

REALNETWORKS INC
Form S-3/A
May 21, 2004

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As filed with the Securities and Exchange Commission on May 21, 2004

Registration No. 333-114088

SECURITIES AND EXCHANGE COMMISSION
Washington, D.C. 20549

Amendment No. 1 to
Form S-3
REGISTRATION STATEMENT
UNDER
THE SECURITIES ACT OF 1933

RealNetworks, Inc.

(Exact name of Registrant as specified in its charter)

Washington
*(State or other jurisdiction of
incorporation or organization)*

2601 Elliott Avenue, Suite 1000
Seattle, Washington 98121
(206) 674-2700
*(Address, including zip code, and telephone number,
including area code, of Registrant's principal executive offices)*

91-1628146
*(I.R.S. Employer
Identification Number)*

Robert Kimball
Vice President, Legal and Business
Affairs, General Counsel and
Corporate Secretary
RealNetworks, Inc.
2601 Elliott Avenue, Suite 1000
Seattle, Washington 98121
(206) 674-2700
(Name, address, including zip code, and telephone number, including area code, of agent for service)

Copies to:
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Professional Corporation
701 Fifth Avenue, Suite 5100
Seattle, Washington 98104-7036
(206) 883-2699

Approximate date of commencement of proposed sale to the public: From time to time after the effective date of this Registration Statement.

If the only securities being registered on this Form are being offered pursuant to dividend or interest reinvestment plans, please check the following box.

If any of the securities being registered on this Form are to be offered on a delayed or continuous basis pursuant to Rule 415 under the Securities Act of 1933, other than securities offered only in connection with dividend or interest reinvestment plans, check the following box.

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If this Form is filed to register additional securities for an offering pursuant to Rule 462(b) under the Securities Act, please check the following box and list the Securities Act registration number of the earlier effective registration statement for the same offering. o

If this Form is a post-effective amendment filed pursuant to Rule 462(c) under the Securities Act, please check the following box and list the Securities Act registration statement number of the earlier effective registration statement for the same offering. o

If delivery of the prospectus is expected to be made pursuant to Rule 434, please check the following box. o

CALCULATION OF REGISTRATION FEE

Title of Each Class of Securities to be Registered	Amount to be Registered	Proposed Maximum Offering Price Per Share(1)	Proposed Maximum Aggregate Offering Price(1)	Amount of Registration Fee
Common stock, \$0.001 par value per share(2)	1,383,312(3)	\$5.97	\$8,258,373	\$1,047.00

- (1) Estimated solely for the purpose of calculating the registration fee pursuant to Rule 457(c), based upon the average high and low trading price of the Common Stock reported on the Nasdaq National Market on March 29, 2004.
- (2) Includes preferred stock purchase rights which, prior to the occurrence of certain events, will not be exercisable or evidenced separately from the common stock.
- (3) Pursuant to Rule 416 under the Securities Act, such number of shares of common stock registered hereby shall include an indeterminate number of shares of common stock that may be issued in connection with a stock split, stock dividend, recapitalization or similar event.

The Registrant hereby amends this Registration Statement on such date or dates as may be necessary to delay its effective date until the registrant shall file a further amendment which specifically states that this Registration Statement shall thereafter become effective in accordance with section 8(a) of the Securities Act of 1933 or until the Registration Statement shall become effective on such date as the Commission, acting pursuant to said Section 8(a), may determine.

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The information in this prospectus is not complete and may be changed. The selling shareholders named herein may not sell these securities until the registration statement filed with the Securities and Exchange Commission is effective. This prospectus is not an offer to sell these securities, and the selling shareholders are not soliciting an offer to buy these securities in any state where the offer or sale is not permitted.

SUBJECT TO COMPLETION, 2004

PROSPECTUS

1,383,312 Shares

RealNetworks, Inc.

**Common Stock
(\$0.001 par value)**

This prospectus relates to the public offering, which is not being underwritten, of up to 1,383,312 shares of our common stock which are held by some of our current shareholders and may be offered and sold from time to time by the selling shareholders described herein.

The prices at which such shareholders may sell the shares will be determined by the prevailing market price for the shares or in negotiated transactions. We will not receive any of the proceeds from the sale of the shares.

Our common stock is traded on the Nasdaq National Market under the symbol RNWK. On May 19, 2004, the last reported sale price for our common stock on the Nasdaq National Market was \$5.91 per share.

See Risk Factors beginning at page 3 to read about certain factors you should consider before buying shares of our common stock.

Neither the Securities and Exchange Commission nor state securities regulators have approved or disapproved of these securities or determined if this prospectus is truthful or complete. Any representation to the contrary is a criminal offense.

The date of this Prospectus is , 2004.

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You should rely only on the information contained in this prospectus. We have not authorized anyone to provide you with information different from that contained in this prospectus. The selling shareholders are offering to sell, and seeking offers to buy, shares of our common stock only in jurisdictions where offers and sales are permitted. The information contained in this prospectus is accurate only as of the date of this prospectus, regardless of the time of delivery of this prospectus or of any sale of our common stock. In this prospectus, RealNetworks, we, us, and our refer to RealNetworks, Inc. and its consolidated subsidiaries.

WHERE YOU CAN FIND MORE INFORMATION

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We file annual, quarterly and current reports, proxy statements and other information with the SEC under the Securities Exchange Act of 1934, as amended (the Exchange Act). You may read and copy this information at the SEC's Public Reference Room, 450 Fifth Street, N.W., Room 1024, Washington, D.C. 20549. You may obtain information on the operation of the public reference room by calling the SEC at 1-800-SEC-0330. The SEC maintains a Web site at <http://www.sec.gov> that contains reports, proxy statements, and other information regarding companies, such as RealNetworks, Inc., that file electronically with the SEC. You can also inspect reports, proxy statements and other information about our company at the offices of The National Association of Securities Dealers, Inc., 1735 K Street, N.W., Washington, D.C. 20006.

We incorporate information into this prospectus by reference, which means that we disclose important information to you by referring you to another document filed separately with the SEC. The information incorporated by reference is deemed to be part of this prospectus, except for any such information superseded by information contained in later-filed documents or directly in this prospectus. This prospectus incorporates by reference the documents set forth below that we have previously filed with the SEC. These documents contain important information about us and our financial condition.

RealNetworks, Inc. SEC Filings (File No. 0-23137)	Period
Annual Report on Form 10-K (including the portions of our Proxy Statement for our 2004 Annual Meeting of Shareholders incorporated by reference therein)	Year ended December 31, 2003
Quarterly Report on Form 10-Q	Quarter ended March 31, 2004
Current Report on Form 8-K	Filed on March 31, 2004
Current Report on Form 8-K/A	Filed on September 12, 2003
Description of our common stock as set forth in our Registration Statement on Form 8-A and all amendments thereto	Filed on September 26, 1997
Description of our preferred share purchase rights as set forth in our Registration Statement on Form 8-A and all amendments thereto	Filed on December 14, 1998

All documents that we file with the SEC under Sections 13(a), 13(c), 14 or 15(d) of the Exchange Act from the date of this prospectus to the end of the offering of the common stock under this document shall also be deemed to be incorporated in this prospectus by reference; provided, however, that we are not incorporating

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any information from any future filed documents furnished under either Item 9 or Item 12 of any Current Report on Form 8-K.

You may request a copy of these filings at no cost, by writing or calling us at the following address or telephone number:

Investor Relations

**RealNetworks, Inc.
2601 Elliott Avenue, Suite 1000
Seattle, Washington 98121
Telephone: (206) 674-2700**

Exhibits to the filings will not be sent, however, unless those exhibits have specifically been incorporated by reference in this document. These filings are also available free of charge through our Internet website, at www.realnetworks.com.

DISCLOSURE REGARDING FORWARD-LOOKING STATEMENTS

In addition to the other information contained or incorporated by reference in this prospectus, investors should carefully consider the risk factors disclosed in this prospectus, including those beginning on page 3, in evaluating an investment in common stock. The information contained or incorporated by reference in this prospectus includes forward-looking statements within the meaning of the Private Securities Litigation Reform Act of 1995. We have in the past and may in the future make forward-looking statements orally to analysts, investors, the media, and others. Forward-looking statements are statements that are not historical facts. The information contained or incorporated by reference in this prospectus includes forward looking statements concerning:

our strategy to continue to grow and leverage the base of users of our technology to generate revenues;

our plans for future strategic investments and acquisitions of businesses and technology; and

the increasing importance of non-PC devices to our business and the establishment of a leading position in that market.

Additional forward-looking statements are identified in the documents incorporated herein by reference. These forward-looking statements are based on current expectations, estimates and projections about RealNetworks' industry, management's beliefs, and certain assumptions made by management. Words such as anticipates, expects, intends, plans, believes, seeks, estimates and similar expressions are intended to identify forward-looking statements.

We believe that it is important to communicate our expectations to our investors. However, there may be events in the future that we are not able to predict accurately or over which we have no control. Consequently, there can be no assurance that our expectations or any of the forward-looking statements will prove to be correct, and actual results could differ materially from those projected or assumed in the forward-looking statements. The future financial condition and results of operations of RealNetworks, as well as any forward-looking statements, are subject to inherent risks and uncertainties, including but not limited to the risk factors set forth herein and those described elsewhere in this offering circular. You should carefully review the risk factors included in other reports or documents filed by RealNetworks from time to time with the Securities and Exchange Commission, referred to as the SEC, particularly our Annual Report on Form 10-K, our Quarterly Reports on Form 10-Q and any Current Reports on Form 8-K. All forward-looking statements and reasons why results may differ included in this prospectus are made as of the date hereof, and RealNetworks assumes no obligation to update any such forward-looking statement or reason why actual results might differ, even if new information becomes available or other events occur in the future.

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SUMMARY

The following summary is qualified in its entirety by the more detailed information, including our consolidated financial statements and related notes, included in this offering circular and incorporated in this offering circular by reference. You should carefully consider the information set forth under Risk Factors .

RealNetworks, Inc.

We are the leading creator of digital media services and software. Consumers use our services and software to find, play, purchase and manage free and premium digital content, including music, video and games. Broadcasters, network operators, media companies and enterprises use our products and services to create and deliver digital media to PCs, mobile phones and consumer electronics devices.

We have been a pioneer in the development of technology for the transmission of digital media over the Internet, and we have used our technology to create a large base of consumers, network operators and content owners who use our products and services to create, send and receive both free and paid content. Our strategy is to continue to grow and leverage this base of users to drive the creation of a market for premium digital audio and video content online and generate profitable revenue from this market in two primary ways:

(1) as a creator, packager and seller of software and digital content to consumers; and

(2) as a supplier of the underlying technology and business services to content owners, enterprises and network operators to create and distribute digital content.

Consumers use our media player software to play, create and manage their digital media, rip and burn CDs, tune in to Internet radio and play streaming and on-demand audio and video. In January 2004, we released the most recent version of our media player software, RealPlayer 10, which offers support for every major media format and includes an integrated digital music download store, the RealPlayer Music Store, along with an integrated radio tuner and premium radio subscription services. RealPlayer users can also subscribe to our RealOne SuperPass subscription service, which offers subscribers a package of premium software and services and access to premium content, including online sports, news, music and entertainment programming from brand-name media companies. We also market and distribute Rhapsody, an online music subscription service, which offers consumers unlimited, on-demand streaming access to over 550,000 songs, and RealArcade, a software platform through which we distribute downloadable games through subscriptions and a la carte sales.

Content owners and network operators use our products to create and distribute free and paid digital content, and other technology companies license our technology in order to integrate digital media into their products. While the primary application of these products today is for Internet-connected PCs, we believe mobile devices will become an increasingly important part of our business, and we believe we are establishing a leading position in the mobile market for media delivery and player products and services.

The technology platform we use for our products and license to other companies consists of the Real 10 Platform (Real 10) and the Helix Platform (Helix). Real 10 is our proprietary technology for digital audio/video compression, transport and playback and includes RealAudio 10, RealVideo 10, RealProducer 10 and RealPlayer 10. Helix includes a suite of commercial rights management and server software products for protecting and delivering digital media in multiple formats to media players, as well as a suite of software source code that third parties can use to build multi-format digital media products. This source code is licensed via the Helix Community, which many leading technology companies have joined in order to incorporate our open source streaming and downloadable media technology in their products.

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The size of our worldwide user base provides us with an ability to pool consumer demand on a very large scale. Accordingly, we have developed a variety of products and services to connect content providers, broadcasters and advertisers with that user base, including our subscription services. Our strategy is to continue to leverage our Internet media technology and our worldwide user base to create and generate revenues from the sale of digital media products and services.

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RISK FACTORS

In addition to reviewing other information in this prospectus and our Annual Report on Form 10-K and the other documents incorporated herein by reference, you should read the following Risk Factors section, so that you understand the risks associated with an investment in our common stock.

We have a relatively limited operating history with our paid media content businesses, which makes it difficult to evaluate our business.

