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

FORM 10-Q

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

For the Quarterly Period Ended June 30, 2005

OR

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

Commission File Number 0-23137

REALNETWORKS, INC.

(Exact name of registrant as specified in its charter)

Washington
(State of incorporation)

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

2601 Elliott Avenue, Suite 1000
Seattle, Washington
(Address of principal executive offices)

98121
(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 No

Indicate by check mark whether the registrant is an accelerated filer (as defined in Exchange Act Rule 12b-2).

Yes No

The number of shares of the registrant's Common Stock outstanding as of July 31, 2005 was 171,752,680.

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FORM 10-Q
FOR THE QUARTER ENDED JUNE 30, 2005
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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)

	June 30, 2005	December 31, 2004
ASSETS		
Current assets:		
Cash, cash equivalents and short-term investments	\$ 363,230	363,621
Trade accounts receivable, net of allowances for doubtful accounts and sales returns	15,818	14,501
Prepaid expenses and other current assets	<u>5,156</u>	<u>8,196</u>
Total current assets	<u>384,204</u>	<u>386,318</u>
Equipment and leasehold improvements, at cost:		
Equipment and software	50,721	45,324
Leasehold improvements	<u>26,141</u>	<u>25,015</u>
Total equipment and leasehold improvements	76,862	70,339
Less accumulated depreciation and amortization	<u>46,235</u>	<u>41,508</u>
Net equipment and leasehold improvements	<u>30,627</u>	<u>28,831</u>
Restricted cash equivalents	18,813	20,151
Notes receivable from related parties	14	106
Equity investments	41,577	36,588
Other assets	2,793	2,908
Goodwill, net	130,581	119,217
Other intangible assets, net	<u>10,041</u>	<u>8,383</u>
Total assets	<u>\$ 618,650</u>	<u>602,502</u>
LIABILITIES AND SHAREHOLDERS' EQUITY		
Current liabilities:		
Accounts payable	\$ 14,962	10,219
Accrued and other liabilities	56,771	50,033
Deferred revenue, current portion	25,532	30,307
Accrued loss on excess office facilities and content agreement, current portion	<u>6,915</u>	<u>8,160</u>
Total current liabilities	<u>104,180</u>	<u>98,719</u>
Deferred revenue, non-current portion	237	548
Accrued loss on excess office facilities and content agreement, non-current portion	16,363	19,017
Deferred rent	3,640	3,413
Convertible debt	100,000	100,000
Other long-term liabilities	200	—
Commitments (Note 8)		
Shareholders' equity:		
Preferred stock, \$0.001 par value, no shares issued and outstanding		
Series A: authorized 200 shares	—	—
Undesignated series: authorized 59,800 shares	—	—
Common stock, \$0.001 par value		

Authorized 1,000,000 shares; issued and outstanding 171,472 shares in 2005 and 170,626 shares in

2004	171	171
Additional paid-in capital	672,141	668,752
Notes receivable from shareholder	—	(10)
Deferred stock compensation	(63)	(147)
Accumulated other comprehensive income	18,808	14,589
Accumulated deficit	<u>(297,027)</u>	<u>(302,550)</u>
Total shareholders' equity	<u>394,030</u>	<u>380,805</u>
Total liabilities and shareholders' equity	<u>\$ 618,650</u>	<u>602,502</u>

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		Six Months ended	
	June 30,		June 30,	
	2005	2004	2005	2004
Net revenue (A)	\$ 82,686	65,473	159,258	125,863
Cost of revenue (B)	24,841	21,735	49,578	43,496
Loss on content agreement	—	—	—	4,938
Gross profit	<u>57,845</u>	<u>43,738</u>	<u>109,680</u>	<u>77,429</u>
Operating expenses:				
Research and development (excluding non-cash stock-based compensation, of \$29 and \$65 for the quarter and six months ending June 30, 2005, respectively, and \$121 and \$295 for the comparable periods during 2004, included below)	15,292	13,219	28,962	25,470
Sales and marketing	35,044	23,247	63,064	45,450
General and administrative (excluding non-cash stock-based compensation of \$19 for the quarter and six months ending June 30, 2005 and \$92 and \$184 for the comparable periods during 2004, included below)	7,898	8,599	14,064	15,420
Antitrust litigation	4,650	2,756	8,394	5,077
Stock-based compensation	<u>48</u>	<u>213</u>	<u>84</u>	<u>479</u>
Total operating expenses	<u>62,932</u>	<u>48,034</u>	<u>114,568</u>	<u>91,896</u>
Operating loss	<u>(5,087)</u>	<u>(4,296)</u>	<u>(4,888)</u>	<u>(14,467)</u>
Other income (expense), net:				
Interest income, net	2,579	800	4,595	1,660
Equity in net loss of MusicNet	(2)	(1,019)	(1,068)	(2,134)
Gain on sale of MusicNet	7,590	—	7,590	—
Other, net	<u>(209)</u>	<u>10</u>	<u>(400)</u>	<u>100</u>
Other income (expense), net	<u>9,958</u>	<u>(209)</u>	<u>10,717</u>	<u>(374)</u>
Net income (loss) before income taxes	4,871	(4,505)	5,829	(14,841)
Income tax provision	<u>(162)</u>	<u>(113)</u>	<u>(306)</u>	<u>(215)</u>
Net income (loss)	<u>\$ 4,709</u>	<u>(4,618)</u>	<u>5,523</u>	<u>(15,056)</u>
Basic net income (loss) per share	\$ 0.03	(0.03)	0.03	(0.09)
Diluted net income (loss) per share	\$ 0.03	(0.03)	0.03	(0.09)
Shares used to compute basic net income (loss) per share	171,393	168,846	171,171	167,930
Shares used to compute diluted net income (loss) per share	184,816	168,846	184,752	167,930
Comprehensive income (loss):				
Net income (loss)	\$ 4,709	(4,618)	5,523	(15,056)
Unrealized gain on investments:				
Unrealized holding gains	2,147	4,425	5,510	5,734
Adjustments for losses reclassified to net loss	—	—	—	(53)
Foreign currency translation losses	<u>(1,186)</u>	<u>(21)</u>	<u>(1,291)</u>	<u>(214)</u>
Comprehensive income (loss)	<u>\$ 5,670</u>	<u>(214)</u>	<u>9,742</u>	<u>(9,589)</u>

(A) Components of net revenue:				
License fees	\$ 20,377	17,136	41,009	35,382
Service revenue	<u>62,309</u>	<u>48,337</u>	<u>118,249</u>	<u>90,481</u>
	\$ <u>82,686</u>	<u>65,473</u>	<u>159,258</u>	<u>125,863</u>
(B) Components of cost of revenue:				
License fees	\$ 7,888	6,745	16,222	12,955
Service revenue	<u>16,953</u>	<u>14,990</u>	<u>33,356</u>	<u>30,541</u>
	\$ <u>24,841</u>	<u>21,735</u>	<u>49,578</u>	<u>43,496</u>

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)

	Six Months Ended June 30,	
	2005	2004
Cash flows from operating activities:		
Net income (loss)	\$ 5,523	(15,056)
Adjustments to reconcile net income (loss) to net cash provided by operating activities:		
Depreciation and amortization	7,674	6,979
Stock-based compensation	84	479
Equity in net losses of MusicNet	1,068	2,134
Net change in accrued loss on excess office facilities and content agreement	(3,899)	528
Loss on disposal of equipment	139	176
Gain on sale of equity investments	(7,590)	(66)
Other	33	—
Net change in certain operating assets and liabilities	<u>7,718</u>	<u>6,146</u>
Net cash provided by operating activities	<u>10,750</u>	<u>1,320</u>
Cash flows from investing activities:		
Purchases of equipment and leasehold improvements	(5,965)	(4,688)
Purchases of intangible assets	(1,000)	—
Purchases of short-term investments	(67,451)	(205,559)
Proceeds from sales and maturities of short-term investments	91,743	221,558
Decrease (increase) in restricted cash equivalents	1,338	(198)
Proceeds from sale of equity investment	7,207	77
Purchases of cost based investments	(647)	—
Payment of acquisition costs, net of cash acquired	<u>(14,615)</u>	<u>(10,477)</u>
Net cash provided by investing activities	<u>10,610</u>	<u>713</u>
Cash flows from financing activities:		
Net proceeds from sale of common stock under employee stock purchase plan and exercise of stock options	3,370	4,155
Repayment of long-term note payable	<u>(648)</u>	<u>—</u>
Net cash provided by financing activities	<u>2,722</u>	<u>4,155</u>
Net effect of exchange rate changes on cash and cash equivalents	<u>(281)</u>	<u>(275)</u>
Net increase in cash and cash equivalents	23,801	5,913
Cash and cash equivalents at beginning of period	<u>219,426</u>	<u>198,028</u>
Cash and cash equivalents at end of period	243,227	203,941
Short-term investments at end of period	<u>120,003</u>	<u>159,286</u>
Total cash, cash equivalents and short-term investments at end of period	<u>\$ 363,230</u>	<u>363,227</u>
Supplemental disclosure of non-cash investing and financing activities:		
Non-cash consideration in business combinations:		

Common stock and options issued in business combination	<u>\$ —</u>	<u>20,901</u>
Accrued acquisition costs	<u>\$ 91</u>	<u>110</u>
Long-term notes payable acquired in business combination	<u>\$ 863</u>	<u>—</u>

See accompanying notes to unaudited condensed consolidated financial statements

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REALNETWORKS, INC. AND SUBSIDIARIES
NOTES TO UNAUDITED CONDENSED CONSOLIDATED FINANCIAL STATEMENTS

NOTE 1 — SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES

(a) Description of Business

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

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

(b) Basis of Presentation

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

These 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 six months ended June 30, 2005 are not necessarily indicative of the results that may be expected for any subsequent quarter or for the year ending December 31, 2005. 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, 2004.

(c) Cash, Cash Equivalents and Short-Term Investments

Cash, cash equivalents and short-term investments are comprised of the following (in thousands):

	June 30, 2005	December 31, 2004
Cash and cash equivalents	\$243,227	219,426
Short-term investments	<u>120,003</u>	<u>144,195</u>
Total cash, cash equivalents and short-term investments	<u>\$363,230</u>	<u>363,621</u>
Restricted cash equivalents	<u>\$ 18,813</u>	<u>20,151</u>

Restricted cash equivalents at June 30, 2005 represent (a) cash equivalents pledged as collateral against a \$10.0 million letter of credit in connection with a lease agreement for the Company's corporate headquarters, (b) cash equivalents pledged as collateral against a \$7.3 million letter of credit with a bank which represents collateral on the lease of a building located near the Company's corporate headquarters, and (c) cash equivalents of approximately \$1.5 million pledged as collateral against guaranteed minimum payments under a discontinued content agreement.

The majority of short-term investments mature within twelve months from the date of purchase.

The Company has classified as available-for-sale all marketable debt and equity securities for which there is a determinable fair market value and on which the Company has no restrictions to sell within the next 12 months. Available-for-sale securities are carried at fair value, with unrealized gains and losses reported as a component of shareholders' equity, net of applicable income taxes. Realized gains and losses and declines in value judged to be other-than-temporary on available-for-sale securities are included in other income (expense), net. The cost basis for determining realized gains and losses on available-for-sale securities is determined using the specific identification method.

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(d) Notes Receivable from Related Parties and Shareholder

Notes receivable from related parties are carried at the estimated net realizable value and consist of cash loans made in 2000 by Listen.com, Inc. (Listen), a company acquired by RealNetworks in 2003, to a certain former officer of Listen. As of June 30, 2005, one note was outstanding and is due in September 2005 with an interest rate of 6.10%. The other note receivable from a related party was due in February 2005, bore an interest rate of 6.6% and was satisfied in April 2005. No amounts were outstanding related to this note at June 30, 2005. Both notes were outstanding at December 31, 2004.

Note receivable from shareholder was carried at the net realizable value and consisted of a full recourse note issued as consideration for the exercise of Listen stock options by an individual that was an employee of the Company through December 2004 and was an employee of Listen on the date of issuance. The note bore interest at a rate of 5.28% and was due seven years from the date of issuance. The note receivable from shareholder was outstanding at December 31, 2004 and was satisfied in March 2005. No amounts were outstanding related to this note at June 30, 2005.

(e) Investments

The Company has certain investments that are accounted for under the cost method of accounting. The cost method is used to account for equity investments in companies in which the Company holds less than a 20 percent voting interest, does not exercise significant influence and for which the related securities do not have a quoted market price.

The Company's investment in MusicNet, Inc. (MusicNet) was accounted for under the equity method of accounting. Under the equity method of accounting, the Company's share of the investee's earnings or loss was included in the Company's consolidated operating results. In certain cases where the Company had loaned the investee funds, the Company may have recorded more than its relative equity share of the investee's losses.

(f) Other Assets

Other assets primarily consist of offering costs and other long-term deposits. The Company incurred the offering costs as a result of its convertible debt offering. These costs are deferred and are being amortized using the straight-line method, which approximates the effective interest method, over a five year period.

(g) Other Intangible Assets, net

Other intangible assets, net primarily consist of trade names, technology, customer and distributor relationships and patents that were acquired through certain of the Company's acquisitions, as well as other purchased technology. The intangible assets are amortized using the straight-line method over their estimated period of benefit, ranging from one to five years. We evaluate the recoverability of intangible assets periodically and take into account events or circumstances that warrant revised estimates of useful lives or that may indicate that impairment exists. All of our intangible assets are subject to amortization. No impairments of intangible assets have been identified during any of the periods presented.

(h) Revenue Recognition

The Company recognizes revenue in connection with its software products pursuant to the requirements of Statement of Position No. 97-2, "Software Revenue Recognition" (SOP 97-2), as amended by Statement of Position No. 98-9, "Software Revenue Recognition with Respect to Certain Arrangements." Some of the Company's software arrangements include consulting implementation services sold separately under consulting engagement contracts. Consulting revenue from these arrangements are generally accounted for separately from new software license revenue because the arrangements qualify as service transactions as defined in SOP 97-2. Revenue for consulting services is generally recognized as the services are performed.

If the Company provides consulting services that are considered essential to the functionality of the software products, both the software product revenue and services revenue are recognized under contract accounting in accordance with the provisions of SOP 81-1, "Accounting for Performance of Construction-Type and Certain Production-Type Contracts." Revenue from these arrangements is recognized under the percentage of completion method based on the ratio of direct labor hours incurred to date to total projected labor

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hours.

For transactions not falling under the scope of SOP 97-2, the Company's revenue recognition policies are in accordance with SEC Staff Accounting Bulletin (SAB) 104, "Revenue Recognition," and the FASB's Emerging Issues Task Force Issue No. 00-21, "Revenue Arrangements with Multiple Deliverables."

Revenue attributable to an element in a customer arrangement is recognized when persuasive evidence of an arrangement exists and delivery has occurred, provided the fee is fixed or determinable, collectibility is probable and the arrangement does not require significant customization of the software. If at the outset of the customer arrangement, the Company determines that the arrangement fee is not fixed or determinable or that collectibility is not probable, the Company defers the revenue and recognizes the revenue when the arrangement fee becomes due and payable or as cash is received when collectibility concerns exist.

For multiple element arrangements when Company-specific objective evidence of fair value exists for all of the undelivered elements of the arrangement, but does not exist for one or more of the delivered elements in the arrangement, the Company recognizes revenue under the residual method. Under the residual method, at the outset of the arrangement with a customer, the Company defers revenue for the fair value of its undelivered elements such as consulting services and product support and upgrades, and recognizes the revenue for the remainder of the arrangement fee attributable to the elements initially delivered, such as software licenses, when the criteria in SOP 97-2 have been met. If specific objective evidence does not exist for an undelivered element in a software arrangement, which may include distribution or other term-based arrangements in which the license fee includes support during the arrangement term, revenue is recognized over the term of the support period commencing upon delivery of the Company's technology to the customer. For software license fees in single element arrangements such as consumer software sales and music copying or "burning," revenue recognition typically occurs when the product is made available to the customer for download or when products are shipped to the customer, or in the case of music burns, when the burn occurs.

Revenue from software license agreements with original equipment manufacturers (OEM) is recognized when the OEM delivers its product incorporating the Company's software to the end user. In the case of prepayments received from an OEM, the Company generally recognizes revenue based on the actual products sold by the OEM. If the Company provides ongoing support to the OEM in the form of future upgrades, enhancements or other services over the term of the contract, revenue is generally recognized ratably over the term of the contract.

Service revenue includes payments under support and upgrade contracts, media subscription services, and fees from consulting services and streaming media content hosting. Support and upgrade revenue is recognized ratably over the term of the contract, which typically is twelve months. Media subscription service revenue is recognized ratably over the period that services are provided, which is generally one to twelve months. Other service revenues are recognized when the services are performed.

