Delays in network operators' deployment schedules (which would delay royalty revenues for us) or delays in our receipt of royalty reports could reduce our revenues for any given quarter. As a result, our revenues are likely to vary from period to period and may be difficult to forecast. Because our expenses are relatively fixed in the near term, any shortfall in anticipated revenues could result in greater short-term losses. If we incur greater short-term losses, our business may suffer and our stock price may decline.

Our deferred revenue balance has declined significantly over time. We may be unable to sustain or replicate our revenues after customers have exhausted their pre-paid balances. Some of our revenues consist of one-time revenues derived from the termination of certain major customers' unused rights to use prepayments for our interactive television products and services. If we cannot substantially increase our sources of sustainable revenues, our business will suffer and our stock price is likely to decline.

In order to approach profitability, we will have to bring our expenses more closely in line with our revenues. In fiscal 2002 and 2003, as part of our continuing program of expense management, we announced reductions in workforce that affected approximately 475 employees across the company. See Financial Statements, Notes 9 and 19. We also instituted other cost-cutting measures, including restricted travel, facilities consolidation, and mandatory vacations and holiday closures. If these cost-cutting measures are not successful, or if we are unable to increase our revenues, we may need to institute further cost reductions.

Since our inception, we have not had a profitable reporting period, and may never achieve or sustain profitability. We may continue to incur significant losses and negative cash flows in the future.

Our future license and royalty revenues and margins may decline if our customers license only certain features of our interactive television products and do not deploy them widely or purchase other products or services from us.

We have developed our interactive television software platform to enable a broad array of interactive television features, and we typically license our entire software platform to our network operator customers. Some network operators are choosing to roll out only certain features of interactive television, such as video-on-demand services, and want to license only certain individual capabilities of our software platform. We have in some cases licensed only some components of our software platform. If our network operator customers do not deploy these or other components widely enough to make up for the resulting lower per-unit license and royalty fees, our license and royalty revenues and margins will decline.

Competition in our market could result in price reductions, reduced gross margins, and loss of market share.

We face intense competition in licensing our interactive television platform software for networks and set-top boxes. Our principal competitors in this market include Microsoft, OpenTV (including Liberty Broadband Interactive Technologies, its controlling shareholder), and Canal+ Technologies (a

subsidiary of Thomson Multimedia). We also face competition from set-top box manufacturers that have their own platform offerings. Additionally, certain interactive television applications developers, such as Gemstar-TV Guide or NDS Group, a partially owned subsidiary of News Corporation, may expand into the interactive television platform market to compete with us.

We also face intense competition in providing our OSS products and services. In that market, we compete primarily with other providers of OSS products and services targeted at the cable broadband market, such as Alopa Networks, Ceon, Core Networks, IBL, Imagine Broadband, Interactive Enterprises, JacobsRimell, and Lemur Networks. We also at times compete with providers of certain components or products or services that complement our OSS offering, including providers of service diagnostics products, providers of billing and customer care applications or services, large equipment vendors who offer OSS solutions, and systems integrators. We may also face competition from internal information technology departments of larger telecommunication companies, that may elect to develop software in-house rather than buy it from us, and other communications service providers, software developers, and smaller emerging companies. The OSS market sector is extremely competitive, and this competition has reduced the prices we can charge for our software.

We expect additional competition from other established and emerging companies in the television, computing, software, and telecommunications sectors and from stronger competitors created by the current consolidation among vendors to the telecommunications industry. Increased competition may result in further price reductions, and may also lead to fewer customer orders, reduced gross margins, longer sales cycles, reduced revenues, and loss of market share.

Several of our competitors have one or more of the following advantages: longer operating histories, larger customer bases, greater name recognition, more patents relating to important technologies, and significantly greater financial, technical, sales and marketing, and other resources. This may place us at a disadvantage in responding to their pricing strategies, technological advances, advertising campaigns, strategic partnerships, and other initiatives. Our competitors may be able to respond more quickly to new or emerging technologies and changes in customer or governmental requirements, or to devote greater resources to the development, marketing, and sale of their technologies than we can. In addition, many of our competitors have well-established relationships with our current and potential customers. Some of our competitors, particularly Microsoft, have made and may continue to make large strategic investments in our current and potential customers. Such investments may allow our competitors to strengthen existing relationships or quickly establish new relationships with our current or potential customers.

Many of our customers and potential customers have publicly announced that they are reducing capital expenditures, and our competitors, even if they have fewer resources or shorter operating histories than we do, have, and may in the future continue to, aggressively cut the prices of their products and services in order to obtain market share. As we compete in this shrinking market, we face increased pricing pressure, which could seriously harm our business, results of operations, and financial condition.

International revenues account for a significant portion of our revenues and are subject to operational risks and currency fluctuations.

International revenues consist of sales to customers outside of the United States and are assigned to specific countries based on the location of the customer. We derive, and may continue to derive a significant portion of our revenues from sources outside the United States. Accordingly, our success will depend, in part, upon international economic, political, legal, and regulatory conditions; our ability to manage international sales and marketing operations; and our ability to collect international accounts receivable. See Financial Statements, Note 15.

To date, the majority of our revenues and costs have been denominated in U.S. dollars. The effect of changes in foreign currency exchange rates on revenues and operating expenses are reflected in our financial statements. See Financial Statements, Note 2. Changes in international operations may result in increased foreign currency receivables and payables. Although we may, from time to time, undertake foreign exchange hedging transactions to cover a portion of our foreign currency transaction exposure, we do not currently do so. Accordingly, fluctuations in the value of foreign currency could significantly reduce our international revenues or increase our international expenses.

Acquisitions or dispositions of businesses or product lines could be difficult to implement or integrate and could disrupt our business and dilute stockholder value.

In August 2002, we completed our acquisition of Sigma Systems Group (Canada), which at the time of the acquisition developed and licensed OSS software to cable operators and telecommunications providers to permit them to create, configure, deliver, and manage subscriber services. We may acquire other businesses in the future in an effort to compete effectively in our market or to acquire new technologies. With our acquisition of Sigma Systems, and with any future acquisitions, it may be difficult to integrate product lines, technologies, personnel, customers, widely dispersed operations, and distinct corporate cultures. These integration efforts have, in some cases, proven more difficult than anticipated and may not succeed or may distract our management from operating our existing business. Our failure to successfully manage current and future acquisitions could seriously harm our operating results. In addition, our stockholders would be diluted if we were to finance acquisitions by incurring convertible debt or issuing equity securities, and our liquidity may be adversely affected if we were to use our cash to make acquisitions.

We offer various types of products to our customers, including interactive television software, operations support software, and billing software. If we determine that one or more of these businesses or acquisitions is not likely to contribute positively to our cash flow or future revenues, we may seek to sell all or part of our interest to a third party or parties. We may have to sell those assets at a loss, and the process of disengaging from a product line may prove costly and disruptive to our operations or customer relationships.

We have been sued for patent infringement by one of our competitors and may be subject to other third-party intellectual property infringement claims that could be costly and time-consuming to defend. We do not have insurance to protect against these claims.

On February 7, 2002, OpenTV filed a lawsuit against Liberate in the United States District Court for the Northern District of California, alleging that Liberate is infringing two of OpenTV's patents and seeking monetary damages and injunctive relief. We have retained O'Melveny & Myers as our legal counsel. We have filed an answer denying OpenTV's allegations and have counter-claimed that OpenTV infringes one of our patents for information retrieval systems. The Court ruled on summary judgment that OpenTV does not infringe one of these patents. We are seeking to have OpenTV's two patents invalidated, requesting a finding that our technology does not infringe OpenTV's patents, and seeking monetary damages and injunctive relief against OpenTV. The court has held a claim construction hearing, and trial is currently scheduled for 2004. Because litigation is by its nature uncertain, we are unable to predict whether we may face any material exposure for damages or the need to alter our software arising from this case.

We expect that, like other software product developers, we will increasingly be subject to infringement claims as the number of products and competitors developing set-top box software grows, software and business-method patents become more common, and the functionality of products in different industry segments overlaps. From time to time, we hire or retain employees or external consultants who have worked for independent software vendors or other companies developing

products similar to ours. These prior employers may claim that our products are based on their products and that we have misappropriated their intellectual property.

Several other companies involved in the interactive television market have large patent portfolios that they have aggressively sought to enforce. While we do not believe we currently infringe such patents, and believe that we have valuable patents that we are seeking to enforce in the context of litigation, claims of infringement are always possible, and success in litigation or other successful resolution of claims is by no means assured.

We currently do not have liability insurance to protect against the risk that our own technology or licensed third-party technology infringes the intellectual property of others. Claims relating to our intellectual property, regardless of their merit, may seriously harm our ability to develop and market our products and manage our day-to-day operations because they are time-consuming and costly to defend, and may divert management's attention and resources, cause product shipment delays, require us to redesign our products, or require us to enter into royalty or licensing agreements.

Our products may contain errors or be unable to support and manage a large number of users.

Software development is an inherently complex and subjective process, which frequently results in products that contain errors, as well as defective or non-competitive features or functions. Moreover, our technology is integrated into the products and services of our network operator customers. Accordingly, a defect, error, or performance problem with our technology could cause our customers' cable television or other telecommunications systems to fail for a period of time. Any such failure could cause severe customer service and public relations problems for our customers and could result in delayed or lost revenues or increased expenses due to adverse customer reaction, negative publicity, and damage claims.

Despite frequent testing of our software's scalability in a laboratory environment and in customer deployments, the ability of our products to support and manage a potentially unlimited number of subscribers is uncertain. If our software does not efficiently scale while maintaining a high level of performance, demand for our products and services and our ability to sell additional products to our existing customers will be significantly reduced.

We must keep pace with the latest technological developments and with changes in the industry and government standards, and any delays or failure in developing and introducing new software products in a cost-effective way could result in a loss of market share or render our technology obsolete.

The market for network operations software is characterized by evolving industry and governmental standards, rapid technological change, and frequent new product introductions and enhancements. Accordingly, our success will depend in large part upon our ability to adhere to and adapt our products to evolving communications protocols and standards. Therefore, we will need to develop and introduce new products that meet changing customer requirements and emerging industry and governmental standards on a timely and cost-effective basis. We have encountered in the past, and may encounter in the future, delays in completing the development and introduction of new software products. The different products that we have developed for different markets may be costly for us to maintain and improve, especially if the product lines remain separate. Any delays or failure in developing or introducing new products that meet consumer or network operator requirements, technological requirements, or industry or governmental standards could result in a loss of customers and render our products and services obsolete or non-competitive.