We have a relatively limited history operating with our paid media content businesses, including our subscription businesses, which in recent periods have become an increasingly important part of our business and now represent a majority of our revenues. As a result, we have limited financial results from these businesses on which you can assess our future prospects. Our prospects must be considered in light of the risks, expenses and difficulties frequently encountered by companies in new and rapidly evolving businesses, such as the paid media content businesses in which we operate. Our paid content business revenue and subscriber/user base have grown relatively rapidly in the early phases of the development of these businesses. If these businesses continue to grow, the growth rates we have experienced to date are unlikely to be sustainable.

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

We have incurred significant losses since our inception. As of March 31, 2004, we had an accumulated deficit of \$290 million. We have had net losses for each year subsequent to the year ended December 31, 1999, and we may not generate sufficient revenue to be profitable on a quarterly or annual basis in the future. We have announced our intention to achieve quarterly profitability (excluding antitrust litigation expense) by the end of 2004. No assurance can be provided that we will achieve quarterly profitability (excluding antitrust litigation expense) in 2004 or in any subsequent period. We devote significant resources to developing and enhancing our technology and to selling, marketing and obtaining content for our products and services. As a result, we will need to generate significant revenue to be profitable in the future.

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

As a result of the rapidly changing and uncertain nature of the markets in which we compete, our quarterly and annual revenue and operating results may fluctuate from period-to-period, and period-to-period comparisons may not be meaningful. These fluctuations are caused by a number of factors, many of which are beyond our control. In past periods, our operating results have been affected by personnel reductions and related charges, charges relating to losses on excess office facilities, and impairment charges for certain of our equity investments. Our operating results may be adversely affected by similar or other charges or events in future periods, which could cause the trading price of our stock to decline.

Certain of our expense decisions (for example, research and development and sales and marketing efforts, our media content licensing efforts and other business expenditures generally) are based on predictions regarding our business and the markets in which we compete. To the extent that these predictions prove inaccurate, our revenue may not be sufficient to offset these expenditures, and our operating results may be harmed.

Our suit against Microsoft for antitrust violations may not be successful and could harm our financial results.

On December 18, 2003, we filed suit against Microsoft Corporation in the U.S. District Court for the Northern District of California, alleging that Microsoft violated U.S. and California antitrust laws. In our lawsuit, we allege that Microsoft has illegally used its monopoly power to restrict competition, limit consumer choice and attempt to monopolize the field of digital media. We expect that the litigation, if it is not resolved before trial, will carry on for several years. It is not possible to predict accurately how much the litigation will cost, or its duration. The costs of the litigation could have an adverse impact on our operating results in excess

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of our current expectations. The litigation may also distract our management team from operational matters, which could harm our business results. We may not prevail in our claims against Microsoft, in which case our costs of litigation will not be recovered. Even if we do prevail, the litigation may not be successful in causing Microsoft to alter its anticompetitive behavior. Furthermore, Microsoft's defense strategy may include the assertion of counterclaims against us, as well as leveraging its power in the commercial marketplace to adversely affect our current and potential business relationships, either of which may have an adverse affect on our business results.

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

Costs of our online paid content services as a percentage of the revenue generated by those businesses are higher than the ratio of costs to revenues in our historical software licensing business. This includes our music subscriptions and sales, video subscription services and games licensing. We expect this trend will continue to negatively impact our overall gross margins as our online paid content businesses grow. If paid content revenue grows as a percentage of our overall revenue, our margins may further decrease which may affect our ability to achieve profitability.

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

We must continue to obtain compelling digital media content for our video, music and games subscription services in order to maintain and increase subscriptions and subscription service revenue and overall customer satisfaction for these products. In some cases, we have had to pay substantial fees to obtain premium content. In particular, we have had to pay substantial fees to obtain premium video content even though we have limited experience determining what video content will be successful with current and prospective customers. In addition, certain of our content licensing agreements have high fixed costs associated with them, and we have decided not to renew certain of these agreements. During the quarter ended March 31, 2004, we incurred a charge of approximately \$4.9 million due to the cancellation of a content licensing agreement with PGA Tour. In addition, we did not renew our content license agreement with MLB Advanced Media because we believe the proposed cost of the license renewal was unreasonably high and not economically viable. Failure to renew these contracts has resulted, and may in the future result, in the loss of subscribers to our video subscription offerings and a corresponding loss of revenue. If we cannot obtain premium digital content for any of our digital content subscription services on commercially reasonable terms, or at all, our business will be harmed.

Our subscription levels may vary due to the seasonal or periodic nature of some popular content and as we experiment with different types of content offerings.

Some of the most popular premium content that we have offered in our premium video subscription services is seasonal or periodic in nature. Additionally, as we develop our video subscription business, we are experimenting with different types of content to determine what consumers prefer. We have limited experience with these types of offerings and cannot predict how the seasonal or periodic nature of these offerings will impact our subscriber growth rates for these products, future subscriber retention levels or our quarterly financial results. We anticipate that subscriber levels for our video subscription offerings will fluctuate due to seasonally available popular content and as we experiment with new types of content offerings.

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

If we do not continue to add new subscribers each quarter while minimizing the rate of loss of existing subscribers, our operating results will be adversely impacted. Because Internet subscription content businesses are a relatively new media delivery model and a new business for us, we cannot predict with accuracy our long-term ability to retain subscribers or add new subscribers. Subscribers may cancel their subscriptions to our services for many reasons, including a perception that they do not use the services sufficiently or that the

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service does not provide enough value, a lack of attractive or exclusive content generally or as compared to competitive service offerings (including Internet piracy), or because customer service issues are not satisfactorily resolved. In addition, the costs of marketing and promotional activities necessary to add new subscribers, and the costs of obtaining content that customers desire, may adversely impact our margins and operating results.

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

Our online music service offerings depend on music licenses from the major music labels. The current license agreements are for relatively short terms (some of these licenses are due to expire and will need to be renewed in 2004), and we cannot be sure that the music labels will renew the licenses on commercially viable terms, or at all. Due to the increasing importance of our music services to our overall revenues, the failure of the major music labels to renew these licenses under terms that are acceptable to us will harm our ability to offer successful music subscription services and would harm our operating results.

Music publishing royalty rates for streaming are not yet established; a determination of high royalty rates could negatively impact our operating results.

Royalty rates associated with streaming musical compositions in the U.S. have not yet been established with respect to public performances and, if required, reproductions. Public performance licenses are negotiated individually, and we have not yet agreed to rates with all of the performing rights societies for all of our music streaming activities. We may be required to pay a rate that is higher than we expect, or the issue may be submitted to a Rate Court for judicial determination. We have a license agreement with the Harry Fox Agency, an agency that represents music publishers, to reproduce musical compositions as required in the creation and delivery of on-demand streams, but this license agreement does not include a rate. The license agreement anticipates industry-wide agreement on rate, or, if no industry-wide agreement can be reached, determination by a copyright arbitration royalty panel (CARP), an administrative judicial proceeding supervised by the United States Copyright Office. If the rates agreed to or determined by a CARP are higher than we expect, this expense could negatively impact our operating results. The publishing rates associated with our international music streaming services are also not yet determined, and may be higher than we anticipate.

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

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

reduced prices, revenues and margins;

increased expenses in responding to competitors;

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

lengthened sales cycles;

degradation of our stature in the market and reputation;

changes in our business and distribution and marketing strategies;

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

strained relationships with partners; and

premature release of products and product enhancements.

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

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

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

We believe that Microsoft has employed, and will likely continue to employ illegal and highly aggressive tactics against us such as leveraging Microsoft's market dominating position in operating systems and servers to distribute and promote its digital media products. We also believe that Microsoft limits exposure to third parties (including us) of the interfaces to its operating systems, which limits the ability of our products to take full advantage of the features and functionality of Microsoft's operating systems and limiting our ability to compete effectively with Microsoft. The effects of Microsoft's activities include loss of customers and market share, unnatural pressure on the pricing of our products and continuing costs of developing and revising business strategies in response to these activities.

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

Video Products and Services. Our video content services (including our RealOne SuperPass subscription service) face competition from existing competitive alternatives and other emerging services and technologies. We face competition in these markets from traditional media outlets such as television, radio, CDs, DVDs, videocassettes and others. We also face competition from emerging Internet media sources and established companies entering into the Internet media content market, including Time Warner's AOL subsidiary, Microsoft, Apple, Yahoo! and broadband Internet service providers. We expect that, as the market for Internet video content matures, more competitors will enter these new markets, making competition even more intense. Competing services may be able to obtain better or more favorable access to compelling video content than us, and may also develop better offerings than us.

Music. Our music service offerings face competition from traditional offline music distribution competitors and from other online digital music services. Some of these competing services have been the subject of substantial marketing efforts and have received significant media attention, including Apple's iTunes music download service and Roxio's Napster online music subscription service. We expect that Microsoft will also begin offering premium music services in conjunction with its Windows Media Player and MSN services, and we also expect increasing competition from online retailers such as Amazon.com and WalMart.com. Our current music service offerings may not be able to compete effectively in this highly competitive market. Our music services also face significant competition from free peer-to-peer services which allow consumers to directly access an expansive array of free content without securing licenses from content providers. The ongoing presence of these free services, even if they are subsequently found to be illegal, substantially impairs the marketability of legitimate services like ours.

Games. Our RealArcade service competes with other online distributors of downloadable games focused on the non-core segment of the market. Some of these distributors have high volume distribution channels and greater financial resources than us, including Yahoo Games, MSN Gamezone, Pogo.com and Shockwave. We expect competition to intensify in this market from these and other competitors and no assurance can be made that we will be able to continue to grow our games distribution business or that we will

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be able to remain competitive in the downloadable games category in the future. We recently completed the acquisition of GameHouse, a developer of downloadable PC games and now also compete with other developers of downloadable games for the non-core segment of the market.

We may not be successful in the market for downloadable media and personal music management systems.

The market for products that enable the downloading of media and that provide a personal music management system is relatively new and still evolving. We may be unable to develop a revenue model or sufficient demand to take advantage of this market opportunity. We cannot predict whether consumers will adopt our products as their primary application to play, record, download and manage their digital music, especially in light of the fact that Microsoft bundles its competing Windows Media Player with its Windows operating system. Our inability to achieve widespread acceptance for our digital music architecture or widespread distribution of our player products could hold back the development of revenue streams from these market segments, including digital music content, and therefore could harm the prospects for our business.

Our paid content businesses depend upon effective digital rights management solutions.

Our paid content businesses depend upon effective digital rights management solutions that allow control of accessibility to online digital content. These solutions are important to the economics of these businesses and also to address concerns of content providers. We cannot be certain that we can develop, license or acquire such solutions, or that content licensors, electronic device makers or consumers will accept them. In addition, consumers may be unwilling to accept the use of digital rights management technologies that limit their use of content, especially with large amounts of free content readily available. We may need to license digital rights management solutions to support our products. No assurance can be given that such solutions will be available to us on reasonable terms or at all. If digital rights management solutions are not effective, or are perceived as not effective, content providers may not be willing to include content in our services, which would harm our business and operating results.

Digital rights management technologies are frequently the subject of hostile attack by third parties seeking to break the system. If our digital rights management technology is compromised or otherwise malfunctions, we could be subject to lawsuits seeking compensation for any harm caused and our business could be harmed if content providers lose confidence in our ability to protect their content.

We may not be able to successfully operate our software game development business because it is a new business for us, and certain distribution partners for our game development business compete with other products and services we offer.

We recently completed the acquisition of GameHouse, a developer of downloadable PC games. Game development is a new business for us, and we may not be able to successfully develop and market software games in the future. In addition, certain competitors of our RealArcade service also distribute and promote games developed by GameHouse. No assurance can be made that these distributors will continue to distribute and promote games in the same manner as a result of our acquisition of GameHouse.

Our systems software business has been negatively impacted by the efforts of our competitors, and this business may not return to previous levels.

The aggressive, and we believe illegal, competitive efforts of Microsoft, including the provision of free software and other incentives to induce customers to use its competing technology, have negatively impacted systems software sales to customers in a variety of business market segments in recent periods. We cannot predict when, or if, we will experience increased demand for our systems software products from customers in these markets.

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

There are a number of risks associated with our Helix open source initiative, including risks associated with open source and community source technology licensing, development and business models and the risks

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typically associated with the introduction of new products and technologies. The industry may not adopt the Helix DNA Platform or the Helix Community, and third parties may not develop or introduce technologies or products based on them. While we have invested substantial resources in the development of these initiatives and products, the market may not accept them, we may not derive substantial revenue from these initiatives and products and the introduction of our Helix open source software may adversely affect our sales. In addition, our open source approach means that we no longer exercise control over many aspects of the development of the technology that comprises our Helix initiative.

If we do not timely and successfully develop, market and implement new products and services, our business and operating results will suffer.

