LIBERATE TECHNOLOGIES
Form 10-Q
September 16, 2003

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UNITED STATES
SECURITIES AND EXCHANGE COMMISSION

WASHINGTON, D.C. 20549

FORM 10-Q

(Mark one)

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

For the quarterly period ended November 30, 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	**94-3245315**
(State or Other Jurisdiction of Incorporation)	(I.R.S. Employer Identification No.)
2 Circle Star Way, San Carlos, California	**94070-6200**
(Address of principal executive office)	(Zip Code)

(650) 701-4000
(Registrant's telephone number, including area code)

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

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

104,006,079 shares of the Registrant's common stock were outstanding as of June 30, 2003.

LIBERATE TECHNOLOGIES
FORM 10-Q
For The Quarterly Period Ended November 30, 2002

TABLE OF CONTENTS

Part I. Financial Information

Item 1. Financial Statements

Concurrent with the filing of this report on Form 10-Q, we are filing a report on Form 10-K/A, which amends our Annual Report on Form 10-K filed on August 8, 2002 with the Securities and Exchange Commission ("SEC") to reflect the restatement of our consolidated financial statements as of, and for the fiscal year ended May 31, 2002.

Concurrently, we are also filing amended reports on Form 10-Q/A reflecting the impact of the restatement as of, and for the quarters ended, November 30, 2001 and February 28, 2002. The condensed consolidated financial statements and related notes for the fiscal quarter and six month period ended November 30, 2002 presented in this report reflect that restatement.

Please consider this report in conjunction with our report on Form 10-K/A for the fiscal year ended May 31, 2002, our reports on Form 10-Q for the quarters ended August 31, 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. For a discussion of the reasons for our restatement, see Condensed Consolidated Financial Statements ("Financial Statements"), Note 3.

LIBERATE TECHNOLOGIES
CONDENSED CONSOLIDATED BALANCE SHEETS
(In thousands)
Unaudited

	May 31, 2002 (As restated)	November 30, 2002
Assets		
Current assets:		
Cash and cash equivalents	$ 111,396	$ 151,568
Short-term investments	106,228	48,810
Accounts receivable, net	12,975	6,730
Receivable from affiliate	174	174
Prepaid expenses and other current assets	6,979	6,835
Total current assets	237,752	214,117
Property and equipment, net	14,500	11,463
Long-term investments	183,409	102,374
Goodwill, net	208,764	34,630
Restricted cash	9,199	9,228
Other assets	27,317	29,660
Total assets	$ 680,941	$ 401,472
Liabilities and Stockholders' Equity		
Current liabilities:		
Accounts payable	$ 2,641	$ 2,226
Accrued liabilities	13,720	17,768
Accrued payroll and related expenses	5,073	3,619
Capital lease obligations, current portion	296	59
Deferred revenues	25,471	20,554
Total current liabilities	47,201	44,226
Capital lease obligations, net of current portion	10	
Long-term excess facilities charges	5,828	17,881
Other long-term liabilities	1,883	2,063
Total liabilities	54,922	64,170
Commitments and contingencies (Notes 8 and 13)		
Stockholders' equity:		
Common stock	1,076	1,040
Contributed and paid-in-capital	1,497,596	1,489,906
Deferred stock-based compensation	(1,163)	(514)
Accumulated other comprehensive income (loss)	518	(198)
Accumulated deficit	(872,008)	(1,152,932)
Total stockholders' equity	626,019	337,302
Total liabilities and stockholders' equity	$ 680,941	$ 401,472

The accompanying notes are an integral part of these condensed consolidated financial statements.

LIBERATE TECHNOLOGIES
CONDENSED CONSOLIDATED STATEMENTS OF OPERATIONS
(In thousands, except per share data)
Unaudited

	Three months ended November 30,		Six months ended November 30,	
	2001 (As restated)	**2002**	**2001 (As restated)**	**2002**
Revenues:				
License and royalty	$ 8,584	$ 2,561	$ 17,414	$ 3,678
Service	9,591	3,838	18,017	12,082
Total revenues	18,175	6,399	35,431	15,760
Cost of revenues:				
License and royalty	550	421	1,028	853
Service	10,114	7,200	19,558	18,549
Total cost of revenues	10,664	7,621	20,586	19,402
Gross margin	7,511	(1,222)	14,845	(3,642)
Operating expenses:				
Research and development	10,951	11,030	23,472	19,776
Sales and marketing	6,346	6,252	12,949	12,129
General and administrative	3,050	5,461	6,441	9,172
Excess facilities charges and related asset impairment		(587)	7,479	16,503
Amortization and impairment of goodwill and intangible assets	55,211	1,298	110,421	2,147
Restructuring costs		22		2,058
Amortization of deferred costs related to warrants	4,782	1,006	9,493	1,947
Amortization of deferred stock-based compensation	630	352	1,064	763
Write-off of acquired in-process research and development				300
Warrant-related asset impairment	44,840		44,840	
Total operating expenses	125,810	24,834	216,159	64,795
Loss from operations	(118,299)	(26,056)	(201,314)	(68,437)
Interest income, net	4,217	2,001	9,567	4,503
Other expense, net	(679)	(7,150)	(792)	(6,896)
Loss before income tax provision	(114,761)	(31,205)	(192,539)	(70,830)
Income tax provision	186	407	405	805
Loss before cumulative effect of a change in accounting principle	(114,947)	(31,612)	$ (192,944)	(71,635)
Cumulative effect of a change in accounting principle				(209,289)
Net loss	$ (114,947)	$ (31,612)	$ (192,944)	$ (280,924)

	Three months ended November 30,		Six months ended November 30,	
Basic and diluted loss per share before cumulative effect of a change in accounting principle	$ (1.09)	$ (0.30)	$ (1.83)	$ (0.68)
Basic and diluted net loss per share	$ (1.09)	$ (0.30)	$ (1.83)	$ (2.68)
Shares used in computing basic and diluted net loss per share	105,805	103,922	105,403	104,992

The accompanying notes are an integral part of these condensed consolidated financial statements.