Fees generated from advertising appearing on the Company's websites, and from advertising included in the Company's products are recognized as revenue over the terms of the contracts. The Company may guarantee a minimum number of advertising impressions, click-throughs or other criteria on the Company's websites or products for a specified period. The Company recognizes the corresponding revenue as the delivery of the advertising occurs.

(i) Net Income (Loss) Per Share

Basic net income (loss) per share is computed by dividing net income (loss) by the weighted average number of common shares outstanding during the period. Diluted net income (loss) per share is computed by dividing net income (loss) by the weighted average number of common and dilutive potential common shares outstanding during the period.

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The share count used to compute basic and diluted net income (loss) per share is calculated as follows (in thousands):

	Quarters Ended June 30,		Six Months Ended June 30,	
	2005	2004	2005	2004
Weighted average common shares outstanding	171,393	169,028	171,171	168,134
Less restricted shares	—	(182)	—	(204)
Shares used to compute basic net income (loss) per share	<u>171,393</u>	<u>168,846</u>	<u>171,171</u>	<u>167,930</u>
Dilutive potential common shares				
Stock options	2,673	—	2,831	—
Convertible debt	<u>10,750</u>	—	<u>10,750</u>	—
Shares used to compute diluted net income (loss) per share	<u>184,816</u>	<u>168,846</u>	<u>184,752</u>	<u>167,930</u>

Approximately 24.8 million of common shares potentially issuable from stock options for the quarter and six months ended June 30, 2005, are excluded from the calculation of diluted net income per share because the exercise price was greater than the average market price of the common stock for the respective period. Potential dilutive securities outstanding were not included in the computation of diluted net loss per common share for the quarter and six months ended June 30, 2004, because to do so would have been anti-dilutive. Potential dilutive securities for the quarter and six months ended June 30, 2004 included options to purchase approximately 35.3 million common shares, and approximately 10.8 million contingently issuable shares related to convertible debt.

(j) Derivative Financial Instruments

During the quarter ended June 30, 2005, the Company entered into foreign currency forward contracts to manage the foreign currency risk of certain intercompany balances denominated in a foreign currency. Although these instruments are effective as a hedge from an economic perspective, they do not meet the criteria for hedge accounting under Statement of Financial Accounting Standards No. 133, "Accounting for Derivative Instruments and Hedging Activities" (SFAS 133), as amended.

At June 30, 2005, the following foreign currency contracts were outstanding and recorded at fair value (in thousands):

	Contract Amount (Local Currency)		Contract Amount (US Dollars)	Fair Value
British Pounds ("GBP") (contracts to receive GBP/pay US\$)	(GBP)	575	\$1,037	\$ —

At December 31, 2004, the following foreign currency contracts were outstanding and recorded at fair value (in thousands):

	Contract Amount (Local Currency)		Contract Amount (US Dollars)	Fair Value
British Pounds ("GBP") (contracts to receive GBP/pay US\$)	(GBP)	780	\$1,502	\$ (1)
Euro ("EUR") (contracts to pay EUR/receive US\$)	(EUR)	2,650	\$3,527	\$(88)
Japanese Yen ("YEN") (contracts to receive YEN/pay US\$)	(YEN)	123,000	\$1,168	\$ 27

No derivative instruments designated as hedges for accounting purposes were outstanding at June 30, 2005 or December 31, 2004.

(k) Accumulated Other Comprehensive Income

The Company's accumulated other comprehensive income at June 30, 2005 and December 31, 2004 consisted of net income (loss), net unrealized gains on investments and the net amount of foreign currency translation adjustments. The tax effect of the foreign currency translation adjustments and unrealized gains and losses on investments has been taken into account if applicable. The components of accumulated other comprehensive income are as follows (in thousands):

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	June 30, 2005	December 31, 2004
Unrealized gains on investments, net of taxes of \$16,916 in 2005 and 2004	\$20,415	14,905
Foreign currency translation adjustments	<u>(1,607)</u>	<u>(316)</u>
Total accumulated other comprehensive income	<u>\$18,808</u>	<u>14,589</u>

(l) Stock-Based Compensation

The Company has elected to apply the disclosure-only provisions of Statement of Financial Accounting Standards No. 123, "Accounting for Stock-Based Compensation" (SFAS 123) and Statement of Financial Accounting Standards No. 148, "Accounting for Stock Based Compensation, Transition and Disclosure" (SFAS 148). Accordingly, the Company accounts for stock-based compensation transactions with employees using the intrinsic value method prescribed in Accounting Principles Board Opinion No. 25, "Accounting for Stock Issued to Employees" (APB 25), and related interpretations. Compensation cost for employee stock options is measured as the excess, if any, of the fair value of the Company's common stock at the date of grant over the stock option exercise price. Compensation cost for awards to non-employees is based on the fair value of the awards in accordance with SFAS 123 and related interpretations.

The Company recognizes compensation cost related to fixed employee awards on an accelerated basis over the applicable vesting period using the methodology described in Financial Accounting Standards Board (FASB) Interpretation No. 28, "Accounting for Stock Appreciation Rights and Other Variable Stock Option or Award Plans" (FIN 28). At June 30, 2005, the Company has two stock-based employee compensation plans. The following table illustrates the effect on net income (loss) and net income (loss) per share if the Company had applied the fair value recognition provisions of SFAS 123 to stock-based employee compensation (in thousands, except per share data):

	Quarters Ended June 30,		Six Months Ended June 30,	
	2005	2004	2005	2004
Net income (loss) as reported	\$ 4,709	(4,618)	5,523	(15,056)
Plus: stock-based employee compensation expense included in reported net income (loss), net of related tax effects	48	213	84	479
Less: stock-based employee compensation expense determined under fair value based methods for all awards, net of related tax effects	<u>(2,471)</u>	<u>(5,679)</u>	<u>(6,414)</u>	<u>(12,327)</u>
Pro forma net income (loss)	<u>\$ 2,286</u>	<u>(10,084)</u>	<u>(807)</u>	<u>(26,904)</u>
Net income (loss) per share:				
Basic — as reported	\$ 0.03	(0.03)	0.03	(0.09)
Diluted — as reported	\$ 0.03	(0.03)	0.03	(0.09)
Basic — pro forma	\$ 0.01	(0.06)	(0.00)	(0.16)
Diluted — pro forma	\$ 0.01	(0.06)	(0.00)	(0.16)

(m) Recently Issued Accounting Standards

In December 2004, the FASB issued SFAS No. 123 (revised 2004), "Share-Based Payment" (SFAS 123R), which requires the measurement of all share-based payments to employees, including grants of employee stock options, using a fair-value-based method and the recording of such expense in an entity's statement of income. The accounting provisions of SFAS 123R are effective for annual reporting periods beginning after June 15, 2005. The Company is required to adopt the provisions of SFAS 123R in the quarter ending March 31, 2006. The pro forma disclosures previously permitted under SFAS 123 no longer will be an alternative to financial statement recognition. See "Stock-Based Compensation" (Note 1 (l)) for the pro forma net loss and net loss per share amounts, for quarters and six months ended June 30, 2005 and 2004, as if the Company had applied the fair value recognition provisions of SFAS 123 to measure compensation expense for employee stock incentive awards. Although the Company has not yet determined whether the adoption of SFAS 123R will result in amounts that are similar to the current pro forma disclosures under SFAS 123, the Company is evaluating the requirements under SFAS 123R and expects the adoption to have a material impact on the consolidated statements of operations and comprehensive income (loss) and net income (loss) per share.

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(n) Reclassifications

Certain reclassifications have been made to the June 30, 2004 unaudited condensed consolidated financial statements, and footnotes thereto, to conform to the June 30, 2005 presentation.

NOTE 2 — SEGMENT INFORMATION

The Company began measuring its business by segments beginning in the quarter ended March 31, 2004, and operates in two business segments: Consumer Products and Services and Business Products and Services, for which the Company receives revenue from its customers. The Company's Chief Operating Decision Maker is considered to be the Company's CEO Staff (CEOS), which is comprised of the Company's Chief Executive Officer, Chief Financial Officer, Executive and Senior Vice Presidents, General Counsel, and the Company's Chief Strategy Officer. 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 and geographical regions for purposes of making decisions and assessing financial performance. The CEOS reviews discrete financial information regarding profitability of the Company's Consumer Products and Services segment and Business Products and Services segment and, therefore, the Company reports these as operating segments as defined by Statement of Financial Accounting Standards No. 131, "Disclosure About Segments of an Enterprise and Related Information".

The Company's customers consist primarily of individual consumers and business customers located in the United States and various foreign countries. Net revenue by geographic region is as follows (in thousands):

	Quarters Ended		Six Months Ended	
	June 30,		June 30,	
	2005	2004	2005	2004
United States	\$63,443	50,949	121,200	94,912
Europe	11,605	9,101	22,610	19,831
Rest of the world	<u>7,638</u>	<u>5,423</u>	<u>15,448</u>	<u>11,120</u>
Total net revenue	<u>\$82,686</u>	<u>65,473</u>	<u>159,258</u>	<u>125,863</u>

The Company's segment revenue is defined as follows:

- Consumer Products and Services, which primarily include revenue from: digital media subscription services such as RealOne SuperPass, Rhapsody, RadioPass, GamePass and stand-alone and add-on subscriptions; sales and distribution of third party products and services; sales of digital content such as music and game downloads; sales of premium versions of the Company's RealPlayer and related products; and advertising. These products and services are sold and provided primarily through the Internet, and payment is provided primarily by the Company charging the customers' credit card at the time of sale. Billing periods for subscription services typically occur monthly, quarterly or annually, depending on the service purchased.
- Business Products and Services, which primarily include revenue from: sales of our media delivery system software, including Helix system software and related authoring and publishing tools, both directly to customers and indirectly through original equipment manufacturer (OEM) channels; support and maintenance services that we sell to customers who purchase the Company's software products; broadcast hosting services; and consulting services we offer to our customers. These products and services are primarily sold to corporate customers.

Net revenue by segment is as follows (in thousands):

	Quarters		Six Months	
	Ended June 30,		Ended June 30,	
	2005	2004	2005	2004
Consumer Products and Services	\$70,593	53,743	134,799	100,768
Business Products and Services	<u>12,093</u>	<u>11,730</u>	<u>24,459</u>	<u>25,095</u>
Total net revenue	<u>\$82,686</u>	<u>65,473</u>	<u>159,258</u>	<u>125,863</u>

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Consumer Products and Services revenue is comprised of the following (in thousands):

	Quarters Ended June 30,		Six Months Ended June 30,	
	2005	2004	2005	2004
Music	\$24,135	14,954	46,378	26,894
Video, consumer software and other	24,607	23,715	48,761	48,004
Games	13,648	8,352	25,837	15,107
Media Publishing	8,203	6,722	13,823	10,763
Total Consumer Products and Services revenue	\$70,593	53,743	134,799	100,768

Consumer Products and Services revenue is comprised of the following (in thousands):

	Quarters Ended June 30,		Six Months Ended June 30,	
	2005	2004	2005	2004
Consumer subscription services	\$47,821	35,459	92,221	67,532
Consumer software and related services	22,772	18,284	42,578	33,236
Total Consumer Products and Services revenue	\$70,593	53,743	134,799	100,768

Long-lived assets, net by geographic region are as follows (in thousands):

	June 30, 2005	December 31, 2004
United States	\$156,036	155,844
Europe	14,855	176
Rest of world	358	411
Total long-lived assets, net	\$171,249	156,431

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

	June 30, 2005	December 31, 2004
Consumer Products and Services	\$122,766	111,402
Business Products and Services	7,815	7,815
Total goodwill, net	\$130,581	119,217

Reconciliation of segment operating income (loss) to net income (loss) before income taxes is as follows (in thousands):

For the Quarter Ended June 30, 2005	Consumer Products and Services	Business Products and Services	Reconciling Amounts	Consolidated
Net revenue	\$70,593	12,093	—	82,686
Cost of revenue	22,800	2,041	—	24,841
Gross profit	47,793	10,052	—	57,845
Antitrust litigation	—	—	4,650	4,650
Stock-based compensation	—	—	48	48
Other operating expenses	45,807	12,427	—	58,234
Operating income (loss)	1,986	(2,375)	(4,698)	(5,087)

Total non-operating income, net	<u>—</u>	<u>—</u>	<u>9,958</u>	<u>9,958</u>
Net income (loss) before income taxes	<u>\$ 1,986</u>	<u>(2,375)</u>	<u>5,260</u>	<u>4,871</u>

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For the Six Months Ended June 30, 2005	Consumer Products and Services	Business Products and Services	Reconciling Amounts	Consolidated
Net revenue	\$134,799	24,459	—	159,258
Cost of revenue	<u>45,363</u>	<u>4,215</u>	<u>—</u>	<u>49,578</u>
Gross profit	89,436	20,244	—	109,680
Antitrust litigation	—	—	8,394	8,394
Stock-based compensation	—	—	84	84
Other operating expenses	<u>81,949</u>	<u>24,141</u>	<u>—</u>	<u>106,090</u>
Operating income (loss)	7,487	(3,897)	(8,478)	(4,888)
Total non-operating income, net	<u>—</u>	<u>—</u>	<u>10,717</u>	<u>10,717</u>
Net income (loss) before income taxes	<u>\$ 7,487</u>	<u>(3,897)</u>	<u>2,239</u>	<u>5,829</u>

For the Quarter Ended June 30, 2004	Consumer Products and Services	Business Products and Services	Reconciling Amounts	Consolidated
Net revenue	\$53,743	11,730	—	65,473
Cost of revenue	<u>19,713</u>	<u>2,022</u>	<u>—</u>	<u>21,735</u>
Loss on content agreement	—	—	—	—
Gross profit	34,030	9,708	—	43,738
Antitrust litigation	—	—	2,756	2,756
Stock-based compensation	—	—	213	213
Other operating expenses	<u>31,251</u>	<u>13,814</u>	<u>—</u>	<u>45,065</u>
Operating loss	2,779	(4,106)	(2,969)	(4,296)
Total non-operating expenses, net	<u>—</u>	<u>—</u>	<u>(209)</u>	<u>(209)</u>
Net loss before income taxes	<u>\$ 2,779</u>	<u>(4,106)</u>	<u>(3,178)</u>	<u>(4,505)</u>

For the Six Months Ended June 30, 2004	Consumer Products and Services	Business Products and Services	Reconciling Amounts	Consolidated
Net revenue	\$100,768	25,095	—	125,863
Cost of revenue	<u>39,256</u>	<u>4,240</u>	<u>—</u>	<u>43,496</u>
Loss on content agreement	<u>4,938</u>	<u>—</u>	<u>—</u>	<u>4,938</u>
Gross profit	56,574	20,855	—	77,429
Antitrust litigation	—	—	5,077	5,077
Stock-based compensation	—	—	479	479
Other operating expenses	<u>59,740</u>	<u>26,600</u>	<u>—</u>	<u>86,340</u>
Operating loss	(3,166)	(5,745)	(5,556)	(14,467)
Total non-operating expenses, net	<u>—</u>	<u>—</u>	<u>(374)</u>	<u>(374)</u>
Net loss before income taxes	<u>\$ (3,166)</u>	<u>(5,745)</u>	<u>(5,930)</u>	<u>(14,841)</u>

Operating expenses of both Consumer Products and Services and Business Products and Services include costs directly attributable to those segments and an allocation of general and administrative expenses and other corporate overhead costs. General and administrative and other corporate overhead costs are allocated to the segments and are generally based on the relative headcount of each segment. The accounting policies used to derive segment results are generally the same as those described in Note 1.

NOTE 3 — ACQUISITION

On May 6, 2005, the Company acquired all of the outstanding securities of Mr. Goodliving Ltd., (Mr. Goodliving) in exchange for approximately \$15.6 million in cash payments. Included in the purchase price is \$0.5 million in estimated acquisition-related expenditures consisting primarily of professional fees. In addition, the Company may be obligated to pay up to \$1.6 million over a four-year period to certain Mr. Goodliving employees in the form of a management incentive plan if certain performance criteria are achieved. Such amounts are not included in the aggregate purchase price and, to the extent earned, will be recorded as compensation expense over the related employment periods. The accrued compensation cost related to this plan was approximately \$0.1 million at June 30, 2005 and is included in the unaudited condensed consolidated balance sheet in accrued and other liabilities.

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Mr. Goodliving, which is located in Helsinki, Finland, is a developer and publisher of mobile games. The Company believes that combining Mr. Goodliving's assets and distribution network with RealNetworks' downloadable, PC-based games assets and distribution platform will enhance the Company's entry into the mobile games market. The results of Mr. Goodliving's operations are included in RealNetworks' consolidated financial statements starting from the date of acquisition.

A summary of the purchase price for the acquisition is as follows (in thousands):

Cash	\$15,089
Estimated direct acquisition costs	<u>534</u>
Total	<u>\$15,623</u>

The aggregate purchase consideration has been allocated to the assets and liabilities acquired, including identifiable intangible assets, based on their respective estimated fair values as summarized below. The respective estimated fair values were determined by a third party appraisal at the acquisition date and resulted in excess purchase consideration over the net tangible and identifiable intangible assets acquired of \$12.2 million.