We have been named in securities class-action litigation involving the underwriters to our public offerings, which may result in substantial costs and occupy management attention and resources.

Beginning on May 16, 2001, a number of class-action lawsuits seeking monetary damages were filed in the United States District Court for the Southern District of New York against several of the firms that underwrote our initial public offering, naming Liberate and certain of our officers and directors as co-defendants. The suits, which have since been consolidated with hundreds of similar suits filed against underwriters and issuers, allege that the underwriters received excessive and improper commissions that were not disclosed in our prospectus and that the underwriters artificially increased the price of our stock. The plaintiffs subsequently added allegations regarding our secondary offering, and named additional officers and directors as co-defendants. While we deny allegations of wrongdoing, we have agreed to enter into a settlement of these claims and expect our insurers to cover amounts in excess of our deductible. A suit making similar allegations based on the same facts has also been filed in California state court. We deny any wrongdoing, and we are seeking to have the claims settled or indemnified on favorable terms. Failure to resolve this litigation on favorable terms could result in substantial costs or otherwise harm our business.

Our limited ability to protect our intellectual property and proprietary rights may harm our competitiveness.

Our ability to compete and continue to provide technological innovation depends substantially upon internally developed technology. We rely primarily on a combination of patents, trademark laws, copyright laws, trade secrets, confidentiality procedures, and contractual provisions to protect our proprietary technology. While we have a number of patent applications pending, patents may not be issued from these or any future applications. In addition, our existing and future patents may not survive a legal challenge to their validity or provide significant protection for us.

The steps we have taken to protect our proprietary rights may not be adequate to prevent misappropriation of our proprietary information. Further, we may not be able to detect unauthorized use of, or take appropriate steps to enforce, our intellectual property rights. Our competitors may also independently develop similar technology. In addition, the laws of many countries do not protect our proprietary rights to as great an extent as do the laws of the United States. If we fail to protect our intellectual property, our competitors could offer products that incorporate our most technologically advanced features, reducing demand for our products and services. Significant portions of our software contain open source-code, which may be subject to claims of ownership by third parties and may require us to pay royalties or otherwise harm our business.

A small group of stockholders owns a majority of our outstanding shares and can exercise significant control over Liberate.

As of June 30, 2003, five stockholders beneficially owned a total of approximately 56% of our outstanding common stock. As a result, these stockholders will be able to exercise control over all matters requiring stockholder approval, including the election of directors and approval of significant corporate transactions. The concentration of ownership may have the effect of delaying or preventing a change in control of Liberate.

We may incur net losses or increased net losses if we are required to amortize or impair deferred costs related to the issuance of warrants.

In fiscal 1999, we entered into agreements to issue warrants to several network operators to purchase up to approximately 4.6 million shares of our stock. Those warrants can be earned and exercised if the network operators satisfy specific milestones within specific time frames. Pursuant to the requirements of Emerging Issues Task Force ("EITF") No. 96-18, "Accounting for Equity Instruments That Are Issued to Other Than Employees for Acquiring, or in Conjunction with Selling, Goods or Services," we will revalue the warrants if appropriate. The fair market value of the warrants is estimated using the Black-Scholes pricing model. Additionally, the value of the warrants is subject to classification as an offset to revenues up to the amount of cumulative revenues recognized or to be recognized, in accordance with EITF 01-09, "Accounting for Consideration Given by a Vendor to a Customer or Reseller of the Vendor's Products." See Financial Statements, Notes 2 and 11.

We have in the past accelerated and made other modifications to these warrants to motivate network operators to deploy our software and we may do so again. If the remaining warrants are earned, accelerated, modified, or impaired, we may be required to record additional significant reductions to revenues. We have in the past and may in the future elect to repurchase warrants. As a result of these developments, we could incur net losses or increased net losses for a given period.

We may incur net losses or increased net losses if we are required to record additional significant charges related to excess facilities that we are unable to sublease.

We have existing commitments to lease office space at our headquarters in San Carlos, California significantly in excess of our needs for the foreseeable future. The commercial real estate market in the San Francisco Bay Area has developed such a large excess inventory of office space that we now believe we will be unable to sublease a substantial portion of our excess office space for some time to come. We recorded excess facilities charges in the first and fourth quarters of fiscal 2002 as well as in the first three quarters of fiscal 2003. If current market conditions for the commercial real estate market worsen, or we conclude that we are not likely to use additional space, we may be required to record additional charges in future periods. See Financial Statements, Note 6.

We may incur increased expenses related to grants of options or other equity awards to our employees.

Current proposed legislation in Congress and proposals before the International Accounting Standards Board and the Financial Accounting Standards Board ("FASB"), if adopted, may require us to record the value of stock options granted to all or certain of our employees as an expense. If we begin recording these amounts as an expense, either voluntarily or in response to proposed legislation or standards or increasingly compensate our employees in other ways, such as with restricted stock, our net loss would increase.

We may have to cease or delay product shipments if we are unable to obtain key technology from third parties.

We rely on technology licensed from third parties, including applications that are integrated with internally developed software and used in our products. Most notably, we license certain technologies from BitStream, Macromedia, RealNetworks, RSA, BEA, and Sun Microsystems. These third-party technology licenses may not continue to be available to us on commercially reasonable terms or at all, and we may not be able to obtain licenses for other existing or future technologies that we desire to integrate into our products. If we cannot maintain existing third-party technology licenses or enter into licenses for other existing or future technologies needed for our products, we may be required to cease or delay product shipments while we seek to develop or license alternative technologies. Any delay in our ability to ship products could have a material adverse effect on our company.

New or changed government regulation could significantly reduce demand for our products and services.

We are subject not only to regulations applicable to businesses generally, but also to laws and regulations directly applicable to the internet, cable television networks, and other telecommunications content and services. State, federal, and foreign governments may adopt laws and regulations that adversely affect us or our markets in any of the following areas: user privacy, copyrights, consumer protection, taxation of e-commerce, the distribution and modification of programming and content, transmission of advanced television services, the collection and exchange of personally identifiable information, and the characteristics and quality of online products and services.

In particular, the market for cable television is extensively regulated by a large number of national, state, and local government agencies. New or altered laws or regulations regarding cable television that change its competitive landscape, limit its market, or affect its pricing could seriously harm our business prospects.

We expect our operations to continue to produce negative cash flows in the near term; consequently, if we require additional capital and cannot raise it, we may not be able to fund our continued operations.

Since our inception, cash used in our operations has substantially exceeded cash received from our operations and this trend may continue. We believe that our existing cash balances will be sufficient to meet our working capital and capital expenditure needs for at least the next twelve months. At some point in the future, we may need to raise additional funds and we cannot be certain that we will be able to obtain additional financing on favorable terms, or at all. If we need additional capital and cannot raise it on acceptable terms, we may not be able to develop our products and services, acquire complementary technologies or businesses, open new offices, hire and retain employees, or respond to competitive pressures or new business requirements. Our inability to obtain additional financing on favorable terms, or at all, could have a material adverse effect on our company.

Provisions of our corporate documents and Delaware law could deter takeovers and prevent stockholders from receiving a premium for their shares.

Certain provisions of our certificate of incorporation and bylaws may discourage, delay, or prevent a change in control of our company that a stockholder may consider favorable. These include provisions that:

- Authorize the issuance of "blank check" preferred stock to increase the number of outstanding shares and thwart a takeover attempt;
- Require super-majority voting to make certain amendments to our certificate of incorporation and bylaws;
- Limit who may call special meetings of stockholders;
- Prohibit stockholder action by written consent, which means that all stockholder actions must be taken at a meeting of the stockholders; and,
- Establish advance notice requirements for nominations of candidates for election to the board of directors or for proposing matters that can be acted upon by stockholders at stockholder meetings.

In addition, Section 203 of the Delaware General Corporation Law and provisions in our stock incentive plans may discourage, delay, or prevent a change in control of our company.

In May 2003, our board of directors adopted a stockholder rights plan, which is designed to give the board flexibility in responding to unsolicited acquisition proposals.

Item 2. Properties

As of June 30, 2003, we leased office space in various locations throughout the United States, Canada, and Europe. Our headquarters is located in San Carlos, California. We have development offices in Ontario, Canada, and a sales office in England.

We leased approximately 181,000 square feet of office space for our headquarters and development offices in San Carlos, California. As of June 30, 2003, approximately 52,000 square feet of our headquarter space was under various sublease agreements ranging from 36- to 38-month terms at an average rate that is less than our cost. Approximately 65,000 square feet of our headquarters office space is available for sublease to third parties. We have engaged a commercial real estate broker to market the remaining space and are exploring other lease options. Additionally, we are reviewing other ways to reduce our cash outflows related to facility leases.

Item 3. Legal Proceedings

Underwriting Litigation. Beginning on May 16, 2001, a number of class-action lawsuits seeking monetary damages were filed in the United States District Court for the Southern District of New York against several of the firms that underwrote our initial public offering, naming Liberate and certain of our officers and directors as co-defendants. The suits, which have since been consolidated with hundreds of similar suits filed against underwriters and issuers, allege that the underwriters received excessive and improper commissions that were not disclosed in our prospectus and that the underwriters artificially increased the price of our stock. The plaintiffs subsequently added allegations regarding our secondary offering, and named additional officers and directors as co-defendants. While we deny allegations of wrongdoing, we have agreed to enter into a global settlement of these claims, and expect our insurers to cover amounts in excess of our deductible. A suit making similar allegations based on the same facts has also been filed in California state court.

OpenTV Patent Litigation. On February 7, 2002, OpenTV filed a lawsuit against Liberate in the United States District Court for the Northern District of California, alleging that Liberate is infringing two of OpenTV's patents and seeking monetary damages and injunctive relief. We have retained O'Melveny & Myers as our legal counsel. We have filed an answer denying OpenTV's allegations. Our counter-claim alleges that OpenTV infringes one of our patents for information retrieval systems. We are seeking to have OpenTV's patents invalidated, requesting a finding that our technology does not infringe OpenTV's patents, and seeking monetary damages and injunctive relief against OpenTV. The court has held a claim construction hearing, and trial is currently scheduled for 2004. Because litigation is by its nature uncertain, we are unable to predict whether we may face any material exposure for damages or the need to alter our software arising from this case.