3

LIBERATE TECHNOLOGIES
CONDENSED CONSOLIDATED STATEMENTS OF CASH FLOWS
(In thousands)
Unaudited

	Six months ended November 30,	
	2001 (As restated)	**2002**
Cash flows from operating activities:		
Net loss	$ (192,944)	$ (280,924)
Adjustments to reconcile net loss to net cash used in operating activities:		
Cumulative effect of a change in accounting principle		209,289
Write-down of equity investments		6,687
Amortization of deferred costs related to warrants	11,441	4,172
Depreciation and amortization	4,387	3,901
Amortization of intangible assets	1,562	2,081
Asset impairment charges	45,343	1,517
Non-cash stock-based compensation expense	1,064	763
Write-off of acquired in-process research and development		300
Provision for (recovery of) doubtful accounts	62	(60)
Loss on disposal of property and equipment	794	16
Amortization of goodwill and assembled workforce	108,859	
Changes in operating assets and liabilities, net of acquisitions:		
Accounts receivable	2,441	7,198
Prepaid expenses and other current assets	2,380	1,484
Notes receivable from officers	(46)	786
Other assets	(46)	(142)
Accounts payable	837	(1,093)
Accrued liabilities	1,386	(1,644)
Accrued payroll and related expenses	1,050	(1,454)
Deferred revenues	(14,052)	(6,423)
Other long-term liabilities	4,715	12,233

	Six months ended November 30,	
Net cash used in operating activities	(20,767)	(41,313)
Cash flows from investing activities:		
Proceeds from maturity of investments	243,680	133,537
Purchases of investments	(212,032)	
Cash used in acquisitions, net of cash received		(38,085)
Purchase of equity investments	(750)	(1,771)
Purchases of property and equipment	(3,207)	(1,659)
Increase in restricted cash	(402)	(29)
Net cash provided by investing activities	27,289	91,993
Cash flows from financing activities:		
Repurchase of common stock		(9,957)
Principal payments on capital lease obligations	(340)	(247)
Proceeds from issuance of common stock	4,804	412
Net cash provided by (used in) financing activities	4,464	(9,792)
Effect of exchange rate changes on cash	30	(716)
Net increase in cash and cash equivalents	11,016	40,172
Cash and cash equivalents, beginning of period	126,989	111,396
Cash and cash equivalents, end of period	$ 138,005	$ 151,568

The accompanying notes are an integral part of these condensed consolidated financial statements.

4

NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS

Unaudited

Note 1. Description of Business

Liberate is 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.

Note 2. Significant Accounting Policies

Basis of Presentation

Our unaudited condensed consolidated financial statements include the accounts of Liberate and our subsidiaries. All intercompany accounts and transactions have been eliminated in consolidation. These interim financial statements are unaudited and reflect all adjustments that we believe are necessary to provide a fair statement of the financial position and the results of operations for the interim periods in accordance with the rules of the SEC. However, these condensed consolidated statements omit certain information and footnote disclosures necessary to conform to generally accepted accounting principles. These statements should be read in conjunction with the audited consolidated financial statements and notes included in our Form 10-K/A for our 2002 fiscal year and our Form 10-K for our 2003 fiscal year, filed concurrently with this report. The results of operations for the interim periods reported below do not necessarily indicate the results expected for the full fiscal year or for any future period.

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 year.

Computation of Basic and Diluted Net Loss Per Share

We compute basic net loss per share using the weighted average number of shares of common stock outstanding during the periods presented. We report net income per share based on fully diluted shares, which includes the weighted average number of shares of common stock, stock options, and warrants outstanding. As we have recorded a net loss for all periods presented, net loss per share on a diluted basis is equivalent to basic net loss per share because converting outstanding stock options and warrants would be anti-dilutive. Accordingly, we did not include 20,587,444 potential shares in the calculations for the periods ended November 30, 2001, or 22,500,595 potential shares in the calculations for the periods ended November 30, 2002.

Stock-Based Compensation

In December 2002, the Financial Accounting Standards Board ("FASB") issued Statement of Financial Accounting Standards ("SFAS") No. 148, "Accounting for Stock-Based Compensation Transition and Disclosure an amendment of FASB Statement No. 123." Under SFAS 148, we are required to disclose the impact on net income and earnings per share assuming the adoption of SFAS 123. This disclosure requirement is effective for both quarterly reports filed on Form 10-Q and annual reports filed on Form 10-K for fiscal years ended after December 31, 2002.

Recent Accounting Pronouncements

In August 2001, the FASB issued SFAS No. 143, "Accounting for Asset Retirement Obligations." SFAS 143 establishes financial accounting and reporting obligations associated with the retirement of tangible long-lived assets and the associated asset retirement costs. SFAS 143 requires that the fair

value of a liability for an asset retirement obligation be recognized in the period in which it is incurred if a reasonable estimate of fair value can be made. The associated asset retirement costs are capitalized as part of the carrying amount of the long-lived asset. The liability is accreted to its present value each period while the cost is depreciated over its useful life. This statement will be effective in fiscal 2004. Although we have not yet assessed the impact of adopting SFAS 143, we do not expect that the adoption will materially affect our financial position, results of operations, or cash flows.

In June 2002, the FASB issued SFAS No. 146, "Accounting for Exit or Disposal Activities." SFAS 146 addresses significant issues regarding the recognition, measurement, and reporting of costs that are associated with exit and disposal activities, including restructuring activities that are currently accounted for under Emerging Issues Task Force ("EITF") No. 94-03, "Liability Recognition for Certain Employee Termination Benefits and Other Costs to Exit an Activity (Including Certain Costs Incurred in a Restructuring)." SFAS 146 also establishes accounting standards for costs related to termination of a contract that is not a capital lease and certain involuntary termination benefits for employees. Under SFAS 146, severance packages for employees in transition are earned and expensed as the exit transition is completed. Our restructurings tend to include transitional employees whose costs were accrued immediately under EITF 94-03. Under SFAS 146, severance packages for employees in transition are earned and expensed as the exit transition is completed. Our restructurings tend to include transitional employees whose costs were accrued immediately under EITF 94-03. SFAS 146 covers exit or disposal activities that are initiated after December 31, 2002. The adoption of SFAS 146 did not materially affect the dollar impact of our restructuring charges on our condensed consolidated financial statements, but did affect the timing of when those restructuring charges were recognized, generally causing them to be recognized in a later quarter.

In November 2002, the EITF reached a consensus on EITF No. 00-21, "Revenue Arrangements with Multiple Deliverables." EITF 00-21 provides guidance on how to account for arrangements that involve the delivery or performance of multiple products, services, and/or rights to use assets. The provisions of EITF 00-21 will apply to revenue arrangements entered into in fiscal periods beginning after June 15, 2003. We are currently evaluating the effect that the adoption of EITF 00-21 will have on our results of operations and financial condition.

In December 2002, the FASB issued SFAS No. 148, "Accounting for Stock-Based Compensation-Transition and Disclosure, an amendment of FASB Statement No. 123." Under SFAS 148, we are required to disclose the impact on net income and earnings per share assuming the adoption of SFAS 123. This disclosure requirement is effective for both quarterly reports filed on Form 10-Q and annual reports filed on Form 10-K for fiscal years ended after December 31, 2002.