A summary of the allocation of the purchase price follows (in thousands):

Current assets	\$ 1,624
Property and equipment	10
Technology/Games	1,460
Tradenames/Trademarks	400
Distributor/Customer Relationships	1,500
Goodwill	12,248
Current liabilities	(756)
Long-term notes payable	<u>(863)</u>
Net assets acquired	<u>\$15,623</u>

Technology/Games have a weighted average estimated useful life of two years. Tradenames and trademarks have a weighted average estimated useful life of four years. Distributor and customer relationships have a weighted average estimated useful life of five years.

NOTE 4 — OTHER INVESTMENTS

RealNetworks has made minority equity investments for business and strategic purposes through the purchase of voting capital stock of certain companies. The Company's 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. The Company periodically evaluates whether declines in fair value, if any, of its investments are other-than-temporary. This evaluation consists of a review of qualitative and quantitative factors. For investments with publicly quoted market prices, these factors include the time period and extent of which the quoted market price is less than its accounting basis. The Company also considers other 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, the Company considers similar qualitative and quantitative factors and also considers the implied value from any recent rounds of financing completed by the investee. Based upon an evaluation of the facts and circumstances at June 30, 2005, the Company determined that there were no other-than-temporary declines in fair value for the quarter or six months then ended.

As of June 30, 2005, the Company owned marketable equity securities of J-Stream Inc., a Japanese media services company, representing approximately 13.2% of J-Stream's outstanding shares. These securities are accounted for by the Company as available-for-sale securities. The market value of these shares has increased from the Company's original cost of approximately \$1.0 million, resulting in a carrying value of \$38.5 million and \$33.1 million at June 30, 2005 and December 31, 2004, respectively. The increase over the Company's cost basis, net of tax effects is \$20.6 million and \$15.2 million at June 30, 2005 and December 31, 2004, respectively, and is reflected as a component of accumulated other comprehensive income. The market for J-Stream's shares is relatively limited, and the share price is volatile. Accordingly, there can be no assurance that a gain of this magnitude, or any gain, can be realized through the disposition of these shares. In July 2005, the Company disposed of a portion of its investment in J-Stream, through open market trades, which resulted in net proceeds of approximately \$11.9 million, for which the Company expects to recognize a gain, net of tax, of approximately \$8.4 million during the quarter ending September 30, 2005. The disposition reduced the Company's ownership

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interest to approximately 10.6%.

NOTE 5 — INVESTMENT IN MUSICNET

The Company's investment in MusicNet, a joint venture with several media companies to create a platform for online music subscription services, was accounted for under the equity method of accounting. As a result, the Company recorded in its statement of operations its equity share of MusicNet's net loss, which was not significant for the quarter ended June 30, 2005, was \$1.1 million for the six months ended June 30, 2005 and was \$1.0 million and \$2.1 million for the quarter and six months ended June 30, 2004, respectively. The Company owned preferred stock in MusicNet and also owned convertible notes that were convertible into shares of MusicNet preferred stock. During 2003, the Company and the other investors in MusicNet contributed additional capital to MusicNet to fund its business. The Company contributed \$3.0 million and received additional convertible notes for this investment. For purposes of calculating the Company's equity in net loss of MusicNet for the quarters and six months ended June 30, 2005 and 2004, the convertible notes were treated on an "as if" converted basis due to the nature and terms of the convertible notes. As a result, the losses recorded by the Company for the quarter and six months ended June 30, 2005 and 2004 represented approximately 36.1% and 36.9%, respectively, of MusicNet's net loss. As of June 30, 2005, the Company no longer held an ownership interest in outstanding shares of capital stock of MusicNet due to the sale of MusicNet in April 2005, as described below. As of December 31, 2004, the Company's ownership interest in the outstanding shares of capital stock of MusicNet was approximately 24.9%. The Company recognized approximately \$0.3 million of revenue during the quarter and \$0.5 million for the six months ended June 30, 2005 and \$0.2 million and \$0.4 million for the quarter and six months ended June 30, 2004, respectively, related to license and services agreements with MusicNet.

On April 12, 2005, the Company disposed of all of its preferred shares and convertible notes in MusicNet to a private equity firm, Baker Capital, in connection with the sale of all of the capital stock of MusicNet. The Company received approximately \$7.2 million of cash proceeds in connection with the closing of the transaction and received an additional \$0.4 million in connection with the expiration of an escrow arrangement in July 2005. The Company also has the right to receive up to an additional \$2.3 million in cash upon the expiration of an indemnity escrow arrangement which expires on the one-year anniversary of the transaction date.

NOTE 6 — LOSS ON EXCESS OFFICE FACILITIES AND CONTENT AGREEMENT

In October 2000, the Company entered into a ten-year lease agreement for additional office space located near its corporate headquarters in Seattle, Washington. Due to a subsequent decline in the market for office space in Seattle and the Company's re-assessment of its facilities requirements, the Company has accrued for estimated future losses on excess office facilities. The Company's estimates are based upon many factors including projections of sublease rates and the time period required to locate tenants. During 2003, the Company secured an additional tenant at a sublease rate lower than the rate used in previous loss estimates. As a result, the Company adjusted its estimates to reflect the lower lease rate and recorded additional losses of \$7.1 million. The loss estimate currently includes \$11.8 million of sublease income, of which \$9.5 million is committed under current sublease contracts. The Company did not identify any factors that caused it to revise its estimates during the quarter ended June 30, 2005. The Company also recorded an accrual for estimated future losses on excess office facilities in its allocation of the purchase price for its acquisition of Listen. The Company regularly evaluates the market for office space. If the market for such space declines further in future periods or if the Company is unable to sublease the space based on its current estimates, the Company may have to revise its estimates, which may result in additional losses on excess office facilities. Although the Company believes its estimates are reasonable, additional losses may result if actual experience differs from projections.

During the quarter ended September 30, 2004, the Company re-negotiated its existing lease for its headquarters building. In addition, the Company ceased use of approximately 16,000 square feet of office space, which was returned to the landlord in May 2005 in accordance with the amended lease agreement. The Company recorded a loss on excess office facilities of approximately \$0.9 million related to the expensing of net leasehold improvements and rent for the period between October 1, 2004 and April 30, 2005 related to the excess space the Company vacated as of September 30, 2004.

During the quarter ended March 31, 2004, the Company cancelled a content licensing agreement with one of its content partners. Under the terms of the cancellation agreement, the Company gave up rights to use the content, and ceased using the content in any of its products or services as of March 31, 2004. The resulting expense of \$4.9 million represents the estimated fair value of payments to be made in accordance with the terms of the cancellation agreement.

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

Accrued loss at December 31, 2004	\$27,177
Less amounts paid, net of sublease income	(2,446)
Less amounts paid on content agreement	<u>(1,453)</u>
Accrued loss at June 30, 2005	<u>\$23,278</u>

NOTE 7 — CONVERTIBLE DEBT

During 2003, the Company issued \$100 million aggregate principal amount of zero coupon convertible subordinated notes due July 1, 2010, pursuant to Rule 144A under the Securities Act of 1933, as amended. The notes are subordinated to any Company senior debt, and are also effectively subordinated in right of payment to all indebtedness and other liabilities of its subsidiaries. The notes are convertible into shares of the Company's common stock based on an initial effective conversion price of approximately \$9.30 per share if (1) the closing sale price of the Company's common stock exceeds \$10.23, subject to certain restrictions, (2) the notes are called for redemption, (3) the Company makes a significant distribution to its shareholders or becomes a party to a transaction that would result in a change in control, or (4) the trading price of the notes falls below 95% of the value of common stock that the notes are convertible into, subject to certain restrictions; one of which allows the Company, at its discretion, to issue cash or common stock or a combination thereof upon conversion. On or after July 1, 2008, the Company has the option to redeem all or a portion of the notes that have not been previously purchased, repurchased or converted, in exchange for cash at 100% of the principal amount of the notes. The purchasers may require the Company to purchase all or a portion of the notes in cash on July 1, 2008 at 100% of the principal amount of the notes. As a result of this issuance, the Company received proceeds of \$97.0 million, net of offering costs. The offering costs are included in other assets and are being amortized over a five-year period. Interest expense from the amortization of offering costs in the amount of \$0.2 million and \$0.3 million is recorded in interest income, net for the quarter and six months ended June 30, 2005 and \$0.2 million and \$0.4 million for the quarter and six months ended June 30, 2004, respectively. The net proceeds of the issuance are intended to be used for general corporate purposes, acquisitions, other strategic transactions including joint ventures, and other working capital requirements.

NOTE 8 — COMMITMENTS

In May 2005, the Company entered into a purchase agreement with a third party vendor to acquire certain products and services. The Company will be invoiced for the products and services at the time of receipt by the vendor. As of June 30, 2005, the Company had authorized the acquisition of approximately \$4.3 million in products and services under the provisions of the agreement. The Company expects these products and services to be received and to be invoiced for them during the quarter ending September 30, 2005. In August 2005, the Company authorized the acquisition of an additional \$2.2 million in products and services. The Company expects these products and services to be received and to be invoiced for them during the quarter ending December 31, 2005.

NOTE 9 — GUARANTEES

In the ordinary course of business, the Company is not subject to potential obligations under guarantees that fall within the scope of FASB Interpretation No. 45, Guarantor's Accounting and Disclosure Requirements for Guarantees, Including Indirect Guarantees and Indebtedness of Others ("FIN 45") an interpretation of FASB Statements No. 5, 57, and 107 and rescission of FASB interpretation No. 34, except for standard indemnification and warranty provisions that are contained within many of the Company's customer license and service agreements, and give rise only to the disclosure requirements prescribed by FIN 45.

Indemnification and warranty provisions contained within the Company's customer license and service agreements are generally consistent with those prevalent in the Company's industry. The duration of the Company's product warranties generally does not exceed 90 days following delivery of the Company's products. The Company has not incurred significant obligations under customer indemnification or warranty provisions historically and does not expect to incur significant obligations in the future. Accordingly, the Company does not maintain accruals for potential customer indemnification or warranty-related obligations.

NOTE 10 — LITIGATION

In December 2003, the Company filed suit against Microsoft Corporation in the U.S. District Court for the Northern District of California, pursuant to U.S. and California antitrust laws. The Company alleged that Microsoft has illegally used its monopoly power to restrict competition, limit consumer choice and attempt to monopolize the field of digital media. Microsoft has filed an answer

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denying the claims and raising a variety of defenses. The Company believes it has a strong case and intends to vigorously pursue the litigation. If successful, the Company may be entitled to receive both monetary and injunctive relief from Microsoft. The Company expects that the litigation will carry on for several years before it can be resolved through trial.

In June 2003, a lawsuit was filed against the Company and Listen in federal district court for the Northern District of Illinois by Friskit, Inc. (Friskit), alleging that certain features of the Company's and Listen's products and services willfully infringe certain patents relating to allowing users "to search for streaming media files, to create custom playlists, and to listen to the streaming media file sequentially and continuously." Friskit seeks to enjoin the Company from the alleged infringing activity and to recover treble damages from the alleged infringement. The Company has filed its answer and a counterclaim against Friskit challenging the validity of the patents at issue. The trial court has also granted the Company's motion to transfer the action to the Northern District of California. The Company disputes Friskit's allegations in this action and intends to vigorously defend itself.

In March 2003, William Cirignani filed a putative consumer class action against the Company in Washington state court, alleging causes of action based on the Washington Consumer Protection Act and unjust enrichment. The plaintiff alleges that consumers who attempted to download or purchase certain of the Company's products and services were fraudulently and deceptively enrolled in, and prevented from canceling, the Company's subscription services. The plaintiff seeks compensatory damages, equitable relief in the form of an order prohibiting the alleged false and deceptive practices, treble damages and other relief. The parties reached a confidential settlement in June 2005 and the case was dismissed with prejudice. The settlement did not have a material effect on the Company's financial position or results of operations.

In July 2002, a lawsuit was filed against the Company in federal court in Boston, Massachusetts by Ethos Technologies, Inc. (Ethos), alleging that the Company willfully infringes certain patents relating to "the downloading of data from a server computer to a client computer." Ethos seeks to enjoin the Company from the alleged infringing activity and to recover treble damages from the alleged infringement. The Company has filed counterclaims against Ethos seeking a declaratory judgment that the patents at issue are invalid and unenforceable due to Ethos' inequitable conduct, as well as its recovery of damages for Ethos' infringement of a Company patent, and reasonable attorneys fees and costs. The Company disputes Ethos' allegations in this action and intends to vigorously defend itself.

From time to time the Company is, and expects to continue to be, subject to legal proceedings and claims in the ordinary course of its 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 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 third party claims and certain pending claims are moving closer to trial. The Company expects that its potential costs of defending these claims may increase as the disputes move into the trial phase of the proceedings. 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 financial position and results of operations.

NOTE 11 – SUBSEQUENT EVENT

In August 2005, the Company announced a new share repurchase program, replacing the Company's existing share repurchase plan. The Company's Board of Directors authorized the repurchase of up to an aggregate of \$75 million of the Company's outstanding common stock. To facilitate its repurchase plan, the Company has entered into a Rule 10(b)5-1 plan designed to facilitate the repurchase of a portion of the authorized repurchase amount. Repurchases of common stock under the Company's share repurchase program may also be made from time-to-time, in the open market, through block trades or otherwise. Depending on market conditions and other factors, these purchases may be commenced or suspended at any time without prior notice. As of August 8, 2005, the Company repurchased approximately 0.2 million shares at an average cost of \$5.31 per share.

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

The discussion in this report contains forward-looking statements that involve risks and uncertainties. RealNetworks' actual results could differ materially from those discussed below. Factors that could cause or contribute to such differences include, but are not limited to, those identified below, and those discussed in the section titled "Factors that May Affect Our Business, Future Operating Results and Financial Condition," included elsewhere in this Report. You should also carefully review the risk factors set forth in other reports or documents that RealNetworks files from time to time with the Securities and Exchange Commission, particularly RealNetworks' Annual Reports on Form 10-K, other Quarterly Reports on Form 10-Q and any Current Reports on Form 8-K. You should also read the following discussion and analysis in conjunction with our unaudited condensed consolidated financial statements and related notes included in this report.

Overview

RealNetworks is a leading creator of digital media services and software. Consumers use our services and software to find, play, purchase and manage free and premium digital content, including music, video and games. We also develop and market software products and services that enable the creation, distribution and consumption of digital media, including audio and video. Broadcasters, network operators, media companies and enterprises use our products and services to create and deliver digital media to PCs, mobile phones and consumer electronic devices.

We have pioneered the development of technology for the transmission of digital media over the Internet, and the use of that technology to create both free and paid consumer services. As adoption of broadband Internet access continues to spread, we believe that consumers will increasingly use and purchase digital media services on the Internet, as demonstrated by the rapid growth of our music and games businesses in recent periods. Our strategy is to continue to grow and leverage our large base of RealPlayer users to help drive our consumer digital media products and services, including our subscription services and our media advertising. At the same time, we will continue to develop and license our digital media technologies that underlie our products and services, including the Helix Universal Server and Helix DRM that enable our business customers to create and deliver their own digital media applications and services.

Over the last several years, our core business has evolved to address changing dynamics in our industry. We initially developed our business as a leading provider of software technology for the delivery and playback of digital media content over digital networks, and became a leader in that business. We have leveraged our technology business and large technology user base to define and develop new consumer-based businesses built using our digital media technology. These new consumer businesses principally involve paid digital media content. In recent periods, we have aggressively pursued development of these businesses through both internal initiatives and strategic acquisitions of businesses and technologies. We have also increased our focus, including our promotional efforts, on these consumer digital media businesses, which has resulted in significant increases in our sales of digital media content and the number of subscribers to our service offerings. This shift in focus and the increases in sales of digital media content and the number of our subscribers are reflected in our results of operations in the following primary ways:

- A significant increase in our Consumer Products and Services revenue driven primarily by growth in revenue from our music and games businesses;
- A higher percentage of our total revenue arising from our Consumer Products and Services businesses; and
- A significant increase in the service revenue component of our Consumer Products and Services, including primarily our consumer subscription services.

Despite the aggregate growth of our Consumer Products and Services revenue, our overall results have been substantially affected over the last several years by slower sales of our Business Products and Services. We believe that the reduction in sales in our Business Products and Services segment during this period and related reduction in usage of the associated products and services has been caused primarily by Microsoft's continuing practice of bundling its competing Windows Media Player and server software for free with its Windows operating system products. We believe that Microsoft's practices are illegal and have directly reduced sales of our Business Products and Services, resulting in declines in related revenue. In response to these business practices, we have filed suit against Microsoft in the U.S. District Court for the Northern District of California, pursuant to U.S. and California antitrust laws, seeking monetary and injunctive relief to remedy these violations.

