REALNETWORKS INC
Form 10-Q
November 08, 2011
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UNITED STATES

SECURITIES AND EXCHANGE COMMISSION

Washington, D.C. 20549

FORM 10-Q

(Mark One)

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

For the Quarterly Period Ended September 30, 2011

OR

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

For the transition period from to

Commission file number 0-23137

RealNetworks, Inc.

(Exact name of registrant as specified in its charter)

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

(206) 674-2700

(Registrant s telephone number, including area code)

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

Indicate by check mark whether the registrant has submitted electronically and posted on its corporate Web site, if any, every Interactive Data File required to be submitted and posted pursuant to Rule 405 of Regulation S-T (§232.405 of this chapter) during the preceding 12 months (or for such shorter period that the registrant was required to submit and post such files). Yes x No ¨

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

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

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

The number of shares of the registrant s Common Stock outstanding as of October 31, 2011 was 34,332,200.

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PART I. FINANCIAL INFORMATION

Item 1. Financial Statements

REALNETWORKS, INC. AND SUBSIDIARIES

UNAUDITED CONDENSED CONSOLIDATED BALANCE SHEETS

(In thousands, except per share data)

	September 30, 2011	December 31, 2010
ASSETS		
Current assets:		
Cash and cash equivalents	$ 102,811	$ 236,018
Short-term investments	80,277	98,303
Trade accounts receivable, net of allowances for doubtful accounts and sales returns	38,725	48,324
Deferred costs, current portion	6,948	9,173
Related party receivable Rhapsody	392	351
Prepaid expenses and other current assets	24,702	30,441
Total current assets	253,855	422,610
Equipment, software, and leasehold improvements, at cost:		
Equipment and software	146,902	144,623
Leasehold improvements	25,534	25,367
Total equipment, software, and leasehold improvements, at cost	172,436	169,990
Less accumulated depreciation and amortization	132,321	126,619
Net equipment, software, and leasehold improvements	40,115	43,371
Restricted cash equivalents and investments	10,130	10,000
Equity method investments	9,956	15,486
Available for sale securities	38,667	27,541
Other assets	2,981	3,316
Deferred costs, non-current portion	15,018	18,401
Deferred tax assets, net, non-current portion	10,775	12,805
Other intangible assets, net	8,049	6,952
Goodwill	6,060	4,960
Total assets	$ 395,606	$ 565,442
LIABILITIES AND SHAREHOLDERS EQUITY		
Current liabilities:		
Accounts payable	$ 18,214	$ 30,413
Accrued and other liabilities	70,107	85,702
Deferred revenue, current portion	14,724	19,036
Accrued loss on excess office facilities, current portion	1,053	1,144
Total current liabilities	104,098	136,295
Deferred revenue, non-current portion	398	460
Accrued loss on excess office facilities, non-current portion	2,458	3,380

Deferred rent	2,961	3,514
Deferred tax liabilities, net, non-current portion	1,790	1,049
Other long-term liabilities	10,813	7,999
Total liabilities	122,518	152,697
Commitments and contingencies		
Shareholders equity:		
Preferred stock, $0.001 par value, no shares issued and outstanding:		
Series A: authorized 200 shares	0	0
Undesignated series: authorized 59,800 shares	0	0
Common stock, $0.001 par value authorized 250,000 shares; issued and outstanding 34,207 shares in 2011 and 34,021 shares in 2010	34	34
Additional paid-in capital	571,622	697,532
Accumulated other comprehensive loss	(21,952)	(32,543)
Retained deficit	(276,616)	(252,278)
Total shareholders equity	273,088	412,745
Total liabilities and shareholders equity	$ 395,606	$ 565,442

See accompanying notes to unaudited condensed consolidated financial statements.

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REALNETWORKS, INC. AND SUBSIDIARIES

UNAUDITED CONDENSED CONSOLIDATED STATEMENTS OF OPERATIONS

AND COMPREHENSIVE INCOME (LOSS)

(In thousands, except per share data)

	Quarters Ended September 30, 2011	Quarters Ended September 30, 2010	Nine Months Ended September 30, 2011	Nine Months Ended September 30, 2010
Net revenue (A)	$ 84,414	$ 86,432	$ 255,467	$ 303,916
Cost of revenue (B)	31,816	30,710	94,548	109,018
Gross profit	52,598	55,722	160,919	194,898
Operating expenses:				
Research and development	16,496	19,517	54,200	81,775
Sales and marketing	28,625	26,321	85,958	91,530
Advertising with related party	0	0	0	1,065
General and administrative	10,522	12,640	27,018	42,151
Restructuring and other charges	438	1,080	7,850	11,487
Loss (gain) on excess office facilities	0	314	(174)	7,396
Total operating expenses	56,081	59,872	174,852	235,404
Operating loss	(3,483)	(4,150)	(13,933)	(40,506)
Other income (expenses):				
Interest income, net	672	1,074	1,362	2,005
Equity in net loss of Rhapsody and other equity method investments	(1,440)	(6,142)	(5,739)	(11,569)
Loss on sale of equity investments, net	0	0	0	(50)
Gain on deconsolidation of Rhapsody	0	0	0	10,929
Other income (expense), net	(228)	(206)	(661)	887
Total other income (expenses), net	(996)	(5,274)	(5,038)	2,202
Loss before income taxes	(4,479)	(9,424)	(18,971)	(38,304)
Income tax benefit (expense)	(703)	33,947	(5,365)	37,238
Net income(loss)	(5,182)	24,523	(24,336)	(1,066)
Net income (loss) attributable to noncontrolling interest in Rhapsody				2,910
Net income (loss) attributable to common shareholders	$ (5,182)	$ 24,523	$ (24,336)	$ 1,844
Basic net income (loss) per share available to common shareholders	$ (0.15)	$ 0.72	$ (0.71)	$ 0.16
Diluted net income (loss) per share available to common shareholders	$ (0.15)	$ 0.71	$ (0.71)	$ 0.16
Shares used to compute basic net income (loss) per share available to common shareholders	34,199	33,905	34,081	33,826
Shares used to compute diluted net income (loss) per share available to common shareholders	34,199	34,442	34,081	34,558
Comprehensive income (loss):				
Net income (loss)	$ (5,182)	$ 24,523	$ (24,336)	$ (1,066)

Unrealized holding gains (losses) on short-term and equity investments, net of income taxes	12,401	1,539	11,014	(70)
Foreign currency translation gains (losses)	(4,335)	4,513	(425)	(1,841)
Comprehensive income (loss)	2,884	30,575	(13,747)	(2,977)
Net loss attributable to noncontrolling interest in Rhapsody	0	0	0	2,910
Comprehensive income (loss) attributable to common shareholders	$ 2,884	$ 30,575	$ (13,747)	$ (67)
(A) Components of net revenue:				
License fees	$ 15,344	$ 15,584	$ 50,576	$ 56,400
Service revenue	69,070	70,848	204,891	247,516
	$ 84,414	$ 86,432	$ 255,467	$ 303,916
(B) Components of cost of revenue:				
License fees	$ 3,458	$ 3,650	$ 13,504	$ 16,867
Service revenue	28,358	27,060	81,044	92,151
	$ 31,816	$ 30,710	$ 94,548	$ 109,018

See accompanying notes to unaudited condensed consolidated financial statements.

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REALNETWORKS, INC. AND SUBSIDIARIES

UNAUDITED CONDENSED CONSOLIDATED STATEMENTS OF CASH FLOWS

(in thousands)

	Nine Months Ended September 30, 2011	Nine Months Ended September 30, 2010
Cash flows from operating activities:		
Net loss	$ (24,336)	$ (1,066)
Adjustments to reconcile net income (loss) to net cash used in operating activities:		
Depreciation and amortization	12,519	19,047
Stock-based compensation	9,086	10,280
Loss (gain) on disposal of equipment, software, and leasehold improvements	81	155
Equity in net loss of Rhapsody and other investments	5,739	11,569
Loss on sale of equity investments, net	0	50
Excess tax benefit from stock option exercises	(57)	(48)
Gain on deconsolidation of Rhapsody	0	(10,929)
Accrued loss (gain) on excess office facilities	(174)	6,108
Deferred income taxes, net	(429)	80
Accrued restructuring and other charges	0	997
Other	(19)	153
Net change in certain operating assets and liabilities, net of acquisitions, disposals and deconsolidation of Rhapsody:		
Trade accounts receivable	9,328	11,483
Prepaid expenses and other assets	11,575	(9,841)
Accounts payable	(13,376)	(7,519)
Accrued and other liabilities	(17,313)	(66,997)
Net cash used in operating activities	(7,376)	(36,478)
Cash flows from investing activities:		
Purchases of equipment, software, and leasehold improvements	(6,013)	(11,415)
Purchases of short-term investments	(77,078)	(102,486)
Proceeds from sales and maturities of short-term investments	95,104	96,026
Decrease (increase) in restricted cash equivalents and investments, net	(141)	3,700
Payment in connection with the restructuring of Rhapsody	0	(18,000)
Payment of acquisition costs, net of cash acquired	(2,888)	(5,760)
Repayment of temporary funding upon deconsolidation of Rhapsody	0	5,869
Net cash provided by (used in) investing activities	8,984	(32,066)
Cash flows from financing activities:		
Net proceeds from sale of common stock under employee stock purchase plan and exercise of stock options	1,940	1,378
Common Stock cash dividend paid	(136,793)	0
Excess tax benefit from stock option exercises	57	48
Net proceeds from sales of interest in Rhapsody	0	1,213
Net cash provided by (used in) financing activities	(134,796)	2,639
Effect of exchange rate changes on cash and cash equivalents	(19)	3,770
Net increase (decrease) in cash and cash equivalents	(133,207)	(62,135)

Cash and cash equivalents, beginning of period	236,018	277,030
Cash and cash equivalents, end of period	$ 102,811	$ 214,895
Supplemental disclosure of cash flow information:		
Cash received from income tax refunds	$ 3,691	$ 29,678
Cash paid for income taxes	$ 4,435	$ 3,056

See accompanying notes to unaudited condensed consolidated financial statements.

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REALNETWORKS, INC. AND SUBSIDIARIES

NOTES TO UNAUDITED CONDENSED CONSOLIDATED FINANCIAL STATEMENTS

Quarters and Nine Months Ended September 30, 2011 and 2010

Note 1. Summary of Significant Accounting Policies

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

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

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

On July 27, 2011, the Company s Board of Directors approved the payment of a special cash dividend of $1.00 per common share and a one-for-four reverse stock split of the Company s common stock. The special dividend was paid on August 23, 2011, to holders of record as of the close of business on August 9, 2011. The aggregate amount of the special cash dividend was approximately $136.8 million. The one-for-four reverse stock split of the Company s common stock was effective at the close of business on August 30, 2011. Four shares of issued and outstanding common stock were automatically combined into one issued and outstanding share of common stock without any change in the par value per share as part of the reverse stock split. All information related to common stock, stock options, restricted stock units and earnings per share included in the accompanying consolidated financial statements has been retroactively adjusted to give effect to the special cash dividend and the reverse stock split.

On August 20, 2007, RealNetworks and MTV Networks, a division of Viacom International Inc. (MTVN), created Rhapsody America LLC (Rhapsody) to jointly own and operate a business-to-consumer digital audio music service. RealNetworks held a 51% interest in Rhapsody and Rhapsody s financial position and operating results were consolidated into RealNetworks financial statements prior to March 31, 2010. MTVN s proportionate share of income (loss) was included in noncontrolling interest in Rhapsody in the unaudited condensed consolidated statements of operations and comprehensive income (loss). MTVN s proportionate share of equity was included in noncontrolling interest in Rhapsody in the unaudited condensed consolidated balance sheets. On March 31, 2010, the Company and MTVN restructured Rhapsody, and RealNetworks held approximately 47% of the outstanding shares of capital stock of Rhapsody after the restructuring. RealNetworks continues to own approximately 47% of the outstanding shares of capital stock as of September 30, 2011. Since March 31, 2010, RealNetworks has not held a controlling interest in Rhapsody and therefore, the Company has treated its ownership interest in Rhapsody as an equity method investment. Rhapsody s financial position as of March 31, 2010 and its operating results beginning April 1, 2010 are no longer consolidated with RealNetworks consolidated financial statements.

The unaudited condensed consolidated financial statements reflect all adjustments, consisting only of normal, recurring adjustments that, in the opinion of the Company s management, are necessary for a fair presentation of the results of operations for the periods presented. Operating results for the quarter and nine month periods ended September 30, 2011 are not necessarily indicative of the results that may be expected for any subsequent period or for the year ending December 31, 2011. Certain information and disclosures normally included in financial statements prepared in conformity with accounting principles generally accepted in the United States of America have been condensed or omitted pursuant to the rules and regulations of the Securities and Exchange Commission (SEC).

These unaudited condensed consolidated financial statements should be read in conjunction with the audited consolidated financial statements and related notes included in the Company s Annual Report on Form 10-K for the year ended December 31, 2010.

Revenue Recognition. The Company recognizes revenue when persuasive evidence of an arrangement exists, delivery has occurred, the sales price is fixed or determinable, and collection is probable. Physical products are considered delivered to the customer once they have been shipped and title and risk of loss have been transferred. For online sales, the products or services are considered delivered at the time the products or services are made available, digitally, to the end user.

The Company recognizes revenue on a gross or net basis. In most arrangements, the Company contracts directly with end user customers, and is considered the primary obligor who carries all collectability risk. In such arrangements, the Company recognizes revenue on a gross basis. In some cases, the Company utilizes third-party distributors to sell products or services directly to end user customers and carries no collectability risk. In such instances, the Company recognizes revenue on a net basis.

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In the Company s direct to consumer business, the Company derives revenue through (1) subscriptions of SuperPass within the Company s Core Products segment and subscriptions sold by the Company s Games segment, (2) sales of content downloads, software and licenses offered by the Company s Core Products, Emerging Products and Games segments and (3) the sale of advertising and the distribution of third-party products on its websites and in its games. Prior to April 1, 2010, the Company s direct to consumer business also included the products and services primarily sold by the Company s Rhapsody joint venture and included in the Company s Music segment. Beginning on April 1, 2010, revenue from the Company s Rhapsody joint venture is no longer consolidated within the Company s financial statements. The Company now reports its share of Rhapsody s net income or losses as Equity in net loss of Rhapsody and other equity method investments.

Consumer subscription products are paid in advance, typically for a monthly, quarterly or annual duration. Subscription revenue is recognized ratably over the related subscription time period. Revenue from sales of content downloads, software and licenses is recognized at the time the product is made available, digitally, to the end user. Revenue generated from advertising on the Company s websites and from advertising and the distribution of third-party products included in the Company s products is recognized as revenue at the time of delivery.

The Company also generates revenue through business-to-business channels by providing services within the Company s Core Products segment enabling mobile carriers to deliver audio and video content to their customers and by selling software licenses and products and related support and other services.

Revenue generated from services provided to mobile carriers that enable the delivery of audio and video content to their customers is recognized as the services are provided. Setup fees to build these services are recognized ratably upon launch of the service over the remaining expected term of the service.

A portion of the revenue related to the sale of software licenses and products, the related support and other services is recorded as unearned due to undelivered elements including, in some cases, post-delivery support and the right to receive unspecified upgrades or enhancements on a when-and-if-available basis. Revenue arrangements with multiple deliverables are divided into separate units and revenue is allocated using estimated selling prices if the Company does not have vendor-specific objective evidence or third-party evidence of the selling prices of the deliverables. Unearned revenue due to undelivered elements is recognized ratably on a straight-line basis over the related products contract term.

Accounting for Gains on Sale of Subsidiary Stock. Effective January 1, 2009, the Company adopted Statement of Financial Accounting Standards No. 160, *Non-controlling Interests in Consolidated Financial Statements, an amendment to ARB No. 51* (SFAS 160) which was primarily codified into FASB ASC 810 *Consolidation* (ASC 810). Current guidance requires that the difference between the carrying amount of the parent s investment in a subsidiary and the underlying net book value be recorded as an equity transaction. The Company elected to recognize any such gain in its consolidated statements of operations prior to January 1, 2009 as was allowable under generally accepted accounting principles in place at that time if certain recognition criteria were met. Due to the completion of the restructuring of Rhapsody on March 31, 2010, which resulted in the Company holding approximately 47% of the outstanding shares of capital stock of Rhapsody, this accounting policy no longer applies with respect to its investment as the Company no longer consolidates Rhapsody and no longer reports a noncontrolling interest.

Noncontrolling Interests. The Company records noncontrolling interest expense (benefit) which reflects the portion of the earnings (losses) of majority-owned entities which are applicable to the noncontrolling interest holders in the consolidated statements of operations. Redeemable noncontrolling interests that are redeemable at either fair value or are based on a formula that is intended to approximate fair value follow the Company s historical disclosure only policy for the redemption feature. Redeemable noncontrolling interests that are redeemable at either a fixed price or are based on a formula that is not akin to fair value are reflected as an adjustment to income attributable to common shareholders based on the difference between accretion as calculated using the terms of the redemption feature and the accretion entry for a hypothetical fair value redemption feature with the remaining amount of accretion to redemption value recorded directly to equity. Net loss attributable to the noncontrolling interest in Rhapsody is included within the consolidated statements of operations and comprehensive income (loss). The Company applied this accounting policy to the noncontrolling interest in Rhapsody that was held by MTVN for periods beginning when Rhapsody was formed in August 2007 through the quarter ended March 31, 2010. Due to the completion of the restructuring of Rhapsody on March 31, 2010, which resulted in the Company holding approximately 47% of the outstanding shares of capital stock of Rhapsody, this accounting policy no longer applies with respect to the Company s investment as the Company no longer consolidates Rhapsody and no longer reports a noncontrolling interest.

Note 2. Recent Accounting Pronouncements

With the exception of those discussed below, there have been no recent accounting pronouncements or changes in accounting pronouncements during the nine months ended September 30, 2011, to be implemented by the Company in future periods as compared to the recent accounting pronouncements described in the Company s Annual Report on Form 10-K for the year ended December 31, 2010, that are of significance, or potential significance to the Company.

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In September 2009, the FASB ratified Accounting Standards Update (ASU) 2009-13 (ASU 2009-13) (previously Emerging Issues Task Force (EITF) Issue No. 08-1, *Revenue Arrangements with Multiple Deliverables* (EITF 08-1)). ASU 2009-13 supersedes EITF 00-21 and addresses criteria for separating the consideration in multiple-element arrangements. ASU 2009-13 requires companies to allocate the overall consideration to each deliverable by using a best estimate of the selling price of individual deliverables in the arrangement in the absence of vendor-specific objective evidence or other third-party evidence of the selling price.