Our business and operating results would be harmed if we fail to timely and successfully develop, market and deliver products and services that achieve widespread market acceptance or if the products and services we develop fail to generate significant revenue or gross profits to offset our development and operating costs. Competitive or technological developments may require us to make substantial investments in new products and technologies, and we may not have sufficient resources to make these investments. If we are unable to be a technological leader in our market our business is likely to be harmed.

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

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

Certain of our products and services are dependent in part on the licensing and incorporation of technology from third party vendors. The markets in which we compete are new and rapidly evolving and, in some cases, significant technology innovation occurs at very early-stage companies. In some cases, we rely on the technology of these types of vendors in order to make our products and services more competitive. If the technology of these vendors fails to perform as expected or if key vendors do not continue to support their technology, because the vendor has gone out of business or otherwise, then we may incur substantial costs in replacing the products and services, or we may fall behind in our development schedule while we search for a replacement. These costs or the potential delay in the development of our products and services could harm our business and our prospects.

We enter into strategic transactions that may not yield direct financial benefits.

Because of the evolving and dynamic nature of the markets in which we compete, from time to time we enter into strategic transactions that have uncertain financial impact on our business and operations. We often enter into these types of transactions with infrastructure providers and other large companies to broaden the reach of our technology, media formats and products. While we believe that these types of transactions are important for our overall business, they may not yield the desired benefits to our business or result in meaningful direct revenue.

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

The success of our products and services depends upon our products support for a variety of media formats and wireless data formats. Technical formats and consumer preferences change over time, and we may be unable to adequately address consumer preferences or fulfill the market demand for new and evolving formats. Changing formats may give our competitors an opportunity to gain market share if they can respond to or anticipate market demand for formats before we do. We also may not be able to license technologies, like codecs or digital rights management technology, that obtain widespread consumer and developer use, which would harm consumer and developer acceptance of our products and services. In addition, our codecs and

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formats may not continue to be in demand or as desirable as other third party codecs and formats, including codecs and formats created by Microsoft or industry standard formats created by MPEG, become more readily available.

Our mobile products will not be successful if consumers do not use mobile devices to access digital media.

In order for our investments in the development of mobile products to be successful, consumers must adopt and use mobile devices for consumption of digital media. To date, consumers have not widely adopted these products for use in accessing and consuming digital media and if the rate of adoption of these products to consume digital media does not increase, our business could be harmed.

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

Our success substantially depends on the continued employment of certain executive officers and key employees, particularly Robert Glaser, our founder, Chairman of the Board and Chief Executive Officer. The loss of the services of Mr. Glaser or other key executive officers or employees could harm our business. If any of these individuals were to leave, we could face high costs and substantial difficulty in hiring qualified successors and could experience a loss in productivity while any such successor obtains the necessary training and experience. If we do not succeed in retaining and motivating existing personnel, our business could be harmed.

Our failure to attract, train or retain highly qualified personnel could harm our business.

Our success also depends on our ability to attract, train or retain qualified personnel in all areas, especially those with management and product development skills. In particular, we must hire and retain experienced management personnel to help us continue to grow and manage our business, and skilled software engineers to further our research and development efforts. At times, we have experienced difficulties in hiring and retaining personnel with the proper training or experience, particularly in technical and media areas. Competition for qualified personnel is intense, particularly in high-technology centers such as the Pacific Northwest, where our corporate headquarters are located. If we do not succeed in attracting new personnel or in retaining and motivating our current personnel, our business could be harmed.

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

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

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

we could lose customers if competitors or users of competing technologies consolidate with our current or potential customers; and

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

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

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Potential acquisitions involve risks that could harm our business and impair our ability to realize potential benefits from acquisitions.

As part of our business strategy, we have acquired technologies and businesses in the past, and expect that we will continue to do so in the future. The failure to adequately address the financial, legal and operational risks raised by acquisitions of technology and businesses could harm our business and prevent us from realizing the benefits of the acquisitions. Financial risks related to acquisitions may harm our financial position, reported operating results or stock price, and include:

potential equity dilution, use of cash resources and incurrence of debt and contingent liabilities in funding acquisitions;

large write-offs and difficulties in assessment of the relative percentages of in-process research and development expense that can be immediately written off as compared to the amount which must be amortized over the appropriate life of the asset; and

amortization expenses related to other intangible assets.

Acquisitions also involve operational risks that could harm our existing operations or prevent realization of anticipated benefits from an acquisition. These operational risks include:

difficulties and expenses in assimilating the operations, products, technology, information systems or personnel of the acquired company and difficulties in retaining key management or employees of the acquired company;

diversion of management's attention from other business concerns and the potential disruption of our ongoing business;

impairment of relationships with employees, affiliates, advertisers and content providers of our business and the acquired business;

the assumption of known and unknown liabilities of the acquired company, including intellectual property claims; and

entrance into markets in which we have no direct prior experience.

We acquired Listen.Com, Inc. in August 2003, and the operations associated with Listen will remain in San Francisco. This will be our first experience operating and integrating a substantial acquired business in a remote location. The geographic separation could increase the operational risks described above. We also acquired GameHouse, Inc. in January 2004. The acquisition of GameHouse is our first attempt to operate and manage a content creation business. We may not be successful in operating this type of business, which could harm our business and our prospects.

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

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

We have a substantial investment in MusicNet, a joint venture formed with several leading media companies to create a technology platform for online digital music subscription sales. We rely on financial statements provided by MusicNet in determining the amount of our equity share of MusicNet's net loss for each of our reporting periods. We do not control MusicNet and we do not participate in the preparation of its financial statements. If the financial statements supplied to us by MusicNet are inaccurate, we may be forced

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to adjust or restate our operating results. If MusicNet does not provide its financial statements to us in a timely manner, we may not be able to timely satisfy our Securities and Exchange Commission reporting obligations. We anticipate that MusicNet will continue to incur losses in the foreseeable future and will need additional funding.

Changes in network infrastructure, transmission methods and protocols, and broadband technologies pose risks to our business.

Our products and services depend upon the means by which users access media content over the Internet and wireless networks. If popular technologies, transmission methods and protocols used for accessing digital media content change, and we do not timely and successfully adapt our products and services to these new technologies, transmission methods and protocols, our reputation could be damaged, use of our technologies and products would decrease, and our business and operating results would be harmed. Communicating Internet access through cable television set-top boxes, cable lines, digital subscriber lines or wireless connections could dramatically reduce the demand for our products and services by utilizing alternate technology that more efficiently or conveniently transmits data and media. This could harm our business as currently conducted. Also, our products and services adapted to new technologies and transmission methods and protocols may not achieve market acceptance or generate sufficient revenue to offset our costs of developing products and services compatible with broadband transmission formats and infrastructure.

Development of new technologies, products and services for new transmission infrastructure could increase our vulnerability to competitors by enabling the emergence of new competitors, such as traditional broadcast and cable television companies, which have significant control over access to content, substantial resources and established relationships with media providers. Our current competitors may also develop relationships with, or ownership interests in, companies that have significant access to or control over the broadband transmission infrastructure or content.

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

Access to the Internet through devices other than a personal computer, such as personal digital assistants, cellular telephones, television set-top devices, game consoles and Internet appliances, has increased dramatically and is expected to continue to increase. Manufacturers of these types of products are increasingly investing in media-related applications, but development of these devices is still in an experimental stage and business models are new and unproven. If a substantial number of alternative device manufacturers do not license and incorporate our technology into their devices, we may fail to capitalize on the opportunity to deliver digital media to non-PC devices. A failure to develop revenue-generating relationships with a sufficient number of device manufacturers could harm our business prospects. We have invested significant resources in adapting our technologies and products to these new technologies, networks and devices (wireless networks in particular), and we will not recoup these investments if they are not widely adopted for accessing data and multimedia content. In addition, our ability to reach customers in these markets is often controlled by large network operators and our success in these markets is dependent on our ability to secure relationships with these key operators.

Emerging new standards for non-PC devices could harm our business if our products and technologies are not compatible with the new standards.

We do not believe that complete standards have emerged with respect to non-PC wireless and cable-based systems. If we do not successfully make our products and technologies compatible with emerging standards, we may miss market opportunities and our business and results will suffer. If other companies' products and services, including industry-standard technologies or other new standards emerge or become dominant in any of these areas, or differing standards emerge among different global markets, demand for our technology and products could be reduced or they could become obsolete.

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

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

Our business and operating results will suffer if our systems or networks fail, become unavailable or perform poorly so that current or potential users do not have adequate access to our products, services and websites.

Our ability to provide our products and services to our customers and operate our business depends on the continued operation of our information systems and networks. A significant or repeated reduction in the performance, reliability or availability of our information systems and network infrastructure could harm our ability to conduct our business, and harm our reputation and ability to attract and retain users, customers, advertisers and content providers.

We have on occasion experienced system errors and failures that cause interruption in availability of products or content or an increase in response time. Problems with our systems and networks could result from our failure to adequately maintain and enhance these systems and networks, natural disasters and similar events, power failures, intentional actions to disrupt our systems and networks and many other causes. The vulnerability of our computer and communications infrastructure is enhanced because it is located at a single leased facility in Seattle, Washington, an area that is at heightened risk of earthquake, flood, and volcanic events. We do not currently have fully redundant systems or a formal disaster recovery plan, and we may not have adequate business interruption insurance to compensate us for losses that may occur from a system outage.

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

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

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

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

Our international operations expose our business to additional operational and financial risks.

We operate subsidiaries in several foreign countries, and market and sell products in a number of countries. We have also entered into joint ventures internationally. A significant portion of our revenue is derived from international operations. Our foreign operations involve risks inherent in doing business on an

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international level, including difficulties in managing operations due to distance, language and cultural differences, different or conflicting laws and regulations and exchange rate fluctuations. Any of these factors could harm our future international operations, and consequently our business, operating results and financial condition. Our foreign currency exchange risk management program reduces, but does not eliminate, the impact of currency exchange rate movements.

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

A key part of our strategy is to develop localized products and services in international markets through joint ventures, subsidiaries and branch offices. If we do not successfully implement this strategy, we may not recoup our international investments, successfully take advantage of international opportunities and we may lose worldwide market share. To date, we have only limited experience in developing localized versions of our products and services and marketing and operating our products and services internationally, and we often rely on the efforts and abilities of our foreign business partners, who we do not control, in such activities. We believe that in light of the potential size of the customer base and the audience for content, and the substantial anticipated competition, we need to continue to expand into international markets in order to effectively obtain and maintain market share.

We may be unable to adequately protect our proprietary rights.

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

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

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

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

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

Another party may obtain a blocking patent so we would need to either obtain a license or design around the patent. We may not be able to obtain such a license on acceptable terms, if at all, or design around the patent.

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

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

From time to time we receive claims and inquiries from third parties alleging that our internally developed technology or technology we license from third parties may infringe the third parties' proprietary rights, especially patents. Third parties have also asserted and most likely will continue to assert claims against us alleging infringement of copyrights, trademark rights, trade secret rights or other proprietary rights, or alleging unfair competition or violations of privacy rights. We are now investigating a number of such pending

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claims, some of which are described in Part II of our Quarterly Report on Form 10-Q filed May 10, 2004 under the heading Legal Proceedings.

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

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

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

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

We may be subject to market risk and legal liability in connection with the data collection capabilities of our products and services.

Many of our products are interactive Internet applications that by their very nature require communication between a client and server to operate. To provide better consumer experiences and to operate effectively, our products send information to our servers. Many of the services we provide also require that a user provide certain information to us. We post an extensive privacy policy concerning the collection, use and disclosure of user data involved in interactions between our client and server products. Any failure by us to comply with our posted privacy policy and existing or new legislation regarding privacy issues could impact the market for our products and services, subject us to litigation and harm our business.

We may be subject to legal liability for the provision of third-party products, services or content.

We periodically enter into arrangements to offer third-party products, services, content or advertising under the RealNetworks brand or via distribution on our Web sites, in products or service offerings. We may be subject to claims concerning these products, services, content or advertising by virtue of our involvement in marketing, branding, broadcasting or providing access to them. Our agreements with these parties may not adequately protect us from these potential liabilities. It is also possible that, if any information provided directly by us contains errors or is otherwise negligently provided to users, third parties could make claims against us, including, for example, claims for intellectual property infringement. Investigating and defending any of these types of claims is expensive, even if the claims do not result in liability. If any of these claims do result in liability, we could be required to pay damages or other penalties, which could harm our business and our operating results.

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

Our executive officers, directors and affiliated persons beneficially owned more than one third of our common stock. Robert Glaser, our Chief Executive Officer and Chairman of the Board, beneficially owns the

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majority of that stock. As a result, our executive officers, directors and affiliated persons will have significant influence to:

- elect or defeat the election of our directors;
- amend or prevent amendment of our articles of incorporation or bylaws;
- effect or prevent a merger, sale of assets or other corporate transaction; and
- control the outcome of any other matter submitted to the shareholders for vote.