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In 2004, we recorded the highest revenue in our history primarily due to the significant growth in our Consumer Products and Services segment. Our overall revenue mix, however, has shifted from higher margin software products related to our Business Products and Services segment toward our Consumer Products and Services segment, which has resulted in a decline in our gross margins from previous periods. In addition, we incurred approximately \$11.0 million in antitrust litigation expenses in 2004 related to Microsoft's business practices, which negatively impacted our overall financial results. These trends continued in the first six months of 2005, as we recorded the highest quarterly revenue in our history and our Consumer Products and Services revenue continued to grow significantly, increasing as a percentage of our total revenue to approximately 85% for the six months ended June 30, 2005. During the quarter ended June 30, 2005, we introduced our Rhapsody 25 product, which offers customers free, limited access to our current library of over one million tracks, and Rhapsody To Go, a subscription service that supports portability with certain compatible devices. As a result of the launch of these products, as well as the introduction of the latest version of our Rhapsody Unlimited product, we incurred incremental marketing expenses of approximately \$6.5 million in the second quarter of 2005. We incurred an additional \$4.7 million and \$8.4 million in antitrust litigation expenses during the quarter and six months ended June 30, 2005, respectively, and we expect that our operating results will continue to be negatively impacted by antitrust litigation expenses for the remainder of 2005. We currently anticipate expenses related to antitrust litigation will be approximately \$16 million for 2005.

Although we expect our total revenue for 2005 to grow substantially over 2004, we currently anticipate that our sequential revenue growth may slow during the second half of 2005, as compared to the first half of 2005. We anticipate that revenue growth in our Consumer Products and Services segment will slow principally because of: (1) the positive impact on revenue in the second quarter of 2005 from an increase in Media Properties revenue from new and expanded advertising and promotion relationships, which, while expected to continue to generate revenue in the second half of 2005, is not expected to increase quarterly revenue substantially from revenue in the second quarter of 2005; and (2) a decrease in revenue related to the discontinuation of several low margin standalone video products. In addition, our Business Products and Services revenue will be impacted by the termination of a long-term legacy systems license agreement which was substantially completed in the second quarter of 2005.

Our second half revenue growth may also be impacted by slowing growth of our premium music subscription service revenue arising in part from a shift in the focus of our marketing and promotion efforts to our free-to-consumer products and services, such as Rhapsody 25, as well as from the fact that an increasingly higher percentage of our new music subscribers are attributable to the wholesale distribution of our radio products through broadband service providers, which tends to generate less revenue per subscriber than non-wholesale providers. Revenue growth may also be impacted by an increase in the number of gross customer cancellations attributable primarily to our increasingly large subscriber base. Finally, our Music business continued to face intense competition in the second quarter of 2005 as major competitors introduced discounted music subscription products and music download offers. We expect our Consumer Products and Services businesses, including our Music business, to experience intense and increasing competition from major competitors in the second half of 2005.

We manage our business, and correspondingly report revenue, based on our two operating segments: Consumer Products and Services and Business Products and Services.

Consumer Products and Services, which primarily include revenue from: digital media subscription services such as RealOne SuperPass, Rhapsody, RadioPass, GamePass and stand-alone and add-on subscriptions; sales and distribution of third party products and services; sales of digital content such as music and game downloads; sales of premium versions of our RealPlayer and related products; and advertising.

Business Products and Services, which primarily include revenue from: sales of our media delivery system software, including Helix system software and related authoring and publishing tools, both directly to customers and indirectly through original equipment manufacturer (OEM) channels; support and maintenance services that we sell to customers who purchase our software products; broadcast hosting services; and consulting services we offer to our customers.

In August 2003, we acquired all of the outstanding securities of Listen. Listen had developed and operated an on-demand streamed

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music subscription service called the Rhapsody service, which is now operated and integrated as part of our music services. Rhapsody subscribers pay a monthly subscription fee and also have the ability to burn tracks to compact discs for which they are charged a per-track fee. The results of Listen's operations are included in our unaudited condensed consolidated financial statements and related notes thereto since the date of acquisition.

In January 2004, we acquired all of the outstanding securities of GameHouse. GameHouse is a developer, publisher and distributor of downloadable PC games. We believe the acquisition strengthened our position in the downloadable PC games market by combining the assets of GameHouse with our downloadable games distribution platform. The results of GameHouse's operations are included in our unaudited condensed consolidated financial statements and related notes thereto since the date of acquisition.

In May 2005, we acquired all of the outstanding securities of Mr. Goodliving. Mr. Goodliving is a developer and publisher of mobile games, which are currently distributed primarily in Europe. We expect that the acquisition will enhance our entry into the mobile games market. The results of Mr. Goodliving's operations are included in our unaudited condensed consolidated financial statements and related notes thereto since the date of acquisition.

Critical Accounting Policies and Estimates

The preparation of our financial statements requires us to make estimates and assumptions that affect the reported amount of assets and liabilities and disclosure of contingent assets and liabilities at the date of the financial statements and the reported amounts of revenues and expenses during the reported period. Our critical accounting policies and estimates are as follows:

- Revenue recognition;
- Estimating music publishing rights and music royalty accruals;
- Estimating sales returns and the allowance for doubtful accounts;
- Estimating losses on excess office facilities;
- Determining whether declines in the fair value of investments are other-than-temporary and estimating fair market value of investments in privately held companies;
- Valuation of goodwill; and
- Valuation of deferred income tax assets.

Revenue Recognition. As described below, significant management judgments and estimates must be made and used in connection with the revenue recognized in any accounting period. Material differences may result in the amount and timing of our revenue for any period if our management made different judgments or utilized different estimates.

For software related products and services, we recognize revenue pursuant to the requirements of Statement of Position No. 97-2, "Software Revenue Recognition" (SOP 97-2), as amended by Statement of Position No. 98-9, "Software Revenue Recognition with Respect to Certain Arrangements" (SOP 98-9). Under SOP 97-2, revenue attributable to an element in a customer arrangement is recognized when persuasive evidence of an arrangement exists and delivery has occurred, provided the fee is fixed or determinable, collectibility is probable and the arrangement does not require significant customization of the software. Some of our software arrangements include consulting implementation services sold separately under consulting engagement contracts. Consulting revenue from these arrangements is generally accounted for separately from new software license revenue because the arrangements qualify as service transactions as defined in SOP 97-2. Revenue for consulting services is generally recognized as the services are performed.

If we provide consulting services that are considered essential to the functionality of the software products, both the software product revenue and services revenue are recognized under contract accounting in accordance with the provisions of SOP 81-1, "Accounting for Performance of Construction-Type and Certain Production-Type Contracts." Revenue from these arrangements is

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recognized under the percentage of completion method based on the ratio of direct labor hours incurred to date to total projected labor hours.

In addition, for transactions not falling under the scope of SOP 97-2, our revenue recognition policies are in accordance with Emerging Issues Task Force Issue No. 00-21, "Revenue Arrangements with Multiple Deliverables" (EITF 00-21) and Securities and Exchange Commission (SEC) Staff Accounting Bulletin 104, "Revenue Recognition" (SAB 104).

For all sales, except those completed via credit cards or other like methods of payment over the Internet, we use either a binding purchase order or signed agreement, depending on the nature of the transaction, as evidence of an arrangement. For sales made via the Internet, we use the customer's authorization to charge their credit card as evidence of an arrangement. Sales through our distributors are evidenced by a master agreement governing the relationship together with binding purchase orders on a transaction-by-transaction basis.

For software license fees in single element arrangements and multiple element arrangements that do not include customization or consulting services, delivery typically occurs when the product is made available to the customer for download or when products are shipped to the customer. For service and advertising revenue, delivery typically occurs as the services are being performed.

At the time of each transaction, we assess whether the fee associated with our revenue transaction is fixed and determinable and whether or not collection is probable. We assess whether the fee is fixed and determinable based on the payment terms associated with the transaction. If a significant portion of a fee is due after our normal payment terms or is subject to refund, we consider the fee to not be fixed and determinable. In these cases, we defer revenue and recognize it when it becomes due and payable.

We assess the probability of collection based on a number of factors, including past transaction history with the customer and the current financial condition of the customer. We do not request collateral from our customers but often require payments before or at the time products and services are delivered. If we determine that collection of a fee is not probable, we defer revenue until the time collection becomes probable, which is generally upon receipt of cash.

For multiple element arrangements, when company-specific objective evidence of fair value exists for all of the undelivered elements of the arrangement, but does not exist for one or more of the delivered elements in the arrangement, we recognize revenue under the residual method. Under the residual method, at the outset of the arrangement with a customer, we defer revenue for the fair value of the arrangement's undelivered elements such as product support and upgrades, and recognize the revenue for the remainder of the arrangement fee attributable to the elements initially delivered, such as software licenses, when the criteria in SOP 97-2 have been met. Company-specific objective evidence is established for support and upgrades of standard products for which no installation or customization is required based upon the amounts we charge when support and upgrades are sold separately. For multiple element arrangements involving installation or customization, company-specific objective evidence is established for support and upgrade arrangements if our customers have an optional renewal rate specified in the arrangement and the rate is substantive. For software license fees in single element arrangements such as consumer software sales and music copying or "burning," revenue recognition typically occurs when the product is made available to the customer for download or when products are shipped to the customer, or in the case of music burns, when the burn occurs.

If Company-specific objective evidence does not exist for an undelivered element in a software arrangement, which may include distribution or other term-based arrangements in which the license fee includes support during the arrangement term, revenue is recognized over the term of the support period commencing upon delivery of our technology to the customer.

Revenue from software license agreements with OEMs is recognized when the OEM delivers its product incorporating our software to the end user. In the case of prepayments received from an OEM, we typically recognize revenue based on the actual products sold by the OEM. If we provide ongoing support to the OEM in the form of future upgrades, enhancements or other services over the term of the contract, all of the revenue under the arrangement is generally recognized ratably over the term of the contract.

Service revenue include payments under support and upgrade contracts, RealOne and Rhapsody subscription services, consulting services and streaming media content hosting. Support and upgrade revenue are recognized ratably over the term of the contract, which typically is twelve months. Media subscription service revenue is recognized ratably over the period that services are provided. Fees generated from advertising are recognized as advertising is delivered over the term of the contract. Other service revenue is recognized as the services are performed.

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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. Material differences may result in the amount and timing of our expense for any period if our 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 are 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 the Company bases its estimates on historical experience and on various other assumptions that management believes to be reasonable under the circumstances, actual results may differ materially from these estimates under different assumptions or conditions and as a result could have a material impact on our operating results.

Sales Returns and the Allowance for Doubtful Accounts. We must 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 and other allowances. Similarly, we must make estimates of the uncollectibility of our accounts receivable. We specifically analyze the age of accounts receivable and analyze historical bad debts, customer credit-worthiness and current economic trends when evaluating the adequacy of the allowance for doubtful accounts. Significant judgments and estimates must be made and used in connection with establishing allowances for sales returns and the allowance for doubtful accounts 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.

Accrued Loss On Excess Office Facilities. We have made significant estimates in determining the appropriate amount of accrued loss on excess office facilities. If we made 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. We have revised our original estimate three times in the last three years, increasing the accrual for loss on excess office facilities each time. The first two revisions were the result of changes in the market for commercial real estate where we operate. The third revision, which took place in 2003, was the result of adding an additional tenant at a sublease rate lower than the rate used in previous estimates. If the market for such space declines further in future periods or we are unable to sublease the space based on our current estimates, we may have to revise our estimates, which may result in additional losses on excess office facilities. The significant factors we considered in making our estimates are discussed in the section entitled "Loss on Excess Office Facilities and Content Agreement."

Impairment of Investments. As part of the process of preparing our consolidated financial statements we periodically evaluate whether any declines in the fair value of our investments are other-than-temporary. Significant judgments and estimates must be made to assess whether an other-than-temporary decline in fair value of investments has occurred and to estimate the fair value of investments in privately held companies. See "Other Income (Expense), Net" in the following pages for a discussion of the factors we considered in evaluating whether declines in fair value of our investments were other-than-temporary and the factors we considered in estimating the fair value of our investments.

Valuation of Goodwill. We assess the impairment of goodwill on an annual basis 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. Factors we consider important which 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;
- changes in the manner of our use of the assets or the plans for our business; and
- loss of key personnel.

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 reporting unit

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goodwill. 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 what our reporting units are for the purpose of assessing fair value compared to carrying value. There were no impairments related to goodwill for any of the periods presented.

Valuation of Deferred Income Tax Assets. In accordance with generally accepted accounting principles, we must periodically assess the likelihood that our deferred tax assets will be recovered from future taxable income, and to the extent that recovery is not likely, 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 benefits in the statement of operations. Factors we consider in making such an assessment include, but are not limited to, past performance and our expectation of future taxable income, macro-economic conditions and issues facing our industry, existing contracts, our ability to project future results and any appreciation of our investments and other assets. As of June 30, 2005 and December 31, 2004, we had established valuation allowances equal to our net deferred tax assets.

Revenue by Segment

We operate our business in two segments: Consumer Products and Services and Business Products and Services.

	Quarters Ended June 30,			Six Months Ended June 30,		
	2005	2004	Change	2005	2004	Change
	(Dollars in thousands)			(Dollars in thousands)		
Consumer Products and Services	\$70,593	53,743	31%	\$134,799	100,768	34%
Business Products and Services	12,093	11,730	3	24,459	25,095	(3)
Total net revenue	<u>\$82,686</u>	<u>65,473</u>	26	<u>\$159,258</u>	<u>125,863</u>	27

	Quarters Ended June 30,		Six Months Ended June 30,	
	2005	2004	2005	2004
	(As a percentage of total net revenue)		(As a percentage of total net revenue)	
Consumer Products and Services	85%	82	85	80
Business Products and Services	15	18	15	20
Total net revenue	100%	100	100	100

Consumer Products and Services. Consumer Products and Services revenue is derived from sales of digital media subscription services, our RealPlayer Plus and other related products, sales and distribution of third party software products and services, sales of digital content such as music and games, and advertising. These products and services are sold primarily through the Internet, and payment is provided primarily by the Company charging the customers' credit card at the time of sale. Billing periods for subscription services typically occur monthly, quarterly or annually, depending on the service purchased. Consumer Products and Services revenue increased in the quarter and six months ended June 30, 2005 primarily due to: (1) growth in subscribers and the related revenue for our subscription services, including Rhapsody, RadioPass, GamePass and SuperPass; (2) increased sales of individual tracks through our Rhapsody and RadioPass music subscription services; and (3) other factors which are discussed in further detail below in the sections included within Consumer Products and Services revenue. These increases were partially offset by decreases in sales of our premium consumer license products and third party stand-alone subscription services. We believe the growth in our music and games subscription services is due in part to the continued shift in our marketing and promotional efforts to these services as well as product improvements and increasing consumer acceptance and adoption of digital media products and services. While revenue related to our digital media subscription services has increased substantially on a year-over-year basis, the rate of growth has decreased on a quarterly basis in recent periods. We anticipate that Consumer Products and Services sequential revenue growth will slow in the second half of 2005, which is discussed further in the Overview of the Management's Discussion and Analysis of Financial Condition and Results of Operations. We cannot predict with accuracy how our subscription offerings will perform in the future, at what rate digital media subscription service revenue will grow, if at all, or the nature or potential impact of anticipated competition.

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Business Products and Services. Business Products and Services revenue is derived from the licensing of our media delivery system software, including Helix system software and related authoring and publishing tools, digital rights management technology, support and maintenance services that we sell to customers who purchase these products, broadcast hosting services we provide and consulting services we offer to our customers. These products and services are primarily sold to corporate, government and educational customers. We do not require collateral from our customers, but we often require payment before or at the time products and services are delivered. Many of our customers are given standard commercial credit terms, and for these customers we do not require payment before products and services are delivered. Business Products and Services revenue increased in the quarter ended June 30, 2005 due primarily to an increase in sales of our system software to an original equipment manufacturing (OEM) customer which was partially offset by a decrease in sales of our system software to mobile and wireless infrastructure companies. Business Products and Services revenue decreased for the six months ended June 30, 2005 primarily due to a decrease in sales to mobile and wireless infrastructure companies which was partially offset by an increase in sales of our system software to an OEM customer. We believe the decreases in sales of certain of our business software products in recent years have been substantially affected by Microsoft's continuing practice of bundling its competing Windows Media Player and server software for free with its Windows operating system products, which we believe is an illegal practice. Our Business Products and Services revenue tends to be comprised of a number of larger transactions, which typically have lengthy and variable sales cycles. Due to the length and variability of these sales cycles and the size of the transactions, our sequential quarterly revenue has fluctuated based on the timing of the consummation of the related agreements. No assurance can be given when, or if, we will experience increased sales of our Business Products and Services segment.