In May 2003, the FASB issued SFAS No. 150, "Accounting for Certain Financial Instruments with Characteristics of both Liabilities and Equity." SFAS 150 establishes standards for how an issuer classifies and measures certain financial instruments with characteristics of both liabilities and equity. It requires that an issuer classify a financial instrument that is within its scope as a liability (or an asset in some circumstances). SFAS 150 is effective for financial instruments entered into or modified after May 31, 2003, and otherwise is effective at the beginning of the first interim period beginning after June 15, 2003 for public companies. We believe that the adoption of SFAS 150 will not have a material effect on our financial position, results of operations, or cash flows.

Effects of Recent Accounting Pronouncements

In April 2001, the FASB issued EITF No. 01-03, "Accounting in a Purchase Business Combination for Deferred Revenue of an Acquiree." EITF 01-03 provides guidance regarding the recognition of deferred revenue as a liability with respect to business combinations. In March 2002, the FASB reached consensus that an acquiring entity should recognize a liability related to a revenue arrangement of an acquired entity only if it has assumed a legal obligation to provide goods, services, or other

consideration to a customer. The amount assigned to this liability should be based on its fair value at the date of the acquisition. We adopted the guidelines set forth in EITF 01-03 to record deferred revenues we received in connection with the Sigma Systems Group (Canada) acquisition in August 2002. See Note 4.

In June 2002, we adopted SFAS No. 144, "Accounting for the Impairment or Disposal of Long-Lived Assets," which superseded SFAS No. 121, "Accounting for the Impairment of Long-Lived Assets and for Long-Lived Assets to be Disposed Of." Under SFAS 144, we periodically review long-lived assets for impairment whenever events or changes in circumstances indicate that the carrying amount of these assets may not be recoverable. We measure recoverability of these assets by comparing their carrying amount to the future undiscounted cash flows that they are expected to generate. Impairment reflects the amount by which the carrying value of the assets exceeds their fair market value. The adoption of SFAS 144 did not materially affect our financial position, results of operations, or cash flows.

In April 2002, the FASB issued SFAS No. 145, "Rescission of FASB Statements No. 4, 44, and 64, Amendment of FASB Statement No. 13, and Technical Corrections." SFAS 145 rescinds SFAS No. 4 "Reporting Gains and Losses from Extinguishment of Debt," and an amendment of that Statement, SFAS No. 64, "Extinguishments of Debt Made to Satisfy Sinking-Fund Requirements." SFAS 145 also rescinds SFAS No. 44, "Accounting for Intangible Assets of Motor Carriers." SFAS 145 amends SFAS No. 13, "Accounting for Leases," to eliminate an inconsistency between the required accounting for sale-leaseback transactions and the required accounting for certain lease modifications that have economic effects that are similar to sale-leaseback transactions. SFAS 145 also amends other existing authoritative pronouncements to make various technical corrections, clarify meanings, or describe their applicability under changed conditions. We adopted SFAS 145 for our fiscal year beginning June 1, 2002, and do not expect that the adoption will materially affect our financial position, results of operations, or cash flows.

Cumulative Effect of a Change in Accounting Principle

On June 1, 2002, we adopted SFAS No. 141, "Business Combinations" and SFAS No. 142, "Goodwill and Other Intangible Assets." SFAS 141 requires us to account for all business combinations initiated after June 30, 2001 using the purchase method of accounting. Under SFAS 142, we no longer amortize the remaining balances of goodwill. Rather, we tested goodwill for impairment immediately upon the date of adoption and will continue to test goodwill for impairment at least once a year. Under SFAS 141 and SFAS 142, the value of an assembled workforce is no longer considered an identifiable intangible asset with a definite useful life, and accordingly, we reclassified the net balance of $526,000 to goodwill as of June 1, 2002. See Note 5.

SFAS 142 requires a different valuation methodology than SFAS 121 and is more likely to result in impairment because SFAS 142 uses discounted rather than undiscounted cash flows. Based on the criteria of SFAS 142, we determined that we had one reporting segment at the time we adopted SFAS 142. Our testing and analysis process included obtaining an independent appraisal of the fair value of Liberate based on two valuation approaches. The first valuation approach determined our market capitalization based on our fair value on the date of adoption using our average stock price over a range of days in May and June 2002. This average stock price was increased by a control premium based on premiums paid for control of comparable companies. The second valuation used a discounted cash flows approach.

This analysis resulted in an allocation of fair values to identifiable tangible and intangible assets and an implied valuation of goodwill of zero as of June 1, 2002. Comparing this goodwill fair value to the carrying value resulted in a goodwill impairment of $209.3 million, with no income tax effect, at June 1, 2002. We recorded the impairment as the cumulative effect of a change in accounting principle on our condensed consolidated statement of operations for Q1 FY03. We will record any future impairments as operating expenses.

As required by SFAS 142, a reconciliation of previously reported net loss and net loss per share to the amounts adjusted for the exclusion of goodwill and assembled workforce is as follows (in thousands, except per share data):

	Three months ended November 30,		Six months ended November 30,	
	2001 (As restated)	**2002**	**2001 (As restated)**	**2002**
Net loss, as reported	$ (114,947)	$ (31,612)	$ (192,944)	$ (280,924)
Add back:				
Amortization of goodwill and assembled workforce, net of tax	54,431		108,859	
Cumulative effect of a change in accounting principle				209,289
Loss before cumulative effect of a change in accounting principle, as adjusted	$ (60,516)	$ (31,612)	$ (84,085)	$ (71,635)
Basic and diluted net loss per share, as reported	$ (1.09)	$ (0.30)	$ (1.83)	$ (2.68)
Add back:				
Amortization of goodwill and assembled workforce, net of tax	0.52		1.03	
Cumulative effect of a change in accounting principle				2.00
Loss per share before cumulative effect of a change in accounting principle, as adjusted	$ (0.57)	$ (0.30)	$ (0.80)	$ (0.68)
Shares used in computing per share amounts	105,805	103,922	105,403	104,992

Note 3. Restatement of Financial Statements for the Fiscal Year Ended May 31, 2002 and Revision of Financial Information 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. Our audit committee, which is composed of independent outside directors, retained independent counsel to review our revenue reported during our fiscal year ended May 31, 2002. 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 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.

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.

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. For further details on the restatement, please read our report on Form 10-K/A for the year ended May 31, 2002, filed concurrently with the SEC.

Note 4. Sigma Systems Acquisition

In August 2002, we acquired the outstanding capital stock of Sigma Systems, a privately-held corporation based in Toronto, Canada, for $60.4 million in cash, before deducting $22.3 million of cash received in connection with the acquisition. We also assumed Sigma Systems' unvested employee options with a fair value of $1.9 million, agreed to satisfy certain obligations of Sigma Systems to its employees in the aggregate amount of $3.0 million, and incurred acquisition costs of approximately $1.3 million. The total consideration and acquisition costs were $66.6 million and we accounted for the acquisition as a purchase.