Restatement Class-Action Litigation. Beginning on October 17, 2002, five securities class action lawsuits were filed in the United States District Court for the Northern District of California against us and certain officers and directors (collectively, the "Class Action Defendants"), which were subsequently consolidated into a single action (the "Class Action"). The law firm of Schiffrin & Barroway has been named to represent the lead plaintiff. The Class Action is based on our announcements in October and November 2002 that we would restate our financial results for fiscal 2002 and that we were investigating other periods. The Class Action generally alleges, among other things, that members of the purported class were damaged when they acquired our securities because, as a result of accounting irregularities, our previously issued financial statements were materially false and misleading, and caused the prices of our securities to be inflated artificially. The Class Action further alleges that, as a result of this conduct, the Class Action Defendants violated Section 10(b) and 20(a) of the Securities Exchange Act of 1934, and SEC Rule 10b-5, promulgated thereunder. The Class Action seeks unspecified monetary damages and other relief from all Class Action Defendants.

Restatement Derivative Litigation. In addition, on or about October 29, 2002, a shareholder derivative action was filed in the California Superior Court for the County of San Mateo, naming us as a nominal party and naming certain of our officers and directors as defendants (collectively, the "Derivative Defendants"). A second shareholder derivative action was filed on or about November 6, 2002. On February 26, 2003, these actions were consolidated into a single action (the "Derivative Action"). The law firm of Robbins Umeda & Fink was named as lead counsel. The Derivative Action is based on substantially the same facts and circumstances as the Class Action and generally alleges that the Derivative Defendants failed to adequately oversee our financial reporting, and thus are liable for breach of their fiduciary duties, abuse of control, gross mismanagement, and waste of corporate assets. The Derivative Action also alleges that certain current or former officers and directors are liable for unjust enrichment. The Derivative Action seeks unspecified monetary damages and other relief.

SEC Investigation. When we announced that we would restate our financial statements, we contacted the SEC and provided them with additional information regarding our findings. In February 2003, we learned that the SEC had initiated a formal, non-public investigation into the events and circumstances that led to the restatement of our financial statements. We have been cooperating with the SEC and will continue to do so.

We have retained Skadden, Arps, Slate, Meagher & Flom as our legal counsel in the SEC investigation, Class Action, and Derivative Action. The cost of participating and defending against these actions is substantial and will require the continuing diversion of management's attention and corporate resources.

We cannot predict or determine the outcome or resolution of the Class Action, the Derivative Action, or the SEC investigation, or estimate the amounts of, or potential range of, loss with respect to these proceedings. In addition, the timing of the final resolution of these proceedings is uncertain. The possible resolutions of these proceedings could include judgments against us or settlements that could require substantial payments by us, which could have a material adverse impact on our financial position, results of operations, and cash flows.

On August 29 2003, Liberate purchased a $100 million supplemental loss mitigation insurance policy from a AAA/A++ rated insurance carrier to cover damages that may arise from pending securities and derivative litigation related to Liberate's restatement. This policy is in addition to Liberate's existing policies that provide up to $15 million of coverage. Liberate paid a $17.9 million premium for the loss mitigation policy, with a rebate of up to $4.4 million if an eventual settlement or judgment is less than specified amounts. Liberate has certain deductibles under its insurance arrangements for which it is solely responsible.

Litigation-Related Indemnification Obligations. We have agreed to indemnify our directors and officers to the fullest extent permitted by Delaware law. As a consequence, we are advancing expenses (including reasonable attorneys' fees) incurred by directors and officers in connection with the Class Action, the Derivative Action, and the SEC investigation. Additionally, we may ultimately be obligated to pay indemnifiable judgments, penalties, fines, and amounts paid in settlement in connection with these proceedings.

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

None.

PART II.

Item 5. Market for Registrant's Common Equity and Related Stockholder Matters

Price Range of Common Stock

Our common stock has been quoted on the Pink Sheets system under the symbol "LBRT" since January 17, 2003. From July 28, 1999 to January 16, 2003, our common stock was traded on the Nasdaq National Market. The following table sets forth, for the periods indicated, the high and low closing sale prices per share of our common stock as reported on the Nasdaq National Market:

Fiscal 2001	High	Low
First Quarter	$ 34.13	$ 16.38
Second Quarter	$ 32.94	$ 10.63
Third Quarter	$ 20.56	$ 9.00
Fourth Quarter	$ 10.80	$ 7.09

Fiscal 2002	High	Low
First Quarter	$ 15.35	$ 7.75
Second Quarter	$ 13.95	$ 7.12
Third Quarter	$ 12.27	$ 6.47
Fourth Quarter	$ 7.60	$ 4.05

As of June 30, 2003, the quoted closing price of our common stock on the Pink Sheets system was $2.98 per share, and there were 328 holders of record of our common stock. This does not include the number of persons whose stock is held in "street name" accounts through brokers.

Recent Sales of Unregistered Securities

During our fiscal year ended May 31, 2002, we did not issue or sell unregistered securities.

Dividend Policy

We have not paid any cash dividends and we currently have no plan to pay any cash dividends.

Use of Proceeds

On July 27, 1999, the SEC declared effective our Registration Statement on Form S-1 (File No. 333-78781) for our initial public offering. We have used all of the net proceeds of our initial public offering for general corporate purposes, such as funding our operations and working capital needs.

Item 6. Selected Financial Data, As Restated

Please read the following selected consolidated financial data in conjunction with Item 7, "Management's Discussion and Analysis of Financial Condition and Results of Operations;" Item 8, "Financial Statements and Supplementary Data;" and the other financial data included elsewhere in this report. We have derived the Consolidated Statements of Operations data for the years ended May 31, 2000, 2001, and 2002 (as restated), and the Consolidated Balance Sheet data as of May 31, 2001 and 2002 (as restated), from audited consolidated financial statements included in Item 8. We have derived the Consolidated Statements of Operations data for the years ended May 31, 1998 and 1999, and the Consolidated Balance Sheet data as of May 31, 1998, 1999, and 2000 from audited consolidated financial statements not included in this report. These historical results do not necessarily indicate the results to be expected in any future period. See Item 1, "Business Restatement of

Liberate's Financial Statements for the Fiscal Year Ended May 31, 2002," and Financial Statements, Note 3.

Consolidated Statements of Operations Data

	Years ended May 31,				
	1998	1999	2000	2001	2002 (As restated)
	(In thousands, except per share data)				
Revenues:					
License and royalty(1)	$ 4,162	$ 5,281	$ 2,970	$ 14,694	$ 32,251
Service(1)	6,131	12,304	18,850	25,138	38,212
Total revenues	10,293	17,585	21,820	39,832	70,463
Cost of revenues:					
License and royalty	3,779	2,279	2,006	1,836	2,091
Service(1)	2,251	8,519	22,804	30,525	40,414
Total cost of revenues	6,030	10,798	24,810	32,361	42,505

	Years ended May 31,				
Gross margin	4,263	6,787	(2,990)	7,471	27,958
Operating expenses:					
Research and development	19,981	18,171	32,271	51,243	44,580
Sales and marketing	14,407	11,730	18,740	24,176	26,137
General and administrative	2,453	3,975	7,837	11,437	12,484
Amortization of goodwill and intangible assets	4,563	6,084	22,081	216,127	220,742
Warrant-related asset impairment					44,840
Amortization of warrants(1)		18	3,513	10,122	12,047
Excess facilities charges and related asset impairment					9,904
Restructuring costs	1,175				3,075
Amortization of deferred stock-based compensation		507	2,053	1,884	1,669
Write-off of acquired in-process research and development	58,100		1,936	22,425	
Total operating expenses	100,679	40,485	88,431	337,414	375,478
Loss from operations	(96,416)	(33,698)	(91,421)	(329,943)	(347,520)
Interest income	115	80	11,634	30,191	15,968
Other expense, net	(105)	(21)	(847)	(6,171)	(2,798)
Loss before income tax provision (benefit)	(96,406)	(33,639)	(80,634)	(305,923)	(334,350)
Income tax provision (benefit)	(2,015)	(586)	137	515	737
Net loss	$ (94,391)	$ (33,053)	$ (80,771)	$ (306,438)	$ (335,087)
Basic and diluted net loss per share	$ (890.48)	$ (56.60)	$ (1.14)	$ (2.99)	$ (3.16)
Shares used in computing basic and diluted net loss per share	106	584	70,988	102,464	106,144

(1) We have reclassified certain amounts in accordance with EITF 01-09 and 01-14. See Financial Statements, Note 2.

22

Consolidated Balance Sheet Data

	As of May 31,				
	1998	**1999**	**2000**	**2001**	**2002 (As restated)**

	As of May 31, (In thousands)				
Cash and cash equivalents	$ 12,138	$ 33,657	$ 132,962	$ 126,989	$ 111,396
Working capital (deficit)	(18,275)	5,446	232,579	221,275	190,551
Total assets	32,311	70,185	746,187	1,026,475	680,941
Deferred revenues	25,367	40,790	69,132	54,216	25,471
Total long-term liabilities	4,115	4,315	1,929	1,734	7,721
Accumulated deficit	(116,659)	(149,712)	(230,483)	(536,921)	(872,008)
Total stockholders' equity (deficit)	(6,136)	12,226	658,167	949,682	626,019

The following table represents the respective balances as a percentage of total revenues:

	Years ended May 31,				
	1998	**1999**	**2000**	**2001**	**2002 (As restated)**
Revenues:					
License and royalty(1)	40%	30%	14%	37%	46%
Service(1)	60	70	86	63	54
Total revenues	100	100	100	100	100
Cost of revenues:					
License and royalty	37	13	9	5	3
Service(1)	22	48	105	76	57
Total cost of revenues	59	61	114	81	60
Gross margin	41	39	(14)	19	40
Operating expenses:					
Research and development	194	103	148	129	63
Sales and marketing	140	66	86	61	37
General and administrative	24	23	36	29	18
Amortization of goodwill and intangible assets	44	35	101	543	313
Warrant-related asset impairment					64
Amortization of warrants(1)			16	25	17
Excess facilities charges and related asset impairment					14
Restructuring costs	11				5
Amortization of deferred stock-based compensation		3	9	5	2
Write-off acquired in-process research and development	565		9	56	
Total operating expenses	978	230	405	848	533
Loss from operations	(937)	(191)	(419)	(829)	(493)
Interest income	1		53	76	23
Other expense, net	(1)		(4)	(15)	(4)
Loss before income tax provision (benefit)	(937)	(191)	(370)	(768)	(474)
Income tax provision (benefit)	(20)	(3)		1	1

	Years ended May 31,				
Net loss	(917)%	(188)%	(370)%	(769)%	(475)%

(1)
These percentages are based on amounts reclassified in accordance with EITF 01-09 and 01-14. See Financial Statements, Note 2.