Consumer Products and Services Revenue

A further analysis of our Consumer Products and Services revenue is as follows:

	Quarters Ended June 30,			Six Months Ended June 30,		
	2005	2004	Change	2005	2004	Change
	(Dollars in thousands)			(Dollars in thousands)		
Music	\$24,135	14,954	61%	\$ 46,378	26,894	72%
Video, Consumer Software and Other	24,607	23,715	4	48,761	48,004	2
Games	13,648	8,352	63	25,837	15,107	71
Media Properties	8,203	6,722	22	13,823	10,763	28
Total Consumer Products and Services revenue	<u>\$70,593</u>	<u>53,743</u>	31	<u>\$134,799</u>	<u>100,768</u>	34

Music. Music revenue primarily includes revenue from our Rhapsody and RadioPass subscription services and sales of digital music content. The increase in Music revenue during the quarter and six months ended June 30, 2005 is due primarily to; (1) growth in subscribers to our Rhapsody and RadioPass subscription services; (2) the online sale of individual tracks through our Rhapsody subscription service and through our RealPlayer Music Store (sales through our RealPlayer Music Store began during the quarter ended March 31, 2004); and (3) the distribution of our radio products through broadband service providers. We believe the continued growth of our Music revenue during the first six months of 2005 is due primarily to the broader acceptance of paid online music services and increased focus of our marketing efforts on our music offerings. Although our Music revenue has grown substantially in recent periods, we anticipate that sequential Music revenue growth will slow in the second half of 2005, as discussed further in the Overview of the Management's Discussion and Analysis of Financial Condition and Results of Operations.

Video, Consumer Software and Other. Video, consumer software and other revenue includes primarily revenue from: our SuperPass and stand-alone premium video subscription services; RealPlayer Plus and related products and revenue from support services that we sell to customers who purchase these products; and sales of third-party software products. Video, consumer software and other revenue increased in the quarter and six months ended June 30, 2005 primarily due to price increases introduced in August

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2004 for our SuperPass digital media subscription service. This increase was partially offset by decreases in: (1) revenue from stand-alone subscription services; (2) revenue related to third party consumer license products; and (3) revenue related to our premium consumer license products. We believe that the decrease in revenue related to our premium consumer license products and third party consumer license products is due to both the effects of Microsoft's business practices and a shift in our marketing and promotional efforts towards our music and games subscription services, which we believe represent a greater growth opportunity for us given current market conditions.

Games. Games revenue primarily includes revenue from: game downloads through our RealArcade service and our GameHouse website; our GamePass subscription service; and advertising through RealArcade and our games related websites. The increase in Games revenue during the quarter and six months ended June 30, 2005 is due primarily to: (1) growth in subscribers to our GamePass subscription service and price increases introduced during the quarter ended March 31, 2005; (2) increased revenue related to our GameHouse product offerings (subsequent to our acquisition of GameHouse in January 2004); (3) increased revenue related to the sale of individual game licenses through our RealArcade service and our websites; and (4) revenue from the sale of game licenses for mobile phones of approximately \$0.5 million arising from our acquisition of Mr. Goodliving in May 2005. Additionally, we believe the growth in our Games revenue is due to the increased focus of our marketing efforts on our Games business and the addition of new game titles to our RealArcade and GamePass offerings.

Media Properties. Media properties revenue includes revenue from our distribution of third party products and all advertising other than that related directly to our games business. Media properties revenue increased in the quarter and six months ended June 30, 2005 primarily due to: (1) increased revenue related to advertising through our websites; and (2) an increase in revenue associated with new and expanded advertising relationships.

Geographic Revenue

	Quarters Ended June 30,			Six Months Ended June 30,		
	2005	2004	Change	2005	2004	Change
	(Dollars in thousands)			(Dollars in thousands)		
United States	\$63,443	50,949	25%	\$121,200	94,912	28%
Europe	11,605	9,101	28	22,610	19,831	14
Rest of the world	7,638	5,423	41	15,448	11,120	39
Total	<u>\$82,686</u>	<u>65,473</u>	26	<u>\$159,258</u>	<u>125,863</u>	27

Revenue generated in the United States increased for the quarter and six months ended June 30, 2005 primarily due to the growth of our Music and Games businesses and increased revenue from distribution of third party products. See Consumer Products and Services Revenue — *Games* and *Music* above for further discussion of the changes.

International revenue increased for the quarter and six months ended June 30, 2005 primarily due to the continued growth of our games business internationally, as well as the contribution of revenue from our international RadioPass subscription service since its introduction during 2004. These increases were partially offset by a decrease in revenue related to sales of our system software to mobile and wireless infrastructure companies. International revenue increased as a percentage of overall revenue from 22% to 23% for the quarter ended June 30, 2005 primarily due to the continued growth of our games business internationally, the contribution of revenue from our international RadioPass subscription service and revenue related to sales of mobile game licenses through Mr. Goodliving, which we acquired in May 2005. These increases were partially offset by a decrease in revenue related to sales of our system software to mobile and wireless infrastructure companies. International revenue decreased as a percentage of overall revenue from 25% to 24% for the six month period primarily due to the strong growth of our overall U.S. consumer business, which resulted in our U.S. revenue growing at a faster rate than our International revenue.

Revenue

In accordance with SEC regulations, we also present our revenue based on License Fees and Service Revenue as set forth below.

	Quarters Ended June 30,			Six Months Ended June 30,		
	2005	2004	Change	2005	2004	Change
	(Dollars in thousands)			(Dollars in thousands)		
License fees	\$20,377	17,136	19%	\$ 41,009	35,382	16%
Service revenue	62,309	48,337	29	118,249	90,481	31
Total net revenue	<u>\$82,686</u>	<u>65,473</u>	26	<u>\$159,258</u>	<u>125,863</u>	27

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	Quarters Ended June 30,		Six Months Ended June 30,	
	2005	2004	2005	2004
	(As a percentage of total net revenue)		(As a percentage of total net revenue)	
License fees	25%	26	26	28
Service revenue	75	74	74	72
Total net revenue	100	100	100	100

License Fees. License fees primarily include: sales of our media delivery system software, including Helix system software and related authoring and publishing tools, both directly to customers and indirectly through OEM channels; revenue from sales of premium versions of our RealPlayer Plus and related products; sales of third-party products and content such as game downloads and digital music. License fees include revenue from both our Consumer and Business Products and Services segments. The increase in license fees for the quarter and six months ended June 30, 2005 was primarily due to: (1) increased revenue from the online sale of individual tracks through our Rhapsody music subscription service and our RealPlayer Music Store (which we launched in January 2004); (2) increased revenue related to the sale of games content related to our GameHouse product offerings (subsequent to our acquisition of GameHouse in January 2004); (3) increased revenue related to the sale of individual game licenses through our RealArcade service and our websites; and (4) an increase in revenue related to the sales of our system software through OEM customers. These increases were partially offset by decreases in revenue from sales of our system software to mobile and wireless infrastructure companies as well as decreased sales of third party consumer license products. See “Revenue by Segment – Consumer Products and Services” and “Revenue by Segment – Business Products and Services” above for further explanation of changes.

Service Revenue. Service revenue primarily includes: revenue from digital media subscription services such as RealOne SuperPass, RadioPass, Rhapsody, GamePass and stand-alone and add-on subscriptions; revenue from support and maintenance services that we sell to customers who purchase our software products; revenue from broadcast hosting services; revenue from consulting services we offer to our customers; revenue from distribution of third party software; and advertising revenue. Service revenue includes revenue from both our Consumer and Business Products and Services segments. The increase in service revenue during the quarter and six months ended June 30, 2005 was primarily attributable to: (1) growth in subscribers to our Rhapsody and RadioPass music subscription services; (2) growth in subscribers to our GamePass subscription service and price increases introduced during the quarter ended March 31, 2005; (3) increased revenue related to our SuperPass subscription service, due in part to a price increase in August 2004; (4) increases in the distribution of certain third party products and the related revenue; (5) growth in revenue related to advertising through our websites; and (6) revenue from the distribution of our radio products through broadband service providers. These increases were partially offset by a decrease in revenue related to sales of stand-alone subscription services. Our subscription services accounted for approximately \$47.8 million and \$35.5 million of service revenue during the quarters ended June 30, 2005 and 2004, respectively, and \$92.2 million and \$67.5 million for the six months ended June 30, 2005 and 2004, respectively. The increases in subscription revenue are explained in more detail in “Revenue by Segment — Consumer Products and Services” above. We believe the decreased revenue in our other service offerings are due primarily to the factors described above in “Revenue by Segment — Business Products and Services.”

Deferred Revenue

Deferred revenue is comprised of the unrecognized revenue related to support contracts, prepayments under OEM arrangements, unearned subscription services and other prepayments for which the earnings process has not been completed. Deferred revenue at June 30, 2005 was \$25.8 million compared to \$30.9 million at December 31, 2004. The decrease in deferred revenue is primarily due to prepayments received under contracts occurring at a slower rate than recognition of revenue on existing contracts. The slower rate of prepayment receipts is due primarily to a decrease in new contracts in our Business Products and Services segment in recent periods, which historically represented a significant portion of deferred revenue. We believe the decrease in new contracts in our Business Products and Services segment results primarily from the conditions described in “Revenue by Segment – Business Products and Services” above. The decrease in prepayments under contracts was partially offset by an increase in deferred revenue from our digital media subscription services.

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Cost of Revenue by Segment

	Quarters Ended June 30,			Six Months Ended June 30,		
	2005	2004	Change	2005	2004	Change
	(Dollars in thousands)			(Dollars in thousands)		
Consumer Products and Services	\$22,800	19,713	16%	\$45,363	44,194	3%
Business Products and Services	2,041	2,022	1	4,215	4,240	(1)
Total cost of revenue	<u>\$24,841</u>	<u>21,735</u>	14	<u>\$49,578</u>	<u>48,434</u>	2
As a percentage of total net revenue	30%	33		31%	38	

Cost of Consumer Products and Services. Cost of Consumer Products and Services revenue includes cost of content, and delivery of the content included in our digital media subscription service offerings, royalties paid on sales of games, music and other third-party products, amounts paid for licensed technology, costs of product media, duplication, manuals, packaging materials, and fees paid to third-party vendors for order fulfillment and support services. Cost of Consumer Products and Services revenue increased in dollars, but decreased as a percentage of Consumer Products and Services revenue from 37% to 32% for the quarter and from 44% to 34% for the six month period primarily due to the renegotiation of certain content agreements with more favorable terms and the discontinuation of certain content offerings related to our SuperPass subscription service, as well as an increase in higher margin revenue from the distribution of certain third party products. The increase in costs is due primarily to: (1) content costs associated with the growth in revenue of our Rhapsody and RadioPass subscription services; (2) an increase in licensing costs associated with the growth in revenue of the online sale of individual tracks; and (3) an increase in licensing costs associated with the growth in revenue from the sale of games license products. The increases were partially offset by decreases in costs related to: (1) the *Loss on Content Agreement* described below which resulted in a significant one-time expense in the quarter ended March 31, 2004; (2) the renegotiation of certain content agreements with more favorable financial terms and the discontinuation of certain content offerings related to our SuperPass subscription service; (3) lower royalties related to third party subscriptions due to the decrease in the related revenue; and (4) an increase in higher margin revenue from the distribution of certain third party products.

Cost of Business Products and Services. Cost of Business Products and Services revenue includes amounts paid for licensed technology, costs of product media, duplication, manuals, packaging materials, fees paid to third-party vendors for order fulfillment, cost of in-house and contract personnel providing support and consulting services, and expenses incurred in providing our streaming media hosting services. Cost of Business Products and Services revenue as a percentage of Business Products and Services revenue for the quarter and six months ended June 30, 2005 was consistent with the same period in 2004.

Cost of Revenue

	Quarters Ended June 30,			Six Months Ended June 30,		
	2005	2004	Change	2005	2004	Change
	(Dollars in thousands)			(Dollars in thousands)		
License fees	\$ 7,888	6,745	17%	\$16,222	12,955	25%
Service revenue	16,953	14,990	13	33,356	30,541	9
Loss on content agreement	—	—	—	—	4,938	—
Total cost of revenue	<u>\$24,841</u>	<u>21,735</u>	14	<u>\$49,578</u>	<u>48,434</u>	2
As a percentage of total net revenue	30%	33		31%	38	

Cost of License Fees. Cost of license fees includes royalties paid on sales of games, music and other third-party products, amounts paid for licensed technology, costs of product media, duplication, manuals, packaging materials, and fees paid to third-party vendors for order fulfillment. Cost of license fees as a percentage of license revenue was consistent at 39% for the quarter and increased from 37% to 40% for the six month periods ended June 30, 2004 and 2005, respectively, primarily due to increased licensing costs associated with: (1) the online sale of individual tracks through our Rhapsody subscription service and RealPlayer Music Store; and (2) an increase in revenue and associated licensing costs related to games license products. The increases were partially offset by a decrease in revenue and associated licensing costs related to third party license products.

Cost of Service Revenue. Cost of service revenue includes the cost of content and delivery of the content included in our digital media subscription service offerings, cost of in-house and contract personnel providing support and consulting services, and expenses incurred in providing our streaming media hosting services. Cost of service revenue for the quarter and six months ended June 30,

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2005 increased in dollars from the prior period but decreased as a percentage of service revenue from 31% to 27% for the quarter and from 34% to 28% for the six month period. The decrease as a percentage of service revenue is due primarily to the renegotiation of certain content agreements with more favorable terms and the discontinuation of certain content, as well as an increase in higher margin revenue from the distribution of certain third party products. The increase in costs for the quarter and six months was primarily due to increased costs of content included in our digital media subscription services. The decrease in cost of service revenue as a percentage of service revenue was due to: (1) the renegotiation of certain content agreements; (2) the discontinuation of certain content offerings related to our SuperPass subscription service; and (3) an increase in higher margin revenue from the distribution of certain third party products.

Our digital media subscription services, including Rhapsody, are a relatively new and growing portion of our business and, to date, have been characterized by higher costs of revenue than our other products and services primarily due to the cost of licensing media content to provide these services. As a result, if our digital media subscription services continue to grow as a percentage of net revenue, our cost of service revenue may grow at an increased rate relative to net revenue, which will result in reductions in our gross margin percentages in the future. In addition, we anticipate that our cost of service revenue as a percentage of service revenue will fluctuate on a quarter-to-quarter basis due to seasonal characteristics of certain popular subscription content and as we periodically enter into new agreements for subscription content.

Loss on Content Agreement. During the quarter ended March 31, 2004, we cancelled a content licensing agreement with PGA TOUR. Under the terms of the cancellation agreement, we gave up rights to use and ceased using PGA TOUR content in our products or services as of March 31, 2004. The expense represents the estimated fair value of payments to be made in accordance with the terms of the cancellation agreement.

Operating Expenses

Research and Development

	Quarters Ended June 30,			Six Months Ended June 30,		
	2005	2004	Change	2005	2004	Change
	(Dollars in thousands)			(Dollars in thousands)		
Research and development	\$15,292	13,219	16%	\$28,962	25,470	14%
As a percentage of total net revenue	18%	20		18%	20	

Research and development expenses consist primarily of salaries and related personnel costs and consulting fees associated with product development. 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. Research and development expenses, excluding non-cash stock-based compensation, increased in the quarter and six months ended June 30, 2005 by 16% and 14%, respectively, and increased in the quarter and six months ended June 30, 2004 by 26% and 27%, respectively. The increase is primarily due to an increase in payroll and consulting related expenses. The decrease as a percentage of total net revenue for the quarter and six months ended June 30, 2005 as compared to the corresponding periods in 2004 was a result of research and development expenses increasing at a lower rate than the increase in our total net revenue.

Sales and Marketing

	Quarters Ended June 30,			Six Months Ended June 30,		
	2005	2004	Change	2005	2004	Change
	(Dollars in thousands)			(Dollars in thousands)		
Sales and marketing	\$35,044	23,247	51%	\$63,064	45,450	39%
As a percentage of total net revenue	42%	36		40%	36	

Sales and marketing expenses consist primarily of salaries and related personnel costs, sales commissions, credit card fees, subscriber acquisition costs, consulting fees, trade show expenses, advertising costs and costs of marketing collateral. Sales and marketing expense increased in the quarter and the six months ended June 30, 2005 primarily due to: (1) increased advertising and product launch costs, including live concert promotions, direct response television advertisements and expanded marketing programs through new and existing channels, related to the launch of our new Rhapsody music products;

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(2) an increase in sales and marketing personnel and the related costs in order to support the continued growth in our Consumer Products and Services business; and (3) an increase in payments made to third parties for referrals of new customers. As we continue to shift the focus of our marketing efforts to our Consumer Products and Services segment, we expect that our sales and marketing expenses will continue at historical levels as a percentage of revenue, excluding the costs associated with the launch related activities during the quarter ended June 30, 2005 related to our new Rhapsody music products. Sales and marketing costs as a percentage of total net revenue increased from 36% to 42% for the quarters and 36% to 40% for the six month periods primarily due to the increase in costs associated with the advertising and product launch costs related to our new Rhapsody music products.