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

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

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

- adopt a plan of merger;
- authorize the sale, lease, exchange or mortgage of assets representing more than 50% of the book value of our assets prior to the transaction or on which our long-term business strategy is substantially dependent;
- authorize our voluntary dissolution; or
- take any action that has the effect of any of the above.

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

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

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

If we account for employee stock options using the fair value method, it could significantly reduce our results of operations.

On March 31, 2004, the FASB issued an Exposure Draft, Share-Based Payment: an amendment of FASB statements No. 123 and 95, which, if issued as an actual statement, would require a company to recognize, as an expense, the fair value of stock options and other stock-based compensation to employees beginning in 2005 and subsequent reporting periods. If we are required to record an expense for our stock-based compensation plans using the fair value method as described in the Exposure Draft, we could have significant and ongoing accounting charges.

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

The trading price of our common stock has been and is likely to continue to be highly volatile. For example, during the 52-week period ended March 31, 2004, the price of our common stock ranged from \$9.29 to \$4.15 per share. Our stock price could be subject to wide fluctuations in response to factors such as actual or anticipated variations in quarterly operating results or changes in financial estimates or recommendations by securities analysts as well as any of the other risk factors described above.

In addition, the stock market in general, and the Nasdaq National Market and the market for Internet and technology companies in particular, have experienced extreme price and volume fluctuations that have often been unrelated or disproportionate to the operating performance of these companies. These broad market and industry factors have in the past and may in the future reduce our stock price, regardless of our operating performance.

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

As a result of the dynamic and changing nature of our products and business, and of the markets in which we compete, it is difficult to accurately forecast our revenues, gross margin, operating expenses, number of subscribers and other financial and operating data. Our inability or the inability of the financial community to accurately forecast our operating results could result in our reported net income (losses) in a given quarter to differ from expectations, which could cause a decline in the trading price of our common stock.

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

We do not currently collect sales or other taxes on the sale of our products, license of technology or provision of services in states and countries other than those in which we have offices or employees. Our business would be harmed if one or more states or any foreign country were able to require us to collect sales or other taxes from past sales of products, licenses of technology or provision of services, particularly because we would be unable to go back to customers to collect sales taxes for past sales and would likely have to pay such taxes out of our own funds.

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

The Internet Tax Freedom Act, or ITFA, expired November 2003 and Congress is currently considering an extension. Among other things, the ITFA imposed a moratorium on discriminatory taxes on electronic commerce. The imposition by state and local governments of various taxes upon Internet commerce could create administrative burdens for us and could decrease our future sales.

We donate a portion of net income to charity.

In future periods, if we achieve profitability (excluding the effects of acquisition charges), we intend to donate 5% of our annual pre-tax net income to charitable organizations, which will reduce our net income for those periods. The non-profit RealNetworks Foundation manages our charitable giving efforts.

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USE OF PROCEEDS

The proceeds from the sale of the common stock offered pursuant to this prospectus are solely for the account of the selling shareholders. Accordingly, we will not receive any proceeds from the sale of the shares by the selling shareholders.

Table of Contents**SELLING SHAREHOLDERS**

The shares of common stock to be sold by the selling shareholders pursuant to this prospectus represent shares issued to the selling shareholders by us in connection with our acquisition of GameHouse, Inc. on January 30, 2004. The following table sets forth the aggregate number of shares of our common stock held by each selling shareholder and the aggregate number of shares of common stock offered by each such selling shareholder. As of May 19, 2004, there were 168,956,302 shares of our common stock outstanding. Beneficial ownership is determined according to the rules of the SEC, and includes shares subject to options currently exercisable or exercisable within 60 days of May 19, 2004. Shares subject to such options are deemed outstanding for computing the percentage ownership of the person holding such options but not for computing the percentage ownership of any other person.

Name of Selling Shareholder	Ownership Prior to Offering Number of Shares Beneficially Owned Prior to Offering	Percentage of Common Stock Outstanding	Number of Shares Being Offered	Ownership After Offering (1) Number of Shares Beneficially Owned After Offering	Percentage of Common Stock Outstanding
Jennie Bowers(2)	5,394	*	1,059	4,335	*
David R. Dunham(3)	5,847	*	317	5,530	*
Ben Exworthy	827,723	*	380,755	446,968	*
Garr Godfrey	1,931,354	1.1%	888,426	1,042,928	*
William B. Horne	34,488	*	15,868	18,620	*
Jason Katsanis(4)	12,156	*	1,322	10,834	*
Ron Powers(5)	229,775	*	81,970	147,805	*
Lynn E. Rott	3,678	*	1,694	1,984	*
David J. Ryan(6)	33,426	*			

Capital lease obligations, net of current portion

796,693

260

Other liabilities

471,759

406,209

Total long-term liabilities

1,268,452

406,469

Commitments and contingencies

Stockholders' equity:

Convertible preferred stock - \$.001 par value; 10,000,000 shares authorized,

Series A convertible preferred stock - 1,000,000 shares authorized, 0 and 1,000,000 issued and outstanding at December 25, 2004 and December 27, 2003, respectively (aggregate liquidation value of \$0 at December 25, 2004)

1,000,000

Series B convertible preferred stock - 1,150,000 shares authorized; 507,460 and 611,080 shares issued and outstanding at December 25, 2004 and December 27, 2003, respectively (aggregate liquidation value of \$10,149,200 at December 25, 2004)

7,551,002

9,092,870

Series C convertible preferred stock - 100,000 shares authorized, issued and outstanding (aggregate liquidation value of \$2,000,000 at December 25, 2004)

1,492,000

1,492,000

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Series D convertible preferred stock - 250,000 shares authorized, issued and outstanding (aggregate liquidation value of \$5,000,000 at December 25, 2004)

3,652,500

3,652,500

Series E convertible preferred stock - 533,333 shares authorized; 296,667 and 389,439 shares issued and outstanding at December 25, 2004 and December 27, 2003, respectively (aggregate liquidation value of \$1,112,500 at December 25, 2004)

1,112,500

1,460,396

Series F convertible preferred stock - 114,286 shares authorized, issued and outstanding (aggregate liquidation value of \$500,000 at December 25, 2004)

500,000

500,000

Total convertible preferred stock

14,308,002

17,197,766

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Common stock - \$.001 par value; 150,000,000 shares authorized; 22,092,717 and 18,780,204 shares issued and outstanding at December 25, 2004 and December 27, 2003, respectively

22,093

18,780

Additional paid-in capital

50,448,100

47,554,621

Accumulated deficit

(58,227,104

)

(59,218,297

)

Total stockholders' equity

6,551,091

5,552,870

Total liabilities and stockholders' equity

\$

19,479,937

\$

15,151,980

The accompanying notes are an integral part of these Consolidated Financial Statements.

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iPARTY CORP.**CONSOLIDATED STATEMENTS OF OPERATIONS**

	Dec 25, 2004	For the twelve months ended		Dec 28, 2002
		Dec 27, 2003		
Revenues	\$ 64,276,225	\$ 56,697,246		\$ 52,177,923
Operating costs:				
Cost of products sold	35,826,820	31,758,625		30,420,475
Marketing and sales	21,176,925	18,363,193		16,527,832
General and administrative	6,335,067	5,516,273		5,245,867
Special charge				396,465
Operating income (loss)	937,413	1,059,155		(412,716)
Other income	382,500			
Income (loss) before income taxes	1,319,913	1,059,155		(412,716)
Interest income	1,354	1,262		9,045
Interest expense	(225,074)	(212,227)		(280,898)
Income (loss) before income taxes	1,096,193	848,190		(684,569)
Income taxes	105,000	97,233		
Net income (loss)	\$ 991,193	\$ 750,957		\$ (684,569)
Net income (loss) available to common stockholders	\$ 991,193	\$ 750,957		\$ (774,719)
Income (loss) per share:				
Basic	\$ 0.03	\$ 0.02		\$ (0.04)
Diluted	\$ 0.02	\$ 0.02		\$ (0.04)
Income (loss) per share available to common stockholders:				
Basic	\$ 0.03	\$ 0.02		\$ (0.05)
Diluted	\$ 0.02	\$ 0.02		\$ (0.05)
Weighted-average shares outstanding:				
Basic	37,649,400	36,683,142		16,219,436
Diluted	41,517,036	38,868,484		16,219,436

The accompanying notes are an integral part of these Consolidated Financial Statements.

IPARTY CORP.

CONSOLIDATED STATEMENTS OF CONVERTIBLE PREFERRED STOCK AND STOCKHOLDERS EQUITY DEFICIT)

	Convertible Preferred Stock		Convertible Preferred Stock		Stockholders Common Stock		Equity (Deficit) Additional Paid-In Capital	Accumulated Deficit	Total Stockholders Equity (Deficit)
	Shares	Amount	Shares	Amount	Shares	Amount			
Balance December 29, 2001	3,274,372	\$ 20,092,667		\$	15,122,675	\$ 15,123	\$ 44,395,314	\$ (59,194,535)	\$ (14,784,098)
Issuance of common stock upon conversion of Series B convertible preferred stock	(119,786)	(1,257,886)			1,197,860	1,198	1,256,688		1,257,886
Issuance of common stock upon conversion of Series E convertible preferred stock	(66,666)	(250,000)			666,660	667	249,333		250,000
Series B convertible preferred stock adjustment	(313,974)	(314)					314		314
Series C convertible preferred stock adjustment	(45,198)	(45)					45		45
Series D convertible preferred stock adjustment	(112,996)	(113)					113		113
Equity portion of special charge							171,465		171,465
Exercise of stock options					9,375	9	4,679		4,688
Convertible preferred stock beneficial conversion dividend							90,150	(90,150)	
Net loss								(684,569)	(684,569)
Balance December 28, 2002	2,615,752	18,584,309			16,996,570	16,997	46,168,101	(59,969,254)	(13,784,156)
Issuance of common stock upon conversion of Series B convertible preferred stock	(73,719)	(1,096,939)			948,690	948	1,095,991		1,096,939
Issuance of common stock upon conversion of Series E convertible preferred stock	(77,228)	(289,604)			823,944	824	288,780		289,604
	(1,000,000)	(1,000,000)	1,000,000	1,000,000					1,000,000

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Reclassification of Series A convertible preferred stock (Note 1)									
Reclassification of Series B convertible preferred stock (Note 1)	(611,080)	(9,092,870)	611,080	9,092,870					9,092,870
Reclassification of Series C convertible preferred stock (Note 1)	(100,000)	(1,492,000)	100,000	1,492,000					1,492,000
Reclassification of Series D convertible preferred stock (Note 1)	(250,000)	(3,652,500)	250,000	3,652,500					3,652,500
Reclassification of Series E convertible preferred stock (Note 1)	(389,439)	(1,460,396)	389,439	1,460,396					1,460,396
Reclassification of Series F convertible preferred stock (Note 1)	(114,286)	(500,000)	114,286	500,000					500,000
Exercise of stock options				11,000	11	1,749			1,760
Net income							750,957		750,957
Balance December 27, 2003			2,464,805	17,197,766	18,780,204	18,780	47,554,621	(59,218,297)	5,552,870
Issuance of common stock upon conversion of Series A convertible preferred stock			(1,000,000)	(1,000,000)	1,000,000	1,000	999,000		
Issuance of common stock upon conversion of Series B convertible preferred stock			(103,620)	(1,541,869)	1,333,693	1,333	1,540,536		
Issuance of common stock upon conversion of Series E convertible preferred stock			(92,772)	(347,895)	961,025	961	346,934		
Exercise of stock options					17,795	19	7,009		7,028
Net income							991,193		991,193
Balance December 25, 2004	\$		1,268,413	\$ 14,308,002	22,092,717	\$ 22,093	\$ 50,448,100	\$ (58,227,104)	\$ 6,551,091

The accompanying notes are an integral part of these Consolidated Financial Statements.

iPARTY CORP.