Item 7. Management's Discussion and Analysis of Financial Condition and Results of Operations, as Restated

We have restated our consolidated financial statements as of, and for the fiscal year ended May 31, 2002 to reflect adjustments made as a result of the investigation discussed in detail in Item 1, "Business Restatement of Liberate's Financial Statements for the Fiscal Year Ended May 31, 2002 and Revision of Liberate's Financial Results for the Quarter Ended August 31, 2002." See Financial Statements, Note 3 for summary financial statement data that reconciles those items that were affected by the restatement of our financial statements for fiscal 2002 to those same items as they were presented in our original report on Form 10-K filed on August 8, 2002.

Overview

We are a leading provider of digital infrastructure software and services for cable networks. Our software supports a wide variety of services, including interactive and enhanced TV, on-demand video, service management, and provisioning of voice and high-speed data communications.

We operate in an industry sector that has been significantly affected by the recent economic downturn, and we believe that our future results of operations will continue to be subject to quarterly variations based upon a wide variety of factors as set forth in Item 1, "Business Risk Factors."

In view of the lapse of time since the original filing of our Annual Report on Form 10-K for our 2002 fiscal year, and our concurrent filing of quarterly reports on Form 10-Q for the first, second, and third quarters of our 2003 fiscal year, and Annual Report on Form 10-K for our 2003 fiscal year we are not providing trend information for the following financial information. Please note that in fiscal 2003 our revenues have declined significantly, our operating expenses have declined to some degree due to several reductions in force, and our general and administrative expenses have increased, largely due to the expenses incurred in connection with our restatement and related investigations, litigation, and proceedings. For additional information regarding results of operations for periods after May 31, 2002, including material trends and uncertainties affecting our future business, see Part 1, Item 1, "Financial Statements" and Item 2, "Management's Discussion and Analysis of Financial Condition and Results of Operations" of our reports on Form 10-Q for the first, second, and third quarters and our Annual Report on Form 10-K for our 2003 fiscal year, which are being filed concurrently with this report.

See Item 1, "Business Restatement of Liberate's Financial Statements for the Fiscal Year Ended May 31, 2002," and Financial Statements, Note 3, for a discussion of the circumstances surrounding the restatement of our consolidated financial statements for fiscal 2002 and the effects of that restatement.

Critical Accounting Policies

The preparation of financial statements and related disclosures in conformity with generally accepted accounting principles requires management to make judgments, assumptions, and estimates that affect the amounts reported in the consolidated financial statements and accompanying notes. Note 2 of the Financial Statements describes the significant accounting policies used in the preparation of these financial statements. Our critical accounting policies require management to make judgments and estimates in its projections of future events, which could differ from actual events. We describe these critical accounting policies in more detail below.

Revenue Recognition

License and Royalty Revenues. For fiscal 2000, 2001, and 2002, license and royalty revenues consisted principally of fees earned from the licensing of our software, as well as royalty fees earned upon the shipment or activation of products that incorporate our software. We recognize revenue in accordance with Staff Accounting Bulletin No. 101, "Revenue Recognition in Financial Statements;"

American Institute of Certified Public Accountants Statement of Position ("SOP") No. 97-2, "Software Revenue Recognition;" and SOP No. 98-9, "Modification of SOP 97-2, Software Revenue Recognition, With Respect to Certain Transactions." We recognize revenues from software license fees when the licensed product is delivered, collection is probable, the fee for each element of the transaction is fixed or determinable, there is persuasive evidence of an arrangement, and there is vendor-specific objective evidence supporting allocation of the total fee to all undelivered elements of the arrangement. We may defer revenue where the license arrangement calls for the future delivery of products or services and we do not have vendor- specific objective evidence to allocate a portion of the total fee to the undelivered element. In such cases, revenue is recognized when the undelivered elements are delivered or vendor-specific objective evidence of the undelivered elements becomes available. However, if such undelivered elements consist of services that are essential to the functionality of the software, we recognize license and service revenues using contract accounting, pursuant to SOP No. 81-1, "Accounting for Performance of Construction-Type and Certain Production-Type Contracts." If license arrangements include the rights to unspecified future products, revenue is recognized over the contractual or estimated economic term of the arrangement. We typically recognize royalty revenues when a network operator reports that it has shipped or activated products or its rights to deploy such products expire.

We offset license and royalty revenues by certain expenses as a result of the application of EITF 01-09, "Accounting for Consideration Given by a Vendor to a Customer or Reseller of the Vendor's Products." EITF 01-09 generally requires that consideration, including warrants, issued to a customer should be classified in a vendor's financial statements not as an expense, but as an offset to revenues up to the amount of cumulative revenues recognized or likely to be recognized from that customer.

We adopted EITF 01-09 on December 1, 2001, and for comparative purposes, we have reclassified our financial statement presentations for prior periods. Adopting EITF 01-09 did not affect our financial position, results of operations, basic and diluted net loss per share, or cash flows. The reclassification did affect the presentation of certain revenue and expense items contained within our financial statements, as set forth in Financial Statements, Note 2.

Service Revenues. For fiscal 2000, 2001, and 2002, service revenues consisted of consulting, maintenance, and other services. We generally recognize consulting and other service revenues, including non-recurring engineering and training, as services are performed. Where consulting services are performed under a fixed-price arrangement, we recognize revenues on a percentage-of-completion basis. We estimate the percentage of completion using hours incurred to date compared with total hours to complete the project. We recognize no more than 90% of the total contract amount until the project is complete. If we do not have a sufficient basis to measure progress towards completion, we recognize the revenue at completion of the project. When total cost estimates exceed revenues, we accrue for the estimated losses immediately, based upon an average fully-burdened daily rate for the consulting organization. The complexity of the estimation process and issues related to the assumptions, risks, and uncertainties inherent in the application of the percentage-of-completion method of accounting affects the amounts of revenue and related expenses reported in our consolidated financial statements. Maintenance services include both updates and technical support. Maintenance revenues are recognized ratably over the term of the maintenance agreement, and generally range between 15% and 25% of the cumulative license fees and activation royalties incurred under the contract, depending upon the level of support being provided. License agreements may include a combination of elements, such as consulting, maintenance, and other services. For license agreements that contain multiple elements, we unbundle the revenue for undelivered elements from the total arrangement based on each element's vendor-specific objective evidence of fair value and defer that revenue until delivery of that element occurs. Once the undelivered elements have been unbundled and valued, we recognize the residual arrangement fees (for the delivered elements), which consist of the value of the arrangement

less the vendor-specific objective evidence of fair value of the undelivered elements. Where vendor-specific objective evidence is not determinable for undelivered elements, we defer all revenue until those elements are delivered or until vendor-specific objective evidence of the undelivered elements is determinable.

Service revenues also include reimbursable expenses billed to customers in accordance with EITF No. 01-14, "Income Statement Characterization of Reimbursements Received for 'Out-of-Pocket' Expenses Incurred," which generally requires that a company recognize travel expenses and other reimbursable expenses billed to customers as revenue. With the adoption of EITF 01-14, we recognize reimbursable expenses as service revenues when there is an agreement to bill the customer for the expenses, the expenses have been incurred and billed, and collection is probable.

We adopted EITF 01-14 on December 1, 2001, and for comparative purposes, we have reclassified our financial statement presentations for prior periods. Adopting EITF 01-14 did not affect our financial position, results of operations, basic and diluted net loss per share, or cash flows. The reclassification did affect the presentation of certain revenue and expense items contained within our financial statements, as set forth in Financial Statements, Note 2.

Warrants

We value warrants based on their estimated fair value using the Black-Scholes pricing model as of the earlier of the date that the warrants are earned or the date that it became likely that they would be earned. Assumptions used to value the equity instruments are consistent with equity instruments issued to employees. Under the requirements of EITF 96-18, "Accounting for Equity Instruments with Variable Terms that are Issued for Consideration Other Than Employee Services under SFAS 123," we continue to revalue warrants if appropriate. We record the value of warrants as a non-current asset on our Consolidated Balance Sheet and generally amortize warrants over the estimated economic life of the arrangements under which the warrants are issued.

Under Statement of Financial Accounting Standards ("SFAS") No. 121, "Accounting for the Impairment of Long-lived Assets and for Long-lived Assets to Be Disposed Of," which was in effect through May 31, 2002, we periodically reviewed warrants for impairment by initiating a review whenever events or changes in circumstances indicated that the carrying amount of the warrants might not be recoverable. Accordingly, under SFAS 121, we recorded a warrant-related asset impairment for fiscal 2002. On June 1, 2002, we began evaluating warrants for impairment in accordance with SFAS No. 144, "Accounting for the Impairment of Long-Lived Assets," which superseded the accounting and reporting provisions of SFAS 121. An assessment of warrants for impairment is subjective by nature, and significant management judgment is required to forecast future revenue streams and projected cash flows. If our estimates or related assumptions change in the future, these changes in conditions could require material write-downs of warrants. See Financial Statements, Notes 2, 10, and 12.

Restructuring Costs

We record restructuring costs in accordance with EITF No. 94-03, "Liability Recognition of Certain Employee Termination Benefits and Other Costs Incurred in a Restructuring," and Staff Accounting Bulletin ("SAB") No. 100, "Restructuring and Impairment Charges." Severance costs include those expenses related to severance pay, related employee benefit obligations, and the acceleration of certain stock option grants in connection with terminated employees. Our executive management approves the scope of any reductions in force. Facilities costs include obligations under non-cancelable leases for facilities we will no longer occupy, as well as the cost associated with unrecoverable leasehold improvements. Other costs related to restructuring include the write-down of intangible assets and amounts expected to be paid in connection with terminated contracts. As of January 1, 2003, we adopted SFAS No. 146, "Accounting for Exit or Disposal Activities," which

addresses the treatment of porting costs associated with exit or disposal activities and nullifies EITF 94-03. See Financial Statements, Notes 2, 9, and 19.