General and Administrative

	Quarters Ended June 30,			Six Months Ended June 30,		
	2005	2004	Change	2005	2004	Change
	(Dollars in thousands)			(Dollars in thousands)		
General and administrative	\$7,888	8,599	(8)%	\$14,064	15,420	(9)%
As a percentage of total net revenue	10%	13		9%	12	

General and administrative expenses consist primarily of salaries, related personnel costs, fees for professional, temporary services and contractor costs and other general corporate costs. General and administrative expenses, excluding non-cash stock-based compensation, decreased in the quarter and six months ended June 30, 2005 primarily due to decreased litigation defense costs (not including antitrust litigation expenses) and decreased costs, due primarily to the implementation efforts in the prior year, related to our efforts to comply with the Sarbanes-Oxley Act of 2002, specifically Section 404. The decrease as a percentage of total net revenue from 13% to 10% for the quarters and from 12% to 9% for the six month periods was a result of our decreased costs as compared to the increase in our total net revenue.

Antitrust Litigation

Antitrust litigation expense of \$4.7 million and \$8.4 million for the quarter and six months ended June 30, 2005, respectively, and \$2.8 million and \$5.1 million for the quarter and six months ended June 30, 2004, respectively, consists of legal fees, personnel costs, communications, equipment, technology and other professional services incurred related to our antitrust case against Microsoft, as well as our participation in various international antitrust proceedings against Microsoft, including the European Union. Only costs that are directly attributable to these antitrust complaints are included.

Stock-Based Compensation

Stock-based compensation expense represents restricted stock and assumption of stock options in our acquisitions. Stock-based compensation was not significant for the quarter and \$0.1 million for the six months ended June 30, 2005 and \$0.2 million and \$0.5 million for the quarter and six months ended June 30, 2004, respectively.

Other Income (Expense), Net

	Quarters Ended June 30,			Six Months Ended June 30,		
	2005	2004	Change	2005	2004	Change
	(Dollars in thousands)			(Dollars in thousands)		
Interest income, net	\$2,579	800	222%	\$ 4,595	1,660	177%
Equity in net loss of MusicNet	(2)	(1,019)	(100)	(1,068)	(2,134)	50
Gain on sale of MusicNet	7,590	—	—	7,590	—	—
Other, net	(209)	10	(2,190)	(400)	100	(500)
Other income (expense), net	<u>\$9,958</u>	<u>(209)</u>	4,865%	<u>\$10,717</u>	<u>(374)</u>	2,966%

Other income (expense), net consists primarily of interest earnings on our cash, cash equivalents and short-term investments, which are net of interest expense due to the amortization of offering costs related to our convertible debt, equity in net loss of MusicNet, Inc. ("MusicNet") and impairment of certain equity investments. Other income (expense), net increased in the quarter and six months ended June 30, 2005 primarily due to: (1) a gain related to the sale of our preferred shares and convertible debt of MusicNet in April 2005 and a decrease in our equity in net loss of MusicNet; and (2) an increase in interest income due to rising effective interest rates on our investment balances.

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Our investment in MusicNet, a joint venture with several media companies to create a platform for online music subscription services, was accounted for under the equity method of accounting. As a result, we recorded in our statement of operations our equity share in MusicNet's net loss, which was not significant for the quarter ended June 30, 2005, was \$1.1 million for the six months ended June 30, 2005 and was \$1.0 million and \$2.1 million during the quarter and six months ended June 30, 2004, respectively. In 2003, MusicNet raised additional capital from its investors to fund its business. In connection with this fund raising, we contributed \$3.0 million of additional capital and received convertible notes that were convertible into additional shares of MusicNet capital stock. Based on the nature and terms of the convertible notes, for purposes of calculating our equity in net loss of MusicNet for the quarters and six months ended June 30, 2005 and 2004, the convertible notes were treated on an "as if" converted basis. As a result, the losses recorded by us for the periods in which we held an ownership interest in MusicNet during the quarters and six months ended June 30, 2005 and 2004 represent approximately 36.1% and 36.9%, respectively, of MusicNet's net loss. As of June 30, 2005, we no longer held an ownership interest in outstanding shares of capital stock of MusicNet due to the sale of MusicNet in April 2005, as described below. As of December 31, 2004, our ownership interest in outstanding shares of capital stock of MusicNet was approximately 24.9%.

On April 12, 2005, we disposed of all of our preferred shares and convertible notes in MusicNet to a private equity firm, Baker Capital, in connection with the sale of all of the capital stock of MusicNet. We received approximately \$7.2 million of cash proceeds in connection with the closing of the transaction and received an additional \$0.4 million in connection with the expiration of an escrow arrangement in July 2005. We also have the right to receive up to an additional \$2.3 million in cash upon the expiration of an indemnity escrow arrangement established as part of the transaction which expires on the one-year anniversary of the transaction date.

We have made minority equity investments for business and strategic purposes through the purchase of voting capital stock of several companies. 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. This evaluation consists of 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 and also consider the implied value from any recent rounds of financing completed by the investee. Based upon an evaluation of the facts and circumstances at June 30, 2005, the Company determined that there were no other-than-temporary declines in fair value for the quarter or six months then ended.

As of June 30, 2005, we owned marketable equity securities of J-Stream Inc., a Japanese digital media services company. We own approximately 13.2% of the outstanding shares. This investment is accounted for as an available-for-sale security. The market value of these shares has significantly increased from our original cost of approximately \$1.0 million, resulting in a carrying value of \$38.5 million and \$33.1 million at June 30, 2005 and December 31, 2004, respectively. The increase over our cost basis, net of tax effects is \$20.6 million and \$15.2 million at June 30, 2005 and December 31, 2004, respectively, and is reflected as a component of accumulated other comprehensive income. The market for J-Stream's shares is relatively limited and the share price is volatile. Accordingly, there can be no assurance that a gain of this magnitude can be realized through the disposition of these shares. In July 2005, we disposed of a portion of our investment in J-Stream, through open market trades, which resulted in net proceeds of approximately \$11.9 million for which we expect to recognize a gain, net of tax, of approximately \$8.4 million during the quarter ending September 30, 2005. The disposition reduced our ownership interest to approximately 10.6%.

Income Taxes

We recognized income tax expense of \$0.2 million and \$0.3 million for the quarter and six months ended June 30, 2005, respectively, and \$0.1 million and \$0.2 million for the quarter and six months ended June 30, 2004, respectively. We must assess the likelihood that our deferred tax assets will be recovered from future taxable income. In making this assessment, all available evidence must be considered including the current economic climate, our expectations of future taxable income and our ability to project such income and the appreciation of our investments and other assets. At June 30, 2005 and December 31, 2004, we recorded a valuation allowance that reduces our net deferred tax assets to zero.

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Impact of Recently Issued Accounting Standards

In December 2004, the FASB issued SFAS No. 123 (revised 2004), "Share-Based Payment" (SFAS 123R), which requires the measurement of all share-based payments to employees, including grants of employee stock options, using a fair-value-based method and the recording of such expense in an entity's statement of income. The accounting provisions of SFAS 123R are effective for annual reporting periods beginning after June 15, 2005. We are required to adopt the provisions of SFAS 123R in the quarter ending March 31, 2006. The pro forma disclosures previously permitted under SFAS 123 no longer will be an alternative to financial statement recognition. See "Stock-Based Compensation" (Note 1 (1)) for the pro forma net loss and net loss per share amounts, for the quarters and six months ended June 30, 2005 and 2004, as if we had applied the fair value recognition provisions of SFAS 123 to measure compensation expense for employee stock incentive awards. Although we have not yet determined whether the adoption of SFAS 123R will result in amounts that are similar to the current pro forma disclosures under SFAS 123, we are evaluating the requirements under SFAS 123R and expect the adoption to have a material impact on the consolidated statements of operations and comprehensive income (loss) and net income (loss) per share.

Liquidity and Capital Resources

Net cash provided by operating activities was \$10.8 million and \$1.3 million for the six months ended June 30, 2005 and 2004, respectively. Net cash provided by operating activities in 2005 was primarily the result of: (1) net income of \$5.5 million; (2) net changes in certain operating assets and liabilities of \$7.7 million, which includes a decrease in deferred revenue of \$3.2 million, due primarily to the timing of cash receipts or payments at the beginning and end of the period; (3) depreciation and amortization of \$7.7 million; (4) payments related to the accrued loss on excess office facilities of \$2.4 million; (5) payments related to the accrued loss on content agreement of \$1.5 million; and (6) equity in net losses of MusicNet of \$1.1 million. Net cash provided by operating activities in 2004 was the result of a net loss of \$15.1 million which was offset by net changes in: (1) certain assets and liabilities of \$6.1 million, due primarily to the timing of cash receipts or payments at the beginning and end of the period; (2) depreciation and amortization of \$7.0 million; (3) loss on content agreement of \$4.3 million; (4) payments related to the accrued loss on excess office facilities of \$3.7 million; and (5) equity in net losses of MusicNet of \$2.1 million.

Net cash provided by investing activities was \$10.6 million and \$0.7 million for the six months ended June 30, 2005 and 2004, respectively. Net cash provided by investing activities in 2005 was primarily due to net sales and maturities of short-term investments of \$24.3 million and proceeds from the sale of our equity investment in MusicNet of \$7.2 million, which were partially offset by cash payments related to the acquisition of Mr. Goodliving, net of cash acquired, of \$14.6 million and purchases of equipment and leasehold improvements of \$6.0 million. Net cash provided by investing activities in 2004 was primarily due to net sales and maturities of short-term investments of \$16.0 million which was offset by: (1) cash payments related to the acquisition of GameHouse, net of cash acquired, of \$10.5 million; and (2) purchases of equipment and leasehold improvements of \$4.7 million.

Net cash provided by financing activities was \$2.7 million and \$4.2 million for the six months ended June 30, 2005 and 2004, respectively. Net cash provided by financing activities in both periods was primarily related to proceeds from the exercise of stock options which was partially offset by a cash payment related to the repayment of a long-term note payable in connection with the acquisition of Mr. Goodliving.

In September 2001, we announced a share repurchase program. Our Board of Directors authorized the repurchase of up to an aggregate of \$50 million of our outstanding common stock. We repurchased approximately 9.1 million shares of our common shares at an average cost of \$4.64 per share for an aggregate value of \$42.4 million from the inception of the plan through June 30, 2005. There were no repurchases during the quarter or six months ended June 30, 2005 or during the year ended December 31, 2004. In August 2005, our Board of Directors approved a new share repurchase program which replaces the September 2001 plan. As of August 8, 2005, the Company repurchased approximately 0.2 million shares at an average cost of \$5.31 per share. Please refer to NOTE 11 – SUBSEQUENT EVENT for further discussion of the new share repurchase plan.

We currently have no planned significant capital expenditures for the remainder of 2005 other than those in the ordinary course of business. 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

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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.

In May 2005, we entered into a purchase agreement with a third party vendor to acquire certain products and services. We will be invoiced for the products and services at the time of receipt by the vendor. As of June 30, 2005, we had authorized the acquisition of approximately \$4.3 million in products and services under the provisions of the agreement. We expect these products and services to be received during the quarter ending September 30, 2005. In August 2005, the Company authorized the acquisition of an additional \$2.2 million in products and services. The Company expects these products and services to be received and to be invoiced for them during the quarter ending December 31, 2005. We may also from time to time make additional purchases of these products and services in the second half of 2005.

At June 30, 2005, we had approximately \$382.0 million in cash, cash equivalents, short-term investments and restricted cash equivalents. 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 twelve 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 would 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 in ten primary functional currencies: the United States dollar, the Japanese yen, the British pound, the Euro, the Mexican peso, the Brazilian real, the Australian dollar, the Hong Kong dollar, the Singapore dollar and the Korean won. Historically, neither fluctuations in foreign exchange rates nor changes in foreign economic conditions have had a significant impact on our financial condition or results of operations. 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 Japan, Germany, France, the United Kingdom and Australia, where we invoice our customers primarily in yen, euros (for Germany and France), pounds and Australian dollars, respectively. 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. Foreign exchange rate fluctuations did not have a material impact on our financial results in either of the quarters or six months ended June 30, 2005 and 2004.

Off-Balance Sheet Agreements

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.

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Factors That May Affect Our Business, Future Operating Results and Financial Condition

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.

Risks Related to Our Consumer Products and Services Business

Our online consumer businesses have grown substantially in recent periods and these businesses compete in rapidly evolving markets, which makes them difficult to evaluate.

Our Consumer Products and Services businesses, including our consumer subscription businesses, now represent approximately 85% of our total revenue. Despite the substantial impact of these consumer businesses on our financial results, we are competing in new and rapidly evolving markets and face substantial competitive threats. Our prospects must be considered in light of the risks, expenses and difficulties frequently encountered by businesses in new and fiercely competitive markets. Our Consumer Products and Services revenue and subscriber and user base have grown substantially in recent periods. If these businesses continue to grow it is unlikely that we will be able to sustain our recent growth levels and we currently anticipate that our rate of sequential revenue growth in the Consumer Products and Services segment may slow during the second half of 2005.

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

Costs of our online Consumer Products and Services as a percentage of the revenue generated by those businesses are higher than the ratio of costs to revenue in our historical software licensing business. The cost of third party content, in particular, is a substantial percentage of the net revenue we receive from subscribers and end-users and is unlikely to decrease significantly over time as a percentage of net revenue. Our Consumer Products and Services businesses now represent a substantial majority of our revenue and include our music subscriptions and sales, video subscription services and games subscription and licensing revenue. If our Consumer Products and Services revenue continues to grow as a percentage of our overall revenue, our margins may further decrease which may affect our ability to achieve or sustain profitability. In addition, we are increasingly acquiring music subscribers through wholesale relationships with broadband service providers and other distribution partners, such as our agreement with Comcast for the distribution of our radio products. Subscribers acquired through these types of distribution relationships tend to generate less revenue per subscriber than non-wholesale subscribers.

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

We must continue to obtain compelling digital media content for our video, music and games subscription services in order to maintain and increase subscriptions and subscription service revenue and overall customer satisfaction for these products. In some cases, we have had to pay substantial fees to obtain premium content. In particular, we have had to pay substantial fees to obtain premium video content even though we have limited experience determining what video content will be successful with current and prospective customers. In addition, certain of our content licensing agreements related to our SuperPass subscription service had high fixed costs associated with them, and we decided not to renew certain of these agreements in recent periods. If we cannot obtain premium digital content for any of our digital content subscription services on commercially reasonable terms, or at all, our business will be harmed.

Our subscription levels may vary due to seasonality.

Our subscription businesses are rapidly evolving and we are still determining the impact of seasonality on these businesses, including our music and games subscription businesses. In addition, some of the most popular premium content that we have offered in our premium video subscription services is seasonal or periodic in nature and we are experimenting with different types of content to determine what consumers prefer. We have limited experience with these types of offerings and cannot predict how the seasonal or periodic nature of these offerings will impact our subscriber growth rates for these products, future subscriber retention levels or our quarterly financial results.

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

If we do not continue to add new subscribers each quarter to our subscription services while minimizing the rate of loss of existing subscribers, our operating results will be adversely impacted. Internet subscription content businesses are a relatively new media delivery model and we cannot predict with accuracy our long-term ability to retain subscribers or add new subscribers. In order to attract subscribers, our customer sign-up process must be simple and logical and our software products must be reliable and provide a rich customer experience. 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 to competitive service offerings (including Internet piracy), or because customer service issues are not satisfactorily resolved. In addition, the costs of marketing and promotional activities necessary to add new subscribers and the costs of obtaining content that customers desire may adversely impact our margins and operating results. In recent periods, we have seen an increase in the number of gross customer cancellations attributable to our subscription services in part to our increasingly large subscriber base and to initial service transition issues that arose with the introduction of our new Rhapsody music products in the second quarter of 2005. We are also increasingly acquiring music subscribers through wholesale relationships with broadband service providers and other distribution partners, such as our agreement with Comcast for the distribution of our radio products. Subscribers acquired through these types of distribution relationships tend to generate less revenue per subscriber than non-wholesale subscribers.

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

Our online music service offerings depend on music licenses from the major music labels and publishers. The current license agreements are for relatively short terms and we cannot be sure that the music labels will renew the licenses on commercially viable terms, or at all. Due to the increasing importance of our music services to our overall revenue, the failure of any major music label or publisher to renew these licenses under terms that are acceptable to us will harm our ability to offer successful music subscription services and would harm our operating results.

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

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

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

Music. Our online music service offerings face significant competition from traditional offline music distribution competitors and from other online digital music services. Some of these competing services have spent substantial amounts on marketing and have received significant media attention, including Napster’s music subscription services, and Apple’s iTunes music download service, which it markets closely with its extremely popular iPod line of portable digital audio players. Microsoft has also begun offering premium music services in conjunction with its Windows Media Player and MSN services, and we also expect increasing competition from online retailers such as Amazon.com and WalMart.com and from Internet portals like Yahoo!, which recently introduced its Yahoo! Unlimited music subscription service at a discounted price from our comparable service. Our current music service offerings may not be able to compete effectively in this highly competitive market.