Sigma Systems developed and marketed operational support systems ("OSS") software that lets network operators create, deploy, monitor, and maintain digital subscriber services. Through this acquisition, we sought to expand our product offerings. In September 2002, Sigma Systems changed its legal name to Liberate Technologies (Toronto) Ltd. We have included the results of operations of Sigma Systems in our consolidated financial statements since August 8, 2002.

We have allocated the total purchase price consideration of $66.6 million as follows (in thousands):

Cash	$	22,314
Receivables and other current assets		2,232
Property, plant, and equipment		672
Liabilities assumed		(3,586)
Deferred compensation		184
In-process research and development		300
Intangible assets		9,830
Goodwill		34,630
Total consideration	$	66,576

We immediately wrote off $300,000 of acquired in-process research and development, based on an independent appraisal, that had not reached technological feasibility and had no alternative future use. The value of Sigma Systems' in-process research and development was determined by using the income approach, which measures the present worth and anticipated future benefit of the intangible asset. We included the write-off of acquired in-process research and development in operating expenses on our condensed consolidated statement of operations.

We also used the income approach to determine the value of Sigma Systems' existing products and technology, customer lists and order backlog, and trademarks. Based on these valuations, we recorded $9.8 million of intangible assets that we will amortize on a straight-line basis over an estimated useful

life of three years. Intangible assets consisted of $9.2 million of existing technology and $630,000 of customer lists and order backlog and trademarks. We also recorded $34.6 million of goodwill, which represents the purchase price in excess of the identified net tangible and intangible assets. In accordance with SFAS 142, we will not amortize goodwill, but will review it for impairment at least once a year. Amortization expense for intangible assets is not deductible for tax purposes.

We present below our unaudited pro forma results as if we had merged with Sigma Systems at the beginning of each of the fiscal periods presented. Pro forma net loss before cumulative effect of change in accounting principle excludes the non-recurring charge related to the write-off of $300,000 of acquired in-process research and development and includes amortization expense of $819,000 related to Sigma Systems intangible assets in Q2 FY02 and $1.6 million in the six months ended November 30, 2001. The pro forma net loss before cumulative effect of change in accounting principle also includes the amortization expense for goodwill and assembled workforce of $2.9 million in Q2 FY02 and $5.8 million in the six months ended November 30, 2001. These pro forma results do not necessarily indicate future combined results of operations. Our pro forma results, as if we had merged with Sigma Systems at the beginning of each of the fiscal periods presented, are set forth in the following table (in thousands, except per share data):

	Three months ended November 30,		Six months ended November 30,	
	2001 (As restated)	2002	2001 (As restated)	2002
Pro forma revenues	$ 24,513	$ 6,399	$ 47,403	$ 17,161
Pro forma loss before cumulative effect of a change in accounting principle	$ (117,358)	$ (31,612)	$ (197,619)	$ (76,015)
Pro forma loss per share before cumulative effect of a change in accounting principle	$ (1.11)	$ (0.30)	$ (1.88)	$ (0.72)

Note 5. Goodwill

Under the provisions of SFAS 142, we no longer amortize goodwill, but rather test it for impairment at least once a year. Additionally, SFAS 142 defines assembled workforce intangible assets as part of goodwill. Effective June 1, 2002, with the adoption of SFAS 142, we transferred the remaining net book value of assembled workforce intangible assets of $526,000 to goodwill and tested the resulting balance of goodwill for impairment.

Based on the results of this testing, we determined that $209.3 million of goodwill was impaired. See Note 2. Goodwill activity for the six months ended November 30, 2002 was as follows (in thousands):

	Gross carrying amount of goodwill	Accumulated amortization	Total
Balance at May 31, 2002	$ 671,763	$ (463,000)	$ 208,763
Assembled workforce reclassification	2,708	(2,182)	526
Impairment upon adoption of SFAS 142	(674,471)	465,182	(209,289)
Sigma Systems acquisition	34,630		34,630
Balance at November 30, 2002	$ 34,630	$	$ 34,630

10

Note 6. Intangible Assets

We amortize intangible assets on a straight-line basis over their estimated useful lives, which are normally three years. In June 2002, we determined that the fair value of the Virtual Modem trademarks that we acquired in fiscal 2000 was zero. This permanent impairment resulted in a write-down of the carrying value from $66,000 to zero.

In August 2002, in connection with the acquisition of Sigma Systems, we acquired intangible assets with a value of $9.8 million. See Note 4. Amortization expense for those intangible assets was $819,000 for Q2 FY03 and $1.1 million for the six months ended November 30, 2002.

Identified intangible assets as of May 31, 2002 and November 30, 2002 were as follows (in thousands):

	May 31, 2002 (As restated)		November 30, 2002	
	Gross carrying amount	Accumulated amortization	Gross carrying amount	Accumulated amortization
Existing products and technology	$ 4,701	$ (3,472)	$ 13,922	$ (5,277)
Customer lists and order backlog	1,055	(690)	1,430	(907)
Trademarks	397	(298)	234	(25)
Assembled workforce	2,708	(2,182)		
Total	$ 8,861	$ (6,642)	$ 15,586	$ (6,209)
Net intangible assets		$ 2,219		$ 9,377

Based upon the intangible assets balance as of November 30, 2002 and assuming no future impairment, we expect amortization expense for intangible assets to be as follows (in thousands):

Fiscal years:	
Remainder of 2003	$ 2,257
2004	3,299
2005	3,277
2006	544
	$ 9,377

In May 2003, we impaired certain intangible assets under a review performed under SFAS 142 and 144. Accordingly, our future amortization expense has been reduced by $6.3 million.

Note 7. 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. Excess facilities charges represent the remaining lease commitment on those vacant facilities, net of expected sublease income. Each quarter we evaluate our existing needs, the current and estimated future value of our subleases, and other future commitments to determine whether we should recognize additional excess facilities charges. Additionally, each quarter, we evaluate our leasehold improvements for impairment and if necessary, we reduce the carrying value using estimates of future cash flows to a level equal to the expected future value at that time. These impairment amounts are included in excess facilities charges and related asset impairment on our condensed consolidated statements of operations.