We have recorded, and may record in the future, significant restructuring costs in connection with reductions in force and the consolidation of our research and development activities into our development centers in San Carlos, California, and Ontario, Canada. In some cases, these costs were based on management estimates. See Financial Statements, Notes 9 and 19.

Equity Investments

We have seen significant declines in the value of our equity investments in private companies. Because our cumulative ownership percentage of each company is less than 20%, we recorded these investments on our consolidated balance sheet at cost. We periodically evaluated our equity investments for impairment, initiating a review whenever events or changes in circumstances indicated that the carrying amount of an investment might not be recoverable. Accordingly, we recorded write-downs for fiscal 2001 and 2002 for equity investments that had been permanently impaired.

Effective June 1, 2002, we began evaluating our equity investments for impairment in accordance with SFAS 144. We continue to consider various factors in determining whether we should recognize an impairment charge, including an entity's cash available for operations, performance to budget, general business condition, ability to obtain additional working capital, and business plan. Negative changes in these factors could materially impair our equity investments. Significant management judgment is required to determine whether the value of these equity investments has become impaired. See Financial Statements, Notes 2, 10, and 19.

Goodwill and Intangible Assets

Under SFAS 121, which was in effect through May 31, 2002, we periodically reviewed intangible assets, including goodwill, for impairment, initiating a review whenever events or changes in circumstances indicated that the carrying amount of a long-lived asset might not be recoverable. We measured recoverability of an asset by comparing its carrying amount to the expected future undiscounted cash flows (without interest charges) that it was expected to generate.

On June 1, 2002, we began evaluating intangible assets for impairment in accordance with SFAS 144, which superseded the accounting and reporting provisions of SFAS 121. An assessment of intangible assets is subjective by nature, and significant management judgment is required to forecast future operating results and projected cash flows. If our estimates or related assumptions change in the future, theses changes in conditions could require material write-downs of net intangible assets, including impairment charges for goodwill.

We adopted SFAS 142 "Goodwill and Other Intangibles," on June 1, 2002. In accordance with the provisions of SFAS 142, the value of an assembled workforce which was previously included in intangible assets, is now considered a part of goodwill. Under SFAS 142, goodwill and the value of an assembled workforce are no longer subject to amortization over their estimated useful lives. Prospectively, we will assess the value of goodwill and the value of an assembled workforce at least once a year. Additionally, an acquired intangible asset will be separately recognized if its benefit comes through contractual or other legal rights, or if it can be sold, transferred, licensed, rented, or exchanged, regardless of the acquirer's intent to do so. See Financial Statements, Notes 2 and 19.

Excess Facilities Charges and Related Asset Impairment

Under SFAS 121, which was in effect through May 31, 2002, we periodically evaluated our excess facilities and related long-lived assets for impairment, initiating a review whenever events or changes in circumstances indicated that the carrying amount of a long-lived asset might not be recoverable.

Accordingly, under SFAS 121, we recorded excess facilities charges and related asset impairment expense for fiscal 2002.

Effective June 1, 2002, we began evaluating our facilities and related long-lived assets for impairment in accordance with SFAS 144, which superseded the accounting and reporting provisions of SFAS 121. Significant management judgment is required in order to estimate the magnitude of the excess facilities charges and related asset impairment. These estimates are based on many factors, including current real estate market rates and conditions, anticipated occupancy rates, and forecasted future sublease income. As of January 1, 2003, we adopted SFAS No. 146 which addresses accounting for and reporting costs associated with exit or disposal activities, including excess facilities charges and related asset impairment associated with reductions in force, and nullifies EITF 94-03. See Financial Statements, Notes 2, 6, and 19.

Allowance for Doubtful Accounts

Management periodically evaluates the adequacy of our allowance for doubtful accounts. In order to do this, we evaluate our accounts receivable at the end of each accounting period for amounts that we believe are subject to collection risk. We perform this evaluation by reviewing customer financial statements and available credit information, historical collection experience with each customer, and the age of each outstanding receivable. Significant management judgment is required in determining the adequacy of the allowance for doubtful accounts. Changes in market or customer conditions could affect this evaluation. See Financial Statements, Notes 2 and 3.

Litigation

Management's estimate of liability related to pending litigation is based on claims for which we can estimate the amount and range of loss with a reasonable degree of confidence. We are currently involved in various claims and legal proceedings. Periodically, we review the status of each significant matter and assess our potential financial exposure. If the potential loss from any claim or legal proceeding is considered probable and the amount can be reasonably estimated, we specifically accrue a liability for the estimated loss. Significant judgment is required in both the determination of probability and the determination as to whether an exposure is reasonably estimable. Because of uncertainties related to these matters, accruals are based only on the best information available at the time the accrual is recorded. As additional information becomes available, we reassess the potential liability related to our pending claims and litigation and may revise our estimates. Such revisions in the estimates of the potential liabilities could have a material impact on our financial position or results of operations. See Financial Statements, Notes 2, 10, and 19.

Accounting for Income Taxes

We account for income taxes in accordance with SFAS No. 109, "Accounting for Income Taxes." Under SFAS 109, deferred tax liabilities and assets are determined based on the differences between the financial statements and tax bases of assets and liabilities, using enacted tax rates in effect for the period in which the differences are expected to be reversed. We are required to estimate our income tax liability in each of the jurisdictions in which we operate. This process requires us to estimate our actual current tax exposures and assess the temporary differences resulting from different treatment of items for tax and accounting purposes. These differences result in deferred tax assets and liabilities. We regularly assess whether we will likely be able to use these tax assets and if we determine that we are not likely to be able to use them, we will record a valuation allowance that offsets their full value. We concluded that a full valuation allowance was required for fiscal 2000, 2001, and 2002. See Financial Statements, Notes 2 and 19.

Accounting for Stock-based Compensation

We account for outstanding stock options under Accounting Principles Board ("APB") Opinion No. 25, "Accounting for Stock Issued to Employees," using intrinsic values as allowed by SFAS No. 123, "Accounting for Stock-Based Compensation." Under APB 25, when the exercise price of a stock option equals the market price of the underlying stock on the date of grant, no compensation expense is recognized. Accordingly, we typically do not recognize compensation expense (except for the deferred stock-based compensation recorded in connection with our initial public offering or for amendments to outstanding options) for options granted to employees. See Financial Statements, Notes 2, 12, and 13.

Results of Operations

Revenues

For fiscal 2000, 2001, and 2002, we generated license and royalty revenues by licensing our client and server products, applications, and tools, primarily to network operators that provide television services, and, in a small number of cases, to set-top box manufacturers. We generated service revenues from consulting, maintenance, and other services provided in connection with those licenses. As discussed above in "Effects of Recent Accounting Pronouncements," the adoption of EITF 01-09 and 01-14 has affected our presentation of all revenue components for the past and present periods reported in this Form 10-K/A. See Financial Statements, Note 2.

A portion of our revenues from fiscal 2000 through 2002 and of our deferred revenue balances during those periods arose from pre-payments we received in fiscal 1999 and 2000 from a limited number of North American network operators. By the end of fiscal 2002, we had recognized a total of $23.7 million in revenue (excluding the impact of warrant-related revenue offsets) from the pre-payments of these large North American network operators. In some cases, we recognized revenue upon termination of a customer's right to credit these fees for services or software deployment.

Total revenues were as follows (in thousands):

	Years ended May 31,		
	2000	2001	2002
			(As restated)
Total revenues	$ 21,820	$ 39,832	$ 70,463
Increase, year over year		$ 18,012	$ 30,631
Percentage increase, year over year		83%	77%

Domestic and international revenues as a percentage of total revenues were as follows:

Years ended May 31,		
2000	2001	2002
		(As restated)

	Years ended May 31,		
International revenues	39%	67%	67%
Domestic (U.S.-based) revenues	61%	33%	33%
Total revenues	100%	100%	100%

License and Royalty. License and royalty revenues were as follows (in thousands):

	Years ended May 31,		
	2000	2001	2002
			(As restated)
License and royalty revenues	$ 2,970	$ 14,694	$ 32,251
Percentage of total revenues	14%	37%	46%
Increase, year over year		$ 11,724	$ 17,557
Percentage increase, year over year		395%	119%

License and royalty revenues increased from fiscal 2000 to fiscal 2001, primarily due to increased deployments to our customers' subscribers, partially offset by the effects of EITF 01-09. See Financial Statements, Note 2. Warrant-related amortization offset to revenues was $7.3 million for fiscal 2000 and $13.1 million for fiscal 2001.

License and royalty revenues increased from fiscal 2001 to fiscal 2002, primarily due to the expiration and recognition of unused prepaid fees of approximately $11.6 million in fiscal 2002. This increase was partially offset by a decrease in royalty revenues of $2.9 million as a result of a slowdown in digital unit deployments from some of our customers. Our European customers also incurred lower per unit royalty rates as they achieved volume discount pricing levels. In addition, license and royalty revenues increased in fiscal 2002 due to the effects of EITF 01-09 which caused the warrant-related amortization offset to decrease significantly. This offset decreased from $13.1 million for fiscal 2001 to $5.0 million for fiscal 2002 which resulted in an increase in license and royalty revenue of $8.1 million. The warrant offset in fiscal 2002 included a charge of $1.1 million related to warrant repurchases. See Financial Statements Note 2.

Service. Service revenues were as follows (in thousands):

	Years ended May 31,		
	2000	2001	2002
			(As restated)
Service revenues	$ 18,850	$ 25,138	$ 38,212
Percentage of total revenues	86%	63%	54%
Increase, year over year		$ 6,288	$ 13,074
Percentage increase, year over year		33%	52%

Service revenues increased from fiscal 2000 to fiscal 2001, and from fiscal 2001 to fiscal 2002, primarily due to the continued growth in our customer base, which resulted in an increase in the amount of integration, implementation, and support services that we provided. Additionally, in fiscal 2002, maintenance revenues from certain of our customers increased because of higher deployment levels. These customers pay maintenance fees based on cumulative license fees and activation royalties incurred. The amendment of certain service contracts with customers, which allowed us to recognize revenues for services that we had previously performed in advance of finalizing the contract also contributed to the growth for fiscal 2002.