In September 2009, the FASB ratified ASU 2009-14 (ASU 2009-14) (previously EITF No. 09-3, *Certain Revenue Arrangements That Include Software Elements)*. ASU 2009-14 modifies the scope of Software Revenue Recognition to exclude (a) non-software components of tangible products and (b) software components of tangible products that are sold, licensed, or leased with tangible products when the software components and non-software components of the tangible product function together to deliver the tangible product s essential functionality.

The Company elected to adopt ASU 2009-13 and ASU 2009-14 at the beginning of the first quarter of 2011 on a prospective basis. The Company did not have a significant change in units of accounting, allocation methodology, or timing of revenue recognition. As a result, the adoption of these accounting standards did not have a material impact on the Company s consolidated financial statements.

In September 2011, the FASB issued ASU 2011-08, *Intangibles Goodwill and Other (Topic 350): Testing Goodwill for Impairment*, which permits an entity to first assess qualitative factors to determine whether it is more likely than not that the fair value of a reporting unit is less than its carrying amount as a basis for determining whether it is necessary to perform the two-step goodwill impairment test. ASU 2011-08 will be effective for fiscal years beginning after December 15, 2011. The Company does not expect the adoption of ASU 2011-08 to have a material effect on its consolidated financial statements.

Note 3. Stock-Based Compensation

Stock-based compensation cost is measured at the grant date based on the fair value of the award and is recognized as expense over the requisite service period, which is the vesting period. The Company uses the Black-Scholes option-pricing model to determine the fair-value of stock-based awards. The Company recognizes compensation cost related to options granted on a straight-line basis over the applicable vesting period.

The expected term of the options represents the estimated period of time until exercise and is based on historical experience of similar awards, including the contractual terms, vesting schedules, and expectations of future employee behavior. Expected stock price volatility is based on a combination of historical volatility of the Company s stock for the related expected term and the implied volatility of its traded options. The risk-free interest rate is based on the implied yield available on U.S. Treasury zero-coupon issues with a term equivalent to the expected term of the stock options. Notwithstanding the special cash dividend of $1.00 per share paid on the Company s common stock during the quarter ended September 30, 2011, the dividend yield is estimated at zero because the Company does not anticipate paying regular dividends in the foreseeable future.

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

	Quarters Ended September 30,		Nine Months Ended September 30,	
	2011	2010	2011	2010
Expected dividend yield	0%	0%	0%	0%
Risk-free interest rate	0.82%	1.14%	1.71%	1.83%
Expected life (years)	4.0	4.0	4.0	4.0
Volatility	54%	62%	54%	62%

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

	Quarters Ended September 30,		Nine Months Ended September 30,	
	2011	2010	2011	2010
Cost of revenue	$ 215	$ 394	$ 737	$ 853
Research and development	237	889	1,040	3,179
Sales and marketing	1,358	1,233	3,286	3,040

General and administrative	1,147	1,072	3,187	3,208
Restructuring and other charges	0	0	836	0
Total stock-based compensation expense	$ 2,957	$ 3,588	$ 9,086	$ 10,280

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No stock-based compensation was capitalized as part of the cost of an asset during the quarters or nine month periods ended September 30, 2011 or 2010. As of September 30, 2011, $12.3 million of total unrecognized compensation cost, net of estimated forfeitures, related to stock options, is expected to be recognized over a weighted-average period of 2.8 years.

In accordance with the Company s equity compensation plans, stock options and restricted stock units were equitably adjusted upon the effectiveness of the dividend and reverse stock split. This resulted in equal value to the holder pre- and post- dividend and reverse stock split. No unvested restricted stock units or stock options participated in the dividend. As a result of the foregoing treatment of outstanding awards, the Company incurred no additional compensation expense.

Note 4. Rhapsody Joint Venture

Restructuring of Rhapsody

As described in Note 1. Summary of Significant Accounting Policies, the Company initially formed in August 2007 a joint venture with MTVN to own and operate a business-to-consumer digital audio music service known as Rhapsody. Prior to March 31, 2010, the Company held a 51% interest in Rhapsody and MTVN owned the remaining 49%. On March 31, 2010, restructuring transactions involving Rhapsody were completed, and Rhapsody was converted from a limited liability company to a corporation. Following the completion of the restructuring transactions, RealNetworks owned approximately 47%, MTVN owned approximately 47%, and two minority stockholders held slightly more than 5% of the outstanding shares of capital stock of Rhapsody.

As part of the March 31, 2010 restructuring, RealNetworks contributed $18.0 million in cash, the Rhapsody brand and certain other assets, including content licenses, in exchange for shares of convertible preferred stock of Rhapsody, carrying a $10.0 million preference upon certain liquidation events. RealNetworks cash contribution included the repurchase of the international radio business that was previously contributed to Rhapsody by RealNetworks. MTVN contributed a $33.0 million advertising commitment in exchange for shares of common stock of Rhapsody, and MTVN s previous obligation to provide advertising of approximately $111 million as of December 31, 2009 was cancelled. In addition, the put and call rights held by RealNetworks and MTVN and MTVN s rights to receive a preferred return in connection with the exercise of RealNetworks put right were terminated. RealNetworks is also providing certain operational transition services to Rhapsody. These transition services are expected to be completed in the first half of 2012. Rhapsody is governed by a board of directors with two directors appointed by each of the Company and MTVN and one independent director appointed by mutual agreement of the Company and MTVN.

Effective March 31, 2010, RealNetworks no longer has a controlling interest in Rhapsody and therefore, the operating results of Rhapsody are accounted for under the equity method of accounting for investments, and the Company s proportionate share of the income or loss is recognized as a component of Other income (expenses), net in the Company s condensed consolidated statements of operations in periods subsequent to March 31, 2010. As a result of the deconsolidation of Rhapsody s operations from the Company s financial statements, the Company no longer records any operating results for its Music segment for periods subsequent to March 31, 2010. The removal of these assets and liabilities and the creation of the initial equity method investment resulted in a one-time net gain of $10.9 million recorded in Other income (expenses), net in the Company s unaudited condensed consolidated statements of operations for the quarter ended March 31, 2010, at which time the Company determined the fair value of its retained interest of approximately 47% to be approximately $29.7 million as of March 31, 2010. The Company recorded its share of losses in the operations of Rhapsody of approximately $1.4 million and $5.7 million for the quarter and nine months ended September 30, 2011, respectively. The Company s share of losses from the quarter and nine months ended September 30, 2010, were $6.1 and $11.6 million, respectively. These losses reduced the carrying value of the investment to approximately $9.7 million as of September 30, 2011.

As mentioned above, MTVN s preferred return rights were terminated in connection with the restructuring of Rhapsody. Prior to the restructuring, if the appraised value of Rhapsody at a redemption date was less than $436.3 million, then the exercise price of the put right would have included a preferred return to MTVN. The Company previously elected to accrete any excess of the redemption value over the carrying amount of the noncontrolling interest as an adjustment to income attributable to common shareholders, and adjusted earnings per share for the current quarter s accretion of the difference between accretion as calculated using the terms of the redemption feature and the accretion entry for a hypothetical fair value redemption feature. Due to the termination of MTVN s preferred return rights at the completion of the restructuring, the Company decreased the noncontrolling interest that was on the unaudited condensed consolidated balance sheet at March 31, 2010, prior to the transaction above by $10.4 million as part of the deconsolidation transactions, of which $3.7 million was an adjustment to income attributable to common shareholders for the purposes of calculating earnings per share for the quarter ended March 31, 2010.

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Noncontrolling interest rollforward

Activity in noncontrolling interest and equity attributable to common shareholders is as follows (in thousands):

	Noncontrolling interest	Total Equity
Balances, December 31, 2009	$ 7,253	$ 375,811
Net loss	0	(1,066)
Net loss attributable to noncontrolling interest in Rhapsody	(2,910)	2,910
Contribution and other transactions with owners	616	619
Reversal of MTVN s accretion equity interest in Rhapsody	(6,736)	6,736
Reversal of MTVN s preferred return in Rhapsody	(3,700)	3,700
Deconsolidation	5,477	0
Unrealized holding losses on short-term and equity investments, net of taxes	0	(70)
Foreign currency translation losses	0	(1,841)
Stock-based transactions and compensation expense, net of taxes	0	11,538
Balances, September 30, 2010	$ 0	$ 398,337

Summarized financial information for Rhapsody for the period accounted for under the equity method (in thousands):

	Quarter Ended September 30, 2011	Nine Months Ended September 30, 2011
Statements of Operations Data:		
Net revenue	$ 30,453	$ 93,508
Gross profit	10,512	29,358
Net loss	(3,064)	(12,211)

Note 5. Fair Value Measurements

The Company measures certain financial assets at fair value on a recurring basis, including cash equivalents, short-term investments, and equity investments. The fair value of these financial assets was determined based on three levels of inputs:

Level 1: Observable inputs such as quoted prices in active markets for identical assets or liabilities

Level 2: Inputs other than quoted prices that are observable for the asset or liability, either directly or indirectly; these include quoted prices for similar assets or liabilities in active markets and quoted prices for identical or similar assets or liabilities in markets that are not active

Level 3: Unobservable inputs that reflect the reporting entity s own assumptions

Items Measured at Fair Value on a Recurring Basis

The following table presents information about the Company s financial assets that have been measured at fair value on a recurring basis as of September 30, 2011, and December 31, 2010, and indicates the fair value hierarchy of the valuation inputs utilized to determine such fair value (in thousands).

	Total	Fair Value Measurements as of September 30, 2011 Level 1	Level 2	Level 3
Cash equivalents:				
Money market funds	$ 2,553	$ 2,553	$ 0	$ 0
Corporate notes and bonds	17,998	17,998	0	0
U.S. government agency securities	100	100	0	0
Short-term investments:				
Corporate notes and bonds	44,732	44,732	0	0
U.S. government agency securities	35,545	35,545	0	0
Restricted cash equivalents and investments	10,130	10,130	0	0
Available for sale securities:				
Publicly traded investments	38,667	38,667	0	0
Total	$ 149,725	$ 149,725	$ 0	$ 0

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	Fair Value Measurements as of December 31, 2010			
	Total	Level 1	Level 2	Level 3
Cash equivalents:				
Money market funds	$ 44,348	$ 44,348	$ 0	$ 0
Corporate notes and bonds	120,984	120,984	0	0
U.S. Government agency securities	3,700	3,700	0	0
Short-term investments:				
Corporate notes and bonds	76,157	76,157	0	0
U.S. government agency securities	22,146	22,146	0	0
Restricted cash equivalents and investments	10,000	10,000	0	0
Available for sale securities:				
Publicly traded investments	27,541	27,541	0	0
Total	$ 304,876	$ 304,876	$ 0	$ 0

Investments in marketable securities classified as short-term investments and equity investments of public companies are measured at fair value using quoted market prices and are classified within Level 1 of the valuation hierarchy. The Company carries its equity investments in private companies at cost and no fair value is derived on a recurring basis. The Company has consistently applied these valuation techniques in all periods presented.

Items Measured at Fair Value on a Nonrecurring Basis

Certain assets and liabilities of the Company are measured at estimated fair value on a non-recurring basis. These instruments are subject to fair value adjustments only in certain circumstances (for example, when there is evidence of impairment). The Company performed a valuation using Level 3 inputs of its investment in the Rhapsody joint venture as of March 31, 2010. The Company performed the analysis as a result of the restructuring and related deconsolidation of Rhapsody, which is further described in Note 4, Rhapsody Joint Venture. The fair value analysis used multiple valuation models and was based on assumptions of future results made by management, including operating and cash flow projections.

Note 6. Cash, Cash Equivalents, Short-Term Investments, Restricted Cash Equivalents and Investments

Cash, cash equivalents, short-term investments, and restricted cash equivalents as of September 30, 2011, consist of the following (in thousands):

	Amortized Cost	Gross Unrealized Gains	Gross Unrealized Losses	Estimated Fair Value
Cash and cash equivalents:				
Cash	$ 82,160	$ 0	$ 0	$ 82,160
Money market mutual funds	2,553	0	0	2,553
Corporate notes and bonds	17,998	0	0	17,998
U.S. government agency securities	100	0	0	100
Total cash and cash equivalents	102,811	0	0	102,811
Short-term investments:				
Corporate notes and bonds	44,702	90	(60)	44,732
U.S. government agency securities	35,466	90	(11)	35,545
Total short-term investments	80,168	180	(71)	80,277
Total cash, cash equivalents and short-term investments	$ 182,979	$ 180	$ (71)	$ 183,088

Restricted cash equivalents and investments	$ 10,130	$ 0	$ 0	$ 10,130

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Cash, cash equivalents, short-term investments, and restricted cash equivalents as of December 31, 2010 consist of the following (in thousands):

	Amortized Cost	Gross Unrealized Gains	Gross Unrealized Losses	Estimated Fair Value
Cash and cash equivalents:				
Cash	$ 66,986	$ 0	$ 0	$ 66,986
Money market mutual funds	44,348	0	0	44,348
Corporate notes and bonds	120,984	0	0	120,984
U.S. government agency securities	3,700	0	0	3,700
Total cash and cash equivalents	236,018	0	0	236,018
Short-term investments:				
Corporate notes and bonds	75,962	221	(26)	76,157
U.S. government agency securities	22,126	23	(3)	22,146
Total short-term investments	98,088	244	(29)	98,303
Total cash, cash equivalents and short-term investments	$ 334,106	$ 244	$ (29)	$ 334,321
Restricted cash equivalents and investments	$ 10,000	$ 0	$ 0	$ 10,000

At September 30, 2011, and December 31, 2010, restricted cash equivalents and investments represent cash equivalents and short-term investments pledged as collateral against a letter of credit for a total of $10.1 million and $10.0 million, respectively, in connection with lease agreements.

Realized gains or losses on sales of available-for-sale securities for the quarters and nine month periods ended September 30, 2011 and 2010, were not significant.

Changes in estimated fair values of short-term investments are primarily related to changes in interest rates and are considered to be temporary in nature.

The contractual maturities of short-term investments at September 30, 2011, are as follows (in thousands):

	Amortized Cost	Estimated Fair Value
Within one year	$ 30,740	$ 30,781
Between one year and five years	49,428	49,496
Total short-term investments	$ 80,168	$ 80,277

Note 7. Allowance for Doubtful Accounts Receivable and Sales Returns

Activity in the allowance for doubtful accounts receivable and sales returns is as follows (in thousands):

Allowance For

	Doubtful Accounts Receivable	Sales Returns
Balances, December 31, 2010	$ 1,529	$ 1,039
Additional charged to expenses	423	688
Amounts written off	(705)	(1,080)
Balances, September 30, 2011	$ 1,247	$ 647

No customers accounted for 10% or more of trade accounts receivable as of September 30, 2011. As of December 31, 2010, one customer accounted for 15% of trade accounts receivable. No one customer accounted for more than 10% of total revenue during the quarters and nine months ended September 30, 2011 and 2010.

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Note 8. Available for Sale Securities

As of September 30, 2011 and December 31, 2010, the carrying value of the Company s equity investments in publicly traded companies consisted primarily of J-Stream Inc., a Japanese media services company, and LoEn Entertainment, Inc., a Korean digital music distribution company. These equity investments are accounted for as available for sale. Although the fair value of the available for sale securities was $38.7 million at September 30, 2011, there can be no assurance that any gain can be realized through the disposition of these shares.

Summary of available for sale securities is as follows (in thousands):

	September 30, 2011		December 31, 2010	
	Cost	Fair Value	Cost	Fair Value
Available for sale securities	$ 10,765	$ 38,667	$ 10,765	$ 27,541

Note 9. Other Intangible Assets

Other intangible assets consist of the following (in thousands):

	Gross Amount	Accumulated Amortization	Net
Customer relationships	$ 29,134	$ 23,955	$ 5,179
Developed technology	28,531	25,836	2,695
Patents, trademarks and tradenames	5,227	5,182	45
Service contracts and other	6,121	5,991	130
Total other intangible assets, September 30, 2011	$ 69,013	$ 60,964	$ 8,049
Total other intangible assets, December 31, 2010	$ 66,831	$ 59,879	$ 6,952

Amortization expense related to other intangible assets during the quarter and nine months ended September 30, 2011 was $1.2 million and $3.0 million, respectively. Amortization expense related to other intangible assets during the quarter and nine months ended September 30, 2010 was $1.2 million and $3.7 million, respectively.

As of September 30, 2011, estimated future amortization of other intangible assets is as follows (in thousands):

2011 (remaining three months)	$ 1,066
2012	3,883
2013	2,406
2014	387
2015	307
Total	$ 8,049

The Company reviews long-lived assets for impairment whenever events or changes in circumstances indicate the carrying amount of such assets may not be recoverable. Recoverability of these assets is measured by comparing their carrying amount to future undiscounted cash flows the assets are expected to generate. If long-lived assets are considered to be impaired, the impairment to be recognized equals the amount by which the carrying value of the assets exceeds their fair market value. The Company did not record any impairment to long-lived assets during the quarter or nine months ended September 30, 2011 or 2010.

Note 10. Goodwill

Changes in goodwill are as follows (in thousands):

Balances, December 31, 2010	$ 4,960
Increases from acquisitions	1,385
Effects of foreign currency translation	(285)
Balances, September 30, 2011	$ 6,060

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

	September 30, 2011	December 31, 2010
Core products	$ 731	$ 0
Emerging products	580	0
Games	4,749	4,960
Total goodwill	$ 6,060	$ 4,960

In accordance with ASC 350 Intangibles Goodwill and Other, goodwill is required to be tested for impairment annually and also if there is an event or change in conditions that would more likely than not reduce the fair value of a reporting unit below its carrying value. The Company performs its annual goodwill impairment test during its fiscal fourth quarter. No impairments were recognized in the quarter or nine months ended September 30, 2011.

Note 11. Accrued and Other Liabilities

Accrued and other liabilities consist of (in thousands):

	September 30, 2011	December 31, 2010
Royalties and other fulfillment costs	$ 24,143	$ 30,190
Employee compensation, commissions and benefits	12,970	19,353
Sales, VAT and other taxes payable	12,787	13,104
Deferred tax liabilities - current	9,919	12,162
Other	10,288	10,893
Total accrued and other liabilities	$ 70,107	$ 85,702

Note 12. Restructuring and Other Charges

Restructuring and other charges consist of costs associated with the realignment and reorganization of the Company s operations and primarily include separation costs for employees, including severance, and other benefits. Included in restructuring and other costs for the nine-month period ended September 30, 2011 are separation costs of approximately $2.8 million related to the resignation of the Company s Chief Executive Officer, of which approximately $2.0 million was severance and $0.8 million was non-cash charges related to accelerated vesting of stock options.