CONSOLIDATED STATEMENTS OF CASH FLOWS

	Dec 25, 2004	For the twelve months ended Dec 27, 2003	Dec 28, 2002
Operating activities:			
Net income (loss)	\$ 991,193	\$ 750,957	\$ (684,569)
Adjustments to reconcile net income (loss) to net cash provided by used in operating activities:			
Depreciation and amortization	634,250	601,015	633,173
Non-cash portion of special charge			171,465
Deferred rent	65,550	(22,723)	102,518
Changes in operating assets and liabilities:			
Accounts receivable	(213,027)	(41,946)	95,715
Inventory	(1,977,508)	(506,799)	366,188
Prepaid expenses and other assets	191,345	55,351	36,541
Accounts payable	325,347	343,537	116,151
Accrued expenses and other liabilities	112,540	189,406	(255,252)
Net cash provided by operating activities	129,690	1,368,798	581,930
Investing activities:			
Purchase of property and equipment	(2,121,134)	(1,166,258)	(775,147)
Net cash used in investing activities	(2,121,134)	(1,166,258)	(775,147)
Financing activities:			
Net borrowings under line of credit	1,497,019	283,933	121,761
Decrease (increase) in restricted cash	(28,123)	(161,332)	296,005
Principal payments on capital lease obligations	(169,794)	(210,773)	(301,978)
Proceeds from exercise of stock options	7,028	1,760	4,688
Net cash provided by (used in) financing activities	1,306,130	(86,412)	120,476
Net increase (decrease) in cash and cash equivalents	(685,314)	116,128	(72,741)
Cash and cash equivalents, beginning of year	2,442,471	2,326,343	2,399,084
Cash and cash equivalents, end of year	\$ 1,757,157	\$ 2,442,471	\$ 2,326,343
Supplemental disclosure of non-cash financing activities:			
Conversion of Series A convertible preferred stock to common stock	\$ 1,000,000	\$	\$
Conversion of Series B convertible preferred stock to common stock	1,541,869	1,096,939	1,257,886
Conversion of Series E convertible preferred stock to common stock	347,895	289,604	250,000
Total conversion of convertible preferred stock to common stock	\$ 2,889,764	\$ 1,386,543	\$ 1,507,886
Acquisition of assets under capital lease	\$ 1,302,681	\$	\$ 7,881

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The accompanying notes are an integral part of these Consolidated Financial Statements.

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iPARTY CORP.

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

December 25, 2004

1. THE COMPANY

Background

The Company's efforts are devoted to the sale of party goods and services through its retail stores. At the end of fiscal 2004 the Company had 40 retail stores located throughout New England, with four additional stores located in Florida. In 2003, the Company licensed its Internet business to a third party in exchange for royalties under a license agreement, which to date have not been significant. Previously, the Company operated the Internet business with the same party under a fulfillment agreement.

The stores feature over 20,000 products ranging from greeting cards and balloons to more unique merchandise such as piñatas, gag gifts, masquerade and Hawaiian Luau items. The Company's sales are driven by the following events: Halloween, Christmas, Easter, Valentine's Day, New Year's, Independence Day, St. Patrick's Day, Thanksgiving, and Chanukah. The Company also focuses its business closely on lifetime events such as anniversaries, graduations, birthdays, and bridal or baby showers. The Company's business has a seasonal pattern with higher revenues in the second and fourth quarters, reflecting school graduations and Halloween, respectively.

Management's Plans

The Company believes, based on its current operating plan, that anticipated revenues from operations and borrowings available under the existing line of credit will be sufficient to fund its operations and working capital requirements through the next twelve months. The Company's current operating plan includes opening up to seven additional new stores in 2005, including the one new store that the Company opened since the end of fiscal 2004. In the event that the Company's operating plan changes or proves inaccurate due to decreased revenues, unanticipated expenses, increased competition, unfavorable economic conditions or other unforeseen circumstances, the Company's liquidity may be negatively impacted. Accordingly, the Company would be required to adjust its expenditures in 2005 to conserve working capital or raise additional capital to fund operations. There can be no assurance, however, that, should the Company require additional financing, such financing will be available on terms and conditions acceptable to the Company.

2. SIGNIFICANT ACCOUNTING POLICIES:

Principles of Consolidation

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The consolidated financial statements include the accounts of the Company and its wholly-owned subsidiaries after elimination of all significant intercompany transactions and balances.

Revenue Recognition

Revenues include the selling price of party goods sold, net of returns and discounts, and are recognized at the point of sale. The Company estimates returns based upon historical return rates and such amounts have not been significant.

Concentrations

The Company purchases its inventory from a diverse group of vendors and is not overly dependent upon any single source for its merchandise, often using more than one vendor for similar kinds of products.

Accounts receivable primarily represent amounts due from credit card companies and vendors for inventory rebates. Management does not provide for doubtful accounts as such amounts have not been significant to date; the Company does not require collateral.

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Use of Estimates

The preparation of financial statements in conformity with accounting principles generally accepted in the United States requires management to make estimates and assumptions that affect the reported amounts of assets and liabilities and disclosure of contingent assets and liabilities at the date of the financial statements and the reported amounts of revenue and expenses during the reporting period. Actual results could differ from these estimates.

Cash and Cash Equivalents, Outstanding Checks and Restricted Cash

The Company considers all highly liquid investments with an original maturity date of three months or less to be cash equivalents. Cash equivalents consist primarily of money market accounts and are carried at cost plus accrued interest, which approximates fair value.

The Company uses controlled disbursement banking arrangements as part of its cash management program. Outstanding checks, which were included in accounts payable, totaled \$950,156 at December 25, 2004 and \$989,816 at December 27, 2003. The Company had sufficient funds available to fund the outstanding checks when they were presented for payment.

Restricted cash represents money deposited in blocked accounts established for the benefit of and under the control of Wells Fargo Retail Finance II, LLC, the Company's lender under its line of credit, and constitutes collateral for amounts outstanding under the Company's line of credit.

Fair Value of Financial Instruments

The carrying values of cash and cash equivalents, accounts receivable and accounts payable approximate fair value because of the short-term nature of these instruments. The fair value of borrowings under its line of credit approximates carrying value because the debt bears interest at a variable market rate.

Inventories

Inventories consist of party supplies and are valued at the lower of moving weighted-average cost or market. Inventory has been reduced by an allowance for obsolete and excess inventory, which is based on management's review of inventories on hand compared to estimated future sales. The Company records vendor rebates, discounts and certain other adjustments to inventory, including freight costs, and these amounts are recognized in the income statement as the related goods are sold.

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The Company also makes adjustments to reduce the value of its inventory for an allowance for obsolete and excess inventory, which is based on its review of inventories on hand compared to estimated future sales.

In 2003, the Company refined its methodology for accounting for vendor rebates, discounts and freight. The net impact of these adjustments increased pre-tax income by \$141,757, net income by \$125,455 and had no impact on net income per basic and diluted share.

Advertising

Advertising costs are expensed upon first showing. Advertising costs amounted to \$3,174,446, \$2,706,596, and \$2,705,330 for the years ended December 25, 2004, December 27, 2003 and December 28, 2002, respectively.

Deferred Rent

Certain operating lease agreements contain scheduled rent increases, which are being amortized over the terms of the agreements using the straight-line method, and are included in other liabilities in the accompanying consolidated balance sheet. Deferred rent was \$471,759 at December 25, 2004 and \$406,209 at December 27, 2003.

Net Income (Loss) per Share

Net income per basic share is computed by dividing net income by the weighted-average number of common shares outstanding plus the common share equivalents of Series B-F preferred stock. The common share equivalents of Series B-F are included in the calculation of net income per basic share in accordance with EITF Topic D-95, *Effect of Participating Convertible Securities on the Computation of Basic Earnings Per Share*, since the preferred stockholders are entitled to participate in dividends when and if declared by the Board of Directors. For the periods with net losses, the Company excludes those common share equivalents since their impact would be anti-dilutive.

Net income per diluted share is computed by dividing net income by the weighted average number of common shares outstanding, plus the common share equivalents of Series A-F preferred stock, plus the common share equivalents of the in the money stock options and warrants as computed by the treasury method. For the periods with net losses, the Company excludes those common share equivalents since their impact would be anti-dilutive.

The following table sets forth the computation of net income (loss) per basic and diluted share available to common stockholders:

	2004		2003		2002	
Net income (loss)	\$	991,193	\$	750,957	\$	(684,569)
Preferred stock beneficial conversion feature						(90,150)
Net income (loss) available to common stockholders	\$	991,193	\$	750,957	\$	(774,719)
Net income (loss) per share available to common stockholders						
Basic	\$	0.03	\$	0.02	\$	(0.05)
Diluted	\$	0.02	\$	0.02	\$	(0.05)
Weighted-average shares outstanding:						
Common shares		21,364,673		17,652,805		16,219,436
Common share equivalents of Series B-F convertible preferred stock		16,284,727		19,030,337		
Basic weighted-average shares outstanding		37,649,400		36,683,142		16,219,436
Common share equivalents of Series A convertible preferred stock		48,077		1,000,000		
Common share equivalents of in the money stock options		3,819,559		1,185,342		
Common share equivalents of in the money warrants						
Diluted weighted-average shares outstanding		41,517,036		38,868,484		16,219,436

The common share equivalents of out of the money stock options and warrants which were excluded from the computation of net income per diluted share available to common stockholders were 3,309,630 and 13,011,215 in 2004, respectively, and 2,157,980 and 13,563,212 in 2003, respectively.

Stock Option Compensation Expense

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The Company accounts for its stock option compensation agreements with employees under the provisions of Accounting Principles Board (APB) Opinion No. 25, *Accounting for Stock Issued to Employees*. The Company has adopted the disclosure-only provisions of Statement of Financial Accounting Standards (SFAS) No. 123, *Accounting for Stock-Based Compensation*, as amended by SFAS No. 148, *Accounting for Stock-Based Compensation - Transition and Disclosure, an amendment of Financial Accounting Standards Board (FASB) Statement No. 123*.

The Company has computed the value of options using the Black-Scholes option pricing model prescribed by SFAS No. 123. The weighted-average fair value of the options granted was \$0.73 per share in 2004, \$0.38 per share

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during 2003 and \$0.29 per share during 2002, using the Black-Scholes option-pricing model with the following assumptions: no dividend yield, volatility of 116% to 119% in 2004, 119% to 125% in 2003, and 125% in 2002, a risk-free interest rate of 2.71% to 4.00% in 2004, 2.13% to 3.51% in 2003 and 4.86% to 5.95% in 2002, and an expected life of five years from date of the grant. Had compensation cost for the Company's stock option plan been determined based upon the fair value at the grant date for awards under the plan consistent with the methodology prescribed under SFAS 123, the Company's net income (loss) and net income (loss) per share and net income (loss) available to common stockholders and net income (loss) per share available to common stockholders would have been the following pro forma amounts:

	2004		2003		2002
Net income (loss):					
Reported	\$ 991,193	\$	750,957	\$	(684,569)
Stock option compensation expense	(668,223)		(480,268)		(671,029)
Pro forma	\$ 322,970	\$	270,689	\$	(1,355,598)
Net income (loss) per basic share:					
Reported	\$ 0.03	\$	0.02	\$	(0.04)
Pro forma	\$ 0.01	\$	0.01	\$	(0.08)
Net income (loss) per diluted share:					
Reported	\$ 0.02	\$	0.02	\$	(0.04)
Pro forma	\$ 0.01	\$	0.01	\$	(0.08)
Net income (loss) available to common stockholders:					
Reported	\$ 991,193	\$	750,957	\$	(774,719)
Stock option compensation expense	(668,223)		(480,268)		(671,029)
Pro forma	\$ 322,970	\$	270,689	\$	(1,445,748)
Net income (loss) per basic share available to common stockholders:					
Reported	\$ 0.03	\$	0.02	\$	(0.05)
Pro forma	\$ 0.01	\$	0.01	\$	(0.09)
Net income (loss) per diluted share available to common stockholders:					
Reported	\$ 0.02	\$	0.02	\$	(0.05)
Pro forma	\$ 0.01	\$	0.01	\$	(0.09)

Property and Equipment

Property and equipment are stated at cost less accumulated depreciation and are depreciated on the straight-line method over the estimated useful lives of the assets. At the beginning of fiscal 2004 the Company adopted a new policy for estimating the useful life of fixed assets which extended the useful life of equipment and furniture and fixtures. Changing the estimated life of the assets in these categories as of the beginning of the year reduced depreciation expense by approximately \$130,885. Net income in 2004 would have been \$0.02 per basic and diluted share if this change in estimating the useful life of fixed assets had not been adopted. Expenditures for maintenance and repairs are charged to operations as incurred. A listing of the estimated useful life of the various categories of property and equipment is as follows:

Asset Classification	Estimated Useful Life
Leasehold improvements	Lesser of term of lease or 10 years
Furniture and fixtures	7 years
Equipment	5 years
Computer hardware and software	3 years

Accounting for the Impairment of Long-Lived Assets

The Company adopted SFAS No. 144, *Accounting for the Impairment or Disposal of Long-Lived Assets*, in fiscal 2002, which requires that long-lived assets be measured at the lower of carrying amount or fair value less cost to sell. The adoption of SFAS No. 144 did not have a material impact on the Company's consolidated results of operations.

New Accounting Pronouncements

In January 2003, the FASB issued Interpretation No. 46, *Consolidation of Variable Interest Entities, an Interpretation of Accounting Research Bulletin (ARB) No. 51 (FIN 46)*. FIN 46 requires certain variable interest entities to be consolidated by the primary beneficiary of the entity if the equity investors in the entity do not have the characteristics of a controlling financial interest or do not have sufficient equity at risk for the entity to finance its activities without additional subordinated financial support from other parties. FIN 46 is effective for all new variable interest entities created or acquired after January 31, 2003. For variable interest entities created or acquired prior to February 1, 2003, the provisions of FIN 46 must be applied for the first interim or annual period beginning after June 15, 2003. However, in October 2003, the FASB deferred the effective date of FIN 46 to the end of the first interim or annual period ending after December 15, 2003 for those arrangements involving special purpose entities entered into prior to February 1, 2003. All other arrangements within the scope of FIN 46 are subject to its provisions beginning in 2004. The Company adopted FIN 46, as required, with no material impact to its consolidated financial position or results of operations.