Service revenues decreased as a percentage of total revenues from fiscal 2000 to fiscal 2001 as well as from fiscal 2001 to fiscal 2002, reflecting higher license and royalty revenues.

Cost of Revenues

Total cost of revenues was as follows (in thousands):

	Years ended May 31,		
	2000	2001	2002
			(As restated)
Cost of revenues	$ 24,810	$ 32,361	$ 42,505
Percentage of total revenues	114%	81%	60%
Increase, year over year		$ 7,551	$ 10,144
Percentage increase, year over year		30%	31%

License and Royalty. Cost of license and royalty revenues consists primarily of costs incurred for licenses and support of third-party technologies that are incorporated in our products. Cost of license and royalty revenues was as follows (in thousands):

	Years ended May 31,		
	2000	2001	2002
			(As restated)
Cost of license and royalty revenues	$ 2,006	$ 1,836	$ 2,091
Percentage of license and royalty revenues	68%	12%	6%
Increase (decrease), year over year		$ (170)	$ 255
Percentage increase (decrease), year over year		(8)%	14%

Cost of license and royalty revenues did not change materially from fiscal 2000 to fiscal 2001, or from fiscal 2001 to fiscal 2002. Cost of license and royalty revenues decreased as a percentage of license and royalty revenues from fiscal 2000 to fiscal 2001 and from fiscal 2001 to fiscal 2002 primarily due to the increase in license and royalty revenues.

Service. Cost of service revenues consists primarily of salary and other related costs for employees and external contractors. Cost of service revenues was as follows (in thousands):

	Years ended May 31,		
	2000	2001	2002 (As restated)
Cost of service revenues	$ 22,804	$ 30,525	$ 40,414
Percentage of service revenues	121%	121%	106%
Increase, year over year		$ 7,721	$ 9,889
Percentage increase, year over year		34%	32%

Cost of service revenues increased in absolute dollars from fiscal 2000 to fiscal 2001 as the number of both permanent employees and external contractors grew primarily through direct hiring. Service headcount grew from 53 employees at the beginning fiscal 2000 to 116 employees at the end of fiscal 2001. This increase was net of a marked decline in fiscal 2001 of development personnel working on customer projects.

Cost of service revenues increased in absolute dollars from fiscal 2001 to fiscal 2002 primarily because higher sales and customer deployments of our software drove more integration and consulting services for our customers. Cost of service revenues decreased as percentage of service revenues from fiscal 2001 to fiscal 2002. This decrease in 2002 was primarily due to the increase in maintenance revenues from some of our European customers as a result of these customers reaching higher deployment levels which decreases the cost in relation to the revenue. Additionally, this decrease was partially due to the amendment of certain services contracts with customers, which allowed us to recognize $1.9 million of service revenues in fiscal 2002 for work performed primarily in 2001. Also contributing to this decrease is the expiration and recognition of unused prepaid service fees of $1.8 million in fiscal 2002 partially offset by $522,000 of unused prepaid service fees in fiscal 2001.

Operating Expenses

Research and Development. Research and development expenses consist primarily of salary, employee-related expenses, and costs for external contractors, as well as costs related to outsourced development projects necessary to support product development. Research and development expenses reported were as follows (in thousands):

	Years ended May 31,		
	2000	2001	2002 (As restated)
Research and development	$ 32,271	$ 51,243	$ 44,580
Percentage of total revenues	148%	129%	63%
Increase (decrease), year over year		$ 18,972	$ (6,663)
Percentage increase (decrease), year over year		59%	(13)%

Research and development expenses increased in absolute dollars from fiscal 2000 to fiscal 2001 primarily due to increased staffing and employee-related expenses. Research and development headcount grew from 119 employees at the beginning of fiscal 2000 to 270 employees at the end of fiscal 2001. Much of this growth was a result of the SourceSuite and MoreCom acquisitions.

Research and development expenses decreased from fiscal 2001 to fiscal 2002 due to decreases in spending for external contractors of $4.5 million and employee-related expenses, including salaries, benefits, and travel of $2.8 million. These decreases were partially offset by increased depreciation expense of $837,000. In addition, fiscal 2001 reflected the recognition of $906,000 of offsets to research and development expenses that were a result of our professional services agreement with Source Media in fiscal 2001 that allowed us to transfer certain costs from research and development to professional services cost of revenues. In February 2002, we restructured operations to close our research and development offices in Horsham, Pennsylvania and Murray City, Utah. As a result of this restructuring, as well as normal attrition, our research and development headcount decreased from 270 employees in fiscal 2001 to 231 employees in fiscal 2002. See Financial Statements, Notes 9 and 19.

Sales and Marketing. Sales and marketing expenses consist primarily of salaries and other employee-related expenses for sales and marketing personnel, sales commissions, travel, public

relations, marketing materials, tradeshows, and facilities for regional offices. Sales and marketing expenses were as follows (in thousands):

	Years ended May 31,		
	2000	2001	2002 (As restated)
Sales and marketing	$ 18,740	$ 24,176	$ 26,137
Percentage of total revenues	86%	61%	37%
Increase, year over year		$ 5,436	$ 1,961
Percentage increase, year over year		29%	8%

Sales and marketing expenses increased in absolute dollars from fiscal 2000 to fiscal 2001 due to increased business levels that resulted in increased staffing and employee-related expenses, as well as increased spending for trade shows, public relations, marketing research, and international expansion. Sales and marketing headcount grew from 44 employees at the beginning of fiscal 2000 to 69 employees at the end of fiscal 2001.

Sales and marketing expenses increased in absolute dollars from fiscal 2001 to fiscal 2002 because of a $1.3 million increase in employee bonuses paid in fiscal 2002. Additionally as sales and marketing headcount grew from 69 employees in fiscal 2001 to 79 employees in fiscal 2002 to meet increased business levels, employee-related expenses grew an additional $268,000. Also contributing to the higher expenses for fiscal 2002 were increased depreciation of $478,000 and increased spending for external contractors of $375,000. These increases were partially offset by a decrease in marketing communications expense of $543,000 and computer, voice, and data expenses of $266,000.

General and Administrative. General and administrative expenses consist primarily of salaries and other employee-related expenses for corporate development, finance, human resources, and legal employees; outside legal and other professional fees; and non-income-based taxes. General and administrative expenses were as follows (in thousands):

	Years ended May 31,		
	2000	2001	2002 (As restated)
General and administrative	$ 7,837	$ 11,437	$ 12,484
Percentage of total revenues	36%	29%	18%
Increase, year over year		$ 3,600	$ 1,047

	Years ended May 31,	
Percentage increase, year over year	46%	9%

General and administrative expenses increased in absolute dollars from fiscal 2000 to fiscal 2001, primarily due to increased business levels that resulted in increased employee-related expenses and the establishment of the infrastructure necessary to support our expansion. General and administrative headcount grew from 24 employees at the beginning of fiscal 2000 to 40 employees at the end of fiscal 2001.

General and administrative expenses increased in absolute dollars from fiscal 2001 to fiscal 2002, primarily due to $982,000 million of increased employee-related expenses, as headcount grew from 40 employees in fiscal 2001 to 46 employees in fiscal 2002 to accommodate increased business levels. In addition, during fiscal 2002, we recorded non-income based taxes related to our Horsham, Pennsylvania operations of $334,000. These increases were partially offset by decreases in professional fees of $864,000 for fiscal 2002.

Amortization of Goodwill and Intangible Assets. Goodwill and intangible assets represent the purchase price of companies that we have acquired in excess of identified tangible assets and are amortized over three years. See Financial Statements, Notes 4 and 19. From our inception through May 31, 2002, we have recorded goodwill and intangible assets related to three acquisitions:

In August 1997, we acquired Navio and recorded $18.3 million of goodwill that became fully amortized in Q1 FY01.

In March 2000, we acquired the Virtual Modem assets of SourceSuite and recorded $185.5 million of goodwill and $6.5 million of intangible assets.

In June 2000, we acquired MoreCom and recorded $468.0 million of goodwill and $2.9 million of intangible assets.

Amortization of goodwill and intangible assets was as follows (in thousands):

	Years ended May 31,		
	2000	2001	2002 (As restated)
Goodwill amortization expense	$ 21,535	$ 213,052	$ 217,718
Intangible assets amortization expense	546	3,075	3,024
Amortization of goodwill and intangible assets	$ 22,081	$ 216,127	$ 220,742
Percentage of total revenues	101%	543%	313%
Increase, year over year		$ 194,046	$ 4,615
Percentage increase, year over year		879%	2%

Amortization of goodwill and intangible assets increased from fiscal 2000 to fiscal 2001 due to amortization expense related to the acquisitions of SourceSuite in late fiscal 2000 and MoreCom in fiscal 2001. Amortization of goodwill and intangible assets increased slightly from fiscal 2001 to fiscal 2002 as we recorded a full year of amortization expense for MoreCom compared to only eleven months of amortization expense for the prior year. We adopted SFAS 142 on June 1, 2002. In accordance with the provisions of SFAS 142, the value of an assembled workforce which was previously included in intangible assets, is now considered a part of goodwill. Additionally, goodwill and the value of an assembled work force is no longer subject to amortization over their estimated useful lives, therefore eliminating amortization expense of $202.6 million for fiscal 2003. See Financial Statements, Notes 2 and 19.

Warrant-Related Asset Impairment. In fiscal 2002, we recorded warrant-related asset impairment expense of $44.8 million under the provisions of SFAS 121. This impairment charge reduced the carrying value of certain warrant-related assets to a level equal to the associated expected future revenues. Based on strong economic factors and management's judgment, we were not required to record warrant-related asset impairment expense for fiscal 2000 or fiscal 2001. Beginning June 1, 2002, we evaluated warrants for impairment in accordance with SFAS 144. See "Critical Accounting Policies" above and Financial Statements, Notes 2 and 19.