A summary of activity for accrued restructuring and other charges is as follows (in thousands):

Accrued restructuring and other charges, December 31, 2010	$ 652
Plus additional restructuring and other charges	7,850
Less non-cash stock-based compensation charges included in restructuring and other charges	(836)
Less amounts paid	(7,524)
Accrued restructuring and other charges, September 30, 2011	$ 142

Note 13. Loss on Excess Office Facilities

The Company completed a business and operational reorganization which led to the reduction of its use of office space in its corporate headquarters in Seattle, Washington and one of its offices in Europe. As a result, the Company recorded losses of $7.4 million during the year ended December 31, 2010. These losses represented approximately $5.5 million of rent and contractual operating expenses over the remaining life of the lease, and approximately $1.6 million for the write-down of leasehold improvements to their estimated fair value. The Company regularly evaluates the market for office space. If the market for such space changes further in future periods, the Company may have to revise its estimates which may result in future gains or losses on excess office facilities.

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

Accrued loss on excess office facilities, December 31, 2010	$ 4,524
Less amounts paid, net of sublease income	(839)
Current period accrued sublease income estimate revision	(174)
Accrued loss on excess office facilities, September 30, 2011	3,511
Less current portion	(1,053)
Accrued loss on excess office facilities, non-current portion	$ 2,458

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Note 14. Earnings Per Share

For periods beginning August 2007 through the quarter ended March 31, 2010, basic net income (loss) available to common shareholders per share is computed by dividing net income (loss) attributable to common shareholders adjusted for the impact of MTVN s preferred return in Rhapsody by the weighted average number of common shares outstanding during the period. Diluted net income (loss) available to common shareholders per share is computed by dividing net income (loss) attributable to common shareholders adjusted for the impact of MTVN s preferred return in Rhapsody by the weighted average number of common and dilutive potential common shares outstanding during the period. Basic and diluted net income (loss) per share available to common shareholders are calculated as follows (in thousands):

	Quarters Ended September 30,		Nine Months Ended September 30,	
	2011	2010	2011	2010
Net income (loss) available to common shareholders:				
Net income (loss) attributable to common shareholders	$ (5,182)	$ 24,523	$ (24,336)	$ 1,844
Less termination of MTVN s preferred return in Rhapsody	0	0	0	3,700
Net income (loss) available to common shareholders	$ (5,182)	$ 24,523	$ (24,336)	$ 5,544
Shares used to compute diluted net income (loss) per share available to common shareholders:				
Weighted average common shares outstanding used to compute basic net income (loss) per share available to common shareholders	34,199	33,905	34,081	33,826
Dilutive stock options and restricted stock	0	537	0	732
Shares used to compute diluted net income (loss) per share available to common shareholders	34,199	34,442	34,081	34,558
Basic net income (loss) per share available to common shareholders	$ (0.15)	$ 0.72	$ (0.71)	$ 0.16
Diluted net income (loss) per share available to common shareholders	$ (0.15)	$ 0.71	$ (0.71)	$ 0.16

During the quarter and nine months ended September 30, 2011, 5.9 million and 6.0 million shares of common stock, respectively, potentially issuable from stock options were excluded from the calculation of diluted net income per share because of their antidilutive effect. During the quarter and nine months ended September 30, 2010, 5.1 million and 4.3 million shares of common stock, respectively, potentially issuable from stock options were excluded from the calculation of diluted net income per share because of their antidilutive effect.

Note 15. Commitments and Contingencies

Borrowing Arrangements. The Company s subsidiary, WiderThan, uses electronic promissory notes issued by a Korean domestic bank with an aggregate line of credit of up to $2.1 million. The charged amounts are generally payable in the following month depending on the billing cycle and are included in accounts payable in the accompanying unaudited condensed consolidated balance sheets. In general, the term of the arrangement is one year, with renewal in April of each year. The arrangement may be renewed in writing by mutual agreement between WiderThan and the bank. WiderThan is not subject to any financial or other restrictive covenants under the terms of this arrangement. As of September 30, 2011, WiderThan had $0.4 million outstanding on this promissory note and other guarantees.

Litigation. On April 25, 2007, a lawsuit was filed by Greenville Communications, LLC in Greenville, Mississippi against a number of cell phone carriers, including the Company s partners T-Mobile USA, Inc. and Alltel Corporation, alleging that they infringe its patents by providing ringback tone services. The Company agreed to indemnify T-Mobile and Alltel against the claims based on an indemnity that is claimed to be owed by the Company. On August 27, 2007, the Company s motion to transfer this matter to the U.S. District Court for the District of New Jersey was granted. The parties briefed claim construction, but the case was subsequently stayed pending reexamination of the patents at issue. On December 10, 2009, the U.S. Patent and Trademark Office issued notice of its intent to issue reexamination certificates for the patents in suit. The District Court lifted the stay on the litigation on January 29, 2010 and discovery has resumed. On September 28, 2011, the District Court held a claims construction hearing but has not yet issued a ruling. The Company disputes the plaintiff s allegations regarding both the validity of its patents and its claims of infringement against the Company s partners. The Company is unable to provide meaningful quantification of how the final resolution of this litigation may impact its future consolidated financial statements.

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The Company has also been involved in a proceeding in the U.S. District Court for the Southern District of New York to determine a royalty rate for the public performance of music contained in the American Society of Composers, Authors and Publishers (ASCAP) catalogue. In April 2008, the District Court issued a preliminary ruling that sets forth, among other things, a methodology to be used to calculate the royalties owed to ASCAP and subsequently issued additional rulings. After working with ASCAP to make a final determination of amounts due under the District Court s rulings, the Company reached a partial agreement with ASCAP on January 12, 2009. The Company appealed some aspects of the District Court s rulings that underlie the agreement, arguing that the District Court had adopted an improper formula for establishing royalty rates. ASCAP also appealed the District Court s ruling, arguing that the district court should have ruled that all transmissions of content downloads constituted public performances. On September 28, 2010, the U.S. Court of Appeals for the Second Circuit issued an opinion substantially ruling in favor of each of the Company s positions that were on appeal. On the public performance issue, the Second Circuit ruled that delivering a download is neither a performance nor public, and therefore ASCAP is not entitled to any royalties for such downloads. ASCAP sought leave to appeal the Second Circuit s decision on the public performance issue to the United States Supreme Court, but the Supreme Court denied certorari on October 3, 2011. The Second Circuit agreed with the Company that the formula adopted by the District Court for establishing royalties was unreasonable and unsupported, and directed the District Court to establish new rates that reflect the varying nature and scope of the Company s music use. These rates are relevant to the Company s operation of the Rhapsody music business prior to the completion of its restructuring at the end of the first quarter of 2010. The rates are also relevant to the ongoing business of Rhapsody in which the Company continues to hold an approximate 47% interest. The case was remanded to the District Court for a new trial to re-determine royalty rates, but on September 29, 2011, the Company, Rhapsody and ASCAP finalized the terms of a settlement agreement. Under the terms of the settlement, the Company owes ASCAP no further payments for performances of ASCAP music during the applicable time period.

From time to time the Company is, and expects to continue to be, subject to legal proceedings, governmental investigations, and claims in the ordinary course of business, including employment claims, contract-related claims, and claims of alleged infringement of third-party patents, trademarks and other intellectual property rights. These claims, including those described above, even if not meritorious, could force the Company to spend significant financial and managerial resources. The Company is not aware of any other legal proceedings or claims that the Company believes will have, individually or taken together, a material adverse effect on the Company s business, prospects, financial condition or results of operations. However, the Company may incur substantial expenses in defending against actual or potential third-party claims. In addition, given the broad distribution of some of the Company s consumer products, any individual claim related to those products could give rise to liabilities that may be material to the Company. In the event of a determination adverse to the Company, the Company may incur substantial monetary liability and/or be required to change its business practices. Either of these could have a material adverse effect on the Company s consolidated financial statements.

Note 16. Segment Information

As of July 1, 2010, the Company reorganized the management of its product lines and businesses in order to more efficiently develop and sell its products, and more cost effectively manage its operations. Beginning in the quarter ended September 30, 2010, the Company s financial results reflect the new corporate reorganization with the following reporting segments: (1) Core Products, which includes financial results from existing and future software as a service offerings of ringback tones, music on demand, video on demand, storefront services and inter-carrier messaging; systems integration and professional services; Helix software and licenses for handsets; SuperPass; and the Company s international radio subscriptions; (2) Emerging Products, which includes financial results from RealPlayer, including distribution of third-party products, advertising and other revenue, and new products and services that will be introduced over time for consumers or enterprise customers; and (3) Games, which is unchanged and includes all games-related financial results, including game sales, subscriptions services, syndication services, advertising-supported games, and mobile and social games. In addition, the Company will continue to present financial results for its former Music segment on a historical basis only. The Music segment primarily includes financial results and operating performance of the Company s Rhapsody joint venture, which was restructured as of March 31, 2010. As a result of the restructuring, Rhapsody s results are no longer consolidated with the Company s financial statements for periods after March 31, 2010. The Company now reports its share of Rhapsody s income or losses as Equity in net loss of Rhapsody and other equity method investments in Other income (expenses), net. The Company has adjusted the financial information for periods prior to September 30, 2010, to reflect the segment reorganization to allow comparability between the periods.

Beginning with the third quarter of 2010, the Company also changed how it allocates corporate and shared overhead expenses. Historically, the Company allocated common corporate overhead expenses, including but not limited to finance, legal and headquarters facilities, to each business segment. Beginning in the quarter ended September 30, 2010, these shared expenses, as well as stock compensation costs, are shown in the aggregate as Corporate expenses and are not reflected in segment results for the business segments described in the preceding paragraph. Only direct business segment expenses, such as research and development, marketing and certain other business shared services are reflected in the associated business segment results. The changes in the allocation of corporate expenses are designed to help ensure that business segment results reflect only those items that are directly attributable to that segment s performance and that shared overhead expenses are centrally managed to promote focus on and accountability for the overall corporate cost structure.

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The Company reports three ongoing reporting segments based on factors such as how the Company manages its operations and how its Chief Operating Decision Maker reviews results. The Company s Chief Operating Decision Maker is considered to be the Company s CEO Staff (CEOS), which includes the Company s Interim Chief Executive Officer, Chief Financial Officer, Chief Legal Officer and certain Senior Vice Presidents. The CEOS reviews financial information presented on both a consolidated basis and on a business segment basis, accompanied by disaggregated information about products and services, geographical regions and corporate expenses for purposes of making decisions and assessing financial performance. The CEOS reviews discrete financial information regarding profitability of the Company s Core Products, Emerging Products, Games, and, prior to April 1, 2010, Music segments and, therefore, the Company reports these as operating segments. The accounting policies used to derive segment results are generally the same as those described in Note 1, Summary of Business and Summary of Significant Accounting Policies.

Segment operating income (loss) for the quarters and nine months ended September 30, 2011 and 2010, are as follows (in thousands):

Core Products

	Quarter Ended September 30,				Nine Months Ended September 30,			
	2011	2010	$ Change	% Change	2011	2010	$ Change	% Change
Revenue	$ 50,705	$ 51,870	$ (1,165)	(2)%	$ 144,547	$ 154,815	$ (10,268)	(7)%
Cost of revenue	22,492	22,230	262	1	62,829	58,054	4,775	8
Gross profit	28,213	29,640	(1,427)	(5)	81,718	96,761	(15,043)	(16)
Gross margin	55%	57%			57%	63%		
Operating expenses	19,398	19,772	(374)	(2)	57,958	66,366	(8,408)	(13)
Operating income (loss)	$ 8,815	$ 9,868	$ (1,053)	(11)%	$ 23,760	$ 30,395	$ (6,635)	(22)%

Emerging Products

	Quarters Ended September 30,				Nine Months Ended September 30,			
	2011	2010	$ Change	% Change	2011	2010	$ Change	% Change
Revenue	$ 10,764	$ 8,778	$ 1,986	23%	$ 34,616	$ 29,203	$ 5,413	19%
Cost of revenue	3,913	1,076	2,837	264	8,431	5,944	2,487	42
Gross profit	6,851	7,702	(851)	(11)	26,185	23,259	2,926	13
Gross margin	64%	88%			76%	80%		
Operating expenses	8,884	6,059	2,825	47	28,144	20,694	7,450	36
Operating income (loss)	$ (2,033)	$ 1,643	$ (3,676)	(224)%	$ (1,959)	$ 2,565	$ (4,524)	(176)%

Games

	Quarters Ended September 30,				Nine Months Ended September 30,			
	2011	2010	$ Change	% Change	2011	2010	$ Change	% Change
Revenue	$ 22,945	$ 25,784	$ (2,839)	(11)%	$ 76,304	$ 84,165	$ (7,861)	(9)%
Cost of revenue	7,197	6,279	918	15	23,771	21,210	2,561	12
Gross profit	15,748	19,505	(3,757)	(19)	52,533	62,955	(10,422)	(17)
Gross margin	69%	76%			69%	75%		
Operating expenses	14,159	17,092	(2,933)	(17)	46,184	60,695	(14,511)	(24)
Operating income (loss)	$ 1,589	$ 2,413	$ (824)	(34)%	$ 6,349	$ 2,260	$ 4,089	181%

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Music

	Quarters Ended September 30, 2011	2010	$ Change	% Change	Nine Months Ended September 30, 2011	2010	$ Change	% Change
Revenue	$ 0	$ 0	$ 0	0	$ 0	$ 35,733	$ (35,733)	(100)%
Cost of revenue	0	0	0	0	0	21,864	(21,864)	(100)
Gross profit	0	0	0	0	0	13,869	(13,869)	(100)
Gross margin						39%		
Operating expenses	0	0	0	0	0	13,911	(13,911)	(100)
Operating loss	$ 0	$ 0	$ 0	0	$ 0	$ (42)	$ 42	(100)%

Corporate

	Quarters Ended September 30, 2011	2010	$ Change	% Change	Nine Months Ended September 30, 2011	2010	$ Change	% Change
Cost of revenue	(1,786)	1,125	(2,911)	(259)	(483)	1,946	(2,429)	(125)
Operating expenses	13,640	16,949	(3,309)	(20)	42,566	73,738	(31,172)	(42)
Operating income (loss)	$ (11,854)	$ (18,074)	$ 6,220	(34)%	$ (42,083)	$ (75,684)	$ 33,601	(44)%

The Company s customers consist primarily of consumers and corporations located in the U.S., Europe and various foreign countries. Revenue by geographic region is as follows (in thousands):

	Quarters Ended September 30, 2011	2010	Nine Months Ended September 30, 2011	2010
United States	$ 38,969	$ 46,874	$ 125,422	$ 179,775
Europe	18,059	17,504	56,043	59,302
Rest of the world	27,386	22,054	74,002	64,839
Total net revenue	$ 84,414	$ 86,432	$ 255,467	$ 303,916

Long-lived assets, consisting of equipment, software, leasehold improvements, other intangible assets, and goodwill by geographic region are as follows (in thousands):

	September 30, 2011	December 31, 2010
United States	$ 41,240	$ 43,655
Republic of Korea	4,409	5,659
Europe	3,025	3,069
Rest of the world	5,550	2,900
Total long-lived assets	$ 54,224	$ 55,283

Net assets including minority interest by geographic location are as follows (in thousands):

	September 30, 2011	December 31, 2010
United States	$ 207,452	$ 352,341
Republic of Korea	4,919	12,374
Europe	41,495	33,029
Rest of the world	19,222	15,001
Total net assets	$ 273,088	$ 412,745

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Note 17. Related Party Transactions

Transactions with MTVN. As part of the initial formation of Rhapsody in 2007, MTVN contributed a $230 million five-year note payable in partial consideration for acquiring MTVN s interest in the venture. In February 2009, RealNetworks and MTVN signed an amendment to the Rhapsody joint venture agreement which reduced the amount payable under the MTVN note to $213.8 million over the original five-year term and on March 31, 2010, the note was cancelled in connection with the completion of the Rhapsody restructuring transactions. During the quarter ended March 31, 2010, Rhapsody received $1.2 million in cash as note payments and spent $1.1 million in advertising with MTVN. MTVN agreed to a new $33.0 million marketing commitment as part of the restructuring transactions that were completed on March 31, 2010. RealNetworks no longer consolidates Rhapsody s financial position and results, and consequently these transactions are no longer considered related party transactions. See Note 4, Rhapsody Joint Venture, for more information on the restructuring transactions.

Transactions with Rhapsody. For periods between August 2007 and March 31, 2010, the Company also provided various support services, including items such as facilities, information technology systems, personnel support and some overhead charges associated with the support services, directly to Rhapsody. The allocation of these and other support service costs were based on various measures depending on the service provided, including employee headcount, time employees spent on providing services to Rhapsody, server usage or number of users of a service. The allocations of these costs were billed directly to Rhapsody. Prior to March 31, 2010, the Company treated these allocations as intercompany transactions and all such transactions were eliminated in consolidation. As of March 31, 2010, the Company no longer consolidates these transactions.

Following the restructuring transactions, the Company is obligated to provide Rhapsody with a reduced amount of support services. These support services are expected to be completed in the first half of 2012 unless earlier terminated by Rhapsody. The support services include information technology and limited operational support provided directly to Rhapsody. The amount charged for these and other support service costs were based on various measures depending on the service provided, including vendor fees, an allocation of fixed costs and time employees spend on providing services to Rhapsody. RealNetworks allocates the cost of providing these support services and records such allocation as a reduction to the related expense in the period for which it was incurred. During the quarter and nine months ended September 30, 2011 the Company charged Rhapsody $0.2 million and $2.0 million, respectively, for the support services. At September 30, 2011, the Related Party Receivable Rhapsody of $0.4 million included these charges.

Transactions with LoEn Entertainment, Inc. During the fourth quarter of 2008, the Company paid $9.9 million to acquire approximately 11% of the outstanding shares of LoEn Entertainment, Inc. (LoEn). The Company paid market price for approximately 2.8 million common shares of LoEn which are traded on the Korean Securities Dealers Automated Quotations. The Company s investment in LoEn is treated as an available for sale investment of a public company and is marked-to-market each period with resulting gains/losses recognized in equity as unrealized holding gains/losses on investment. During the quarters ended September 30, 2011 and 2010, the Company recorded revenue from LoEn of approximately $7.0 million and $4.5 million, respectively. During the nine month periods ended September 30, 2011 and 2010, the Company recorded revenue from LoEn of approximately $15.6 million and $12.0 million, respectively. This revenue consisted primarily of sales of application service provider services, which includes sales of ringback tones, music-on-demand, video-on-demand, and inter-carrier messaging services. Associated with these transactions, the Company also recorded accounts receivable of approximately $3.4 million as of September 30, 2011. Accounts payable and cost of revenue balances associated with LoEn as of and for the quarters and nine month periods ended September 30, 2011 and 2010, were nominal.

Note 18. Income Taxes

As of September 30, 2011, there have been no material changes to the Company s uncertain tax positions disclosures as provided in Note 15 to the Company s audited financial statements included in the Company s 2010 Annual Report on Form 10-K. The Company currently anticipates the closure of foreign income tax examinations in the next twelve months that may reduce total unrecognized tax benefits by an amount up to $9.3 million as a result of the successful defense of the Company s positions, the settlement and payment of a liability, or a combination thereof.