For the periods ended November 30, 2001 and 2002, we recorded excess facilities charges and related asset impairment as follows:

	Three months ended November 30,		Six months ended November 30,	
	2001 (As restated)	2002	2001 (As restated)	2002
Excess facilities charges related to leases	$	$ (1,094)	$ 6,976	$ 15,052
Related asset impairment		507	503	1,451

	Three months ended November 30,		Six months ended November 30,	
Excess facilities charges and related asset impairment	$	$ (587)	$ 7,479	$ 16,503

In Q2 FY03, we recorded a decrease to excess facilities charges and asset impairment of $587,000, related to a change in estimates regarding impairment of our excess facilities. For the six months ended November 30, 2002, we recorded excess facilities charges and asset impairment of $16.5 million to record additional impairment based on a change in estimates of our ability to lease our excess facilities.

Note 8. Commitments and Contingencies

Equity Investments

China Broadband (H.K.). 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 and we believe that we will not make further investments.

ExtendMedia. 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. In Q2 FY03, we loaned $105,000 to ExtendMedia, and as of November 30, 2002, we had made total payments of $350,000 to ExtendMedia under the agreement.

MetaTV. In July 2002, we purchased shares of the Series D Preferred Stock of MetaTV for a total purchase price of $410,000 and received a warrant to purchase 85,984 shares of MetaTV's Series D Preferred Stock.

Two Way TV, Ltd. ("TWTV"). In July 2002, we committed to loan up to £509,000, approximately $811,000, to TWTV in phases through December 2002. The loan is secured by certain assets of TWTV, carries an annual interest rate of 20%, plus a one-time 5% facility fee, and is due on June 30, 2004. At our discretion, we may convert this loan into the common equity of TWTV. Additionally, for every £1 drawn down from us under the loan facility, we earned warrants to purchase shares of TWTV common stock.

In Q2 FY03, TWTV drew down $453,000 under the agreement, and as of November 30, 2002, TWTV had drawn down the full amount from us under this loan facility and issued warrants to us to purchase 254,462,000 shares of TWTV common stock, which we immediately exercised. Upon full conversion of all debt and warrants issued to us in this transaction, our ownership percentage will remain less than 20%, and we do not exert significant influence over TWTV's business and financial decisions.

Sportvision. In August 2002, we entered into an agreement to loan Sportvision $200,000. The loan has a maturity of eighteen months and bears interest at the rate of 5% per annum. No payments of principal or interest will be due until maturity. The debt and interest amount is automatically convertible into equity at the next round of financing. As of November 30, 2002, our investment in Sportvision, including accrued interest, was $206,000. See Note 13.

12

For the three and six months ended November 30, 2002, we wrote down $6.7 million of equity investments, whose value we determined may not be recoverable, reducing our net equity investments to $5.4 million as of November 30, 2002. These existing investments may be subject to additional impairment. See Note 13.

Lease Commitments

In connection with our acquisition of Sigma Systems, we assumed an existing lease to occupy approximately 41,000 square feet of office space in Toronto, Ontario, Canada. Under this lease, which terminates on November 30, 2009, we are obligated to pay approximately $30,000 per month. The monthly lease payment will increase at predetermined dates and rates over the lease term.

Transactions with Executive Officers

Outstanding Executive Loans. In 2001, we extended loans in the principal amount of $500,000 to each of David Limp, Donald Fitzpatrick, and Coleman Sisson, who were then executive officers. Each loan carried an interest rate of 5.9% compounded annually and was due two years from issuance. In July 2002, Mr. Limp repaid the full principal and interest due under his promissory note. In November 2002, Mr. Fitzpatrick repaid $275,000 of the principal amount of his promissory note. As of November 30, 2002, accrued interest receivable for these outstanding promissory notes was $58,000 for Mr. Sisson and $49,000 for Mr. Fitzpatrick. See Note 13.

Fiscal 2001 Executive Retention Agreements. In January 2001, we entered into employee retention agreements with Mr. Sisson, Mr. Fitzpatrick, and Mr. 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. In July 2002, Mr. Limp left Liberate as part of a reduction in force and realignment of management roles, which triggered a payment of the remaining $526,000 under his retention agreement. In the six months ended November 30, 2002, we also paid Mr. Fitzpatrick and Mr. Sisson $219,000 under the retention agreements. See Note 13.

Sales Commission Plan. In July 2002, the compensation committee approved a sales commission plan under which Mr. Fitzpatrick would have been eligible to receive commissions based on achievement of revenue and earnings targets. In Q2 FY03, we paid Mr. Fitzpatrick $31,000 under this plan.

Termination of Executives' Employment. In September 2002, we entered into a consulting agreement with David Limp in which we agreed to pay Mr. Limp not less than $10,000 per month for consulting services. We paid Mr. Limp approximately $123,000 under this consulting agreement, which terminated in March 2003.

Consulting Agreement. In November 2002, we entered into a letter agreement with Philip Vachon, in which we agreed to pay him $56,500 per month for advisory services through February 28, 2003. We subsequently extended that agreement through April 11, 2003, at which time Mr. Vachon became president Liberate International.

Other Commitments

In July 2002, we entered into an agreement with a content provider. Under the agreement, we paid $600,000 for certain license rights to content, $200,000 for future services, and $400,000 for a future equity investment in a venture then being contemplated by the provider. We had previously received $550,000 from another party who proved to be affiliated with the content provider. Accordingly, we are treating the $550,000 payment as an offset to the cost of this transaction, and have reduced the carrying value of our license of the content by that amount. We have the right to choose whether or not to proceed with the investment when we are presented with the terms. If we do not

proceed with the investment, the $400,000 will be refunded to us or applied to extend the term of our license rights, at the provider's option. It does not currently appear that the provider will proceed with the venture or refund the $400,000, resulting in an extension of the license term.

In August 2001, we amended our prior agreements with Motorola. The amendment reduced the total payments due to Motorola for development fees from $10.0 million to $8.9 million (excluding applicable taxes). The amendment also waived any payments that might have been payable by Motorola to us for any shortfall of set-top-box sales below committed volume levels at the end of the three-year period. We made no payments in Q2 FY03 or the six months ended November 30, 2002, and no further payments are required under this agreement.

Legal Matters

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 Northern 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 for 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, 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 in connection with these proceedings.

We have notified our various insurance carriers of the Class Action, the Derivative Action, and the SEC investigation. Our insurance, however, 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.

Note 9. Offerings of Common Stock

Common Stock

We issued 43,935 shares of stock in Q2 FY03 and 182,672 shares of stock during the six months ended November 30, 2002, to employees upon exercise of stock options. During Q2 FY03 and the six

months ended November 30, 2002, we also issued 204,068 shares of stock pursuant to the 1999 Employee Stock Purchase Plan ("ESPP").

Stock Repurchase

In July 2002, we repurchased 3,963,780 shares of our common stock beneficially owned by Cisco for an aggregate purchase price of $10.0 million. The purchase price per share of $2.5117 was our average stock price for the ten consecutive trading days prior to July 18, 2002, less a 2% discount. Following the repurchase, the shares were retired and are now authorized and unissued.