Amortization of Warrants. We amortize warrants that have been valued over their estimated useful life, generally five years. Warrant amortization expense includes that portion of periodic expense for

those warrants that is not offset to revenues. See Financial Statements, Notes 12 and 19. Warrant amortization expense was as follows (in thousands):

	Years ended May 31,		
	2000	2001	2002 (As restated)
Amortization of warrants	$ 3,513	$ 10,122	$ 12,047
Percentage of total revenues	16%	25%	17%
Increase, year over year		$ 6,609	$ 1,925
Percentage increase, year over year		188%	19%

Warrant amortization expense increased from fiscal 2000 to fiscal 2001 as certain network operators earned additional warrants to purchase shares of our common stock in late fiscal 2000. These warrants were valued and began to amortize in May 2000. Those warrants carried a full year of amortization expense for fiscal 2001 compared to less than one-half of a year of amortization expense for fiscal 2000. The increase in amortization expense for fiscal 2001 was partially offset by an increase in the amount of warrant amortization expense that was classified as offsets to revenues through the adoption of EITF 01-09. See Financial Statements, Note 2. Amortization expenses classified as offsets to revenues increased from $7.3 million for fiscal 2000 to $13.1 million for fiscal 2001.

Warrant amortization expense increased from fiscal 2001 to fiscal 2002 because we reclassified less amortization expense as an offset to revenues ($13.1 million in fiscal 2001 versus $3.8 million in fiscal 2002.) See Financial Statements, Note 2. This increase was partially offset by a reduction in the actual amount of periodic amortization expense due to the impairment of warrant-related assets in fiscal 2002.

In fiscal 2001, we offset more warrant amortization to revenues related to network operators who had made prepayments that we had recorded as deferred revenue. In some cases, those offsets decreased in fiscal 2002 as all available amounts of deferred prepayments had been absorbed against offsets for prior years. This increase in warrant amortization expense was partially offset by a decrease in the periodic amount of warrant amortization charged to operating expenses as a result of the impairment of warrant-related assets discussed above. The impairment, valued at $44.8 million, reduced warrant amortization by $7.3 million for fiscal 2002. See Financial Statements, Notes 12 and 19.

Excess Facilities Charges and Related Asset Impairment. We have existing commitments to lease office space at our headquarters in San Carlos, California in excess of our needs for the foreseeable future and do not anticipate that we will be able to sublease a substantial portion of our excess office space in the near future. We record excess facilities charges and related asset impairment when we believe that the future cash flows will not cover the carrying amounts of those assets. For fiscal 2002, we recorded excess facilities charges and related asset impairment of $9.9 million. Of that amount, $9.3 million related to a change in estimated future income from excess facilities and represented the remaining lease commitment on the excess facilities, net of expected sublease income. Additionally, approximately $600,000 of that amount related to the impairment of certain long-lived assets, including leasehold improvements, that we estimated would not generate future cash flows sufficient to cover their carrying amounts. We did not record excess facilities charges and related asset impairment for fiscal 2000 or fiscal 2001. See

Financial Statements, Note 19.

Restructuring Costs. Restructuring costs include severance costs, facilities costs, and other costs. Severance costs include those expenses related to severance pay and related employee benefit obligations, including the acceleration of certain stock option grants in connection with terminated employees. Facilities costs include obligations under non-cancelable leases for facilities that we will no longer occupy, as well as the cost associated with unrecoverable leasehold improvements. Other costs

related to restructuring include the write-down of intangible assets, disposal of fixed assets, and amounts paid in connection with terminated contracts. See Financial Statements, Notes 9 and 19.

We recorded $3.1 million of restructuring costs for fiscal 2002, which consisted of $2.5 million of restructuring costs and $616,000 of expenses related to the impairment of fixed assets. We did not record restructuring costs for fiscal 2000 or fiscal 2001. See Financial Statements, Notes 9 and 19. Restructuring costs for fiscal 2002 consisted of the following components (in thousands):

Salaries and employee-related expenses	$ 978
Disposal of fixed assets	616
Write-down of intangible assets	500
Lease commitments	438
Acceleration of certain stock option grants	281
Other items	262
Restructuring costs	$ 3,075

As a result of our restructuring plans, we expect to realize annualized cost reductions of approximately $8 million in employee-related expenses.

Amortization of Deferred Stock-based Compensation. Deferred stock-based compensation represents the difference between the estimated fair value of our common stock for accounting purposes and the option exercise price of such options at the grant date, which were granted prior to our initial public offering. We amortize stock-based compensation for stock options granted to employees and others on a straight-line basis over the vesting period of such options. Amortization of deferred stock-based compensation expense was as follows (in thousands):

	Years ended May 31,		
	2000	**2001**	**2002 (As restated)**
Amortization of deferred stock-based compensation	$ 2,053	$ 1,884	$ 1,669

The decrease in amortization for deferred stock-based compensation for each of the fiscal years was attributable to employee terminations and, to a lesser extent, to the completion of vesting of certain employee options.

Write-off of Acquired In-Process Research and Development. The write-off of acquired in-process research and development expense consists of the value of research projects and products that were in process on the date of certain acquisitions that, we believe, had not reached technological feasibility and had no alternative future use. In fiscal 2000, we recorded $1.9 million of acquired in-process research and development expense related to our acquisition of SourceSuite. For fiscal 2001, we recorded $22.4 million of acquired in-process research and development expense related to our acquisition of MoreCom. The value of the in-process research and development was determined by using the income approach, which measures the present value and anticipated future benefit of the intangible asset. See Financial Statements, Notes 4 and 19. We did not record acquired in-process research and development expense for fiscal 2002.

Interest Income

Interest income consists of interest earned on our cash and cash equivalents and short-term and long-term investments, and is netted against interest expense related to capital leases. Interest income was as follows (in thousands):

	Years ended May 31,		
	2000	2001	2002 (As restated)
Interest income	$ 11,634	$ 30,191	$ 15,968

Interest income increased from fiscal 2000 to fiscal 2001, primarily due to interest income on proceeds from our initial public offering of common stock in July 1999, our secondary offering in February 2000, and purchase of our common stock by Cisco in July 2000. See Financial Statements, Note 12. Interest income decreased from fiscal 2001 to fiscal 2002, primarily due to lower cash balances, declining market interest rates, and the reinvestment of some of our longer-term investments previously invested at higher yields.

Other Expense, Net

Other expense, net consists of write-downs of equity investments that have been permanently impaired, losses on disposals of fixed assets, foreign currency exchange gains and losses, and other non-operating income and expenses. The components of other expense, net were as follows (in thousands):

	Years ended May 31,		
	2000	2001	2002 (As restated)
Other (income) expense	$ 61	$ (914)	$ (54)
Loss on equity investments		5,300	1,400
Loss on fixed assets	604	630	1,144
Exchange loss	182	1,155	308
Other expense, net	$ 847	$ 6,171	$ 2,798
Percentage of total revenues	4%	15%	4%
Increase (decrease), year over year		$ 5,324	$ (3,373)
Percentage increase (decrease), year over year		629%	(55)%

Other expense, net increased from fiscal 2000 to fiscal 2001, primarily due to a $5.3 million write-down for certain private equity security investments whose value was permanently impaired and an increase of $1.0 million for foreign exchange losses recorded for intercompany transactions. These increases in expenses were partially offset by an increase in other income of $1.0 million primarily related to sublease income and a gain on an investment that was sold prior to its maturity date.

Other expense, net decreased from fiscal 2001 to fiscal 2002, primarily due to a decrease of $3.9 million of impairment expense recorded for certain private equity security investments whose value was permanently impaired. Additionally, foreign exchange losses resulting from the translation of non-US dollar assets and liabilities to US dollars decreased by $847,000 from fiscal 2001 to fiscal 2002. These decreases were partially offset by a decrease in other income of $861,000 in fiscal 2002 primarily related to decreases in sublease income. Loss on disposal of fixed assets increased by $514,000 from fiscal 2001 to fiscal 2002 due to the disposal of capital software not used and the disposal of excess fixed assets in our Utah and Pennsylvania operations. See Financial Statements, Notes 2 and 19.

Income Tax Provision

Income tax provision consists of foreign withholding tax expense and foreign and state income taxes. Income tax provision was as follows (in thousands):

	Years ended May 31,		
	2000	2001	2002 (As restated)
Income tax provision	$ 137	$ 515	$ 737

Income tax provision increased from fiscal 2000 to fiscal 2001 and from fiscal 2001 to fiscal 2002, primarily due to increased foreign revenues and operating activities, resulting in increased foreign withholding and income taxes. In addition, state income tax expense increased for fiscal 2002. See Financial Statements, Note 14.

As of May 31, 2002, we had federal and state net operating loss carry-forwards of $365.8 million and $101.8 million, respectively, and tax credits totaling $10.9 million. The federal and state net operating loss carry-forwards expire at various dates between 2005 and 2022. The tax credits expire at various dates between 2011 and 2022. The Tax Reform Act of 1986 imposes substantial restrictions on the use of net operating losses and tax credits in the event of an ownership change of a corporation. Our ability to use net operating loss carry-forwards on an annual basis may be limited as a result of a prior ownership change in connection with private sales of equity securities, and accordingly, we have provided a full valuation allowance on the deferred tax asset because of this uncertainty. We account for deferred taxes under SFAS 109, which requires the evaluation of a number of factors concerning the realizability of our deferred tax assets, including factors such as our history of operating losses, expected future losses, and the nature of our deferred tax assets. In the future, we expect income tax expense to be comprised of state taxes, foreign withholding taxes, and international taxes.

Liquidity and Capital Resources

Cash Flows

Our principal source of liquidity as of May 31, 2002 was cash and cash equivalents of $111.4 million and short-term investments of $106.2 million. Additionally, as of May 31, 2002, our long-term investments were valued at $183.4 million and included $10.4 million of equity investments. See Financial Statements, Note 5. Through the end of fiscal 2002, we raised cash to fund our operations through a series of public and private offerings of our securities.

Cash Flows From Operating Activities. Net cash used in operating activities increased from $16.8 million in fiscal 2000 to $62.0 million in fiscal 2001. Net cash used in operating activities decreased from $62.0 million in fiscal 2001 to $60.9 million in fiscal 2002.

For fiscal 2000, net cash used in operating activities of $16.8 million was comprised of a net loss of $80.8 million, $39.8 million of non-cash adjustments to reconcile net loss to net cash used in operating activities, $3.7 million of prepaid expenses and other current assets, and $2.5 million of accrued liabilities. These amounts were offset by $28.3 million of deferred revenues and $2.1 million of accrued payroll and related expenses.