Historically, the Company has not provided for U.S. deferred income taxes or withholding taxes on certain foreign subsidiaries undistributed earnings. These earnings are intended to be permanently reinvested in operations outside of the U.S. As part of the Company s decision to pay the special cash dividend and to effect the reverse stock split in August 2011, the Company expects to repatriate some of its foreign subsidiaries undistributed earnings. This planned repatriation is a one-time change in the Company s assertion on foreign subsidiaries undistributed earnings, as the Company otherwise intends to reinvest undistributed future earnings outside of the U.S. indefinitely.

As of September 30, 2011, approximately $65.6 million of the $183.1 million of cash, cash equivalents, and short-term investments was held by our foreign subsidiaries. The Company expects to repatriate a significant portion of the cash held by its foreign subsidiaries in future periods, likely on or around December 31, 2011. The Company believes repatriation of these funds will result in additional taxable income. The Company currently has significant net operating losses and other tax attributes that will be used to offset the potential U.S. income tax that will result when these amounts are distributed to the U.S. As such, the Company does not anticipate a material U.S. tax impact on the repatriation of such funds as of September 30, 2011, and will provide for, and disclose, the tax impact of such amounts in the consolidated financial statements in the quarter ending December 31, 2011.

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The cumulative amount of permanently reinvested foreign subsidiaries funds, in addition to certain future foreign subsidiaries earnings, are intended to be reinvested permanently outside the U.S. If these amounts were distributed to the U.S., in the form of dividends or otherwise, the Company could be subject to additional U.S. income taxes. It is not practicable to determine the U.S. federal income tax liability or benefit on such earnings due to the timing of such future distributions, the availability of foreign tax credits, and the complexity of the computation if such earnings were not deemed to be permanently reinvested. If future events, including material changes in estimates of cash, working capital, and long-term investment requirements necessitate that these earnings be distributed, an additional provision for U.S. income and foreign withholding taxes, net of foreign tax credits, may be necessary.

The Company files numerous consolidated and separate income tax returns in the United States including federal, state and local, as well as foreign jurisdictions. With few exceptions, the Company is no longer subject to United States federal income tax examinations for tax years before 2006 or state, local, or foreign income tax examinations for years before 1993. RealNetworks, Inc. and/or subsidiaries are under audit by various states and foreign jurisdictions for certain tax years subsequent to 1993.

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

This Quarterly Report on Form 10-Q and the documents incorporated herein by reference contain forward-looking statements that have been made pursuant to the provisions of the Private Securities Litigation Reform Act of 1995. These forward-looking statements are based on current expectations, estimates, and projections about RealNetworks industry, products, 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. All statements contained in this report that do not relate to matters of historical fact should be considered forward-looking statements. Forward-looking statements include statements with respect to:

future revenues, operating expenses, income and other taxes, tax benefits, net income (loss) per diluted share available to common shareholders, acquisition costs and related amortization, and other measures of results of operations;

the effects of our past acquisitions and expectations for future acquisitions;

plans, strategies and expected opportunities for future growth, increased profitability and innovation;

the prospects for creation and growth of strategic partnerships and the resulting financial benefits from such partnerships;

the expected financial position, performance, growth and profitability of our businesses and the availability of resources;

our involvement in potential claims and legal proceedings, the expected course and costs of existing claims and legal proceedings, and the potential outcomes and effects of both existing and potential claims, legal proceedings and governmental investigations on our business, prospects, financial condition or results of operations;

our plans to repatriate some of the cash held by our foreign subsidiaries in a tax efficient manner;

the expected benefits and other consequences from restructuring Rhapsody and from our other strategic initiatives;

our expected introduction of new and enhanced products, services and technologies across our businesses;

the effects of legislation, regulations, administrative proceedings, court rulings, settlement negotiations and other factors that may impact our businesses;

the continuation and expected nature of certain customer relationships;

impacts of competition and certain customer relationships on the future financial performance and growth of our businesses;

the effects of U.S. and foreign income and other taxes on our business, prospects, financial condition or results of operations; and

the effect of economic and market conditions on our business, prospects, financial condition or results of operations.
These statements are not guarantees of future performance and actual actions or results may differ materially. These statements are subject to certain risks, uncertainties and assumptions that are difficult to predict, including those noted in the documents incorporated herein by reference. Particular attention should also be paid to the cautionary language in Item 1A of Part II entitled Risk Factors. RealNetworks undertakes no obligation to update publicly any forward-looking statements as a result of new information, future events or otherwise, unless required by law. Readers should, however, carefully review the risk factors included in other reports or documents filed by RealNetworks from time to time with the Securities and Exchange Commission, particularly the Quarterly Reports on Form 10-Q and any Current Reports on Form 8-K.

Overview

RealNetworks mission is to create innovative applications and services that make it easy to connect with and enjoy digital media. We pioneered the development of technology for streaming digital media over the Internet and have continued creating and delivering digital-media technology, services and content, such as music, games and video, around the world. We distribute our products and services directly to consumers and through mobile carriers, original equipment manufacturers and other communications companies who offer these products and services to their customers. We are primarily focused on the following three businesses: (1) our software as a service (SaaS) offerings; (2) our RealPlayer media player software and related businesses; and (3) our casual games business.

Since the quarter ended September 30, 2010, we report our results in the following reporting segments: (1) Core Products, (2) Emerging Products and (3) Games. We present financial results from our former Music segment on a historical basis only. The Music segment primarily included the financial results and operating performance of our Rhapsody joint venture, which was restructured as of March 31, 2010. In addition, we report common overhead expenses and stock compensation costs in the aggregate as corporate expenses and, therefore, these expenses are not reflected in the financial and operating results of our business segments. The historical financial information presented in this report has been adjusted to reflect the new segments and the new corporate expense presentation.

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During 2010 and continuing into the first part of 2011, we implemented a significant restructuring of our business, which affected our year-over-year results for the quarter and nine months ended September 30, 2011. As part of these activities we restructured our Rhapsody joint venture, and as of March 31, 2010, no longer consolidate its results in our financial statements. We also implemented other significant internal restructuring measures, including reductions in personnel and facilities and the discontinuance or de-emphasis of certain unprofitable products and service offerings, while continuing to invest in major business initiatives.

Condensed consolidated results of operations for the quarter and nine month periods ended September 30, 2011 and 2010, are as follows (dollars in thousands):

	Quarters Ended September 30,				Nine Months Ended September 30,			
	2011	2010	$ Change	% Change	2011	2010	$ Change	% Change
Revenue								
Core Products	$ 50,705	$ 51,870	$ (1,165)	(2)%	$ 144,547	$ 154,815	$ (10,268)	(7)%
Emerging Products	10,764	8,778	1,986	23	34,616	29,203	5,413	19
Games	22,945	25,784	(2,839)	(11)	76,304	84,165	(7,861)	(9)
Music	0	0	0	0	0	35,733	(35,733)	(100)
Total revenue	84,414	86,432	(2,018)	(2)	255,467	303,916	(48,449)	(16)
Cost of revenue	31,816	30,710	1,106	(4)	94,548	109,018	(14,470)	(13)
Gross profit	52,598	55,722	(3,124)	(6)	160,919	194,898	(33,979)	(17)
Gross margin	62%	64%			63%	64%		
Operating expenses	56,081	59,872	(3,791)	(6)	174,852	235,404	(60,552)	(26)
Operating income (loss)	$ (3,483)	$ (4,150)	$ 667	(16)%	$ (13,933)	$ (40,506)	$ 26,573	(66)%

In the quarter ended September 30, 2011, our total consolidated revenue declined by $2.0 million, compared with the year-earlier period. The reduction in revenue largely resulted from reduced SaaS and subscription revenue in our Core Products segment and a decline in revenue in our Games segment. These declines were partially offset by an increase in revenue from our Emerging Products segment. Notwithstanding the decline in total revenue, cost of revenue increased by approximately $1.1 million from the year earlier quarter due to increases within our Emerging Products and Games segments. This increase was substantially offset by a decrease of approximately $4.2 million due to a change of estimates in our accrued royalties. We reduced operating expenses by $3.8 million in the quarter ended September 30, 2011, compared with the same period in 2010, principally through reduced personnel expenses and lower restructuring charges.

In the nine months ended September 30, 2011, our total consolidated revenue declined by $48.5 million, compared with the year-earlier period. The reduction in revenue was largely a result of the deconsolidation of our Rhapsody joint venture as of March 31, 2010. Further contributing to the decline in revenue was reduced SaaS and subscription revenue in our Core Products segment and a decline in Games revenue. Cost of revenue decreased by $14.5 million compared with the year earlier period due primarily to the deconsolidation of our Rhapsody joint venture, the extinguishment of certain accrued royalties and a change of estimates in our accrued royalties. We reduced operating expenses by $60.6 million in the nine months ended September 30, 2011, compared with the same period in 2010, principally through reduced personnel expenses, lower costs resulting from the Rhapsody deconsolidation, lower restructuring charges and losses on excess office facilities. In addition, we received an insurance settlement reimbursement of $6.4 million related to previously settled litigation that further reduced operating expenses in the nine months ended September 30, 2011.

See Segment Operating Results below for more information and discussion regarding changes in the operating results for each of our reporting segments for the quarter and nine months ended September 30, 2011.

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Segment Operating Results

Core Products

The Core Products segment primarily generates revenue and incurs costs from the sales of SaaS services, such as ringback tones, inter-carrier messages, music on demand and video on demand; professional services and system integration services to carriers and mobile handset companies; sales of licenses of our software products such as Helix for handsets; and consumer subscriptions such as SuperPass and international radio subscriptions. Core Products segment results of operations for the quarter and nine months ended September 30, 2011 and 2010, are as follows (dollars in thousands):

	Quarter Ended September 30,				Nine Months Ended September 30,			
	2011	**2010**	**$ Change**	**% Change**	**2011**	**2010**	**$ Change**	**% Change**
Revenue	$ 50,705	$ 51,870	$ (1,165)	(2)%	$ 144,547	$ 154,815	$ (10,268)	(7)%
Cost of revenue	22,492	22,230	262	1	62,829	58,054	4,775	8
Gross profit	28,213	29,640	(1,427)	(5)	81,718	96,761	(15,043)	(16)
Gross margin	55%	57%			57%	63%		
Operating expenses	19,398	19,772	(374)	(2)	57,958	66,366	(8,408)	(13)
Operating income (loss)	$ 8,815	$ 9,868	$ (1,053)	(11)%	$ 23,760	$ 30,395	$ (6,635)	(22)%

Total Core Products revenue decreased by $1.2 million in the quarter ended September 30, 2011, compared with the year-earlier period, due to reduced service revenue from our SaaS offerings of $1.5 million. Our SaaS revenue in the United States declined $4.5 million due primarily to lower intercarrier messaging contract prices as well as declines in transaction volume in our other SaaS services. This was partially offset by increased SaaS revenue in our rest of world markets due to increased transaction volume as well as the addition of several new carrier customers. In addition, subscription revenue, mainly from SuperPass, declined by $1.3 million compared with the same period in 2010 resulting primarily from a decline in the number of subscribers. Further contributing to the decrease was a decline of $1.2 million in technology license sales. Partially offsetting these declines was an increase in systems integration revenue of $2.9 million.

Total Core Products revenue decreased by $10.3 million in the nine months ended September 30, 2011, compared with the year-earlier period, due primarily to reduced service revenue from our SaaS offerings of $6.8 million. The decline in SaaS revenue was mainly due to lower intercarrier messaging contract prices, resulting in a decline of $6.3 million. In addition, subscription revenue, mainly from SuperPass, declined by $3.3 million during the nine months ended September 30, 2011, compared with the same period in 2010 due primarily to a decline in the number of subscribers. Further contributing to the decrease was a decline of $3.9 million in license sales. Partially offsetting these declines was an increase in systems integration revenue of $3.8 million.

Cost of revenue increased slightly in the quarter ended September 30, 2011, compared with the year-earlier period. During the quarter, costs related to sales of systems integrations increased by approximately $2.0 million. This increase was partially offset by a change of estimates in our accrued royalties, which resulted in a reversal of royalty expense associated with our SuperPass product.

Cost of revenue increased by $4.8 million in the nine months ended September 30, 2011, compared with the year-earlier period principally due to increased costs related to sales of systems integrations of approximately $2.9 million. There were also increased costs of approximately $4.2 million associated with personnel working on the delivery of our SaaS services to an expanded number of carrier customers. These increases were partially offset by the change of estimates in our accrued royalties, which resulted in a reversal of royalty expense associated with our SuperPass product. Gross margins declined for the quarter and nine months ended September 30, 2011, mainly due to declines in intercarrier messaging revenue and SuperPass revenue, which are higher margin services.

Operating expenses declined by $8.4 million in the nine months ended September 30, 2011, compared with the year-earlier period, primarily due to reductions in personnel and related costs that resulted from our restructuring efforts.

Emerging Products

The Emerging Products segment primarily generates revenue and incurs costs from sales of RealPlayer and its related products, such as the distribution of third-party software products, advertising on RealPlayer websites, and sales of RealPlayerPlus software licenses to consumers. Also included within the Emerging Products segment is the cost to build and develop new product offerings for consumers and business customers, including Unifi. Emerging Products segment results of operations for the quarter and nine months ended September 30, 2011 and 2010, are as follows (dollars in thousands):

	Quarters Ended September 30,				Nine Months Ended September 30,			
	2011	**2010**	**$ Change**	**% Change**	**2011**	**2010**	**$ Change**	**% Change**
Revenue	$ 10,764	$ 8,778	$ 1,986	23%	$ 34,616	$ 29,203	$ 5,413	19%
Cost of revenue	3,913	1,076	2,837	264	8,431	5,944	2,487	42
Gross profit	6,851	7,702	(851)	(11)	26,185	23,259	2,926	13
Gross margin	64%	88%			76%	80%		
Operating expenses	8,884	6,059	2,825	47	28,144	20,694	7,450	36
Operating income (loss)	$ (2,033)	$ 1,643	$ (3,676)	(224)%	$ (1,959)	$ 2,565	$ (4,524)	(176)%

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Total Emerging Products revenue increased by $2.0 million in the quarter ended September, 30, 2011, compared with the year-earlier period. Higher unit sales of our RealPlayer Plus software contributed approximately $1.1 million to the increase during the quarter ended September 30. 2011. This increase was primarily attributable to our marketing efforts to increase distribution of RealPlayer.

Total Emerging Products revenue increased by $5.4 million in the nine months ended September 30, 2011, compared with the year-earlier period. Higher unit sales of our RealPlayer Plus software and higher distribution of third-party software products contributed approximately $3.4 million and $2.1 million, respectively, to the increase during the period.

Cost of revenue increased for the quarter and nine months ended September 30, 2011, mainly due to increases in costs related to certain advertising agreements as well as increased costs to provide our new products.

Operating expenses increased by $2.8 million and $7.5 million in the quarter and nine months ended September 30, 2011, respectively, compared with the year-earlier periods primarily due to increased marketing expense to drive the distribution of RealPlayer and related third-party software as well as the development of new products.

Games

The Games segment primarily generates revenue and incurs costs from the creation, distribution and sales of games licenses, online games subscription services, advertising on game sites and social network sites, games syndication services, microtransactions from online and social games, and sales of mobile games. Games segment results of operations for the quarter and nine months ended September 30, 2011 and 2010, are as follows (dollars in thousands):

	Quarters Ended September 30,				Nine Months Ended September 30,			
	2011	2010	$ Change	% Change	2011	2010	$ Change	% Change
Revenue	$ 22,945	$ 25,784	$ (2,839)	(11)%	$ 76,304	$ 84,165	$ (7,861)	(9)%
Cost of revenue	7,197	6,279	918	15	23,771	21,210	2,561	12
Gross profit	15,748	19,505	(3,757)	(19)	52,533	62,955	(10,422)	(17)
Gross margin	69%	76%			69%	75%		
Operating expenses	14,159	17,092	(2,933)	(17)	46,184	60,695	(14,511)	(24)
Operating income (loss)	$ 1,589	$ 2,413	$ (824)	(34)%	$ 6,349	$ 2,260	$ 4,089	181%

Total Games revenue decreased by $2.8 million in the quarter ended September 30, 2011, compared with the year-earlier period. Lower revenue from our subscription products and a decline in the distribution of third-party software contributed approximately $1.0 million and $1.1 million, respectively, to the decline during the period. The decline in subscription revenue was due to fewer subscribers compared with the year-earlier period. The decline in distribution of third party software was due to reduced traffic to our games properties. Further contributing to the decline was lower license revenue of $1.0 million primarily due to a decrease in the number of games sold through our games syndication services.

Total Games revenue decreased by $7.9 million in the nine months ended September 30, 2011, compared with the year-earlier period. The decline was due to lower revenue from our subscription products of $3.2 million as a result of fewer subscribers. In addition, distribution of third party software declined by $2.8 million due to reduced traffic to our games properties. Further contributing to the decline was lower license revenue of $2.3 million primarily due to a decrease in the number of games sold through our games syndication services.

Cost of revenue increased by $0.9 million and $2.6 million in the quarter and nine months ended September 30, 2011, respectively, compared with the year-earlier periods. The increases were due primarily to higher costs associated with distribution of third party games and increased personnel costs related to the delivery of our games products and services. Gross margins decreased for the quarter and nine months ended September 30, 2011, due to lower subscription revenue and lower distribution of third party software, both of which have higher margins.

Operating expenses declined by $2.9 million and $14.5 million in the quarter and nine months ended September 30, 2011, respectively, compared with the year-earlier period. The decreases were primarily due to reductions in personnel and related costs of approximately $1.6 million and $6.8 million in the quarter and nine months ended September 30, 2011, respectively. In addition, depreciation expense, related to our Games technology platform, decreased by $3.0 million in the nine months ended September 30, 2011.

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Music

Music segment results of operations for the quarter and nine months ended September 30, 2011 and 2010, are as follows (dollars in thousands):

	Quarters Ended September 30,				Nine Months Ended September 30,			
	2011	2010	$ Change	% Change	2011	2010	$ Change	% Change
Revenue	$ 0	$ 0	$ 0	0	$ 0	$ 35,733	$ (35,733)	(100)%
Cost of revenue	0	0	0	0	0	21,864	(21,864)	(100)
Gross profit	0	0	0	0	0	13,869	(13,869)	(100)
Gross margin						39%		
Operating expenses	0	0	0	0	0	13,911	(13,911)	(100)
Operating loss	$ 0	$ 0	$ 0	0	$ 0	$ (42)	$ 42	(100)%

On March 31, 2010, we completed the restructuring of Rhapsody, which resulted in our ownership interest of Rhapsody decreasing to approximately 47% and the loss of our operating control over Rhapsody. Our revenue for the first quarter of 2010 includes results from Rhapsody s operations. Beginning with the second quarter of 2010, Rhapsody s revenue and other operating results are no longer consolidated within our condensed consolidated financial statements, and we are not recording any operating or other financial results for our Music segment. We now report our share of Rhapsody s income or losses as Equity in net loss of Rhapsody and other equity method investments in Other income (expenses), net. Our share of Rhapsody s losses for the quarter and nine months ended September 30, 2011 was $1.4 million and $5.7 million, respectively.