On December 16, 2004, the FASB issued SFAS No. 123 (revised 2004), *Share-Based Payment*, which is a revision of SFAS No. 123, *Accounting for Stock-Based Compensation*. Statement 123(R) supersedes APB Opinion No. 25, *Accounting for Stock Issued to Employees*, and amends SFAS No. 95, *Statement of Cash Flows*. Generally, the approach in SFAS 123(R) is similar to the approach described in SFAS 123. However, SFAS 123(R) requires all share-based payments to employees, including grants of employee stock options, to be recognized in the income statement based on their fair values. Pro forma disclosure is no longer an alternative.

SFAS 123(R) must be adopted by the Company no later than July 1, 2005. Early adoption will be permitted in periods in which financial statements have not yet been issued. The Company expects to adopt SFAS 123(R) on July 1, 2005.

SFAS 123(R) permits public companies to adopt its requirements using one of two methods:

A modified prospective method in which compensation cost is recognized beginning with the effective date (a) based on the requirements of SFAS 123(R) for all share-based payments granted after the effective date and (b) based on the requirements of SFAS 123 for all awards granted to employees prior to the effective date of SFAS 123(R) that remain unvested on the effective date.

A modified retrospective method which includes the requirements of the modified prospective method described above, but also permits entities to restate based on the amounts previously recognized under SFAS 123 for purposes of pro forma disclosures either (a) all prior periods presented or (b) prior interim periods of the year of adoption.

The Company has not yet determined which method it will use.

As permitted by SFAS 123, the Company currently accounts for share-based payments to employees using Opinion 25's intrinsic value method and, as such, generally recognizes no compensation cost for employee stock options. Accordingly, the adoption of SFAS 123(R)'s fair value method will have a significant impact on the Company's results of operations, although it will have no impact on its overall financial position. The impact of adoption of SFAS 123(R) cannot be predicted at this time because it will depend on levels of share-based payments granted in the future. However, had the Company adopted SFAS 123(R) in prior periods, the impact of that standard would have approximated the impact of SFAS 123 as described in the disclosure of pro forma net loss and net loss per share discussed above.

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Reclassifications

Certain reclassifications have been made to prior year's amounts to conform to the current year presentation.

3. PROPERTY AND EQUIPMENT:

Property and equipment consist of the following:

	Dec 25, 2004	Dec 27, 2003
Leasehold improvements	\$ 2,017,339	\$ 996,460
Furniture and fixtures	1,798,389	860,982
Equipment under capital leases	1,321,160	289,737
Computer hardware and software	728,946	401,598
Equipment	446,680	339,922
Property and equipment	6,312,514	2,888,699
Less accumulated depreciation	(1,828,809)	(1,194,559)
Property and equipment, net	\$ 4,483,705	\$ 1,694,140

4. LEASES:

The Company conducts its operations in leased facilities with certain leased equipment accounted for as operating and capital leases. Real estate leases generally provide for fixed minimum rentals, which typically increase periodically during the life of the lease, and, in some instances, contingent rentals based on a percentage of sales in excess of specified minimum sales levels, as well as occupancy costs, such as property taxes and common area maintenance. The leases are typically for 10 years, usually with options from the Company's landlords to renew the Company's leases for an additional 5 or 10 years.

The original cost of assets under capital leases at December 25, 2004 and December 27, 2003 was \$1,321,161 and \$289,737, respectively. The accumulated depreciation of assets under capital leases at December 25, 2004 and December 27, 2003 was \$132,631 and \$286,847, respectively. The amortization related to those assets under capital lease is included in depreciation expense.

At December 25, 2004 the minimum rental commitments under all non-cancelable capital and operating leases with initial or remaining terms of more than one year were as follows:

Year	Capital	Operating
2005	\$ 490,561	\$ 7,223,873
2006	501,942	6,949,341

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2007	323,784	5,642,420
2008		4,293,303
2009		4,104,859
Thereafter		14,601,593
Total future minimum lease payments	1,316,287	\$ 42,815,389
Less amount representing interest	153,920	
Present value of minimum lease payments	1,162,367	
Less current portion of obligation under capital leases	365,674	
Long-term obligation under capital leases	\$	796,693

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The Company's rental expense under operating leases amounted to \$6,431,752 in 2004, \$5,323,409 in 2003 and \$4,746,886 in 2002. Included in these amounts are contingent rentals totaling \$45,039 in 2004, \$37,948 in 2003 and \$24,941 in 2002.

5. ACCRUED EXPENSES:

There was no accrued expense which exceeded 5% of current liabilities on the balance sheet at December 25, 2004. The only accrued expense which exceeded 5% of current liabilities on the balance sheet at December 27, 2003 was accrued payroll and benefits of \$461,204.

6. INCOME TAXES:

A reconciliation of the effective rate with the federal statutory rate is as follows:

	2004	2003	2002
Federal statutory rate	34.0%	34.0%	-34.0%
State income taxes, net of federal benefit	5.1%	5.2%	-6.0%
Permanent differences	1.7%	1.1%	10.0%
Change in valuation allowance	-31.2%	-28.8%	30.0%
Effective tax rate	9.6%	11.5%	0.0%

Deferred tax assets consist of the following:

	2004	2003
Net operating loss carryforwards	\$ 8,732,000	\$ 9,436,000
Inventory reserves	503,000	557,000
Deferred rent	186,000	162,000
Accrued vacation	103,000	90,000
Other	91,000	40,000
Excess book over tax depreciation and amortization	60,000	156,000
	9,675,000	10,441,000
Less valuation allowance	(9,675,000)	(10,441,000)
Net deferred tax asset	\$	\$

The Company has recorded a valuation allowance against its deferred tax assets because of the uncertainty regarding the realizability of these assets against future taxable income.

The Company used approximately \$923,000 and \$792,000 of net operating loss carryforwards in 2004 and 2003, respectively.

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As of December 25, 2004, the Company has estimated net operating loss carryforwards of approximately \$23.0 million, which begin to expire in 2018. In accordance with Section 382 of the Internal Revenue Code, the use of some of these carryforwards will be subject to annual limitations based upon ownership changes of the Company's stock which may have occurred or that may occur.

The Company made cash payments for state income taxes of \$157,752 in 2004, \$77,279 in 2003 and \$16,500 in 2002. The Company made cash payments for federal income taxes of \$35,000 in 2004, \$0 in 2003 and \$0 in 2002.

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7. CONTRACTUAL ARRANGEMENTS:

License Arrangement

On July 8, 1999, the Company entered into a product fulfillment agreement with Taymark, a direct marketer of party supplies, to utilize the direct marketer's inventory and fulfillment services to deliver merchandise ordered on the Company's website, or directly through a toll-free telephone number, to consumers.

On July 8, 2003 the Company signed a new agreement with Taymark to license the iParty.com name to Taymark, which now operates the website at www.iparty.com. In return, Taymark pays the Company a 15% royalty on all net sales realized through its operation of www.iparty.com. The term of this agreement is for a period of two (2) years, unless sooner terminated. If this agreement is not terminated, it shall be automatically renewed for successive one-year periods.

Earn-out agreement

The Company purchased from The Big Party, Debtor and Debtor-in-Possession (the sellers) in 2000 inventory, fixed assets and the leases of 33 retail stores in consideration of cash and assumption of certain liabilities. In addition, the Company agreed to pay the sellers, no later than March 31, 2004, an amount equivalent to the greater of \$250,000, or a percentage of the aggregate operating results of the 33 acquired locations. In connection with the Company's purchase accounting in 2000, the Company accrued the guaranteed amount of \$250,000, which based on actual results is the minimum and final amount due as of December 27, 2003, and paid this amount during the first quarter of 2004.

8. RELATED PARTY TRANSACTIONS:

On August 26, 1999 the Company granted Mr. Sal Perisano, its Chief Executive Officer, options to purchase an aggregate of 434,730 shares of the Company's common stock pursuant to the Company's stock option plan with an exercise price of \$2.00, which was below the then-current market price of \$3.38. As of December 29, 2001 all such options had vested. These options were fully expensed as of December 29, 2001. The Company charged \$273,971 related to this stock option grant to stock option compensation expense in 2001, the final year of vesting.

On September 7, 1999, the Company and Mr. Stuart Moldaw, who served as a Director of the Company from 1999 to 2003, entered into a consulting agreement that had a term of three years. Upon the expiration of this agreement, the Company and Mr. Moldaw entered into an oral agreement that Mr. Moldaw would continue to provide consulting services to the Company. On November 6, 2003 the Compensation Committee of the Company's Board of Directors approved a stock option grant to Mr. Moldaw, vesting immediately, with the strike price set at the closing price of the Company's common stock on that day, to purchase 50,000 shares of common stock, for consulting services performed by Mr. Moldaw in 2003. The fair value of the options granted to Mr. Moldaw on November 6, 2003 was \$25,000. On January 31, 2005 the Compensation Committee of the Company's Board of Directors approved a stock option grant to Mr. Moldaw, vesting immediately, with the strike price set at the closing price of the Company's common stock on that day, to purchase 50,000 shares of common stock, for consulting services performed by Mr. Moldaw in 2004. The fair value of the options granted on January 31, 2005 was \$28,500. The committee approved this grant, but noted that Mr. Moldaw would not receive any additional stock option grants for consulting services in the future.

9. LINE OF CREDIT:

On January 2, 2004 the Company amended its existing line of credit (the line) with Wells Fargo Retail Finance II, LLC. The amendment extended the maturity date of the line to January 2, 2007, eliminated the minimum interest rate of 6.5%, established a new interest rate at the bank's base rate plus 50 basis points and added the option to increase the line in increments of \$2,500,000 beyond the previous limit of \$7,500,000, to a limit of \$12,500,000, upon 15 days written notice, as long as the Company is in compliance of all debt covenants and the provisions of the loan agreement. Inventory and accounts receivable secure the Company's line.

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The amended agreement includes a financial covenant requiring the Company to maintain a minimum availability under the line of 5% of the credit limit, which at the current limit of \$7,500,000, is \$375,000. If the Company adjusts the credit limit in the future, the minimum availability would be 5% of the adjusted credit limit. The amended agreement also has a covenant that requires the Company to limit its capital expenditures to within 110% of those amounts included in its business plan, which may be updated from time to time. At December 25, 2004, the Company was in compliance with these financial covenants. The line generally prohibits the payment of any dividends or other distributions to any of the Company's classes of capital stock.

At December 27, 2003 the line had a maturity date of July 31, 2004 and a minimum interest rate of 6.5%. The line allowed for borrowings equal to the lesser of \$7,500,000 or the borrowing base, as defined. Inventory and other assets secured the line. The Company was required to maintain a minimum availability under the line in the amount of \$300,000.

The amounts outstanding under the line as of December 25, 2004 and December 27, 2003 were \$5,257,690 and \$3,760,671, respectively. The interest rate on these borrowings was 5.75% at December 25, 2004 and 6.5% at December 27, 2003. The outstanding balances under the line are classified as current liabilities in the accompanying consolidated balance sheets since the Company is required to apply daily lock box receipts to reduce the amount outstanding. At December 25, 2004, the Company had approximately \$305,000 of additional availability under the line. In the third quarter of fiscal 2004, the Company established a letter of credit for \$356,000 with Wells Fargo Bank, N.A. associated with the leasing of its new point-of-sale system. This \$356,000 letter of credit was outstanding at December 25, 2004.

The Company made cash payments for interest of \$218,765 in 2004, \$217,268 in 2003, and \$285,515 in 2002.

10. PREFERRED STOCK:

The following table summarizes the changes in the number of shares of convertible preferred stock during the past two years.

	Shares Issued and Outstanding as of 12/25/04	Conversions to Common Stock	Shares Issued and Outstanding as of 12/27/03	Conversions to Common Stock	Shares Historically Reported as Issued and Outstanding as of 12/28/02
Series A convertible preferred stock		(1,000,000)	1,000,000		1,000,000
Series B convertible preferred stock	507,460	(103,620)	611,080	(73,719)	684,799
Series C convertible preferred stock	100,000		100,000		100,000
Series D convertible preferred stock	250,000		250,000		250,000
Series E convertible preferred stock	296,667	(92,772)	389,439	(77,228)	466,667
Series F convertible preferred stock	114,286		114,286		114,286
Total	1,268,413	(1,196,392)	2,464,805	(150,947)	2,615,752

On October 31, 2002, the Company concluded it had incorrectly applied the anti-dilution provisions of its Series B, C and D convertible preferred stock (the Affected Preferred Stock) in conjunction with dilutive financings in August and September 2000. The Company determined that it inadvertently issued additional shares of Affected Preferred Stock, instead of adjusting the Affected Preferred Stock's conversion ratios. The Company also miscalculated the number of common shares issuable upon conversion of the Affected Preferred Stock. As a result of the above transactions, the anti-dilution provisions of the Company's Series E and Series F convertible preferred stock were also triggered,

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increasing the number of shares issuable upon conversion of the Company's Series E and Series F convertible preferred stock.