Warrant Agreements

In fiscal 1999, we agreed to issue warrants to purchase up to 4,599,992 shares of our common stock to certain network operators who satisfied specific performance milestones within specific time frames. We estimated the market value of the warrants using the Black-Scholes pricing model as of the earlier of the date the warrants were earned or the date that it became likely that they would be earned. Pursuant to the requirements of EITF 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.

As of November 30, 2002, network operators had earned warrants to purchase 2,396,660 shares. Of these warrants, warrants to purchase 552,774 shares had previously been exercised and warrants to purchase 163,890 shares were retired in connection with those exercises. As of November 30, 2002, there were earned and outstanding warrants to purchase 1,679,996 shares.

As of November 30, 2002, warrants to purchase 270,000 shares had expired before they were earned. Additionally, in August 2002, we paid $1.1 million to MediaOne of Colorado and MediaOne of Michigan, each a wholly owned subsidiary of AT&T Broadband, to buy back unearned warrants to purchase 400,000 shares. If network operators earn warrants to purchase the remaining 1,533,332 shares, we may be required to record additional warrant-related assets and resulting warrant amortization expense or offsets to license and royalty revenues. Warrant activity as of November 30, 2002 was as follows:

	Warrants available	Warrants repurchased	Warrants earned	Warrants Expired	Warrants to be earned
Balance May 31, 2000	4,599,992		(2,336,660)		2,263,332
Fiscal 2001 activity				(50,000)	(50,000)
Balance May 31, 2001	4,599,992		(2,336,660)	(50,000)	2,213,332
Fiscal 2002 activity			(60,000)	(170,000)	(230,000)
Balance May 31, 2002	4,599,992		(2,396,660)	(220,000)	1,983,332
Fiscal 2003 activity		(400,000)		(50,000)	(450,000)
Balance November 30, 2002	4,599,992	(400,000)	(2,396,660)	(270,000)	1,533,332

We record amortization expense for deferred costs related to warrants in accordance with EITF 01-09. Under EITF 01-09, such amortization expense may be classified as an offset to associated

revenues up to the amount of cumulative revenues recognized or to be recognized. Such amortization expense was classified as follows (in thousands):

	Three months ended November 30,		Six months ended November 30,	
	2001 (As restated)	2002	2001 (As restated)	2002
Amortization offset to license and royalty revenues	$ 939	$ 1,079	$ 1,948	$ 2,225
Amortization included in operating expenses	4,782	1,006	9,493	1,947
Total amortization expense	$ 5,721	$ 2,085	$ 11,441	$ 4,172

Deferred Stock-based Compensation

In connection with the grant of certain stock options to employees in fiscal 1999 and 2000 prior to our initial public offering, we recorded gross deferred compensation of $8.7 million, which represents the difference between the estimated fair value of the stock for accounting purposes and the option exercise price of such options at the date of grant. This amount, net of accumulated amortization, is presented as a reduction of stockholders' equity. We expensed $630,000 in Q2 FY02 and $1.1 million for the six months ended November 30, 2001. We expensed $352,000 for Q2 FY03 and $763,000 for the six months ended November 30, 2002. We will expense the remaining balance of $514,000 as of November 30, 2002 over the remainder of fiscal 2003.

We report amortization of deferred stock-based compensation as a separate line item in the accompanying condensed consolidated statements of operations. Had amortization of deferred stock-based compensation been included in the following expense categories, such expense categories would have increased by the following amounts (in thousands):

	Three months ended November 30,		Six months ended November 30,	
	2001 (As restated)	2002	2001 (As restated)	2002
Cost of service revenues	$ 54	$ 65	$ 110	$ 135
Research and development	202	150	413	341
Sales and marketing	143	63	245	159
General and administrative	231	74	296	128
Total deferred stock-based compensation	$ 630	$ 352	$ 1,064	$ 763

Option Grants

For the six months ended November 30, 2002, we issued options to purchase 6,179,000 shares to employees and directors under our 1999 Equity Incentive Plan. During that period, we also assumed options to purchase 1,165,291 shares in connection with our acquisition of Sigma Systems.

Note 10. Restructuring Costs

During Q1 FY03, we initiated and carried out two restructurings of our workforce. During Q3 FY02, we initiated and carried out one restructuring. We recorded restructuring costs as operating expenses in the quarters in which each occurred. We included amounts not yet paid in accrued restructuring costs in current liabilities on our condensed consolidated balance sheets.

Q1 FY03 Restructuring Costs. In July 2002, we initiated a company-wide headcount reduction of 32 employees, of whom 29 were located in the United States and three were located in the United Kingdom. At the end of August 2002, in response to the continued economic slowdown and the acquisition of Sigma Systems, we initiated another company-wide reduction in force, which affected an additional 74 employees, of whom 58 were located in the United States, 10 were located in the United Kingdom, and 6 were located in Canada. As a result of these actions, during Q1 FY03, we recorded restructuring costs of $2.2 million, comprised of salary and employee-related expenses. The following table reflects restructuring costs incurred and payments made during the six months ended November 30, 2002 related to this restructuring (in thousands):

	Severance
Restructuring costs	$ 2,250
Cash payments	(2,193)
Foreign exchange effect	5
Accrued restructuring costs at November 30, 2002	$ 62

We believe that the remaining accrued restructuring costs of $62,000 will be substantially paid out over the next few fiscal quarters.

Q3 FY02 Restructuring Costs. In February 2002, we announced the consolidation of our research and development activities into our development centers located in San Carlos, California and Ontario, Canada. As part of this consolidation, we closed our Horsham, Pennsylvania and Murray City, Utah facilities. The consolidation resulted in a headcount reduction of 67 employees and a total restructuring charge of $3.1 million. In connection with this restructuring and closure of two facilities, we took out of service and relocated certain assets that we deemed excess or unnecessary. In Q1 FY03, management determined that the Q3 FY02 restructuring was substantially completed and $210,000 of the restructuring reserve was reversed and included as a credit to restructuring costs in our Q1 FY03 statement of operations. We believe the remaining $4,000 related to this restructuring will be paid out over the quarter.

The following table reflects restructuring accrual activity during the six months ended November 30, 2002, related to this restructuring (in thousands):

	Severance	Facilities	Other	Total
Accrued restructuring costs at May 31, 2002	$ 65	$ 188	$ 14	$ 267
Cash payments	(17)	(37)	1	(53)
Non-cash reductions	(48)	(151)	(11)	(210)
Accrued restructuring costs at November 30, 2002	$	$	$ 4	$ 4

See Note 13 regarding subsequent reductions in force.