Corporate

Certain corporate-level activity is not allocated to our segments, including costs of the following: general and administrative functions and activities related to information technology, procurement activities, corporate headquarters, legal settlements and contingencies, stock compensation, losses on excess office facilities and employee severance costs. Corporate segment results of operations for the quarter and nine months ended September 30, 2011 and 2010, are as follows (dollars in thousands):

	Quarters Ended September 30,				Nine Months Ended September 30,			
	2011	2010	$ Change	% Change	2011	2010	$ Change	% Change
Cost of revenue	$ (1,786)	$ 1,125	$ (2,911)	(259)%	$ (483)	$ 1,946	$ (2,429)	(125)%
Operating expenses	13,640	16,949	(3,309)	(20)	42,566	73,738	(31,172)	(42)
Operating income (loss)	$ (11,854)	$ (18,074)	$ 6,220	(34)%	$ (42,083)	$ (75,684)	$ 33,601	(44)%

Cost of revenue declined by $2.9 million and $2.4 million in the quarter and nine months ended September 30, 2011, respectively, compared with the earlier periods. The majority of the decline was the result of a change of estimates in our accrued royalties, which resulted in a reversal of approximately $2.8 million in royalty expense primarily associated with our historical music business in the quarter and nine months ended September 30, 2011.

Operating expenses decreased by $3.3 million in the quarter ended September 30, 2011, compared with the year-earlier period. The decrease compared with the prior period was due to lower restructuring charges and loss of excess office facility charges related to our corporate headquarters in Seattle and our offices in Europe and Asia of $1.0 million. Lower personnel costs of $1.4 million as a result of our restructuring efforts also contributed to the decrease.

Operating expenses decreased by $31.2 million in the nine months ended September 30, 2011, compared with the year-earlier period. The decrease was due in part to lower restructuring charges and loss on excess office facilities of approximately $11.2 million as well as a reduction in personnel and related costs and professional services expense of approximately $10.0 million in the nine months ended September 30, 2011, compared with the year-earlier period. The remaining decrease in operating expenses in the nine months ended September 30, 2011 was due in part to a benefit from an insurance reimbursement of $6.4 million related to previously settled litigation, which is accounted for as a reduction to operating expenses.

Consolidated Operating Expenses

Consolidated operating expenses consist primarily of salaries and related personnel costs including stock based compensation, consulting fees associated with product development, sales commissions, amortization of certain intangible assets capitalized in our

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acquisitions, professional service fees, advertising costs, restructuring and related charges, impairments of goodwill and losses on excess office facilities. To date, all research and development costs have been expensed as incurred because technological feasibility for software products is generally not established until substantially all development is complete. Operating expenses and changes for the quarters and nine months ended September 30, 2011 and 2010, are as follows (dollars in thousands):

	Quarters Ended September 30,				Nine Months Ended September 30,			
	2011	2010	$ Change	% Change	2011	2010	$ Change	% Change
Research and development	$ 16,496	$ 19,517	$ (3,021)	(15)%	$ 54,200	$ 81,775	$ (27,575)	(34)%
Sales and marketing	28,625	26,321	2,304	9	85,958	91,530	(5,572)	(6)
Advertising with related party	0	0	0	0	0	1,065	(1,065)	(100)
General and administrative	10,522	12,640	(2,118)	(17)	27,018	42,151	(15,133)	(36)
Restructuring and other charges	438	1,080	(642)	(60)	7,850	11,487	(3,637)	(32)
Loss (gain) on excess office facilities	0	314	(314)	(100)	(174)	7,396	(7,570)	(102)
Total consolidated operating expenses	$ 56,081	$ 59,872	$ (3,791)	(6)%	$ 174,852	$ 235,404	$ (60,552)	(26)%

Research and development expenses decreased by $3.0 million in the quarter ended September 30, 2011, compared with the year-earlier period. The decline was primarily due to a decrease in personnel and related costs of approximately $1.8 million and lower professional services of $1.1 million, all resulting from our restructuring activities.

Research and development expenses decreased by $27.6 million in the nine months ended September 30, 2011, compared with the year-earlier period. The decline was primarily due to a decrease in personnel and related costs of approximately $16.8 million as well as a decrease in depreciation expense related to our Games technology platform of $3.0 million. In addition, the removal of Rhapsody s operating expenses from our consolidated financial results beginning April 1, 2010, contributed approximately $3.8 million to the decline.

Sales and marketing expenses increased by $2.3 million in the quarter ended September 30, 2011, compared with the year-earlier period. The increase during the quarter was primarily due to an increase in marketing expenses of $2.4 million for RealPlayer.

Sales and marketing expenses decreased by $5.6 million in the nine months ended September 30, 2011, compared with the year-earlier period. The decrease during the nine-month period was due primarily to the removal of Rhapsody s operating expenses of $8.8 million from our consolidated financial results beginning April 1, 2010. All of the historical costs associated with Advertising with related party were included within our Music segment as discussed in Segment Operating Results Music above. Also contributing to the overall decrease of sales and marketing expenses was a decrease in personnel and related costs of approximately $3.0 million due to our restructuring activities. These decreases in sales and marketing costs were partially offset by an increase in marketing expenses of $6.5 million for RealPlayer, as well as an increase in professional services expense of $2.5 million.

General and administrative expenses decreased by $2.1 million in the quarter ended September 30, 2011, compared with the year-earlier period due to our restructuring activities, of which approximately $1.5 million related to lower personnel and professional services expense.

General and administrative expenses decreased by $15.1 million in the nine months ended September 30, 2011, compared with the year-earlier period primarily due to an insurance reimbursement of $6.4 million related to previously settled litigation and a reduction in personnel and related costs of $5.8 million.

Restructuring and other charges consist of costs associated with the realignment and reorganization of our business operations and primarily include separation costs for employees, including severance, and other benefits. For the nine months ended September 30, 2011, we recorded $7.9 million in restructuring and other charges that included separation costs of approximately $2.8 million related to the resignation of our Chief Executive Officer, of which approximately $2.0 million was severance and $0.8 million was non-cash charges related to accelerated vesting of stock options.

Loss on excess office facilities represent the reduction in the use of our current office space in our headquarters in Seattle, as well as our other offices in Europe in connection with the reorganization of our business and operational structure, including the restructuring of Rhapsody. For the nine months ended September 30, 2010, the estimated loss on excess office facilities, including the write-down of leasehold improvements, was approximately $7.1 million. Our estimates are based upon many factors including projections of sublease rates and the time period required to locate tenants which are updated from time to time as deemed necessary.

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Other Income (Expenses), Net

Other income (expenses), net consists primarily of the following: interest income on our cash, cash equivalents, and short-term investments, our equity in net loss of Rhapsody and other equity method investments and our gain on deconsolidation of Rhapsody. Other income (expenses), net for the quarter and nine months ended September 30, 2011 and 2010, are as follows (dollars in thousands):

	Quarters Ended September 30,				Nine Months Ended September 30,			
	2011	2010	$ Change	% Change	2011	2010	$ Change	% Change
Interest income, net	$ 672	$ 1,074	$ (402)	(37)%	$ 1,362	$ 2,005	$ (643)	(32)%
Equity in net loss of Rhapsody and other equity method investments	(1,440)	(6,142)	4,702	(77)	(5,739)	(11,569)	5,830	(50)
Loss on sale of equity investments, net	0	0	0	0	0	(50)	50	(100)
Gain on deconsolidation of Rhapsody	0	0	0	0	0	10,929	(10,929)	(100)
Other income (expense), net	(228)	(206)	(22)	11	(661)	887	(1,548)	(175)
Total other income (expense), net	$ (996)	$ (5,274)	$ 4,278	(81)%	$ (5,038)	$ 2,202	$ (7,240)	(329)%

Total other income (expense), net increased by $4.3 million in the quarter ended September 30, 2011, compared with the year-earlier period. The increase during the quarter ended was primarily due to the reduction in loss of $4.7 million in our equity method investment in Rhapsody.

Total other income (expense), net decreased by $7.2 million in the nine months ended September 30, 2011, compared with the year-earlier period. The decrease during the nine-month period was primarily due to a $10.9 million one-time gain on the deconsolidation of Rhapsody in 2010, partially offset by the decline in equity loss for our investment in Rhapsody of $5.8 million.

Since March 31, 2010, we do not hold a controlling interest in Rhapsody and we no longer consolidate Rhapsody s results with our own. We now account for our ownership interest in Rhapsody as an equity method investment.

Income Taxes

During the quarters ended September 30, 2011 and 2010, we recognized income tax expense of $0.7 million and income tax benefit of $33.9 million, respectively, related to U.S. and foreign income taxes. During the nine months ended September 30, 2011 and 2010, we recognized income tax expense of $5.4 million and income tax benefit of $37.2 million, respectively, related to U.S. and foreign income taxes. The increase in income tax expense and the change in income tax expense as a percentage of pre-tax loss during the quarter and nine months ended September 30, 2011, was largely the result of a reduction in unrecognized tax benefits in the prior period and a change in our jurisdictional income mix.

As of September 30, 2011, there have been no material changes to our uncertain tax positions disclosures as provided in Note 15 to our audited financial statements included in our 2010 Annual Report on Form 10-K. We currently anticipate the closure of foreign income tax examinations in the next twelve months that may reduce our total unrecognized tax benefits by an amount up to $9.3 million as a result of the successful defense of the Company s positions, the settlement and payment of a liability, or a combination thereof.

The majority of our tax expense is due to income in our foreign jurisdictions as we do not currently benefit from losses in the U.S. We generate income in a number of foreign jurisdictions, some of which have higher tax rates and some of which have lower tax rates relative to the U.S. federal statutory rate. Our tax expense could fluctuate significantly on a quarterly basis to the extent income is lower than anticipated in countries where we have lower statutory tax rates and higher than anticipated in countries where we have higher statutory tax rates. For the quarter ended September 30, 2011, decreases in tax expense from income generated in foreign jurisdictions with lower tax rates in comparison to the U.S. federal statutory rate was offset by increases in tax expense from income generated in foreign jurisdictions having comparable, or higher tax rates in comparison to the U.S. federal statutory rate. As such, the effect of differences in foreign tax rates on the Company s tax expense for the third quarter of 2011 is minimal.

We file numerous consolidated and separate income tax returns in the United States, including federal, state and local returns, as well as in foreign jurisdictions. With few exceptions, we are no longer subject to United States federal income tax examinations for tax years prior to 2006 or state, local or foreign income tax examinations for years prior to 1993. RealNetworks, Inc. and /or subsidiaries are under audit by various states and foreign jurisdictions for certain tax years subsequent to 1993.

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Geographic Revenue

Revenue by geographic region is as follows (dollars in thousands):

	Quarters Ended September 30,				Nine Months Ended September 30,			
	2011	**2010**	**$ Change**	**% Change**	**2011**	**2010**	**$ Change**	**% Change**
United States	$ 38,969	$ 46,874	$ (7,905)	(17)%	$ 125,422	$ 179,775	$ (54,353)	(30)%
Europe	18,059	17,504	555	3	56,043	59,302	(3,259)	(5)
Rest of world	27,386	22,054	5,332	24	74,002	64,839	9,163	14
Total net revenue	$ 84,414	$ 86,432	$ (2,018)	(2)%	$ 255,467	$ 303,916	$ (48,449)	(16)%

Revenue in the United States declined by $7.9 million in the quarter ended September 30, 2011, compared with the year-earlier period. The decline was due to reductions in revenue generated from our SaaS offerings of $4.5 million and lower sales of games subscriptions and license sales of approximately $2.5 million. See the section Segment Operating Results above for further discussion of these changes.

Revenue in the United States declined by $54.4 million in the nine months ended September 30, 2011, compared with the year-earlier period. The decrease for the nine months ended September 30, 2011 resulted primarily from a loss of revenue of $33.6 million from the deconsolidation of Rhapsody, which generated its revenue primarily in the United States. The decline was also due to reductions in revenue generated from our SaaS offerings of $12.3 million, lower sales of games subscriptions and license sales of approximately $5.3 million and a decrease in revenue from our SuperPass subscription service of $2.8 million. See the section Segment Operating Results above for further discussion of these changes.

Revenue in Europe declined $3.3 million in the nine months ended September 30, 2011, compared with the year-earlier period. The decrease in the nine-month period was due primarily to lower licensing revenue from our Core Products segment of $2.5 million. See the section Segment Operating Results above for further discussion of these changes.

Revenue in rest of world increased by $5.3 million in the quarter ended September 30, 2011, compared with the year-earlier period. The increase in the quarter ended September 30, 2011 was primarily due to increased systems integration revenue of $2.9 million and revenue generated from our SaaS services of $1.9 million. See the section Segment Operating Results above for further discussion of these changes.

Revenue in rest of world increased by $9.2 million in the nine months ended September 30, 2011, compared with the year-earlier period. The increase for the nine months ended September 30, 2011 was primarily due to increased systems integration revenue of $3.8 million and SaaS revenue of $4.5 million due primarily to increased transaction volume as well as several new carrier customers. See the section Segment Operating Results above for further discussion of these changes.

License Fees and Service Revenue

We also present our revenue based on License fees and Service revenue as set forth below (dollars in thousands):

	Quarters Ended September 30,				Nine Months Ended September 30,			
	2011	**2010**	**$ Change**	**% Change**	**2011**	**2010**	**$ Change**	**% Change**
License	$ 15,344	$ 15,584	$ (240)	(2)%	$ 50,576	$ 56,400	$ (5,824)	(10)%
Service	69,070	70,848	(1,778)	(3)	204,891	247,516	(42,625)	(17)
Total net revenue	$ 84,414	$ 86,432	$ (2,018)	(2)%	$ 255,467	$ 303,916	$ (48,449)	(16)%

License Fees. License fees primarily include revenue from sales of content such as game licenses, sales of licenses of our system software products such as Helix for handsets, and sales of premium versions of our RealPlayer and related products. Prior to March 31, 2010, license fees also included the sales from digital music tracks from our Music segment. License fees include revenue from all of our reporting segments.

License fees decreased by $5.8 million in the nine months ended September 30, 2011, compared with the year-earlier period. The deconsolidation of our Music segment contributed $3.9 million to the overall decrease for the nine months ended September 30, 2011. Sales of games during the nine-month period also declined by $3.8 million, partially offset by higher unit sales of RealPlayer Plus of $3.4 million compared with the year-earlier period. See the section Segment Operating Results above for further discussion of these changes.

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Service Revenue. Service revenue primarily includes revenue from sales of digital media subscription services such as SuperPass, GamePass and FunPass, revenue from SaaS services, distribution of third party software, and advertising. Prior to March 31, 2010, service revenue also included sales of the Rhapsody music subscription service from our Music segment. Service revenue includes revenue from all of our reporting segments.

Service revenue decreased by $1.8 million in the quarter ended September 30, 2011, compared with the year-earlier period. The decline was due to lower sales of our subscription products of $2.3 million and reduced service revenue from our SaaS offerings of approximately $1.5 million. Partially offsetting these declines was an increase in systems integration revenue of $2.9 million. See the section Segment Operating Results above for further discussion of these changes.

Service revenue decreased by $42.6 million in the nine months ended September 30, 2011, compared with the year-earlier period. The deconsolidation of our Music segment contributed $31.8 million to the overall decrease for the nine months ended September 30, 2011. The decline was also due to reduced service revenue from our SaaS offerings of approximately $6.8 million and lower sales of our subscription products of $6.5 million and lower revenue from services associated with our technology licensing products of $2.6 million. Partially offsetting these declines was an increase in systems integration revenue of $3.8 million. See the section Segment Operating Results above for further discussion of these changes.

Cost of License Fees and Service Revenue

We also present our cost of revenue based on License fees and Service revenue as set forth below (dollars in thousands):

	Quarters Ended September 30,				Nine Months Ended September 30,			
	2011	2010	$ Change	% Change	2011	2010	$ Change	% Change
License	$ 3,458	$ 3,650	$ (192)	(5)%	$ 13,504	$ 16,867	$ (3,363)	(20)%
Service	28,358	27,060	1,298	5	81,044	92,151	(11,107)	(12)
Total cost of revenue	$ 31,816	$ 30,710	$ 1,106	4%	$ 94,548	$ 109,018	$ (14,470)	(13)%

Cost of License Fees. Cost of license fees includes royalties paid on the sales of games, amounts paid for licensed technology, amortization of acquired technology, and music royalties paid for periods prior to March 31, 2010.

Cost of license fees decreased by $3.4 million in the nine months ended September 30, 2011, compared with the year-earlier period. The decrease for the nine months ended was primarily due to a one-time expense paid for the rights to use certain technologies within our RealPlayer software in the amount of $1.5 million in the prior period. The deconsolidation of our Music segment contributed $2.7 million to the decline for the nine months ended September 30, 2011. See the section Segment Operating Results above for further discussion of these changes.

Cost of Service Revenue. Cost of service revenue includes the cost of content and delivery of the content included in our digital media subscription and mobile service offerings, cost of in-house and contract personnel providing support services, amortization of acquired technology, fees for consulting services, expenses incurred in providing our SaaS hosting services and cost of content for our Rhapsody service for periods prior to March 31, 2010. Content costs are expensed over the period the content is available to our subscription services customers.

Cost of service revenue increased by $1.3 million in the quarter ended September 30, 2011, compared with the year-earlier period. The increase during the period is primarily due to increased costs related to sales of system integrations within our Core Products segment of approximately $2.0 million. Further contributing to the increase were increased costs within our Emerging Products segment to provide our new products and increased costs related to certain advertising agreements of approximately $1.5 million and $1.8 million, respectively. These increases were partially offset by the change of estimates in our accrued royalties, which resulted in a reversal of approximately $4.2 million in royalty expense primarily associated with our historical music business and our SuperPass product.

Cost of service revenue decreased by $11.1 million in the nine months ended September 30, 2011, compared with the year-earlier period. The deconsolidation of our Music segment contributed $19.2 million to the overall decrease. Further contributing to the decrease were a change in estimates of our accrued royalties and the extinguishment of certain accrued royalties of $5.5 million primarily associated with our historical music business and our SuperPass product. These decreases were partially offset by increases in costs of $7.1 million from delivery of our systems integration and SaaS services to an expanded customer base during the nine months ended September 30, 2011. Further offsetting the decrease of cost of service revenue were increased costs within our Emerging Products segment to provide our new products and increased costs related to certain advertising agreements of approximately $2.2 million and $1.9 million, respectively.