See Note 16 for additional information on this subject.

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Series A Convertible Preferred Stock

On January 13, 2004, all shares of Series A convertible preferred stock were converted into 1,000,000 shares of common stock on a 1.00 to 1.00 ratio. Holders of Series A convertible preferred stock had a liquidation preference senior to the Company's common stockholders, and were *pari passu* with the Company's Series B, C, D, E and F convertible preferred stock. Until their shares of Series A convertible preferred stock were converted into shares of common stock, holders of Series A convertible preferred stock were not entitled to any dividends or to vote on matters submitted to a vote of the Company's stockholders, except to the extent otherwise expressly provided by the General Corporation Law of Delaware.

Series B Convertible Preferred Stock

The shares of Series B convertible preferred stock are immediately convertible into 6,531,105 shares of common stock on a 1.000 to 12.870 ratio at December 25, 2004, and carry an aggregate liquidation value of \$10,149,200 (\$1.55 per common share issuable upon conversion) at December 25, 2004. With certain exceptions, the conversion price will be adjusted on a weighted-average basis in the event the Company issues common stock or certain rights, including option activity in excess of certain amounts, to purchase or convert into common stock as defined in the Company's Certificate of Incorporation as amended at a price below the conversion price. The Series B convertible preferred stock will automatically convert into common stock at the conversion price then in effect in the event the Company consummates a secondary public offering resulting in gross proceeds to the Company of at least \$10,000,000.

In the event of liquidation, the holders of Series B convertible preferred stock have preference to holders of the Company's common stock, and are *pari passu* with the Company's Series C, D, E and F convertible preferred stock.

Holders of Series B convertible preferred stock are entitled to 12 votes per share (i.e., one vote for each whole number of shares of common stock into which each such share is presently convertible) on all matters submitted to a vote of the Company's stockholders and are entitled to participate in dividends when and if declared by the Board of Directors.

Series C Convertible Preferred Stock

The shares of Series C convertible preferred stock are immediately convertible into 1,310,600 shares of common stock on a 1.000 to 13.106 ratio at December 25, 2004, and carry an aggregate liquidation value of \$2,000,000 (\$1.53 per common share issuable upon conversion) at December 25, 2004. With certain exceptions, the conversion price will be adjusted on a weighted-average basis in the event the Company issues common stock or certain rights, including option activity in excess of certain amounts, to purchase or convert into common stock as defined in the Company's Preferred Stock Charter at a price below the conversion price. The Series C convertible preferred stock will automatically convert into common stock at the conversion price then in effect in the event the Company consummates a secondary public offering resulting in gross proceeds to the Company of at least \$10,000,000.

In the event of liquidation, the holders of Series C convertible preferred stock have preference to holders of the Company's common stock, and are *pari passu* with the Company's Series B, D, E and F convertible preferred stock.

Holders of Series C convertible preferred stock are entitled to 13 votes per share (i.e., one vote for each whole number of shares of common stock into which each such share is presently convertible) on all matters submitted to a vote of the Company's stockholders and are entitled to participate in dividends when and if declared by the Board of Directors.

Series D Convertible Preferred Stock

The shares of Series D convertible preferred stock are immediately convertible into 3,513,750 shares of common stock on a 1.000 to 14.055 ratio at December 25, 2004, and carry an aggregate liquidation value of

\$5,000,000 (\$1.42 per common share issuable upon conversion) at December 25, 2004. With certain exceptions, the conversion price will be adjusted on a weighted-average basis in the event the Company issues common stock or certain rights, including option activity in excess of certain amounts, to purchase or convert into common stock as defined in the Company's Preferred Stock Charter at a price below the conversion price. The Series D convertible preferred stock will automatically convert into common stock at the conversion price then in effect in the event the Company consummates a secondary public offering resulting in gross proceeds to the Company of at least \$10,000,000.

In the event of liquidation, the holders of Series D convertible preferred stock have preference to holders of the Company's common stock, and are *pari passu* with the Company's Series B, C, E and F convertible preferred stock.

Holders of Series D convertible preferred stock are entitled to 14 votes per share (i.e., one vote for each whole number of shares of common stock into which each such share is presently convertible) on all matters submitted to a vote of the Company's stockholders and are entitled to participate in dividends when and if declared by the Board of Directors.

Series E Convertible Preferred Stock

The shares of Series E convertible preferred stock are immediately convertible into 3,073,168 shares of common stock on a 1.000 to 10.359 ratio at December 25, 2004, and carry an aggregate liquidation value of \$1,112,500 (\$0.36 per common share issuable upon conversion) at December 25, 2004. With certain exceptions, the conversion price will be adjusted on a weighted-average basis in the event the Company issues common stock or certain rights, including option activity in excess of certain amounts, to purchase or convert into common stock as defined in the Company's Preferred Stock Charter at a price below the conversion price. The Series E convertible preferred stock will automatically convert into common stock at the conversion price then in effect in the event the average closing bid price of the common stock equals or exceeds \$10.00 per share for 20 days within any 30-day period.

In the event of liquidation, the holders of Series E convertible preferred stock have preference to holders of the Company's common stock, and are *pari passu* with the Company's Series B, C, D and F convertible preferred stock.

Holders of Series E convertible preferred stock are entitled to 10 votes per share (i.e., one vote for each whole number of shares of common stock into which each such share is presently convertible) on all matters submitted to a vote of the Company's stockholders and are entitled to participate in dividends when and if declared by the Board of Directors.

Series F Convertible Preferred Stock

The shares of Series F convertible preferred stock are immediately convertible into 1,184,803 shares of common stock on a 1.000 to 10.367 ratio at December 25, 2004, and carry an aggregate liquidation value of \$500,000 (\$0.42 per common share issuable upon conversion) at December 25, 2004. With certain exceptions, the conversion price will be adjusted on a weighted-average basis in the event the Company issues common stock or certain rights, including option activity in excess of certain amounts, to purchase or convert into common stock as defined in the Company's Preferred Stock Charter at a price below the conversion price. The Series F convertible preferred stock will automatically convert into common stock at the conversion price then in effect in the event the average closing bid price of the common stock equals or exceeds \$10.00 per share for 20 days within any 30-day period.

In the event of liquidation, the holders of Series F convertible preferred stock have preference to holders of the Company's common stock, and are pari passu with the Company's Series B, C, D and E convertible preferred stock.

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Holders of Series F preferred stock are entitled to 10 votes per share (i.e., one vote for each whole number of shares of common stock into which each such share is presently convertible) on all matters submitted to a vote of the Company's stockholders and are entitled to participate in dividends when and if declared by the Board of Directors.

Accretion of Dividends in the Event of Liquidation

The carrying values of Series B-F convertible preferred stock have been determined based on their fair market values at the original dates of issuance. In certain cases, warrants were issued, which the Company allocated value to and included in additional paid in capital. Should such a liquidation event occur, the difference between the carrying value of the convertible preferred stock and their liquidation value will be accreted. This amount was \$4,453,698 on December 25, 2004.

11. WARRANTS:

At December 25, 2004, there were various warrants outstanding for shares of the Company's common stock. These warrants were issued in connection with certain preferred stock financings and certain licensing and marketing arrangements. Substantially all of the warrant agreements contain certain anti-dilution provisions, which protect the warrant holders against dilution upon the occurrence of certain events, including the sale of common stock or certain rights, including option activity in excess of certain amounts, to purchase or convert into common stock, as defined in the warrant agreement for less than fair market value or less than the exercise price of the previously issued warrants. If such an event occurs, this can result in additional shares being available to the warrant holder and a reduction in the exercise price for each share.

The following table summarizes the Company's outstanding warrants, including the impact of anti-dilution events which occurred in previous years, at December 25, 2004:

Number of Warrants	Total Common Shares Issuable	Exercise Price per Common Share Issuable	Expiration Date
528,210	528,210	\$ 2.63 - \$5.13	04/16/09 - 08/15/09
5,223,512	8,357,619	1.25	08/26/05
500,000	800,000	1.25	08/26/05
929,929	1,487,886	1.25	08/26/05
1,250,000	1,837,500	1.36	08/26/05
8,431,651	13,011,215	1.37	

Commencing one year from the issue date, the Company may, at its option, on a 30-day notice, redeem certain common stock warrants at a price of \$0.05 per warrant if the average closing bid price of the common stock equals or exceeds \$8.00 per share for 20 days within any 30-day period.

12. STOCK OPTION PLAN:

Under the Company's Amended and Restated 1998 Incentive and Nonqualified Stock Option Plan (the "1998 Plan") options to acquire 11,000,000 shares of common stock may be granted to officers, directors, key employees and consultants. The exercise price for qualified incentive options cannot be less than the fair market value of the stock on the grant date and the exercise price of nonqualified options can be fixed by the Board.

Qualified incentive options to purchase the Company's common stock under the 1998 Plan have been granted to employees, directors and consultants of the Company at fair market value at the date of grant. Generally, the options become exercisable over periods of up to four years, and expire ten years from the date of grant.

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A summary of the Company's stock options is as follows:

	Number of Stock Options	Weighted Average Exercise Price	Price Range
Outstanding - December 29, 2001	7,522,964	\$ 1.07	\$ 0.10 - \$ 5.38
Granted	863,457	0.33	0.21 - 0.67
Expired/Forfeited	(133,862)	0.31	0.10 - 0.50
Exercised	(9,375)	0.50	0.50 - 0.50
Outstanding - December 28, 2002	8,243,184	1.01	0.11 - 5.38
Granted	455,555	0.45	0.15 - 1.06
Expired/Forfeited	(170,021)	0.29	0.15 - 0.44
Exercised	(11,000)	0.16	0.16 - 0.16
Outstanding - December 27, 2003	8,517,718	0.99	0.11 - 5.38
Granted	1,801,300	0.89	0.69 - 1.33
Expired/Forfeited	(269,406)	1.50	0.11 - 4.00
Exercised	(17,795)	0.39	0.20 - 0.50
Outstanding - December 25, 2004	10,031,817	\$ 0.96	\$ 0.13 - \$ 5.38
Exercisable - December 25, 2004	8,210,070	\$ 1.01	\$ 0.13 - \$ 5.38
Available for grant - December 25, 2004	595,013		

The following table summarizes information for options outstanding and exercisable at December 25, 2004:

Price Range	Number of Stock Options	Weighted Average Remaining Life (Years)	Weighted Average Exercise Price	Number of Stock Options	Weighted Average Exercise Price
\$ 0.11 - \$ 0.20	244,860	6.9	\$ 0.18	187,396	\$ 0.18
0.21 - 0.30	3,832,882	6.2	0.25	3,592,078	0.25
0.31 - 0.50	1,092,768	7.2	0.35	980,726	0.35
0.51 - 1.00	2,882,177	8.1	0.80	1,497,515	0.74
1.01 - 3.50	989,130	4.7	2.17	962,355	2.19
3.51 - 5.38	990,000	4.4	3.82	990,000	3.82
Total	10,031,817	6.5	\$ 0.96	8,210,070	\$ 1.01

The Company has reserved 38,656,458 shares of common stock for issuance in connection with the conversion of convertible preferred stock and the exercise of warrants and stock options.

13. STOCKHOLDER RIGHTS PLAN:

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The Company has a Stockholder Rights Plan (the Plan) effective November 9, 2001. Under the Plan each share of the Company s capital stock outstanding at the close of business on November 9, 2001 and each share of the Company s capital stock issued subsequent to that date has a right associated with it, such that each share of its

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common stock is entitled to one right and each share of its preferred stock is entitled to such number of rights equal to the number of common shares into which it is convertible.

The rights are exercisable only in the event, with certain exceptions, an acquiring party accumulates 10 percent or more of the Company's voting stock, or if a party announces an offer to acquire 15 percent or more of the Company's voting stock. The rights expire on November 9, 2011.

When exercisable, each right entitles the holder to purchase from the Company, one one-hundredth of a share of a new series of Series G junior preferred stock at an initial purchase price of \$2.00. In addition, upon the occurrence of certain events, holders of the rights will be entitled to purchase either iParty Corp. stock or shares in an acquiring entity at half of market value. The Company generally will be entitled to redeem the rights at \$0.001 per right at any time until the date on which a 10 percent position in its voting stock is acquired by any person or group. Until a right is exercised, the holder thereof, as such, will have no rights as a stockholder of the Company, including, without limitation, the right to vote or receive dividends.