Our online music services also face significant competition from “free” peer-to-peer services, which allow consumers to directly access an expansive array of free content without securing licenses from content providers.

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Enforcement efforts against those in violation have not effectively shut down these services and there can be no assurance that these services will ever be shut down. The ongoing presence of these “free” services substantially impairs the marketability of legitimate services like ours.

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

Games. Our RealArcade service competes with other online distributors of downloadable PC games focused on the non-core, or casual, segment of the games market. Some of these distributors have high volume distribution channels and greater financial resources than us, including Yahoo! Games, MSN Gamezone, Pogo.com and Shockwave. We expect competition to intensify in this market from these and other competitors and no assurance can be made that we will be able to continue to grow our games distribution business or that we will be able to remain competitive in the downloadable games category in the future. We also own and operate GameHouse, a developer of downloadable PC games for the casual segment of the market and we recently acquired Mr. Goodliving, a developer and publisher of mobile games for mobile handsets. GameHouse competes with other developers of downloadable games in the casual segment of the market and Mr. Goodliving faces intense competition from a wide variety of mobile game developers and publishers, many of which are larger and devote substantially more resources to the mobile games business than we do.

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

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

Our consumer businesses depend upon effective digital rights management solutions.

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

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

Our Harmony Technology may not achieve consumer or market acceptance and may be subject to legal challenge.

We recently created a new digital rights management translation technology called Harmony. Our Harmony technology enables consumers to securely transfer purchased music to digital music devices, including certain versions of the market leading iPod line of digital music players made by Apple Computer, as well as certain devices that use Microsoft Windows Media DRM. Harmony is designed to enable consumers to transfer music purchased from our RealPlayer Music Store to a wide variety of portable music

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devices, rather than being restricted to a specific portable device. We do not know whether consumers will accept Harmony or whether it will lead to increased sales of any of our consumer products or services or increased usage of our media player products.

There are other risks associated with our Harmony technology, including the risk that Apple will continue to modify its technology to “break” the interoperability that Harmony provides to consumers, which Apple has done in connection with the release of certain new products. If Apple chooses to continue this course of action, Harmony may no longer work with Apple’s products, which could harm our business and reputation, or we may be forced to incur additional development costs to refine Harmony to make it interoperate again. Although we believe our Harmony technology is legal, there is no assurance that a court would agree with our position. If Apple decides to commence litigation against us in order to prevent interoperation with its products, we may be forced to spend money defending their legal challenge, which could harm our operating results.

The success of our music services depend, in part, on interoperability with our customer’s music playback hardware.

In order for our Rhapsody service and our RealPlayer Music Store to continue to be successful we must design our service to interoperate effectively with a variety of hardware products, including home stereos, car stereos, portable digital audio players and PCs. We depend on significant cooperation with manufacturers of these products and with software manufacturers that create the operating systems for such hardware devices to achieve our business and design objectives. To date, Apple has not agreed to design its popular iPod line of portable digital audio players to function with our music services and users of our music services must rely on our Harmony technology for interoperability with iPods. If we cannot successfully design our service to interoperate with the music playback devices that our customers own, either through relationships with manufacturers or through our Harmony technology, our business will be harmed.

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

In 2004, we acquired GameHouse, a developer of downloadable PC games and we recently acquired Mr. Goodliving, a developer and publisher of mobile games for mobile handsets. Game development is a new business for us, and we may not be able to successfully develop and market software games in the future. In addition, certain competitors of our RealArcade service also distribute and promote games developed by GameHouse. No assurance can be made that these distributors will continue to distribute and promote games in the same manner as a result of our acquisition of GameHouse.

Risks Related to Our Business Products and Services Business

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

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

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

There are a number of risks associated with our Helix Community initiative, including risks associated with market and industry acceptance, development processes and software licensing practices, and business models. The broader media technology and product industry may not adopt the Helix DNA Platform and/or the Helix Community as a development platform for media delivery and playback products and third parties may not enhance, develop or introduce technologies or products based on Helix DNA technology. While we have invested substantial resources in the development of the underlying technology within the Helix DNA technology and the Helix Community process itself, the market and industry may not accept them and we may not derive royalty or support revenue from them. The introduction of the Helix DNA Platform open source and community source licensing schemes may adversely affect sales of our commercial system software products to mobile operators, broadband providers, corporations, government agencies, educational institutions and other business and non-business organizations. In those areas where adoption of the Helix Community and Helix DNA occurs, our community and open source approach means that we no longer exercise sole control over many aspects of the development of the Helix DNA technology. In addition, we designed our commercial open source license to bear royalties when third parties sell products that include Helix DNA technology. To date, however, royalty revenue has not been significant.

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Sales of our commercial system products could be negatively affected by open source technologies.

Competitive technologies to our commercial system software products have been made available under open source license terms. The introduction of such technologies under broadly available open source software license terms may adversely affect sales of our commercial system software products to mobile operators, broadband providers, corporations, government agencies, educational institutions and other business organizations.

Risks Related to Our Business in General

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

We have incurred significant losses since our inception. As of June 30, 2005, we had an accumulated deficit of approximately \$297 million. We have had net losses for each year subsequent to the year ended December 31, 1999, and we may not generate sufficient revenue to be profitable on a quarterly or annual basis in the future. In addition, we devote significant resources to developing and enhancing our technology and to selling, marketing and obtaining content for our products and services. As a result, we will need to generate significant revenue to sustain profitability in the future.

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

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

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

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

In December 2003, we filed suit against Microsoft Corporation in the U.S. District Court for the Northern District of California, alleging that Microsoft violated U.S. and California antitrust laws. In our lawsuit, we allege that Microsoft has illegally used its monopoly power to restrict competition, limit consumer choice and attempt to monopolize the field of digital media. We expect that the litigation, if it is not resolved before trial, will carry on for several years. It is not possible to predict accurately how much the litigation will cost, or its duration. The costs of the litigation could have an adverse impact on our operating results in excess of our current expectations. The litigation may also distract our management team from operational matters, which could harm our business results. We may not prevail in our claims against Microsoft, in which case our costs of litigation will not be recovered. Even if we do prevail, the litigation may not be successful in causing Microsoft to alter its anticompetitive behavior. Furthermore, Microsoft's defense strategy may include the assertion of counterclaims against us, as well as leveraging its power in the commercial marketplace to adversely affect our current and potential business relationships, either of which may have an adverse affect on our business results.

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

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

- reduced prices, revenue and margins;
- increased expenses in responding to competitors;
- loss of current and potential customers, market share and market power;

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- lengthened sales cycles;
- degradation of our stature in the market and reputation;
- changes in our business and distribution and marketing strategies;
- changes to our products, services, technology, licenses and business practices, and other disruption of our operations;
- strained relationships with partners; and
- pressure to prematurely release products or product enhancements.

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

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

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

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

Any development delays or cost overruns may affect our operating results.

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

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

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

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

The success of our products and services depends upon our products' support for a variety of media formats and wireless data formats. Technical formats and consumer preferences may change over time, and we may be unable to adequately address consumer preferences or fulfill the market demand for new and evolving formats. We may not be able to license technologies, like codecs or

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digital rights management technology, that obtain widespread consumer and developer use, which would harm consumer and developer acceptance of our products and services. In addition, our codecs and formats may not continue to be in demand or as desirable as other third party codecs and formats, including codecs and formats created by Microsoft or industry standard formats created by MPEG.

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

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

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

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

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

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

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

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

- we could lose strategic relationships if our strategic partners are acquired by or enter into relationships with a competitor (which could cause us to lose access to distribution, content, technology and other resources);
- we could lose customers if competitors or users of competing technologies consolidate with our current or potential customers; and
- our current competitors could become stronger, or new competitors could form, from consolidations.

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

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

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

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

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

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

- difficulties and expenses in assimilating the operations, products, technology, information systems or personnel of the acquired company and difficulties in retaining key management or employees of the acquired company;
- diversion of management's attention from other business concerns and the potential disruption of our ongoing business;
- impairment of relationships with employees, affiliates, advertisers or content providers of our business or the acquired business;
- the assumption of known and unknown liabilities of the acquired company, including intellectual property claims; and
- entrance into markets in which we have no direct prior experience.

We acquired Listen in 2003 and the operations associated with Listen have remained in San Francisco. This is our first experience operating and integrating a substantial acquired business in a remote location. The geographic separation could increase the operational risks described above. We also acquired GameHouse in 2004 and Mr. Goodliving in 2005. The acquisition of GameHouse is our first attempt to operate and manage a content creation business and we may not be successful in operating this type of business. The operations of Mr. Goodliving are based in Helsinki, Finland. This represents our first attempt at acquiring, integrating and operating a business abroad and it will require substantial efforts to integrate and operate. In addition, the mobile games market represents a new business for us and is a highly competitive market with strong competitors, many of which devote substantially more resources to mobile games than we do. No assurance can be made that we will be able to successfully integrate or operate Mr. Goodliving or that we will be able to leverage Mr. Goodliving's assets and distribution network to compete successfully in the mobile games market.

Acquisition-related costs could cause significant fluctuation in our net income (loss).

Previous acquisitions have resulted in significant expenses, including amortization of purchased technology, charges for in-process research and development and amortization of acquired identifiable intangible assets, which are reflected in our operating expenses. New acquisitions and any potential future impairment of the value of purchased assets could have a significant negative impact on our future operating results.

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

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

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

Our products and services depend upon the means by which users access media content over the Internet and wireless networks. If popular technologies, transmission methods and protocols used for accessing digital media content change, and we do not timely and

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successfully adapt our products and services to these new technologies, transmission methods and protocols, our reputation could be damaged, use of our technologies and products would decrease, and our business and operating results would be harmed.

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

We operate subsidiaries in several foreign countries, and market and sell products in a number of countries. A significant portion of our revenue is derived from international operations. Our foreign operations involve risks inherent in doing business on an international level, including difficulties in managing operations due to distance, language and cultural differences, different or conflicting laws and regulations and exchange rate fluctuations. Any of these factors could harm our future international operations, and consequently our business, operating results and financial condition. Our foreign currency exchange risk management program reduces, but does not eliminate, the impact of currency exchange rate movements.

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

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

We may be unable to adequately protect our proprietary rights.

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

- Our applications for patents and trademarks relating to our business may not be granted and, if granted, may be challenged or invalidated;
- Issued patents and trademarks may not provide us with any competitive advantages;
- Our efforts to protect our intellectual property rights may not be effective in preventing misappropriation of our technology;
- Our efforts may not prevent the development and design by others of products or technologies similar to or competitive with, or superior to those we develop; or

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- Another party may obtain a blocking patent and we would need to either obtain a license or design around the patent in order to continue to offer the contested feature or service in our products.

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

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

From time to time we receive claims and inquiries from third parties alleging that our internally developed technology or technology we license from third parties may infringe the third parties' proprietary rights, especially patents. Third parties have also asserted and most likely will continue to assert claims against us alleging infringement of copyrights, trademark rights, trade secret rights or other proprietary rights, or alleging unfair competition or violations of privacy rights. We are now investigating a number of such pending claims, some of which are described in Part II of this report under the heading "Legal Proceedings." In addition, certain of these pending claims are moving closer to trial and we expect that our potential costs of defending these claims may increase as we move into the trial phase of the proceedings.

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

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

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

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

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

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

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

We periodically enter into arrangements to offer third-party products, services, content or advertising under our brands or via distribution on our websites or in our products or service offerings. We may be subject to claims concerning these products, services, content or advertising by virtue of our involvement in marketing, branding, broadcasting or providing access to them. Our agreements with these parties may not adequately protect us from these potential liabilities. It is also possible that, if any information provided directly by us contains errors or is otherwise negligently provided to users, third parties could make claims against us, including, for example, claims for intellectual property infringement. Investigating and defending any of these types of claims is expensive, even if

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the claims do not result in liability. If any of these claims results in liability, we could be required to pay damages or other penalties, which could harm our business and our operating results.

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

In December 2004, the FASB issued SFAS 123 (revised 2004), “Share-Based Payment” (SFAS 123R), which requires a company to recognize, as an expense, the fair value of stock options and other stock-based compensation beginning in the quarter ending September 30, 2005. In April 2005, the Securities and Exchange Commission issued “Amendment to Rule 4-01(a) of Regulation S-X Regarding the Compliance Date for Statement of Financial Accounting Standards No. 123 (Revised 2004), Share Based Payment”, which amends the compliance date with regard to SFAS 123R to annual periods beginning on or after June 15, 2005, which would result in our recognizing the related expense starting in the quarter ending March 31, 2006. We will be required to record an expense for our stock-based compensation plans using the fair value method as described in SFAS 123R, which will result in significant and ongoing accounting charges. Stock options are also a key part of the compensation packages that we offer our employees. If we are forced to curtail our broad-based option program due to these additional charges, it may become more difficult for us to attract and retain employees.

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

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

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

The Internet Tax Freedom Act, or ITFA, which Congress extended until November 2007, among other things, imposed a moratorium on discriminatory taxes on electronic commerce. The imposition by state and local governments of various taxes upon Internet commerce could create administrative burdens for us and could decrease our future sales.

We donate a portion of our net income to charity.

In periods where we achieve profitability, we intend to donate 5% of our pre-tax net income to charitable organizations, which will reduce our net income for those periods. The non-profit RealNetworks Foundation manages our charitable giving efforts.

Risks Related to the Securities Markets and Ownership of Our Common Stock

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

Our executive officers, directors and affiliated persons beneficially own more than one third of our common stock. Robert Glaser, our Chief Executive Officer and Chairman of the Board, beneficially owns the majority of that stock. As a result, our executive officers, directors and affiliated persons will have significant influence to:

- elect or defeat the election of our directors;
- amend or prevent amendment of our articles of incorporation or bylaws;
- effect or prevent a merger, sale of assets or other corporate transaction; and

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- control the outcome of any other matter submitted to the shareholders for vote.

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

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

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

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

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

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

Washington law imposes restrictions on some transactions between a corporation and certain significant shareholders. The foregoing provisions of our charter documents, shareholder rights plan, our agreement with Mr. Glaser, our zero coupon convertible subordinated notes 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.

If we fail to maintain an effective system of internal controls, we may not be able to accurately report our financial results or prevent or detect fraud. As a result, current and potential shareholders could lose confidence in our financial reporting, which would harm our business and the trading price of our stock.

Effective internal controls are necessary for us to provide reliable financial reports and effectively prevent or detect fraud. If we cannot provide reliable financial reports or prevent or detect fraud, investors may lose confidence in our financial reporting and the trading price of our stock could be harmed. In addition, we are in an on-going process of complying with requirements resulting from the Sarbanes-Oxley Act of 2002 ("SOX"), including those provisions of Section 404 of SOX that establish requirements for both management and auditors of public companies with respect to reporting on internal control over financial reporting. In 2004, we devoted significant financial and other resources to review and strengthen our internal controls in advance of complying with the Section 404 requirements and we expect to continue to devote resources in 2005 to maintain compliance. The requirements and processes associated with Section 404 are new and untested and we cannot be certain that the measures we have taken will be sufficient to meet the Section 404 requirements or that we will be able to implement and maintain adequate controls over our financial processes and reporting in the future. Moreover, we cannot be certain that the costs associated with such measures will not exceed our estimates, which could impact our overall level of profitability. Any failure to meet the Section 404 requirements or to implement required new or improved controls, or difficulties or unanticipated costs encountered in their implementation, could cause investors to lose confidence in our reported financial information or could harm our financial results, which could have a negative effect on the trading price of our stock.

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

The trading price of our common stock has been and is likely to continue to be highly volatile. For example, during the 52-week period ended June 30, 2005, the price of our common stock ranged from \$7.40 to \$4.31 per share. Our stock price could be subject to wide fluctuations in response to factors such as actual or anticipated variations in quarterly operating results or changes in financial estimates or recommendations by securities analysts, as well as any of the other risk factors described above.