Note 11. Comprehensive Loss

Comprehensive loss consists of net loss on our condensed consolidated statements of operations and foreign currency translation adjustments. The following table reflects our comprehensive loss (in thousands):

	Three months ended November 30,		Six months ended November 30,	
	2001 (As restated)	2002	2001 (As restated)	2002
Net loss	$ (114,947)	$ (31,612)	$ (192,944)	$ (280,924)
Foreign currency translation adjustment	235	61	30	(716)
Comprehensive loss	$ (114,712)	$ (31,551)	$ (192,914)	$ (281,640)

18

Note 12. Segment Information

As of November 30, 2002, we operated solely in one segment providing digital infrastructure software and services for cable networks. We derived revenues for this one segment from licenses, royalties, and services. As of November 30, 2001 and 2002, Mitchell Kertzman, then our chief executive officer and chief operating decision maker, evaluated performance and allocated resources, and our long-term assets were located primarily in the United States.

We classify our revenues by geographic region based on the country in which the sales order originates. Our North American region includes sales attributable to the United States and Canada. Our EMEA region includes sales attributable to Europe, the Middle East, and Africa. Our Asia Pacific region includes sales attributable to all of Asia and Australia. The following table details the revenues of significant countries and regions (in thousands):

	Three months ended November 30,		Six months ended November 30,	
	2001 (As restated)	2002	2001 (As restated)	2002
Canada	577	2,244	1,192	5,092
United States	6,164	1,877	12,160	4,972
United Kingdom	6,084	1,445	14,284	3,669
Rest of EMEA	4,351	612	5,086	1,309
Asia Pacific	999	221	2,709	718
Total revenues	$ 18,175	$ 6,399	$ 35,431	$ 15,760

International revenues consist of sales to customers outside of the United States and domestic revenues consist of sales to customers within the United States. International and domestic revenues as a percentage of our total revenues were as follows:

	Three months ended November 30,		Six months ended November 30,	
	2001 (As restated)	2002	2001 (As restated)	2002
International revenues	66%	71%	66%	68%
Domestic revenues	34%	29%	34%	32%
Total revenues	100%	100%	100%	100%

For each of the periods presented below, the number of customers that accounted for 10% or more of our total revenues were as follows: Q2 FY02, three customers; Q2 FY03, two customers; the six months ended November 30, 2001, two customers; and the six months ended November 30, 2002, four customers. The percentage of sales to significant customers was as follows:

	Three months ended November 30,		Six months ended November 30,	
	2001 (As restated)	2002	2001 (As restated)	2002
Customer A	*	28%	*	18%
Customer B	*	*	*	13%
Customer C	18%	*	20%	11%
Customer D	12%	13%	19%	10%
Customer E	14%	*	*	*

* Less than 10%

Financial instruments that potentially subject us to a concentration of credit risk consist principally of accounts receivable. As of May 31, 2002, two customers accounted for 10% or more of our accounts receivable. As of November 30, 2002, three customers accounted for 10% or more of our accounts receivable. The percentage of receivables to significant customers for the periods reported were as follows:

	May 31, 2002 (As restated)	**November 30, 2002**
Customer A	21%	18%
Customer B	35%	13%
Customer C	*	12%

*

Less than 10%

We perform ongoing credit evaluations of our customers' financial conditions and reserve for credit losses as required.

Note 13. Subsequent Events

Equity Investments

Sportvision. In August 2002, we entered into an agreement to loan Sportvision $200,000. In December 2002, the debt and interest automatically converted into shares of Series B Preferred Stock.

In February and May 2003, we wrote-down $5.4 million of equity investments that had been permanently impaired, reducing the value of our net equity investments to zero.

Suspension of 1999 Employee Stock Purchase Plan

In January 2003, because we were not current in our filing obligations with the SEC, we terminated the offering period of our 1999 Employee Stock Purchase Plan before the purchase of shares scheduled for March 31, 2003 and refunded contributions to employees.

Rights Plan

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. Under the plan, rights were distributed as a dividend at the rate of one right for each share of Liberate common stock held by stockholders of record as of the close of business on May 30, 2003. Each right will initially entitle stockholders to buy a fraction of a share of preferred stock. The rights will generally be exercisable only if a person or group acquires beneficial ownership of at least 15% of our common stock or starts a tender or exchange offer that would give them beneficial ownership of at least 15% of our common stock. The rights plan will expire on May 30, 2013.

Bylaw Amendment

In May 2003, our board of directors amended our bylaws to provide that a majority of stockholders can remove directors for any reason (rather than permitting removal only upon a two-thirds vote and for cause), and to provide that stockholders may not call special meetings of stockholders.

Restructuring Costs

In January 2003, we announced a further reduction in force. We terminated the employment of 228 employees. Under SFAS 146, we initially expected to record a restructuring charge of $5.3 million comprised of salaries and employee-related expenses. In fiscal 2003 we recorded approximately $5.1 million of the estimated $5.3 million charge and expect to incur approximately $4,000 more.

In April 2003, we announced another reduction in force. This action resulted in a headcount reduction of 75 employees worldwide, of whom 32 were on transition plans as of May 31, 2003. As a result of this action, under SFAS 146, we expect to record a restructuring charge of approximately $2.3 million, comprised of salary and employee-related expenses. For the quarter ended May 31, 2003, we recorded approximately $2.1 million of the estimated $2.3 million charge. We expect to record the remainder in subsequent periods.

Lease Amendment

In January 2003, we amended our current lease in London, Ontario, Canada to include an additional 5,000 square feet, bringing the total space under lease at that location to 25,000 square feet. We also extended the term of this lease through December 31, 2007.

Litigation

See Note 8.

Executive Compensation

Outstanding Executive Loans. According to the terms of Mr. Fitzpatrick's promissory note, his outstanding balance of $225,000 and all accrued interest was due 60 days from December 27, 2002, the date of the termination of his employment. As of June 30, 2003, Mr. Fitzpatrick had not repaid the balance of this loan and we have recorded a reserve to cover our potential loss. In January 2003, Coleman Sisson repaid the full principal and interest of $561,000 due under his promissory note.

Fiscal 2001 Executive Retention Agreements. In connection with the events leading to the restatement of our financial statements, we terminated Mr. Fitzpatrick's employment on December 27, 2002, before additional payments were due under his retention agreement. In January 2003, we paid Mr. Sisson the remaining $307,000 due under his January 2001 retention agreement.