14. PROFIT SHARING 401(k) PLAN:

The iParty 401(k) Plan is a qualified profit sharing plan covering substantially all of its employees. Contributions to this plan are at the discretion of the Board of Directors. The Company's expense, including matching contributions and any discretionary amounts was \$111,799 in 2004, \$95,405 in 2003 and \$88,532 in 2002.

15. SEGMENT REPORTING:

SFAS No. 131, *Disclosures about Segments of an Enterprise and Related Information*, establishes standards for the way business enterprises report information about operating segments in annual financial statements and requires that those enterprises report selected information about operating segments in interim financial reports issued to stockholders.

In the past the Company had determined that its reportable segments consisted of a retail stores operation and an Internet operation. As of 2003, with the transition of the Internet operation to a license arrangement and the insignificance of the revenues prior to the transition (less than 2%) and results of operations (less than 5%) to the overall business, the Company no longer reports Internet operating segment information.

16. SPECIAL CHARGE:

On October 31, 2002, the Company concluded it had incorrectly applied the anti-dilution provisions of its Series B, C and D convertible preferred stock (the Affected Preferred Stock) in conjunction with dilutive financings in August and September 2000.

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The Company determined that it inadvertently issued additional shares of Affected Preferred Stock, instead of adjusting the Affected Preferred Stock's conversion ratios. The Company also miscalculated the number of common shares issuable upon conversion of the Affected Preferred Stock.

The Company also reviewed the anti-dilution provisions of certain of its warrants to purchase common stock that were issued in conjunction with the Affected Preferred Stock (the Affected Warrants), and has determined that it mistakenly issued additional warrant certificates, instead of adjusting the Affected Warrants' conversion ratios. The warrant calculations also mistakenly omitted the dilutive effect of a warrant issued by the Company in December 1999.

The Company performed the calculations to compute the correct number of shares of Affected Preferred Stock and Affected Warrants that should be issued and outstanding as of December 28, 2002, along with the appropriate conversion ratios in effect at December 28, 2002. The Company notified each holder of Affected Preferred Stock as of December 2, 2002. The Company also instructed its transfer agent to apply any Affected Stock conversions using the corrected ratios and prices. The Company has presented its earnings per share and all footnotes information for 2002, in accordance with the corrected information. The accounting implications of this situation are as follows:

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Beginning in September 2000, the Company believed and treated holders of Affected Preferred Stock as if they were entitled to approximately 2.3 million more common shares upon conversion of their Affected Preferred Stock than they were in fact entitled to. Of this overstated amount, 590,327 common shares were issued upon conversions of shares of Affected Preferred Stock and sold in the public market (the Overissued Shares) beginning in October 2000. On October 31, 2002, the Company's Board of Directors ratified the issuance of the Overissued Shares.

Beginning in September 2000, the Company believed and treated holders of Affected Warrants as if they were entitled to 116,291 fewer common shares upon exercise of their Affected Warrants than they were in fact entitled to.

None of the Affected Warrants have been exercised as of March 21, 2005.

The impact of these matters did not require the Company to make any changes to its previously reported earnings per share. The impact of the common stock equivalents did not affect quarterly or annual loss per diluted share, since such the inclusion of such shares would have been anti-dilutive. The impact of common stock equivalents did not impact quarterly net income per diluted share in such periods of profit, given the minimal amount of net income in comparison to the weighted-average shares outstanding.

The Company recorded a special charge for the year ended December 28, 2002 in the amount of \$396,465, which included a non-cash charge of \$171,465 for the recognition of the Overissued Shares, and \$225,000 of professional fees incurred through December 28, 2002.

The Company also recorded a beneficial conversion dividend in the amount of \$90,150 in the fourth quarter of 2002, which reflects the impact of anti-dilution adjustments to the conversion ratios of the Series E and F convertible preferred stock.

In 2004 the Company reached a settlement with a third party in connection with the special charge previously recorded in fiscal year 2002. The Company recorded the net settlement of \$382,500 as other income.

17. QUARTERLY FINANCIAL DATA (UNAUDITED):**QUARTERLY FINANCIAL DATA**

	Mar 27, 2004		Jun 26, 2004		Sep 25, 2004		Dec 25, 2004	
Revenues	\$	12,036,066	\$	15,360,388	\$	13,157,546	\$	23,722,225
Cost of products sold (1), (2)		6,973,329		8,482,813		7,849,135		12,521,543
Operating income (loss)		(810,759)		494,417		(1,477,668)		2,731,423
Net income (loss)		(838,005)		805,852		(1,526,977)		2,550,323
Net income (loss) per share								
Basic	\$	(0.04)	\$	0.02	\$	(0.07)	\$	0.07
Diluted	\$	(0.04)	\$	0.02	\$	(0.07)	\$	0.06
Weighted-average shares outstanding:								
Basic		20,227,671		37,698,128		22,019,408		37,649,400
Diluted		20,227,671		41,834,415		22,019,408		41,468,959
	Mar 27, 2003		Jun 28, 2003		Sep 27, 2003		Dec 27, 2003	
Revenues	\$	10,287,577	\$	13,805,555	\$	11,878,460	\$	20,725,654
Cost of products sold (1), (3)		6,241,696		7,849,863		7,060,170		10,606,896
Operating income (loss)		(1,112,040)		408,242		(969,252)		2,732,205
Net income (loss)		(1,164,266)		351,777		(1,034,727)		2,598,173
Net income (loss) per share								
Basic	\$	(0.07)	\$	0.01	\$	(0.06)	\$	0.07
Diluted	\$	(0.07)	\$	0.01	\$	(0.06)	\$	0.06
Weighted-average shares outstanding:								
Basic		16,999,935		36,678,915		17,687,448		36,688,228
Diluted		16,999,935		37,747,608		17,687,448		41,091,732

(1) Cost of products sold consists of the cost of merchandise sold to customers and the occupancy costs for stores.

(2) The fourth quarter of 2004 included an estimated reduction of \$149,316 to the cost of products sold during the previous three quarters due to the completion of physical inventories, for which shortage had been estimated during the year.

(3) The fourth quarter of 2003 included an estimated reduction of \$145,983 to the cost of products sold during the previous three quarters due to the completion of physical inventories, for which shortage had been estimated during the year.

EXHIBIT INDEX

EXHIBIT NUMBER	DESCRIPTION
3.1 (1)	Restated Certificate of Incorporation of WSI Acquisition Corp. and Certificate of Merger by iParty Corp. into WSI Acquisition Corp.
3.2 (1)	Certificate of Designation of Series A Preferred Stock of WSI Acquisitions, Corp.
3.3 (2)	Certificate of Designation of Series B Preferred Stock of iParty Corp.
3.4 (2)	Certificate of Designation of Series C Preferred Stock of iParty Corp.
3.5 (4)	Certificate of Designation of Series D Preferred Stock of iParty Corp.
3.6 (6)	Certificate of Designation of Series E Preferred Stock of iParty Corp.
3.7 (12)	Certificate of Correction to Certificate of Designation of Series E Preferred Stock of iParty Corp.
3.8 (7)	Certificate of Designation of Series F Preferred Stock of iParty Corp.
3.9 (9)	Certificate of Designation of Series G Junior Preferred Stock of iParty Corp.
3.10 (1)	By-Laws of WSI Acquisition Corp., as amended.
4.1 (2)	Warrant Agreement between iParty Corp., Continental Stock Transfer & Trust Company and Commonwealth Associates, LP.
4.2 (2)	Warrant Agreement between iParty Corp., Continental Stock Transfer & Trust Company and Commonwealth Associates, LP.
4.3 (5)	Taymark Warrant Certificate.
10.1 (1)	Agreement and Plan of Merger between iParty Corp. and WSI Acquisitions Corp.
10.2 (1)	1998 Incentive and Non-Qualified Stock Option Plan.
10.3 (11)	Amended and Restated 1998 Incentive and Non-Qualified Stock Option Plan.
10.4 (14) ##	Employment Agreement between iParty Corp. and Sal Perisano, dated May 14, 2004.
10.5 (14) ##	Employment Agreement between iParty Corp. and Patrick Farrell, dated May 14, 2004.
10.6 (14) ##	Employment Agreement between iParty Corp. and Dorice Dionne, dated May 14, 2004.
10.7 (3)	Fulfillment Agreement between iParty Corp. and Taymark.
10.8 (11)	Extension to Fulfillment Agreement between iParty Corp. and Taymark.
10.9 (12)	Web Site License Agreement between iParty Corp. and Taymark, Inc.
10.10 (8)	Rights Agreement between iParty Corp. and Continental Stock Transfer & Trust, as Rights Agent.
10.11 (11)	Loan and Security Agreement between iParty Retail Stores Corp. and Paragon Capital LLC.
10.12 (10)	First Amendment to Loan and Security Agreement by and among iParty Corp., iParty Retail Stores Corp. and Wells Fargo Retail Finance, LLC.
10.13 (13)	Second Amendment to Loan and Security Agreement by and among iParty Corp., iParty Retail Stores Corp. and Wells Fargo Retail Finance II, LLC.
10.14 (11)	Trademark Security Agreement between iParty Retail Stores Corp. and Paragon Capital LLC.
10.15 (11)	Trademark Security Agreement between iParty Corp. and Wells Fargo Retail Finance, LLC.
10.16 (6)	Stock Purchase Agreement by and among iParty Corp., Ajmal Khan and Robert Lessin.
10.17 (7)	Stock Purchase Agreement between iParty Corp. and Patriot Capital Ltd.
10.18 (3)	Funding Agreement among iParty Corp., Robert Lessin and Ajmal Khan.
21.1 (15)	Subsidiaries of Registrant.
23.1 (15)	Consent of Ernst & Young LLP, Independent Registered Public Accounting Firm.
31.1 **	Certification of Chief Executive Officer pursuant to Section 302 of Sarbanes-Oxley Act.
31.2 **	Certification of Chief Financial Officer pursuant to Section 302 of Sarbanes-Oxley Act.
32.1 **	Certification of Chief Executive Officer pursuant to Section 906 of Sarbanes-Oxley Act.
32.2 **	Certification of Chief Financial Officer pursuant to Section 906 of Sarbanes-Oxley Act.

** Filed herewith.

Management contract or compensatory plan or arrangement.

(1) Filed as an exhibit to iParty's Registration Statement on Form 10-SB, Registration No. 0-25507, as filed with the SEC on March 8, 1999 and incorporated herein by reference.

(2) Filed as an exhibit to Amendment No. 2 to iParty's Registration Statement on Form 10-SB, Registration No. 0-25507, as filed with the SEC on October 19, 1999 and incorporated herein by reference.

(3) Filed as an exhibit to Amendment No. 1 to iParty's Registration Statement on Form 10-SB, Registration No. 0-25507, as filed with the SEC on July 12, 1999 and incorporated herein by reference.

- (4) Filed as an exhibit to iParty's Annual Report on Form 10-KSB for the year ended December 31, 1999, as filed with the SEC on April 14, 2000 and incorporated herein by reference.
 - (5) Filed as an exhibit to iParty's Registration Statement on Form SB-2, Registration No. 333-40568, as filed with the SEC on June 30, 2000 and incorporated herein by reference.
 - (6) Filed as an exhibit to iParty's Current Report on Form 8-K, filed with the SEC on August 30, 2000 and incorporated herein by reference.
 - (7) Filed as an exhibit to iParty's Current Report on Form 8-K, filed with the SEC on September 15, 2000 and incorporated herein by reference.
 - (8) Filed as an exhibit to iParty's Current Report on Form 8-K, filed with the SEC on November 16, 2001 and incorporated herein by reference.
 - (9) Included as an exhibit (Exhibit C) to Exhibit 99.2 to iParty's Current Report on Form 8-K, filed with the SEC on November 16, 2001 and incorporated herein by reference.
 - (10) Filed as an exhibit to iParty's Quarterly Report on Form 10-QSB for the quarterly period ended June 29, 2002, as filed with the SEC on August 13, 2002 and incorporated herein by reference.
 - (11) Filed as an exhibit to iParty's Annual Report on Form 10-KSB for the year ended December 28, 2002, filed with the SEC on March 28, 2003 and incorporated herein by reference.
 - (12) Filed as an exhibit to iParty's Quarterly Report on Form 10-Q, filed with the SEC on August 12, 2003 and incorporated herein by reference.
 - (13) Filed as an exhibit to iParty's Current Report on Form 8-K, filed with the SEC on January 29, 2004 and incorporated herein by reference.
 - (14) Filed as an exhibit to iParty's Quarterly Report on Form 10-Q, filed with the SEC on August 10, 2004 and incorporated herein by reference.
 - (15) Filed as an exhibit to iParty's Annual Report on Form 10-K, filed with the SEC on March 25, 2005 and incorporated herein by reference.
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