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New Accounting Pronouncements

See Note 2 Recent Accounting Pronouncements to Condensed Consolidated Financial Statements included in Part I, Item 1 of this report for information regarding new accounting pronouncements.

Liquidity and Capital Resources

The following summarizes working capital, cash, cash equivalents, short-term investments, and restricted cash (in thousands):

	September 30, 2011	December 31, 2010
Working capital	$ 149,757	$ 286,315
Cash, cash equivalents, and short-term investments	183,088	334,321
Restricted cash equivalents and investments	10,130	10,000

The following summarizes cash flows (in thousands):

	Nine Months Ended September 30, 2011	2010
Cash used in operating activities	$ (7,376)	$ (36,478)
Cash provided by (used in) investing activities	8,984	(32,066)
Cash provided by (used in) financing activities	(134,796)	2,639

Cash used in operating activities consisted of net loss adjusted for certain non-cash items including depreciation, amortization, stock-based compensation, deferred income taxes, gain on deconsolidation of Rhapsody, accrued restructuring and other charges and the effect of changes in certain operating assets and liabilities, net of acquisitions and deconsolidation of Rhapsody. Cash used in financing activities primarily consisted of the payment of the special dividend to the holders of our common stock.

Cash used in operating activities in the nine months ended September 30, 2011, was $7.4 million and consisted of (1) a net loss of $24.3 million, (2) adjustments to reconcile the net loss to cash used in operating activities of $26.7 million and (3) cash used in activities related to changes in certain operating assets and liabilities, net of acquisitions and deconsolidation of Rhapsody, of $9.8 million. Adjustments to reconcile the net loss to cash used in operating activities primarily consisted of $12.5 million of depreciation and amortization expense, $9.1 million of stock-based compensation and $5.7 million of equity in the net loss of Rhapsody and other equity investments.

Changes in certain operating assets and liabilities, net of acquisitions and deconsolidation of Rhapsody, in the nine months ended September 30, 2011 primarily consisted of uses of cash from a decrease in accounts payable, accrued and other liabilities of $13.4 million and $17.3 million, respectively. This decrease in accounts payable was primarily related to the timing of certain payments. The decrease in accrued and other liabilities primarily relates to the reduction of accrued royalties due to changes in certain estimates. These uses of cash were partially offset by decreases in accounts receivable, prepaid and other assets of approximately $9.3 million and $11.6 million, respectively. The decrease in accounts receivable was due primarily to the timing of cash receipts. The decrease in prepaid and other assets was due primarily to the amortization of previously deferred costs exceeding amounts deferred in the period.

Cash used in operating activities in the nine months ended September 30, 2010, was $36.5 million and consisted of net loss of $1.1 million, adjustments for cash provided by non-cash items of $37.5 million and cash used in activities related to changes in certain operating assets and liabilities, net of acquisitions and disposals, of $72.9 million. Adjustments for cash provided by non-cash items primarily consisted of $19.0 million of depreciation and amortization expense, $10.3 million of stock-based compensation, $6.1 million of accrued loss on excess office facilities, $11.6 million of equity in the net loss of Rhapsody and other equity investments, and $1.0 million for amounts accrued relating to restructuring expenses incurred during the quarter, partially offset by $10.9 million of gain related to the deconsolidation of the Rhapsody joint venture.

Changes in certain operating assets and liabilities, net of acquisitions, in the nine months ended September 30, 2010 primarily consisted of uses of cash from the decrease in accrued and other liabilities of $67.0 million. These decreases were related to reductions in accrued royalties and other fulfillment costs as well as a reduction in amounts payable to MTVN for related party advertising incurred during the quarter ended

March 31, 2010 as compared to the quarter ended December 31, 2009. Also contributing to the decline was the payment of the legal settlement and related legal expenses attributable to the RealDVD litigation of $5.5 million that was accrued for in the quarter ended December 31, 2009.

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In the nine months ended September 30, 2011, cash provided by investing activities of $9.0 million was due primarily from the sales and maturities, net of purchases, of short-term investments of $18.0 million, offset by purchases of equipment, software and leasehold improvements of $6.0 million and the payment of acquisition costs of $2.9 million. In the nine months ended September 30, 2010, investing activities used cash primarily for payments made in connection with the restructuring of Rhapsody of $18.0 million, purchases of equipment, software, and leasehold improvements of $11.4 million, as well as the $5.8 million payment of acquisition costs for Backstage, net of cash acquired. These uses of cash were partially offset by the repayment of temporary funding upon the deconsolidation of Rhapsody of approximately $5.9 million. Purchases, net of sales and maturities, of short-term investments used cash of $6.5 million during 2010.

Financing activities in the nine months ended September 30, 2011 used cash mainly from the payment of the special dividend to the holders of our common stock of approximately $136.8 million. The payment of the special dividend was based on an analysis of RealNetworks capital structure and the belief that we had excess cash relative to our future operational or strategic needs. Financing activities in 2010 provided cash from the proceeds of sales of (1) common stock under employee stock purchase plans and the exercise of stock options of $1.4 million and (2) payments received from the MTVN marketing note for our Rhapsody joint venture of $1.2 million.

The declaration and payment of future dividends, as well as the amount thereof, are subject to the discretion of our board of directors and will depend upon our results of operations, financial condition, capital levels, cash requirements, future prospects and other factors deemed relevant by our board of directors. Accordingly, there can be no assurance that we will declare and pay any dividends in the future.

We currently have no planned significant capital expenditures or other uses of cash for 2011 other than those in the ordinary course of business and those mentioned above. In the future, we may seek to raise additional funds through public or private equity financing, or through other sources such as credit facilities. The sale of additional equity securities could result in dilution to our shareholders. In addition, in the future, we may enter into cash or stock acquisition transactions or other strategic transactions that could reduce cash available to fund our operations or result in dilution to shareholders.

Our principal commitments include office leases and contractual payments due to content and other service providers. We believe that our current cash, cash equivalents, and short-term investments will be sufficient to meet our anticipated cash needs for working capital and capital expenditures for at least the next 12 months.

We do not hold derivative financial instruments or equity securities in our short-term investment portfolio. Our cash equivalents and short-term investments consist of high quality securities, as specified in our investment policy guidelines. The policy limits the amount of credit exposure to any one non-U.S. Government or non-U.S. Agency issue or issuer to a maximum of 5% of the total portfolio. These securities are subject to interest rate risk and will decrease in value if interest rates increase. Because we have historically had the ability to hold our fixed income investments until maturity, we do not expect our operating results or cash flows to be significantly affected by a sudden change in market interest rates in our securities portfolio.

We conduct our operations primarily in five functional currencies: the U.S. dollar, the Korean won, the Japanese yen, the British pound and the euro. We currently do not hedge the majority of our foreign currency exposures and are therefore subject to the risk of exchange rate fluctuations. We invoice our international customers primarily in U.S. dollars, except in Korea, Japan, Germany, France, the United Kingdom and Australia, where we invoice our customers primarily in the respective foreign currencies. We are exposed to foreign exchange rate fluctuations as the financial results of foreign subsidiaries are translated into U.S. dollars in consolidation. Our exposure to foreign exchange rate fluctuations also arises from intercompany payables and receivables to and from our foreign subsidiaries.

As of September 30, 2011, approximately $65.6 million of the $183.1 million of cash, cash equivalents, and short-term investments was held by our foreign subsidiaries. We expect to repatriate a significant portion of the cash held by our foreign subsidiaries in future periods, likely on or around December 31, 2011. We believe repatriation of these funds will result in additional taxable income. We currently have significant net operating losses and other tax attributes that will be used to offset the potential U.S. income tax that will result when these amounts are distributed to the U.S. As such, we do not anticipate a material U.S. tax impact on the repatriation of such funds as of September 30, 2011, and will provide for, and disclose, the tax impact of such amounts in the consolidated financial statements in the quarter ending December 31, 2011.

The cumulative amount of permanently reinvested foreign subsidiaries funds, in addition to certain future foreign subsidiaries earnings, are intended to be reinvested permanently outside the U.S. If these amounts were distributed to the U.S, in the form of dividends or otherwise, we could be subject to additional U.S. income taxes. It is not practicable to determine the U.S. federal income tax liability or benefit on such earnings due to the timing of such future distributions, the availability of foreign tax credits, and the complexity of the computation if such earnings were not deemed to be permanently reinvested. If future events, including material changes in estimates of cash, working capital, and long-term investment requirements necessitate that these earnings be distributed, an additional provision for U.S. income and foreign withholding taxes, net of foreign tax credits, may be necessary.

Off-Balance Sheet Arrangements

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

Critical Accounting Policies and Estimates

The preparation of our financial statements requires us 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 reported period. Our critical accounting policies and estimates are as follows:

- Revenue recognition;
- Estimating music publishing rights and music royalties;
- Estimating recoverability of deferred costs;
- Estimating allowances for doubtful accounts and sales returns;
- Estimating losses on excess office facilities;
- Valuation of equity method investments;
- Valuation of available for sale securities;
- Valuation of long-lived assets;
- Valuation of goodwill;
- Stock-based compensation;
- Noncontrolling interest;

Accounting for gains on sale of subsidiary stock; and

Accounting for income taxes.

Revenue Recognition. We recognize revenue when persuasive evidence of an arrangement exists, delivery has occurred, the sales price is fixed or determinable, and collection is probable. Physical products are considered delivered to the customer once they have been shipped and title and risk of loss have been transferred. For online sales, the products or services are considered delivered at the time the product or services are made available, digitally, to the end user.

We recognize revenue on a gross or net basis. In most arrangements, we contract directly with end user customers, and are considered the primary obligor who carries all collectability risk. In such arrangements, we recognize revenue on a gross basis. In some cases, we utilize third-party distributors to sell products or services directly to end user customers and carry no collectability risk. In such instances, we recognize revenue on a net basis.

In our direct to consumer business, we derive revenue through (1) subscriptions of SuperPass within our Core Products segment and subscriptions sold by our Games segment, (2) sales of content downloads, software and licenses offered by the Company s Core Products, Emerging Products and Games segments and (3) the sale of advertising and the distribution of third-party products on our websites and in our games. Prior to April 1, 2010, our direct to consumer business also included the products and services primarily sold by the Rhapsody joint venture and included in the Company s Music segment. Beginning April 1, 2010, revenue from the Company s Rhapsody joint venture is no longer consolidated within the Company s financial statements. The Company now reports its share of Rhapsody s net income or losses as Equity in net loss of Rhapsody and other equity method investments .

Consumer subscription products are paid in advance, typically for monthly, quarterly or annual duration. Subscription revenue is recognized ratably over the related subscription time period. Revenue from sales of content downloads, software and licenses is recognized at the time the product is made available, digitally, to the end user. Revenue generated from advertising on our websites and from advertising and the distribution of third-party products included in our products is recognized as revenue at the time of delivery.

We also generate revenue through business-to-business channels by providing services within our Core Products segment enabling mobile carriers to deliver audio and video content to their customers and by selling software licenses and products and related support and other services.

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Revenue generated from services provided to mobile carriers that enable the delivery of audio and video content to their customers is recognized as the services are provided. Setup fees to build these services are recognized ratably upon launch of the service over the remaining expected term of the service.

A portion of the revenue related to the sale of software licenses and products, the related support and other services is recorded as unearned due to undelivered elements including, in some cases, post-delivery support and the right to receive unspecified upgrades or enhancements on a when-and-if-available basis. Revenue arrangements with multiple deliverables are divided into separate units and revenue is allocated using estimated selling prices if we do not have vendor-specific objective evidence or third-party evidence of the selling prices of the deliverables. Unearned revenue due to undelivered elements is recognized ratably on a straight-line basis over the related products contract term.

Estimating Music Publishing Rights and Music Royalty Accruals. We must make estimates of amounts owed related to our music publishing rights and music royalties for our domestic and international music services primarily incurred by Rhapsody which was separated from our operating results beginning April 1, 2010. Unsettled obligations incurred prior to April 1, 2010 remain our liability. Material differences between these estimates and the actual amounts owed may impact the amount and timing of our expense for any period if management made different judgments or utilized different estimates. Under copyright law, we may be required to pay licensing fees for digital sound recordings and compositions we deliver. Copyright law generally does not specify the rate and terms of the licenses, which are determined by voluntary negotiations among the parties or, for certain compulsory licenses where voluntary negotiations are unsuccessful, by arbitration. There are certain geographies and agencies for which we have not yet completed negotiations with regard to the royalty rate to be applied to the current or historic sales of our digital music offerings. Our estimates were based on contracted or statutory rates, when established, or management s best estimates based on facts and circumstances regarding the specific music services and agreements in similar geographies or with similar agencies. While we based our estimates on historical experience and on various other assumptions that management believed to be reasonable under the circumstances, actual results may differ materially from these estimates under different assumptions or conditions.

Estimating Recoverability of Deferred Costs. We defer costs on projects for service revenue and system sales. Deferred costs consist primarily of direct and incremental costs to customize and install systems, as defined in individual customer contracts, including costs to acquire hardware and software from third parties and payroll costs for our employees and other third parties.

We recognize such costs as a component of cost of revenue, the timing of which is dependent upon the revenue recognition policy by project. For revenue recognized under the completed contract method, costs are deferred until the products are delivered, or upon completion of services or customer acceptance, where applicable. For revenue recognized under the percentage of completion method, costs are recognized as products are delivered or services are provided in accordance with the percentage of completion calculation. For revenue recognized ratably over the term of the contract, costs are recognized ratably over the term of the contract, commencing on the date of revenue recognition. At each balance sheet date, we review deferred costs to ensure they are ultimately recoverable. Any anticipated losses on uncompleted contracts are recognized when evidence indicates the estimated total cost of a contract exceeds its estimated total revenue.

Estimating Allowances for Doubtful Accounts and Sales Returns. We make estimates of the uncollectible portion of our accounts receivable. We specifically analyze the age of accounts receivable and historical bad debts, customer credit-worthiness and current economic trends when evaluating the adequacy of the allowance for doubtful accounts. Similarly, we make estimates of potential future product returns related to current period revenue. We analyze historical returns, current economic trends, and changes in customer demand and acceptance of our products when evaluating the adequacy of the sales returns allowance. Significant judgments and estimates are made and used in connection with establishing allowances for doubtful accounts and sales returns in any accounting period. Material differences may result in the amount and timing of our revenue for any period if we were to make different judgments or utilize different estimates or actual future experience was different from the judgments and estimates.

Estimating Losses on Excess Office Facilities. We make significant estimates in determining the appropriate amount of accrued loss on excess office facilities. If we make different estimates, our loss on excess office facilities could be significantly different from that recorded, which could have a material impact on our operating results.

Valuation of Equity Method Investments. We use the equity method in circumstances where we have the ability to exert significant influence, but not control, over an investee or joint venture. We initially record our investments based on a fair value analysis of the investment. Prior to 2010, most of our equity method investments were purchased with cash which was determined to be fair value. For the investment in Rhapsody as of March 31, 2010, we used multiple valuation models to calculate the fair value since we contributed both cash and non-cash items in exchange for our interest. These models were based upon estimates and assumptions relating to future revenue, cash flows, operating expenses, costs of capital and capital purchases. These estimates and assumptions are complex and subject to a significant degree of judgment with respect to certain factors including, but not limited to, the cash flows of long-term operating plans, market and interest rate risk, and risk-commensurate discount rates and cost of capital.

We record our percentage interest in the investee or joint venture s income or loss under this method, which will increase or decrease the net book value of the investment. We record investee losses up to the aggregate amount of the investment.

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We evaluate impairment of an investment valued under the equity method only if events and circumstances warrant. An impairment charge would be recorded whenever a decline in value of an equity investment below its carrying amount is determined to be other than temporary. In determining if a decline is other than temporary, we consider factors such as the length of time and extent to which the fair value of the investment has been less than the carrying amount of the investee or joint venture, the near-term and longer-term operating and financial prospects of the investee or joint venture and our intent and ability to hold the investment for a period of time sufficient to allow for any anticipated recovery.

Valuation of Available for Sale Securities. Our investments in publicly traded companies are accounted for as available-for-sale and are carried at current market value. We periodically evaluate whether any declines in fair value of our available for sale securities are other-than-temporary based on a review of qualitative and quantitative factors. For investments with publicly quoted market prices, these factors include the time period and extent by which its accounting basis exceeds its quoted market price. We consider additional factors to determine whether declines in fair value are other-than-temporary, such as the investee s financial condition, results of operations, and operating trends. The evaluation also considers publicly available information regarding the investee companies.

Valuation of Long-Lived Assets. Long-lived assets consist primarily of property, plant and equipment, as well as amortizable intangible assets acquired in business combinations. Long-lived assets are amortized on a straight line basis over their estimated useful lives. We review long-lived assets for impairment whenever events or changes in circumstances indicate the carrying amount of such assets may not be recoverable. Recoverability of these assets is measured by comparison of their carrying amount to future undiscounted cash flows the assets are expected to generate. If long-lived assets are considered to be impaired, the impairment to be recognized equals the amount by which the carrying value of the assets exceeds their fair market value. The impairment analysis of long-lived assets is based upon estimates and assumptions relating to our future revenue, cash flows, operating expenses, costs of capital and capital purchases. These estimates and assumptions are complex and subject to a significant degree of judgment with respect to certain factors including, but not limited to, the cash flows of our long-term operating plans, market and interest rate risk, and risk-commensurate discount rates and cost of capital. Significant or sustained declines in future revenue or cash flows, or adverse changes in our business climate, among other factors, and their resulting impact on the estimates and assumptions relating to the value of our long-lived assets could result in the need to perform an impairment analysis in future interim periods which could result in a significant impairment. While we believe our estimates and assumptions are reasonable, due to their complexity and subjectivity, these estimates and assumptions could vary period to period.

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

- poor economic performance relative to historical or projected future operating results;
- significant negative industry, economic or company specific trends;
- market and interest rate risk;
- changes in the manner of our use of the assets or the plans for our business; and
- loss of key personnel.

In addition, we perform a reconciliation of our market capitalization plus a reasonable control premium to the aggregated implied fair value of all of our reporting units.

If we were to determine that the fair value of a reporting unit was less than its carrying value, including goodwill, based upon the annual test or the existence of one or more of the above indicators of impairment, we would measure impairment based on a comparison of the implied fair value of reporting unit goodwill with the carrying amount of goodwill. The implied fair value of goodwill is determined by allocating the fair value of a reporting unit to its assets (recognized and unrecognized) and liabilities in a manner similar to a purchase price allocation. The residual fair value after this allocation is the implied fair value of the goodwill of the reporting unit. To the extent the carrying amount of reporting unit goodwill is greater than the implied fair value of reporting unit goodwill, we would record an impairment charge for the difference. Judgment is required in determining our reporting units and assessing fair value of the reporting units.