For fiscal 2001, net cash used in operating activities of $62.0 million was comprised of a net loss of $306.4 million, $275.1 million of non-cash adjustments to reconcile net loss to net cash used in operating activities, $14.9 million of deferred revenues, $8.1 million of accounts receivable, $4.7 million of accrued liabilities, and $3.2 million of prepaid expenses.

For fiscal 2002, net cash used in operating activities of $60.9 million was comprised of a net loss of $335.1 million, $295.7 million of non-cash adjustments to reconcile net loss to net cash used in

operating activities, $28.7 million of deferred revenues, and $2.0 million of accounts receivable. These amounts were offset by $6.4 million of other long-term liabilities, $2.0 million of prepaid expenses and other current assets, and $942,000 of accounts payable.

As of May 31, 2002 deferred revenues were $25.5 million, reflecting a decrease of $28.7 million from the prior year. The majority of this decrease resulted from customers using prepaid products and services and the amendment of certain contract terms with several of our large North American network operators. During fiscal 2002, we amended these contract terms in order to encourage more timely deployments and predictable revenue streams. These amended agreements provided that network operators could use their prepaid royalty, license, or service balances in future quarters. If they failed to do so, portions of the unused balances expire at the end of each quarter and are recognized as revenue. In connection with these amendments, some of the network operators also provided marketing commitments and we provided temporary deployment discounts, acceleration of vesting of pre-existing warrants, or both. Deferred revenues also decreased due to our recognition of $11.6 million in deferred revenues related to legacy products, in some cases as a result of the termination of license agreements.

Cash Flows From Investing Activities. Net cash used in investing activities decreased from $297.6 million in fiscal 2000 to $51.6 million in fiscal 2001. For fiscal 2002, net cash provided by investing activities was $36.7 million.

For fiscal 2000, net cash used in investing activities of $297.6 million included $379.2 million used to purchase investments, $10.9 million used to purchase property and equipment for our new facilities, $8.8 million held as restricted cash, and $4.0 million used to purchase equity investments, offset by $105.3 million of proceeds received from the maturation of investments.

For fiscal 2001, net cash used in investing activities of $51.6 million included $488.6 million used to purchase investments, $11.5 million used to purchase property and equipment, and $11.2 million used to purchase equity investments, offset by $458.3 million of proceeds received from the maturation of investments, and $1.5 million of cash resulting from the MoreCom acquisition.

For fiscal 2002, net cash provided by investing activities of $36.7 million included $415.9 million of proceeds received from the maturation of investments, offset by $371.2 million used to purchase investments, $5.7 million used to purchase property and equipment, and $1.9 million used to purchase equity investments.

Cash Flows From Financing Activities. Net cash provided by financing activities decreased from $413.6 million for fiscal 2000 to $107.1 million for fiscal 2001. For fiscal 2002, net cash provided by financing activities decreased to $8.7 million.

For fiscal 2000, net cash provided by financing activities of $413.6 million included $297.2 million of proceeds from our secondary public offering in February 2000, $97.8 million of proceeds from our initial public offering in July 1999, $12.5 million of proceeds from our private placement in July 1999, and $6.4 million of proceeds from the issuance of common stock to employees, directors, and external consultants through our stock option plans, and to employees in connection with purchases through our employee stock purchase plan.

For fiscal 2001, net cash provided by financing activities of $107.1 million included $100.0 million of proceeds from our private placement in July 2000, and $7.8 million attributable to the issuance of common stock to employees, directors, and external consultants through our stock option plans, and to employees in connection with purchases through our employee stock purchase plan.

For fiscal 2002, net cash provided by financing activities of $8.7 million included $9.4 million of proceeds from the issuance of common stock to employees, directors, and external consultants through

our stock option plans, and to employees in connection with purchases through our employee stock purchase plan. This amount was offset by payments made for capital lease obligations.

Contractual Obligations

A summary of our contractual obligations as of May 31, 2002, some of which are discussed in more detail below, are as follows (in thousands):

		Payments due by period			
	Total	**Less than one year**	**1-3 years**	**4-5 years**	**After 5 years**
Operating leases(1)	$ 48,040	$ 6,769	$ 12,275	$ 14,472	$ 14,524
Equity investment obligations(2)	1,600	850	750		

		Payments due by period			
Employment agreements(3)	1,577	1,577			
Unconditional purchase obligations(4)	1,125	1,125			
Capital lease obligations	306	296	10		
Total contractual obligations	$ 52,648	$ 10,617	$ 13,035	$ 14,472	$ 14,524

(1) Does not include common area maintenance expenses for our headquarters of approximately $15.6 million through the lease term.

(2) Equity investment obligations are discussed below.

(3) These obligations consist of payments due under employment agreements. See "Subsequent Developments" below and Financial Statements, Note 19.

(4) The unconditional purchase obligations consist of a commitment due to MediaOne discussed in the section below titled "Unconditional Purchase Obligations," in Subsequent Developments, and in Financial Statements, Note 19.

Equity Investment Obligations

In June 2001, we committed to invest up to $2.0 million in China Broadband (H.K.) for reinvestment in a Chinese joint venture that makes interactive television software. In fiscal 2002, we made an investment of $750,000. See Financial Statements, Notes 10 and 19.

In May 2002, we entered into a debenture purchase agreement committing us to loan ExtendMedia up to $350,000 in phases through the end of calendar 2002. The loan is secured by certain assets of ExtendMedia, carries an annual interest rate of 6.5%, and is due on May 31, 2005. See Financial Statements, Notes 2, 10, and 19.

Employment Agreements. In January 2001, we entered into employee retention agreements with Coleman Sisson, Donald Fitzpatrick, and David Limp. Each retention agreement was to provide $818,000 in periodic payments to each officer who achieved two years of continuous service through January 2003. During fiscal 2002, we paid $292,000 to each of these executive officers under these agreements. See "Subsequent Developments" below and Financial Statements, Notes 10, 16, and 19.

Unconditional Purchase Obligations. In March 2002, we agreed to repurchase for $1.1 million 400,000 unvested warrants that we had previously issued to MediaOne of Colorado and MediaOne of Michigan (each a wholly owned subsidiary of AT&T Broadband.) That purchase occurred in fiscal 2003. See "Subsequent Developments" below and Financial Statements, Notes 10, 12, and 19.

Cash Requirements. Since our incorporation, we raised a significant amount of capital by selling small equity positions to a number of investors, by issuing shares of our stock to the public, by

conducting a secondary public offering, and through private offerings of our stock. In addition to funding normal operating expenses, we anticipate that we will use this cash to finance our operations, pay outstanding commitments, and acquire products and technologies to complement our existing business. We believe that the net proceeds from our various offerings, together with cash and cash equivalents generated from operations, if any, will be sufficient to meet our working capital requirements for the next twelve months. We expect that net cash used in operations for fiscal 2003 will exceed net cash used in operations of $60.9 million for fiscal 2002.

Litigation

For a discussion of our pending litigation and related matters, see Item 3, "Legal Proceedings" and Financial Statements, Note 10.

Restatement of Liberate's Quarterly Results of Operations (Unaudited)

Based upon the results of the audit committee's investigation, we are restating our unaudited consolidated quarterly balance sheets as of November 30, 2001, February 28, 2002, and May 31, 2002 and the related consolidated statements of operations and statements of cash flows for the quarters then ended. The following summary quarterly financial statement data reconciles those items that were affected by the restatement of our financial statements for these quarters of fiscal 2002 to those same items as they were presented in our original reports on Form 10-Q for the second and third quarters of fiscal 2002 and our original Form 10-K for fiscal 2002. See Item 1, "Business Restatement of Liberate's Financial Statements for the Fiscal Year Ended May 31, 2002," for a discussion of the circumstances surrounding the restatement of our financial statements for fiscal 2002. We are concurrently filing amendments to our quarterly reports on Form 10-Q for the second and third quarters of fiscal 2002 to present the effects of the restatement on those quarters.

The adjustments to certain line items of our unaudited consolidated statement of operations data for the quarter ended November 30, 2001, were as follows (in thousands, except for basic and diluted net loss per share):

	Three months ended November 30, 2001		
	As previously reported	Restatement adjustments	As restated
Revenues:			
License and royalty	$ 9,320	$ (736)	$ 8,584
Service	11,088	(1,497)	9,591
Total revenues	20,408	(2,233)	18,175
Cost of revenues:			
License and royalty	550		550
Service	10,046	68	10,114
Total cost of revenues	10,596	68	10,664
Gross margin	9,812	(2,301)	7,511
Total operating expenses	125,672	138	125,810
Loss from operations	(115,860)	(2,439)	(118,299)
Interest income	4,217		4,217
Other expense, net	(678)	(1)	(679)
Loss before income tax provision	(112,321)	(2,440)	(114,761)
Income tax provision	186		186
Net loss	$ (112,507)	$ (2,440)	$ (114,947)
Basic and diluted net loss per share	$ (1.06)	$ (0.03)	$ (1.09)

The adjustments to certain line items of our unaudited consolidated statement of operations data for the quarter ended February 28, 2002, were as follows (in thousands, except for basic and diluted net loss per share):

	Three months ended February 28, 2002		
	As previously reported	Restatement adjustments	As restated
Revenues:			
License and royalty	$ 10,675	$ 72	$ 10,747
Service	13,008	(1,818)	11,190
Total revenues	23,683	(1,746)	21,937
Cost of revenues:			
License and royalty	657		657
Service	10,355	126	10,481
Total cost of revenues	11,012	126	11,138
Gross margin	12,671	(1,872)	10,799
Total operating expenses	81,099	(333)	80,766
Loss from operations	(68,428)	(1,539)	(69,967)
Interest income	3,453		3,453
Other income (expense), net	(769)	1	(768)
Loss before income tax provision	(65,744)	(1,538)	(67,282)
Income tax provision	303		303
Net loss	$ (66,047)	$ (1,538)	$ (67,585)
Basic and diluted net loss per share	$ (0.62)	$ (0.01)	$ (0.63)

The adjustments to certain line items of our unaudited consolidated statement of operations data for the quarter ended May 31, 2002, were as follows (in thousands, except for basic and diluted net loss per share):

	Three months ended May 31, 2002		
	As previously reported	Restatement adjustments	As restated
Revenues:			
License and royalty	$ 8,976	$ (4,886)	$ 4,090
Service	10,000	(995)	9,005
Total revenues	18,976	(5,881)	13,095
Cost of revenues:			