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

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

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

Special Note Regarding Forward-Looking Statements

We have made forward-looking statements in this document, all of which are subject to risks and uncertainties. When we use words such as “may”, “anticipate,” “expect,” “intend,” “plan,” “believe,” “seek” and “estimate” or similar words, we are making forward-looking statements. Forward-looking statements include information concerning our possible or assumed future business success or financial results. Such forward-looking statements include, but are not limited to, statements as to our expectations regarding:

- the future development and growth of, and opportunities for, premium digital audio and video content online and our music and games subscription services;
- anticipated effects of the increased adoption of broadband on consumers use and purchase of digital media over the Internet;
- competition from existing and new competitors in each of our markets, and our ability to compete with such competitors;
- anticipated future competitive activities of Apple and Microsoft, and the anticipated results of those activities;
- our total revenue growth for 2005, including the slowing of sequential revenue growth in the second half of 2005;
- slowing growth of our premium music subscription service revenue in the second half of 2005;
- the impact of antitrust litigation expenses on our operating results;
- anticipated fluctuation in our online content subscriber base and revenue;
- anticipated fluctuations in our revenue and cost of service revenue;
- anticipated future levels in our sales and marketing expenses;
- anticipated effects of potential content acquisition transactions;
- the impact of our acquisition of Mr. Goodliving on our ability to enter the mobile games market;

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- our future activities under our stock repurchase program;
- future capital needs and capital expenditures;
- the future impact of a sudden change in market interest rates on our operating results and cash flows;
- the impact and duration of current litigation in which we are involved, including our suit with Microsoft for alleged antitrust violations;
- the impact of SFAS 123R on our consolidated statements of operations;
- the likelihood of, and the likely effect and costs of, potential future litigation involving us;
- anticipated consolidation and strategic partnering activities in our markets; and
- potential future charges relating to excess facilities, impairment of assets and reduction in value of investments.

You should note that an investment in our common stock involves certain risks and uncertainties that could affect our future business success or financial results. Our actual results could differ materially from those anticipated in these forward-looking statements as a result of certain factors, including those set forth in “Factors That May Affect Our Business, Future Operating Results and Financial Condition” and elsewhere in our Quarterly Report on Form 10-Q.

We believe that it is important to communicate our expectations to our investors. However, there may be events in the future that we are not able to predict accurately or over which we have no control. Before you invest in our common stock, you should be aware that the occurrence of the events described in the “Factors That May Affect Our Business, Future Operating Results and Financial Condition” and elsewhere in our Quarterly Report on Form 10-Q could materially and adversely affect our business, financial condition and operating results. We undertake no obligation to publicly update any forward-looking statements for any reason, even if new information becomes available or other events occur in the future.

Item 3. Quantitative and Qualitative Disclosures About Market Risk

The following discussion about our market risk involves forward-looking statements. Actual results could differ materially from those projected in the 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 securities as specified in our investment policy guidelines. 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 falling 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 and the substantial majority of our short-term investments mature within one year of purchase, we would not expect our operating results or cash flows to be significantly impacted by a sudden change in market interest rates. There has been no material change in our investment methodology regarding our cash equivalents and short-term investments in 2005, and as such, the descriptions under the captions “Interest Rate Risk” remain unchanged from those included in our Annual Report on Form 10-K for the year ended December 31, 2004.

Investment Risk. As of June 30, 2005, we had investments in voting capital stock of both publicly- and privately-held technology companies for business and strategic purposes. Some of these securities do not have a quoted market price. Our investments in publicly-traded companies are 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. This evaluation consists of a review of qualitative and quantitative factors. Equity price fluctuations of plus or minus 10% of prices at June 30, 2005 would have had an impact of approximately \$3.9 million on the value of our investments in publicly-traded companies at June 30, 2005, related primarily to our investment in J-Stream, a publicly-traded Japanese company.

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Foreign Currency Risk. International revenue accounted for approximately 24% of total net revenue for the six months ended June 30, 2005. Our international subsidiaries incur most of their expenses in their respective local currencies. Accordingly, all foreign subsidiaries use their local currency as their functional currency.

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 re-measurement 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.

We manage a portion of these risks 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 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.

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

Historically, neither fluctuations in foreign exchange rates nor changes in foreign economic conditions have had a significant impact on our financial condition or results of operations. Foreign exchange rate fluctuations did not have a material impact on our financial results for the quarters or six months ended June 30, 2005 and 2004.

Item 4. Controls and Procedures

(a) *Evaluation of Disclosure Controls and Procedures.* Based on their evaluation as of the end of the period covered by this report, the Company's principal executive officer and principal financial officer have concluded that the Company's disclosure controls and procedures (as defined in Rules 13a-15(e) and 15d-15(e) under the Securities Exchange Act of 1934 (the "Exchange Act")) were sufficiently effective to ensure that information required to be disclosed by the Company in reports that it files or submits under the Exchange Act is (1) 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 the Company's Management, including its 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 the Company's internal control over financial reporting (as such term is defined in Rule 13a-15(f) and 15d-15(f) under the Securities Exchange Act) during the fiscal quarter ended June 30, 2005 that have materially affected, or are reasonably likely to materially affect, the Company's internal control over financial reporting.

PART II. OTHER INFORMATION

Item 1. Legal Proceedings

In December 2003, the Company filed suit against Microsoft Corporation in the U.S. District Court for the Northern District of California, pursuant to U.S. and California antitrust laws. The Company alleged that Microsoft has illegally used its monopoly power to restrict competition, limit consumer choice and attempt to monopolize the field of digital media. Microsoft has filed an answer denying the claims and raising a variety of defenses. The Company believes it has a strong case and intends to vigorously pursue the litigation. If successful, the Company may be entitled to receive both monetary and injunctive relief from Microsoft. The Company expects that the litigation will carry on for several years before it can be resolved through trial.

In June 2003, a lawsuit was filed against the Company and Listen in federal district court for the Northern District of Illinois by Friskit, Inc. (Friskit), alleging that certain features of the Company's and Listen's products and services willfully infringe certain

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patents relating to allowing users “to search for streaming media files, to create custom playlists, and to listen to the streaming media file sequentially and continuously.” Friskit seeks to enjoin the Company from the alleged infringing activity and to recover treble damages from the alleged infringement. The Company has filed its answer and a counterclaim against Friskit challenging the validity of the patents at issue. The trial court has also granted the Company’s motion to transfer the action to the Northern District of California. The Company disputes Friskit’s allegations in this action and intends to vigorously defend itself.

In March 2003, William Cirignani filed a putative consumer class action against the Company in Washington state court, alleging causes of action based on the Washington Consumer Protection Act and unjust enrichment. The plaintiff alleges that consumers who attempted to download or purchase certain of the Company’s products and services were fraudulently and deceptively enrolled in, and prevented from canceling, the Company’s subscription services. The plaintiff seeks compensatory damages, equitable relief in the form of an order prohibiting the alleged false and deceptive practices, treble damages and other relief. The parties reached a confidential settlement in June 2005 and the case was dismissed with prejudice. The settlement did not have a material effect on our financial position or results of operations.

In July 2002, a lawsuit was filed against the Company in federal court in Boston, Massachusetts by Ethos Technologies, Inc. (Ethos), alleging that the Company willfully infringes certain patents relating to “the downloading of data from a server computer to a client computer.” Ethos seeks to enjoin the Company from the alleged infringing activity and to recover treble damages from the alleged infringement. The Company has filed counterclaims against Ethos seeking a declaratory judgment that the patents at issue are invalid and unenforceable due to Ethos’ inequitable conduct, as well as its recovery of damages for Ethos’ infringement of a Company patent, and reasonable attorneys fees and costs. The Company disputes Ethos’ allegations in this action and intends to vigorously defend itself.

From time to time the Company is, and expects to continue to be, subject to legal proceedings and claims in the ordinary course of its 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 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 third party claims and certain pending claims are moving closer to trial. The Company expects that its potential costs of defending these claims may increase as the disputes move into the trial phase of the proceedings. 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 financial position and results of operations.

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

(a) Between April 1, 2005 and June 30, 2005, the Company has issued and sold unregistered securities as follows:

- (1) On June 30, 2005, the Company issued an aggregate of 3,173 shares of Common Stock to three non-employee directors as compensation for board service during the second quarter of 2005 pursuant to the RealNetworks, Inc. Director Compensation Stock Plan. The aggregate value of the shares was approximately \$15,735. The shares were issued in reliance on Section 4(2) under the Securities Act of 1933, as amended, on the basis that the transactions did not involve a public offering.

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

An Annual Meeting of Shareholders of RealNetworks, Inc. (the "Annual Meeting") was held on June 9, 2005. The matters voted on at the Annual Meeting and votes cast on such matters were as follows:

The election of two Class 2 directors to serve until the 2008 Annual Meeting of Shareholders, or until such directors' earlier retirement, resignation or removal, or the election of their successors.

<u>Directors Elected</u>	<u>For</u>	<u>Withheld</u>
James W. Breyer	153,041,246	6,756,076
Jonathan D. Klein	157,179,327	2,617,995

The terms of the following directors continued after the Annual Meeting:

Eric Benhamou
Edward Bleier
Robert Glaser
Jeremy Jaech
Kalpana Raina

The approval of the RealNetworks, Inc. 2005 Stock Incentive Plan.

<u>For</u>	<u>Against</u>	<u>Abstain</u>	<u>Broker Non-votes</u>
104,446,226	21,355,780	551,485	33,443,831

Item 6. Exhibits

Exhibits Required by Item 601 of Regulation S-K:

<u>Exhibit Number</u>	<u>Description</u>
31.1	Certification of Robert Glaser, Chairman and 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 Roy B. Goodman, 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 Robert Glaser, Chairman and 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
32.2	Certification of Roy B. Goodman, Senior Vice President, Chief Financial Officer and Treasurer 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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SIGNATURES

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 August 5, 2005.

REALNETWORKS, INC.

By: /s/ Roy B. Goodman

Roy B. Goodman

Title: Senior Vice President, Chief Financial
Officer and Treasurer

(Principal Financial and Accounting Officer)

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INDEX TO EXHIBITS

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32.2	Certification of Roy B. Goodman, Senior Vice President, Chief Financial Officer and Treasurer of RealNetworks, Inc., Pursuant to 18 U.S.C. Section 1350, as Adopted Pursuant to Section 906 of the Sarbanes-Oxley Act of 2002

CERTIFICATION PURSUANT TO
SECTION 302 OF THE SARBANES-OXLEY ACT OF 2002

I, Robert Glaser, certify that:

1. I have reviewed this quarterly report on Form 10-Q of RealNetworks, Inc.;
2. Based on my knowledge, this report does not contain any untrue statement of a material fact or omit to state a material fact necessary to make the statements made, in light of the circumstances under which such statements were made, not misleading with respect to the period covered by this report;
3. Based on my knowledge, the financial statements, and other financial information included in this report, fairly present in all material respects the financial condition, results of operations and cash flows of the registrant as of, and for, the periods presented in this report;
4. The registrant's other certifying officer and I are responsible for establishing and maintaining disclosure controls and procedures (as defined in Exchange Act Rules 13a-15(e) and 15d-15(e)) and internal control over financial reporting (as defined in Exchange Act Rules 13a-15(f) and 15d-15(f)) for the registrant and have:
 - a) designed such disclosure controls and procedures, or caused such disclosure controls and procedures to be designed under our supervision, to ensure that material information relating to the registrant, including its consolidated subsidiaries, is made known to us by others within those entities, particularly during the period in which this report is being prepared;
 - b) designed such internal control over financial reporting, or caused such internal control over financial reporting to be designed under our supervision, to provide reasonable assurance regarding the reliability of financial reporting and the preparation of financial statements for external purposes in accordance with generally accepted accounting principles;
 - c) evaluated the effectiveness of the registrant's disclosure controls and procedures and presented in this report our conclusions about the effectiveness of the disclosure controls and procedures, as of the end of the period covered by this report based on such evaluation; and
 - d) disclosed in this report any change in the registrant's internal control over financial reporting that occurred during the registrant's most recent fiscal quarter (the registrant's fourth fiscal quarter in the case of an annual report) that has materially affected, or is reasonably likely to materially affect, the registrant's internal control over financial reporting; and
5. The registrant's other certifying officer and I have disclosed, based on our most recent evaluation of internal control over financial reporting, to the registrant's auditors and the audit committee of the registrant's board of directors (or persons performing the equivalent functions):
 - a) all significant deficiencies and material weaknesses in the design or operation of internal control over financial reporting which are reasonably likely to adversely affect the registrant's ability to record, process, summarize and report financial information; and
 - b) any fraud, whether or not material, that involves management or other employees who have a significant role in the registrant's internal control over financial reporting.

Date: August 5, 2005

/s/ Robert Glaser

 Robert Glaser
 Title: Chairman and Chief Executive Officer
 (Principal Executive Officer)

CERTIFICATION PURSUANT TO
SECTION 302 OF THE SARBANES-OXLEY ACT OF 2002

I, Roy B. Goodman, certify that:

1. I have reviewed this quarterly report on Form 10-Q of RealNetworks, Inc.;
2. Based on my knowledge, this report does not contain any untrue statement of a material fact or omit to state a material fact necessary to make the statements made, in light of the circumstances under which such statements were made, not misleading with respect to the period covered by this report;
3. Based on my knowledge, the financial statements, and other financial information included in this report, fairly present in all material respects the financial condition, results of operations and cash flows of the registrant as of, and for, the periods presented in this report;
4. The registrant's other certifying officer and I are responsible for establishing and maintaining disclosure controls and procedures (as defined in Exchange Act Rules 13a-15(e) and 15d-15(e)) and internal control over financial reporting (as defined in Exchange Act Rules 13a-15(f) and 15d-15(f)) for the registrant and have:
 - a) designed such disclosure controls and procedures, or caused such disclosure controls and procedures to be designed under our supervision, to ensure that material information relating to the registrant, including its consolidated subsidiaries, is made known to us by others within those entities, particularly during the period in which this report is being prepared;
 - b) designed such internal control over financial reporting, or caused such internal control over financial reporting to be designed under our supervision, to provide reasonable assurance regarding the reliability of financial reporting and the preparation of financial statements for external purposes in accordance with generally accepted accounting principles;
 - c) evaluated the effectiveness of the registrant's disclosure controls and procedures and presented in this report our conclusions about the effectiveness of the disclosure controls and procedures, as of the end of the period covered by this report based on such evaluation; and
 - d) disclosed in this report any change in the registrant's internal control over financial reporting that occurred during the registrant's most recent fiscal quarter (the registrant's fourth fiscal quarter in the case of an annual report) that has materially affected, or is reasonably likely to materially affect, the registrant's internal control over financial reporting; and
5. The registrant's other certifying officer and I have disclosed, based on our most recent evaluation of internal control over financial reporting, to the registrant's auditors and the audit committee of the registrant's board of directors (or persons performing the equivalent functions):
 - a) all significant deficiencies and material weaknesses in the design or operation of internal control over financial reporting which are reasonably likely to adversely affect the registrant's ability to record, process, summarize and report financial information; and
 - b) any fraud, whether or not material, that involves management or other employees who have a significant role in the registrant's internal control over financial reporting.

Date: August 5, 2005

/s/ Roy B. Goodman

 Roy B. Goodman
 Title: Senior Vice President, Chief
 Financial Officer and Treasurer
 (Principal Financial and Accounting
 Officer)

CERTIFICATION PURSUANT TO
SECTION 906 OF THE SARBANES-OXLEY ACT OF 2002
(18 U.S.C. SECTION 1350)

I, Robert Glaser, Chairman and Chief Executive Officer of RealNetworks, Inc., certify, pursuant to 18 U.S.C. Section 1350, as adopted pursuant to Section 906 of the Sarbanes-Oxley Act of 2002, that the Quarterly Report of RealNetworks, Inc. on Form 10-Q for the fiscal quarter ended June 30, 2005 fully complies with the requirements of Section 13(a) or 15(d) of the Securities Exchange Act of 1934 and that information contained in such Quarterly Report on Form 10-Q fairly presents in all material respects the financial condition and results of operations of RealNetworks, Inc.

Date: August 5, 2005

By: /s/ Robert Glaser

Name: Robert Glaser
Title: Chairman and Chief Executive Officer
(Principal Executive Officer)

A signed original of this written statement required by Section 906 has been provided to RealNetworks, Inc. and will be retained by RealNetworks, Inc. and furnished to the Securities and Exchange Commission or its staff upon request.

CERTIFICATION PURSUANT TO
SECTION 906 OF THE SARBANES-OXLEY ACT OF 2002
(18 U.S.C. SECTION 1350)

I, Roy B. Goodman, Senior Vice President, Chief Financial Officer and Treasurer of RealNetworks, Inc., certify, pursuant to 18 U.S.C. Section 1350, as adopted pursuant to Section 906 of the Sarbanes-Oxley Act of 2002, that the Quarterly Report of RealNetworks, Inc. on Form 10-Q for the fiscal quarter ended June 30, 2005 fully complies with the requirements of Section 13(a) or 15(d) of the Securities Exchange Act of 1934 and that information contained in such Quarterly Report on Form 10-Q fairly presents in all material respects the financial condition and results of operations of RealNetworks, Inc.

Date: August 5, 2005

By: /s/ Roy B. Goodman

Name: Roy B. Goodman
Title: Senior Vice President,
Chief Financial Officer and Treasurer
(Principal Financial and Accounting
Officer)

A signed original of this written statement required by Section 906 has been provided to RealNetworks, Inc. and will be retained by RealNetworks, Inc. and furnished to the Securities and Exchange Commission or its staff upon request.

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