The impairment analysis of goodwill is based upon estimates and assumptions relating to our future revenue, cash flows, operating expenses, costs of capital and capital purchases. These estimates and assumptions are complex and subject to a significant degree of judgment with respect to certain factors including, but not limited to, the cash flows of our long-term operating plans, market and interest rate risk, and risk-commensurate discount rates and cost of capital.

Stock-Based Compensation. Stock-based compensation cost is estimated at the grant date based on the award s fair-value as calculated by the Black-Scholes option-pricing model and is recognized as expense over the requisite service period, which is the vesting period. The Black-Scholes model requires various highly speculative assumptions including volatility in our common stock

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price and expected option life. If any of the assumptions used in the Black-Scholes model change significantly, stock-based compensation expense may differ materially in the future from the amounts recorded in our consolidated statements of operations. We are required to estimate forfeitures at the time of grant and revise those estimates in subsequent periods if actual forfeitures differ from those estimates. We use historical data to estimate pre-vesting option forfeitures and record stock-based compensation expense only for those awards that are expected to vest.

Noncontrolling Interests. We record noncontrolling interest expense (benefit) which reflects the portion of the earnings (losses) of majority-owned entities which are applicable to the noncontrolling interest partners in the consolidated statements of operations. Redeemable noncontrolling interests that are redeemable at either fair value or are based on a formula that is intended to approximate fair value follow our historical disclosure only policy for the redemption feature. Redeemable noncontrolling interests that are redeemable at either a fixed price or are based on a formula that is not akin to fair value are reflected as an adjustment to income attributable to common shareholders based on the difference between accretion as calculated using the terms of the redemption feature and the accretion entry for a hypothetical fair value redemption feature with the remaining amount of accretion to redemption value recorded directly to equity. Net loss attributable to the noncontrolling interest in Rhapsody is included within the consolidated statements of operations and comprehensive income (loss). We applied this accounting policy to the noncontrolling interest in Rhapsody that was held by MTVN for periods beginning when Rhapsody was formed in August 2007 through the quarter ended March 31, 2010. Due to the completion of the restructuring of Rhapsody on March 31, 2010 which resulted in our holding approximately 47% of the outstanding shares of capital stock of Rhapsody, this accounting policy no longer applies with respect to our investment in Rhapsody as we no longer consolidate Rhapsody and no longer report a noncontrolling interest.

Accounting for Gains on Sale of Subsidiary Stock. Effective January 1, 2009, we adopted Statement of Financial Accounting Standards No. 160, *Noncontrolling Interests in Consolidated Financial Statements, an amendment to ARB No. 51 (*SFAS 160) which was primarily codified into FASB ASC 810 *Consolidation* (ASC 810). Current guidance requires the difference between the carrying amount of the parent s investment in a subsidiary and the underlying net book value of the subsidiary after the issuance of stock by the subsidiary to be recorded as equity transactions. We elected to recognize any such gain in our consolidated statements of operations prior to January 1, 2009 as was allowable under generally accepted accounting principles in place at that time if certain recognition criteria were met. Due to the completion of the restructuring of Rhapsody on March 31, 2010, which resulted in our holding approximately 47% of the outstanding shares of capital stock of Rhapsody, this accounting policy will no longer apply with respect to our investment as we no longer consolidate Rhapsody and no longer report a noncontrolling interest.

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

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

Historically, we have not provided for U.S. deferred income taxes or withholding taxes on certain foreign subsidiaries undistributed earnings. These earnings are intended to be permanently reinvested in operations outside of the U.S. As a result of the decision to pay the special cash dividend and to effect the reverse stock split in August 2011, we expect to repatriate some of our foreign subsidiaries undistributed earnings in future periods. This planned repatriation is a one-time change in our assertion on foreign subsidiaries undistributed earnings, as we otherwise intend to reinvest future earnings outside of the U.S. indefinitely.

As of September 30, 2011, approximately $65.6 million of the $183.1 million of cash, cash equivalents, and short-term investments was held by our foreign subsidiaries. We expect to repatriate a significant portion of the cash held by our foreign subsidiaries in future periods, likely on or around December 31, 2011. We believe repatriation of these funds will result in additional taxable income. We currently have significant net operating losses and other tax attributes that will be used to offset the potential U.S. income tax that will result when these amounts are distributed to the U.S. As such, we do not anticipate a material U.S. tax impact on the repatriation of such funds as of September 30, 2011, and will provide for, and disclose, the tax impact of such amounts in the consolidated financial statements in the quarter ending December 31, 2011.

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The cumulative amount of permanently reinvested foreign subsidiaries funds, in addition to certain future foreign subsidiaries earnings, are intended to be reinvested permanently outside the U.S. If these amounts were distributed to the U.S., in the form of dividends or otherwise, the Company could be subject to additional U.S. income taxes. It is not practicable to determine the U.S. federal income tax liability or benefit on such earnings due to the timing of such future distributions, the availability of foreign tax credits, and the complexity of the computation if such earnings were not deemed to be permanently reinvested. If future events, including material changes in estimates of cash, working capital, and long-term investment requirements necessitate that these earnings be distributed, an additional provision for U.S. income and foreign withholding taxes, net of foreign tax credits, may be necessary.

Item 3. Quantitative and Qualitative Disclosures About Market Risk

The following discussion about our market risk involves forward-looking statements. All statements that do not relate to matters of historical fact should be considered forward-looking statements. Actual results could differ materially from those projected in any forward-looking statements.

Interest Rate Risk. Our exposure to interest rate risk from changes in market interest rates relates primarily to our short-term investment portfolio. We do not hold derivative financial instruments or equity investments in our short-term investment portfolio. Our short-term investments consist of high quality debt securities as specified in our investment policy. Investments in both fixed and floating rate instruments carry a degree of interest rate risk. The fair value of fixed rate securities may be adversely impacted due to a rise in interest rates, while floating rate securities may produce less income than expected if interest rates fall. Additionally, a declining rate environment creates reinvestment risk because as securities mature the proceeds are reinvested at a lower rate, generating less interest income. Due in part to these factors, our future interest income may be adversely impacted due to changes in interest rates. In addition, we may incur losses in principal if we are forced to sell securities that have declined in market value due to changes in interest rates. Because we have historically had the ability to hold our short-term investments until maturity, we would not expect our operating results or cash flows to be significantly impacted by a sudden change in market interest rates. There have been no material changes in our investment methodology regarding our cash equivalents and short-term investments during the quarter or nine months ended September 30, 2011. Based on our cash, cash equivalents, short-term investments, and restricted cash equivalents at September 30, 2011, a hypothetical 10% increase/decrease in interest rates would not increase/decrease our annual interest income and cash flows by more than a nominal amount.

Investment Risk. As of September 30, 2011, we had investments in voting capital stock of both publicly traded and privately-held technology companies for business and strategic purposes. Our investments in publicly traded companies are accounted for as available-for-sale, carried at current market value and are classified as long-term as they are strategic in nature. We periodically evaluate whether any declines in fair value of our investments are other-than-temporary based on a review of qualitative and quantitative factors. For investments with publicly quoted market prices, these factors include the time period and extent by which its accounting basis exceeds its quoted market price. We consider additional factors to determine whether declines in fair value are other-than-temporary, such as the investee s financial condition, results of operations, and operating trends. The evaluation also considers publicly available information regarding the investee companies. For investments in private companies with no quoted market price, we consider similar qualitative and quantitative factors as well as the implied value from any recent rounds of financing completed by the investee. Based upon an evaluation of the facts and circumstances during the quarter and nine months ended September 30, 2011 and 2010, we determined that no other-than-temporary decline in fair value had occurred and therefore no impairment charges were recorded.

Foreign Currency Risk. We conduct business internationally in several currencies. As such, we are exposed to adverse movements in foreign currency exchange rates.

Our exposure to foreign exchange rate fluctuations arises in part from: (1) translation of the financial results of foreign subsidiaries into U.S. dollars in consolidation; (2) the remeasurement of non-functional currency assets, liabilities and intercompany balances into U.S. dollars for financial reporting purposes; and (3) non-U.S. dollar denominated sales to foreign customers. A portion of these risks is managed through the use of financial derivatives, but fluctuations could impact our results of operations and financial position.

Generally, our practice is to manage foreign currency risk for the majority of material short-term intercompany balances through the use of foreign currency forward contracts. These contracts require us to exchange currencies at rates agreed upon at the contract s inception. Because the impact of movements in currency exchange rates on forward contracts offsets the related impact on the short-term intercompany balances, these financial instruments help alleviate the risk that might otherwise result from certain changes in currency exchange rates. We do not designate our foreign exchange forward contracts related to short-term intercompany accounts as hedges and, accordingly, we adjust these instruments to fair value through results of operations. However, we may periodically hedge

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a portion of our foreign exchange exposures associated with material firmly committed transactions, long-term investments, highly predictable anticipated exposures and net investments in foreign subsidiaries. Some of our unhedged exposures are reconciled through our statement of operations on a mark-to-market basis each quarter, so to the extent we continue to experience adverse economic conditions, we may record losses related to such unhedged exposures in future periods that may have a material adverse effect on our financial condition and results of operations.

Our foreign currency risk management program reduces, but does not entirely eliminate, the impact of currency exchange rate movements.

We have cash balances denominated in foreign currencies which are subject to foreign currency fluctuation risk. The majority of our foreign currency denominated cash is held in Korean won and euros. A hypothetical 10% increase or decrease in the Korean won and euro relative to the U.S. dollar from September 30, 2011, would not result in more than a nominal amount of unrealized gain or loss.

Foreign currency transaction gains and losses were not material for the quarter or nine month periods ended September 30, 2011 and 2010.

Item 4. Controls and Procedures

(a) *Evaluation of Disclosure Controls and Procedures.* Based on an evaluation as of the end of the period covered by this report, our principal executive officer and principal financial officer have concluded that our disclosure controls and procedures (as defined in Rules 13a-15(e) and 15d-15(e) under the Securities Exchange Act of 1934, as amended (the Exchange Act)) were effective to ensure that information required to be disclosed by us in reports that we file or submit under the Exchange Act (1) is recorded, processed, summarized and reported within the time periods specified in Securities and Exchange Commission rules and forms, and (2) is accumulated and communicated to our management, including our principal executive officer and principal financial officer, as appropriate to allow timely decisions regarding required disclosure.

(b) *Changes in Internal Controls.* There have not been any changes in our internal control over financial reporting (as such term is defined in Rule 13a-15(f) and 15d-15(f) under the Exchange Act) during the quarter ended September 30, 2011, that have materially affected, or are reasonably likely to materially affect, our internal control over financial reporting.

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PART II. OTHER INFORMATION

Item 1. Legal Proceedings

See Note 15. Commitments and Contingencies to Condensed Consolidated Financial Statements included in Part I, Item 1 of this report for information regarding legal proceedings.

Item 1A. Risk Factors

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

We need to successfully introduce new products and services to grow our businesses.

Our business is dependent upon the introduction of new products and services, which is subject to a number of risks. The process of developing new, and enhancing existing, products and services is complex, costly and uncertain. Providing products and services that are attractive and useful to subscribers and consumers is in part subject to unpredictable and volatile factors beyond our control, including end-user preferences and competing products and services. Any failure by us to timely respond to or accurately anticipate consumers changing needs, emerging technological trends or important changes in the market or competition for products and services we plan to introduce could significantly harm our current market share or result in the loss of market opportunities. In addition, we must make long-term investments, develop or obtain appropriate intellectual property and commit significant resources before knowing whether our predictions will accurately reflect consumer demand for our products and services, which may result in no return or a loss on our investments. Furthermore, new products and services may be subject to legal challenge. Responding to these potential claims may require us to enter into royalty and licensing agreements on unfavorable terms, require us to stop distributing or selling, or to redesign our products or services, or to pay damages. If we do not successfully introduce new products and services, our operating results may be materially harmed.

The mobile entertainment market is evolving rapidly and highly competitive.

The market for mobile entertainment services, including our ring back tones, music on demand and video on demand solutions, is highly competitive and evolving rapidly, particularly with the growth in the use of smartphones. Increased use of smartphones has resulted in a proliferation of applications and services that compete with our SaaS services and, in many cases, are not dependent upon our carrier customers to make them available to subscribers. To maintain or enhance our competitive position, we may need to develop new SaaS services that enable our carrier customers to compete with the broad range of applications and other services available in the market. We face competition, and may face future competition, from major media companies, Internet portal companies, content aggregators, wireless software providers and other pure-play wireless entertainment publishers, some of which have greater financial resources than we do. Furthermore, while most of our carrier customers do not offer internally developed services that compete with ours, if our carrier customers begin developing these services internally, we could be forced to lower our prices or increase the amount of service we provide in order to maintain our business with those carrier customers. Increased competition has in the past resulted in pricing pressure, forcing us to lower the selling price of our services. If we are unable to develop or provide services that compete effectively in the mobile entertainment market, our operating results and financial condition may be materially harmed.

Contracts with our carrier customers subject us to significant risks that could negatively impact our revenue or otherwise harm our operating results.

We derive a material portion of our revenue from our SaaS offerings we provide to carriers. Many of our SaaS contracts with carriers provide for revenue sharing arrangements, but we have little control over the pricing decisions of our carrier customers. Furthermore, most of these contracts do not provide for guaranteed minimum payments or usage levels. Because most of our carrier customer contracts are nonexclusive, it is possible that our mobile carrier customers could purchase similar services from third parties and cease to use our services in the future. As a result, our revenue derived under these agreements could be substantially reduced depending on the pricing and usage decisions of our carrier customers. In addition, some of our SaaS contracts require us to incur significant set-up costs prior to the launch of services with a carrier customer. These costs, particularly if combined with significant or sustained declines in revenue from our SaaS contracts, could result in impairments of deferred project costs in future periods, which would negatively impact our results of operations.

In addition, none of our SaaS contracts with carriers obligates our carrier customers to market or distribute any of our SaaS offerings. Despite the lack of marketing commitments, revenue related to our SaaS offerings is, to a large extent, dependent upon the marketing and promotion activities of our carrier customers. In addition, many of our carrier contracts are short term and allow for early termination by the carrier with or without cause. These contracts are therefore subject to renegotiation of pricing or other key

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terms that could be adverse to our interests and leave us vulnerable to non-renewal by the carriers. The loss of carrier customers, a reduction in marketing or promotion of our SaaS offerings, or the termination, non-renewal or renegotiation of contract terms that are less favorable to us would likely result in the loss of future revenues from our SaaS offerings.

Finally, nearly all of our carrier contracts obligate us to indemnify the carrier customer for certain liabilities and losses incurred by them, including liabilities resulting from third party claims for damages that arise out of the use of our technology. These indemnification terms provide us with certain procedural safeguards, including the right to control the defense of the indemnified party. Pursuant to these indemnifications obligations, we have agreed to control the defense on behalf of two of our carrier customers related to a pending patent infringement proceeding, and we are vigorously defending them. This pending proceeding or future claims against which we may be obligated to defend our carrier customers could result in payments that could materially harm our business or our consolidated financial statements.

A majority of the revenue that we generate in our Core Products business segment is dependent upon our relationship with a few customers, including SK Telecom and Verizon; any deterioration of these relationships could materially harm our business.

We generate a significant portion of our revenue from sales of our mobile entertainment services to a few of our mobile carrier customers, including SK Telecom, a leading wireless carrier in South Korea. In the near term, we expect that we will continue to generate a significant portion of our total revenue from these customers, particularly SK Telecom and Verizon. If these customers fail to market or distribute our services or terminate their business contracts with us, or if our relationships with these customers deteriorate in any significant way, we may be unable to replace the affected business arrangements with acceptable alternatives. Our relationship with SK Telecom may also be affected by the general state of the economy of South Korea. Failure to maintain our relationships with these customers could have a material negative impact on our revenue and operating results.

Our businesses face substantial competitive and other challenges that may prevent us from being successful in, and negatively impact future growth in, those businesses.

Many of our current and potential competitors in our businesses have longer operating histories, greater name recognition, more employees and significantly greater resources than we do. To effectively compete in the markets for our products and services, we may experience the following consequences, any of which would adversely affect our operating results and the trading price of our stock:

- reduced prices or margins,
- loss of current and potential customers, or partners and potential partners who provide content we distribute to our customers,
- changes to our products, services, technologies, licenses or business practices or strategies,
- lengthened sales cycles,
- industry-wide changes in content distribution to customers,
- pressure to prematurely release products or product enhancements, or
- degradation in our stature or reputation in the market.

In addition, we face the following competitive risks relating to our businesses:

Our SuperPass subscription service faces competition from a broad variety of entertainment sources, including traditional media outlets and emerging Internet media sources. We expect this competition to continue to be intense as the market and business models for Internet video content mature and more competitors enter these new markets. Competing services may be able to obtain better or more favorable access to compelling video content than us, may develop better offerings than us and may be able to leverage other assets or technologies to promote or distribute their offerings successfully. Our RealPlayer software services compete with alternative streaming media playback technologies and audio and video formats including Microsoft Windows Media Player and Adobe Flash and their related file formats, each of which has obtained very broad market penetration. In addition, our overall ability to sell subscription services depends in part on the use of our formats on the Internet, and declines in the use of our formats have negatively affected, and are expected to continue to negatively affect, our subscription revenue and increase costs of obtaining new subscribers. If we are unable to compete successfully, including through the introduction of compelling new products and services, our SuperPass and RealPlayer businesses could continue to decline.

Our GameHouse, Zylom and Atrativa branded services compete with other online aggregators and distributors of online, downloadable and social casual PC games. Some of these competitors have high volume distribution channels and greater financial resources than we do. Our Games business also competes with many other smaller companies that may be able to adjust to market conditions, including responding effectively to the growing popularity of casual games on social networks, faster than us. We also face increasing price competition in the casual games market, and some of our competitors may be able to lower prices more aggressively than us. 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 achieve growth in our revenue. Our games development studios compete primarily with other developers of online, downloadable, mobile and social casual PC games and must continue to develop popular and high-quality game titles. Our Games business must also continue to execute on opportunities to expand the play of our games on a variety of non-PC platforms, including social networks, in order to maintain our competitive position and to grow the business.

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

Maintaining and growing the distribution of digital media products through our websites and our other distribution channels is important to our future prospects, including future growth through the introduction of new products and services distributed through these channels. We cannot predict whether consumers will continue to download and use our digital media products consistent with past usage, which may reduce our ability to generate revenue from those products as well as result in lower than expected adoption of newly introduced products and services. Our inability to maintain continued high volume distribution of our digital media products could also hold back the growth and development of related revenue streams from these market segments, including the distribution of third-party products and sales of our subscription services, and therefore could harm our business and our prospects. Our revenue from the distribution of third-party products will also be negatively impacted if those products are not widely downloaded by consumers, including due to the relative market saturation of such products. In addition, our revenue from the distribution of third party products is currently significantly dependent on a single customer contract. If that contract is not renewed or terminated and cannot be replaced by another similar customer contract, our financial results would be harmed.