Fiscal 2003 Executive Retention Agreements. In March and April 2003, we entered into new employee retention agreements with David Lockwood, Patrick Nguyen, Gregory Wood, Philip Vachon, Coleman Sisson, and Kent Walker. Under the terms of the retention agreements, in the event of a change of control of Liberate that is followed within one year by the officer's actual or constructive termination, the officer will receive a payment equal to twice his total taxable compensation for the prior fiscal year, with a minimum payment of $500,000 and a maximum payment of $750,000. These agreements supersede the previous employee retention agreements that we entered into with Mr. Sisson and Mr. Walker.

Termination of Executives' Employment. In June 2003, Mitchell Kertzman and Coleman Sisson terminated their employment with Liberate. We entered into an agreement with Mr. Sisson under which he will receive $10,000 per month for his services as an independent contractor and may receive additional compensation. We may terminate this agreement at any time. We also agreed to pay the premiums for Mr. Sisson's health coverage for twelve months.

Consulting Agreements. In fiscal 2003, we paid Mr. Limp approximately $123,000 under his consulting agreement, which terminated in March 2003. In February 2003, we extended Mr. Vachon's

letter agreement through April 11, 2003, at which time Mr. Vachon became president Liberate International.

Option Grants. In Q4 FY03, we agreed to amend the terms of outstanding option grants to Mr. Sisson and Mr. Walker so that they would become fully vested upon certain employment termination events in connection with a change of control of Liberate. The compensation committee of the board also approved new option grants for 1.3 million shares to each of Mr. Lockwood, Mr. Wood, and Mr. Nguyen and 1.7 million shares to Mr. Vachon.

Discontinued Operations

In August 2002, we acquired the outstanding capital stock of Sigma Systems. In accordance with SFAS 142, we determined that Sigma Systems had two reporting units, OSS and Bill-Care. Subsequently, in May 2003, we sold the business and assets related to Bill-Care to Sigma Software Solutions, Inc, a company owned by certain former shareholders of Sigma Systems, for consideration of $1.0 million in cash. We recorded a loss of $177,000 arising on the sale of discontinued operations in the fourth quarter of fiscal 2003. We reclassified $1.2 million of revenue and $2.3 million of net loss as part of discontinued operations for the year ended May 31, 2003.

Sale of Our Stock by Oracle

In July 2003, Delphi Asset Management (a wholly-owned subsidiary of Oracle Corporation) filed a report on Form 4 with the SEC disclosing that it had disposed of all its 33 million shares of our common stock.

Management Changes

In June 2003, Mitchell Kertzman and Coleman Sisson resigned from their positions as officers and directors of Liberate. The board of directors expanded to seven members and the board elected David Lockwood, Patrick S. Jones, and Robert R. Walker to fill the vacancies. The board also named Mr. Lockwood as chairman and chief executive officer, Gregory S. Wood as executive vice president and chief financial officer, Patrick Nguyen as executive vice president corporate development, and Kent Walker as executive vice president corporate and legal affairs, general counsel, and secretary, and confirmed the April 2003 appointment of Philip Vachon as president-Liberate International.

Loss Mitigation Insurance Policy

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 for 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.

Expected Sale of OSS Division

In September 2003, we announced that we are actively exploring the sale of our OSS division, and that we expect to reach a definitive agreement in the near future. The division is based in Toronto, Ontario and employs approximately 100 professionals. It had net assets of approximately $1.1 million as of May 31, 2003, and had revenues of approximately $2.3 million for fiscal 2003 following our acquisition of Sigma Systems in August 2002. There can be no assurance that we will consummate such a sale on reasonable terms or at all.

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

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, such as those discussed in "Risk Factors" below. Many statements in this report are forward-looking within the meaning of the securities laws of the United States. These statements involve both known and unknown risks and uncertainties and our actual results in future periods may differ materially from any future performance suggested in this report. For additional information regarding results of operations for periods after November 30, 2002 and for material trends and uncertainties affecting our future business, please see our report on Form 10-Q for the quarter ended February 28, 2003 and our report on Form 10-K for the fiscal year ended May 31, 2003, which are filed concurrently with this report.

Overview

Adverse economic conditions within the global cable and telecommunications industry significantly reduced our revenues in Q2 FY03 and the six months ended November 30, 2002 in comparison to prior periods. Many of the companies operating in this industry have publicly reported decreased revenues and earnings, significant financial restructuring efforts, and reduced capital expenditures, all of which affect their willingness to purchase our products and services.

During the six months ended November 30, 2002, as part of our continuing program of expense management, we announced reductions in workforce that affected approximately 105 employees. We also instituted other cost-cutting measures, including restricted travel, facilities consolidation, and holiday shutdowns. In January and April 2003, we announced further reductions in workforce that affected approximately 300 employees worldwide. See Financial Statements, Notes 10 and 13.

In August 2002, we acquired the outstanding capital stock of Sigma Systems, a privately-held corporation based in Toronto, Canada, for $60.4 million in cash, before deducting $22.3 million of cash received in connection with the acquisition. We also assumed Sigma Systems' unvested employee options with a fair value of $1.9 million, agreed to satisfy certain obligations of Sigma Systems to its employees in the aggregate amount of $3.0 million, and incurred acquisition costs of approximately $1.3 million. The total consideration and acquisition costs were $66.6 million and we accounted for the acquisition as a purchase.

At the time of acquisition, Sigma Systems developed and marketed OSS software that let network operators create, deploy, monitor, and maintain digital subscriber services. Through this acquisition, we sought to expand our product offerings. In September 2002, Sigma Systems changed its legal name to Liberate Technologies (Toronto) Ltd. We have included the results of operations of Sigma Systems in our consolidated financial statements since August 8, 2002. See Financial Statements, Note 4.

We made several investments during the six months ended November 30, 2002, including the purchase of Series D Preferred Stock from MetaTV, the issuance of a new convertible loan to TWTV, and the issuance of a convertible loan to Sportvision. See Financial Statements, Notes 8 and 13.

Restatement of Liberate's Financial Statements for the Fiscal Year Ended May 31, 2002 and Revision of Liberate's Financial Information 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. Our audit committee, which is composed of independent

outside directors, retained independent counsel to review our revenue reported during our fiscal year ended May 31, 2002. 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 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 the quarter should have been reported as $9.4 million rather than $10.3 million. Expenses for the quarter were overstated by $1.2 million. As a result, our reported net loss for the quarter should have been $249.3 million rather than $249.6 million.

In addition, our audit committee and its independent advisors concluded that our historical financial statements had overstated our revenue by $9.9 million in fiscal 2002, so that our revenue for that year should have been reported as $70.5 million. Our reported net loss for fiscal 2002 was understated by $10.1 million, and should have been reported as $335.1 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.

For further details on the restatement, see Financial Statements, Note 3 and our amended annual report on Form 10-K/A filed concurrently with the SEC.