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

The trading price for our common stock has been volatile, ranging from $7.40 to $17.24 per share during the 52-week period ended September 30, 2011. These prices reflect the one-for-four reverse stock split of the Company s common stock that was effective at the close of business on August 30, 2011. As a result of the rapidly changing markets in which we compete, our operating results may fluctuate from period-to-period, which may continue to contribute to the volatility of our stock price. 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, goodwill and other long-lived assets. Our operating results may be adversely affected by similar or other charges or events in future periods, including, but not limited to:

- impairments of long-lived assets,
- integrating and operating newly acquired businesses and assets, and
- the general difficulty in forecasting our operating results and metrics, which could result in actual results that differ significantly from expected results.

Certain of our product and service investment decisions (for example, research and development and sales and marketing efforts) are based on predictions regarding business and the markets in which we compete. Fluctuations in our operating results, particularly when experienced beyond what we expected, could cause the trading price of our stock to continue to fluctuate.

Continued loss of revenue from some of our subscription services may harm our operating results.

Our operating results could be adversely impacted by the loss of subscription revenue. Subscribers may cancel their subscriptions to our services for many reasons, including a perception that they do not use the services sufficiently or that the service does not provide enough value, a lack of attractive or exclusive content generally or as compared with competitive service offerings, or because customer service issues are not satisfactorily resolved. Revenue from our SuperPass subscription service has declined in recent periods due in part to our focus on other products and services we offer, and we expect this trend to continue. For the subscription services we offer, we must continue to obtain compelling digital media content for our video and games services in order to maintain and increase usage and overall customer satisfaction for these products. Our operating results may be negatively impacted if we cannot obtain content for our subscription services on commercially reasonable terms.

Government regulation of the Internet is evolving, and unfavorable developments could have an adverse affect on our operating results.

We are subject to regulations and laws specific to the marketing, sale and delivery of goods and services over the Internet. These laws and regulations cover taxation, user privacy, data collection and protection, copyrights, electronic contracts, sales procedures, automatic subscription renewals, credit card processing procedures, consumer protections, broadband Internet access and content restrictions. We cannot guarantee that we have been or will be fully compliant in every jurisdiction, as it is not entirely clear how existing laws and regulations governing issues such as privacy, taxation and consumer protection apply or will be enforced with respect to the products and services we sell through the Internet. Moreover, as Internet commerce continues to evolve, increasing regulation and/or enforcement efforts by federal, state and foreign agencies becomes more likely. The adoption of any laws or regulations or the imposition of other legal requirements that adversely affect our ability to market, sell, and deliver our products and services could decrease demand for our service offerings, resulting in lower revenue. Future regulations, or changes in laws and regulations or their existing interpretations or applications, could also require us to change our business practices, raise compliance costs or other costs of doing business and result in additional historical or future liabilities for us, resulting in adverse impacts on our business and our operating results. As a consumer-facing business, we receive complaints from our customers regarding our consumer marketing efforts and our customer service practices. Occasionally, these customers will also complain to government agencies, and from time to time, those agencies have made inquiries to us about these practices. We cannot guarantee that these government agencies will not commence an enforcement action against us based on these types of complaints, nor can we guarantee that the outcome of any such action would not have a material adverse effect on our consolidated financial statements.

Uncertainty and adverse conditions in the economy could have a material adverse impact on our business, financial condition and results of operations.

Weaknesses in the national and global economy has resulted in recent years in a decline in overall consumer and corporate spending, declines in consumer and corporate access to credit, fluctuations in foreign exchange rates, declines in the value of assets and increased liquidity risks, all of which could materially impact our business, financial condition and results of operations. We provide digital entertainment services to consumers directly and indirectly through our carrier customers. Consumers may consider the purchase of our products and services to be a discretionary expenditure. As a result, consumers considering whether to purchase our products or services may be influenced by macroeconomic factors that affect consumer spending such as unemployment, conditions in the residential real estate and mortgage markets and access to credit when making a determination whether to commence, continue, or stop subscribing to or otherwise purchasing our products and services. In addition, businesses may reduce their advertising spending during adverse macroeconomic conditions, which would negatively impact the revenue we generate through sales of advertising on our websites and other properties. We have recorded impairments to our assets in 2008 and 2009 due in part to weakness in the global economy, and if there is a sustained period of significant weakness or uncertainty in the global economy, we may need to record additional impairments to our assets in future periods. If any of these risks are realized, we may experience a material adverse impact on our financial condition and results of operations.

Our restructuring efforts may not yield the anticipated benefits to our shareholders.

We have been restructuring the operating and overhead costs of, and taking other measures to simplify, our business and operations. We have never before pursued initiatives to this extent and there is no assurance that our efforts will be successful. Our business and operations may be harmed to the extent there is customer or employee uncertainty surrounding the future direction of our product and service offerings and strategy for our businesses. Our restructuring activities have included implementing cost-cutting initiatives, which could materially impact our ability to compete in future periods. If we have not effectively re-aligned the cost structure of our remaining businesses or otherwise do not execute effectively on our strategic plans, our stock price may be adversely affected, and we and our shareholders will not realize the anticipated financial, operational and other benefits from such initiatives.

The restructuring of Rhapsody may not yield the anticipated benefits to us or to Rhapsody.

On March 31, 2010, we completed the restructuring transactions of our digital audio music service joint venture, Rhapsody America LLC (Rhapsody). As a result of the restructuring, we no longer have operational control over Rhapsody and Rhapsody s operating performance is no longer consolidated with our condensed consolidated financial statements. We believe the restructuring will provide Rhapsody with the financial, intellectual property and other key assets, and the operational flexibility to compete more effectively in the digital music market. Rhapsody s inability to operate and compete effectively as an independent company could adversely impact its financial condition and results of operations, which in turn would materially impact our reported net income (loss) in future periods. In addition, Rhapsody has generated losses since its inception, and the new structure may not alter this trend. If Rhapsody continues to incur losses, or if it otherwise experiences a significant decline in its business, we may incur a loss on our investment, which would have a material adverse effect on our financial condition and results of operations.

Given the current proportion of the outstanding equity of Rhapsody that we hold, we anticipate that we will need to receive Rhapsody s unaudited quarterly financial statements in order to timely prepare our quarterly consolidated financial statements and also to report certain of Rhapsody s financial results, as may be required, in our quarterly reports on Form 10-Q. In addition, we may be required to include Rhapsody s annual audited financial statements in our annual report on Form 10-K in future periods. As we no longer exert operational control over Rhapsody, we cannot guarantee that Rhapsody will deliver its financial statements to us in a timely manner, or at all, or that the unaudited financial statement information provided by Rhapsody will not contain inaccuracies that are material to our reported results. Any failure to timely obtain Rhapsody s quarterly financial statements or to include its audited financial statements in our future annual reports on Form 10-K, if required, could cause our reports to be filed in an untimely manner, which would preclude us from utilizing certain registration statements and could negatively impact our stock price.

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We depend upon our executive officers and key personnel, but may be unable to attract and retain them, which could significantly harm our business and results of operations.

Our success depends on the continued employment of certain executive officers and key employees. In January 2010, Rob Glaser, our founder and the only Chief Executive Officer in our history, resigned as Chief Executive Officer, but remained the Chairman of our Board of Directors. In March 2011, Robert Kimball resigned as Chief Executive Officer and Michael Lunsford was appointed as Interim Chief Executive Officer, and effective November 9, 2011, Thomas Nielsen will serve as our President and Chief Executive Officer. Accordingly, we are experiencing our third transition at the Chief Executive Officer level in less than two years. We cannot provide assurance that we will effectively manage these transitions, which may impact our ability to retain our remaining key executive officers and which could harm our business and operations to the extent there is customer or employee uncertainty arising from these transitions.

Our success is also dependent upon our ability to identify, attract and retain highly skilled management, technical and sales personnel. Qualified individuals are in high demand and competition for such qualified personnel in our industry, particularly engineering talent, is intense, and we may incur significant costs to attract or retain them. Our ability to attract and retain personnel may also be made more difficult by the uncertainty created by the recent changes at our Chief Executive Officer position. There can be no assurance that we will be able to attract and retain the key personnel necessary to sustain our business or support future growth.

Acquisitions involve costs and 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 manage the costs and 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.

Acquisition-related costs and financial risks related to completed and potential future acquisitions may harm our financial position, reported operating results, or stock price. Previous acquisitions have resulted in significant expenses, including amortization of purchased technology, amortization of acquired identifiable intangible assets and the incurrence of charges for the impairment of goodwill and other intangible assets, which are reflected in our operating expenses. New acquisitions and any potential additional future impairment of the value of purchased assets, including goodwill, could have a significant negative impact on our future operating results.

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, and/or personnel of the acquired company;
- retaining key management or employees of the acquired company;
- entrance into unfamiliar markets, industry segments, or types of businesses;
- operating and integrating acquired businesses in remote locations;
- integrating and managing businesses based in countries in which we have little or no prior experience;
- diversion of management time and other resources from existing operations to integration activities for acquired businesses;
- impairment of relationships with employees, affiliates, advertisers or content providers of our business or acquired business; and

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

We may be unable to adequately protect our proprietary rights or leverage our patent portfolio, and may face risks associated with third-party claims relating to our intellectual property.

Our ability to compete across our businesses partly depends on the superiority, uniqueness and value of our patent portfolio and other 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. Our efforts to protect our intellectual property rights may not assure our ownership rights in our intellectual property, protect or enhance the competitive position of our products and services or effectively prevent misappropriation of our technology. We also routinely receive challenges to our trademarks and other proprietary intellectual property that we are using in our business activities in China. Disputes regarding the validity and scope of patents or the ownership of technologies and rights associated with streaming media, digital distribution, and online businesses are common and likely to arise in the future. We may be forced to litigate to enforce or defend our patents and other intellectual property rights or to determine the validity and scope of other parties proprietary rights, enter into royalty or licensing agreements on unfavorable terms or redesign our product features and services. Any such dispute would likely be costly and distract our management, and the outcome of any such dispute could fail to improve our business prospects or otherwise harm our business.

From time to time we receive claims and inquiries from third parties alleging that our technology 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 contract breaches, infringement of copyrights, trademark rights, trade secret rights or other proprietary rights, or alleging unfair competition or violations of privacy rights. These claims, even if not meritorious, could force the Company to spend significant financial and managerial resources. Given the broad distribution of some of our consumer products, any individual claim related to those products could give rise to liabilities that may be material to us. Currently, we are investigating or litigating a variety of such pending claims, some of which are described in Note 15. Commitments and Contingencies to Condensed Consolidated Financial Statements included in Part I, Item 1 of this report. In the event of a determination adverse to the Company, the Company may incur substantial monetary liability and/or be required to change its business practices.

Our business and operating results will suffer if our systems or networks fail, become unavailable, unsecured 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 and security of our information systems and networks. A significant or repeated reduction in the performance, reliability, security 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 caused 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, HVAC failures, intentional actions to disrupt our systems and networks and many other causes. The vulnerability of a large portion of our computer and communications infrastructure is enhanced because much of it is located at a single leased facility in Seattle, Washington, an area that is at heightened risk of earthquake, flood, and volcanic events. Many of our services 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.

The growth of our business is dependent in part on successfully managing our international operations.

Our international operations involve risks inherent in doing business globally, including difficulties in managing operations due to distance, language, and cultural differences, local economic conditions, different or conflicting laws and regulations, taxes, and exchange rate fluctuations. The functional currency of our foreign subsidiaries is the local currency of the country in which each subsidiary operates. We translate our subsidiaries revenues into U.S. dollars in our financial statements, and continued volatility in foreign exchange rates, particularly if the U.S. dollar strengthens against the euro or the Korean won, may result in lower reported revenue or net assets in future periods. Our foreign currency exchange risk management program reduces, but does not eliminate, the impact of currency exchange rate movements. If we do not effectively manage any of the risks inherent in running our international businesses, our operating results and financial condition could be harmed.

We may be subject to market risk and legal liability in connection with our data collection and data security capabilities.

Many of our products are interactive Internet applications that by their very nature require communication between a client and server to operate. For example, to provide better consumer experiences and to operate effectively, our products send information, including personally identifiable information, to our servers. In addition, we sell many of our products and services through online sales transactions directly with consumers, through which we collect and store credit card information. In connection with our direct sales to consumers, we may be the victim of fraudulent transactions, including credit card fraud, which presents a risk to our revenue and potentially disrupts service to our consumers. While we take measures to protect our consumer data from unauthorized access or disclosure, it is possible that our security controls over consumer data may not prevent the improper access or disclosure of credit card information or personally identifiable information. We also are not yet fully compliant with the Payment Card Industry (PCI) compliance standard for data security in connection with our use of credit card services for payment. We have an extensive privacy policy concerning the collection, use and disclosure of user data involved in interactions between our client and server products. A security breach that leads to disclosure of consumer account information (including personally identifiable information) or any failure by us to comply with our posted privacy policy or existing or new legislation regarding privacy issues could harm our reputation, impact the market for our products and services, subject us to litigation, and require us to expend significant resources to mitigate the breach of security, comply with breach notification laws or address related matters. In addition, if we fail to satisfy timely the PCI compliance standards we may be subject to substantial penalties and we could lose the ability to accept credit card payments for transactions with our customers. Any of these consequences could materially harm our business or our consolidated financial statements.

Changes in regulations applicable to the Internet and e-commerce that increase the taxes on the services we provide could materially harm our business and operating results.

As Internet commerce continues to evolve, increasing taxation by state, local or foreign tax authorities becomes more likely. For example, taxation of electronically delivered products and services or other charges imposed by government agencies may also be

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imposed. We believe we collect transactional taxes and are compliant and current in all jurisdictions where we believe we have a collection obligation for transaction taxes. Any regulation imposing greater taxes or other fees for products and services could result in a decline in the sale of products and services and the viability of those products and services, harming our business and operating results. A successful assertion by one or more states or foreign tax authorities that we should collect and remit sales or other taxes on the sale of our products or services could result in substantial liability for past sales.

In those countries where we have taxable presence, we collect value added tax, or VAT, on sales of electronically supplied services provided to European Union residents. The collection and remittance of VAT subjects us to additional currency fluctuation risks.

We may be subject to additional income tax assessments.

We are subject to income taxes in the U.S. and numerous foreign jurisdictions. Significant judgment is required in determining our worldwide provision for income taxes, income taxes payable, and net deferred tax assets. In the ordinary course of business, there are many transactions and calculations where the ultimate tax determination is uncertain. Although we believe our tax estimates are reasonable, the final determination of tax audits and any related litigation could be materially different than that which is reflected in our historical financial statements. An audit or litigation can result in significant additional income taxes payable in the U.S. or foreign jurisdictions which could have a material adverse effect on our financial condition and results of operations.

Our Chairman of the Board beneficially owns approximately 38% of our stock, which gives him significant control over certain major decisions on which our shareholders may vote or may discourage an acquisition of us.

Robert Glaser, our Chairman of the Board, beneficially owns approximately 38% of our common stock. As a result, Mr. Glaser and his affiliates 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.

At our 2010 annual meeting of shareholders, Mr. Glaser withheld votes of his shares of our common stock with respect to the election of four of our directors, including three of our incumbent directors and Robert Kimball, our former President and Chief Executive Officer. Although these four directors were re-elected, none of them received approval of a majority of the votes cast. The stock ownership of Mr. Glaser and his affiliates 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.

In addition, Mr. Glaser has special rights under our articles of incorporation to appoint or remove members of the strategic transaction committee at his discretion that could make it more difficult for RealNetworks to be sold or to complete another change of control transaction without Mr. Glaser s consent. RealNetworks has 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. These rights and his role as Chairman of the Board of Directors, together with Mr. Glaser s significant beneficial ownership, create unique potential for concentrated influence of Mr. Glaser over potentially material transactions involving RealNetworks and decisions regarding the future strategy and leadership of RealNetworks.

We have adopted a shareholder rights plan, which was amended and restated in December 2008, which 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.

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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, and Washington law, as well as our charter provisions that provide for a classified board of directors and the availability of blank check preferred stock, could have the effect of making it more difficult or more expensive for a third-party to acquire, or of discouraging a third-party from attempting to acquire, control of us. These provisions may therefore have the effect of limiting the price that investors might be willing to pay in the future for our common stock.

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

(a) Not applicable

(b) Not applicable

(c) Not applicable

Item 3. Default Upon Senior Securities

None

Item 4. Removed and Reserved

Reserved

Item 5. Other Information

None

Item 6. Exhibits

Exhibits Required by Item 601 of Regulation S-K

Exhibit Number	Description
3.1	Articles of Amendment to the Amended and Restated Articles of Incorporation of RealNetworks, Inc. (incorporated by reference from Exhibit 3.1 to RealNetworks Current Report on Form 8-K filed with the Securities and Exchange Commission on August 31, 2011)
31.1	Certification of Michael Lunsford, Interim Chief Executive Officer of RealNetworks, Inc., Pursuant to Exchange Act Rules 13a-14(a) and 15d-14(a), as Adopted Pursuant to Section 302 of the Sarbanes-Oxley Act of 2002
31.2	Certification of Michael Eggers, Senior Vice President, Chief Financial Officer and Treasurer of RealNetworks, Inc., Pursuant to Exchange Act Rules 13a-14(a) and 15d-14(a), as Adopted Pursuant to Section 302 of the Sarbanes-Oxley Act of 2002
32.1	Certification of Michael Lunsford, Interim Chief Executive Officer of RealNetworks, Inc., Pursuant to 18 U.S.C. Section 1350, as Adopted Pursuant to Section 906 of the Sarbanes-Oxley Act of 2002
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101.INS**	XBRL Instance Document
101.SCH**	XBRL Taxonomy Extension Schema Document
101.CAL**	XBRL Taxonomy Extension Calculation Linkbase Document
101.LAB**	XBRL Taxonomy Extension Label Linkbase Document
101.PRE**	XBRL Taxonomy Extension Presentation Linkbase Document
101.DEF**	XBRL Taxonomy Extension Definition Linkbase Document

** Pursuant to Rule 406T of Regulation S-T, these interactive data files are deemed not filed or part of a registration statement or prospectus for purposes of Sections 11 or 12 of the Securities Act of 1933 or Section 18 of the Securities Exchange Act of 1934 and otherwise are not subject to liability.

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SIGNATURE

Pursuant to the requirements of the Securities Exchange Act of 1934, the Registrant has duly caused this Report to be signed on its behalf by the undersigned, thereunto duly authorized, on November 8, 2011.

REALNETWORKS, INC.

By: /s/ Michael Eggers
Michael Eggers
Title: **Senior Vice President, Chief Financial Officer and Treasurer**

(Principal Financial and Accounting Officer)

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