

EXHIBIT Y

PART 1

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

Form 10-K

(Mark One)

- ANNUAL REPORT PURSUANT TO SECTION 13 OR 15(d) OF THE SECURITIES EXCHANGE ACT OF 1934
For the Fiscal Year Ended December 31, 2008
OR
TRANSITION REPORT PURSUANT TO SECTION 13 OR 15(d) OF THE SECURITIES EXCHANGE ACT OF 1934
For the transition period from to

Commission file number 0-23137

RealNetworks, Inc.

(Exact name of registrant as specified in its charter)

Washington
(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)

Registrant's telephone number, including area code:
(206) 674-2700

Securities registered pursuant to Section 12(b) of the Act:

Table with 2 columns: Title of Each Class, Name of Each Exchange on Which Registered. Rows include Common Stock and Preferred Share Purchase Rights.

Securities registered pursuant to Section 12(g) of the Act:

None
(Title of Class)

Indicate by check mark if the registrant is a well-known seasoned issuer, as defined in Rule 405 of the Securities Act. Yes [X] No []

Indicate by check mark if the registrant is not required to file reports pursuant to Section 13 or Section 15(d) of the Act Yes [] No [X]

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

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

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

Large accelerated filer [X] Accelerated filer [] Non-accelerated filer [] Smaller reporting company []
(Do not check if a smaller reporting company)

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

The aggregate market value of the Common Stock held by non-affiliates of the registrant was \$602,368,054 on June 30, 2008, based on the closing price of the Common Stock on that date, as reported on the Nasdaq Global Select Market.(1)

The number of shares of the registrant's Common Stock outstanding as of January 31, 2009 was 134,358,494.

DOCUMENTS INCORPORATED BY REFERENCE

Portions of the registrant's Proxy Statement relating to the registrant's 2009 Annual Meeting of Shareholders to be held on or about June 9, 2009 are incorporated by reference into Part III of this Report.

- (1) Excludes shares held of record on that date by directors, executive officers and 10% shareholders of the registrant. Exclusion of such shares should not be construed to indicate that any such person directly or indirectly possesses the power to direct or cause the direction of the management of the policies of the registrant.
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PART I.

This Annual Report on Form 10-K and the documents incorporated herein by reference contain forward-looking statements that have been made pursuant to the provisions of the Private Securities Litigation Reform Act of 1995. These forward-looking statements are based on current expectations, estimates, and projections about RealNetworks' industry, products, management's beliefs, and certain assumptions made by management. Words such as "anticipates," "expects," "intends," "plans," "believes," "seeks," "estimates," and similar expressions are intended to identify forward-looking statements. All statements contained in this annual report on Form 10-K that do not relate to matters of historical fact should be considered forward-looking statements. Forward-looking statements include statements with respect to:

- future revenues, income taxes, tax benefits, net income per diluted share, acquisition costs and related amortization, and other measures of results of operations;*
- the effects of our acquisitions, including WiderThan, Sony NetServices GmbH, Exomi Oy and Trymedia, and our position as a technology services provider for leading wireless carriers;*
- plans, strategies and expected opportunities for growth, increased profitability and innovation in 2009 and future years;*
- the creation of new strategic partnerships and broadening of existing strategic partnerships and the advantages and growth we will achieve as a result of such partnerships (including in connection with our Games, Music and Technology Products and Solutions businesses);*
- the expected growth and profitability of our Technology Products and Solutions business;*
- the performance, governance, management, accounting and integration of our Rhapsody America venture;*
- the dilutive impact on our shareholders if the call or put rights contained in the limited liability agreement for Rhapsody America are exercised and result in the issuance of additional shares of our common stock;*
- the financial performance and growth of our Games business, including future international growth;*
- our intention to separate our Games business, distribute shares of the newly created games company to its shareholders, and the potential sale of up to 20% of the shares of the new games company in an initial public offering;*
- the migration of our Media Software and Services businesses from general purpose subscription businesses toward premium services and free-to-consumer services, the popularity of the RealPlayer and our expected introduction of new products and innovations in our Media Software and Services business;*
- our ability to grow our Music business, including opportunities for us to become the platform of choice for the consumer electronics industry, the integration of our Rhapsody DNA into the digital devices of an expanding list of partners and our plans to introduce additional innovations;*
- the effect of future interoperability on our Music business, the significance of growth opportunities in the digital music market and our expectations for short-term progress and long-term success in our Music business;*
- the effects of legislation, regulations, administrative proceedings, court rulings, settlement negotiations and other factors that may impact music publishing royalty rates;*
- the potential outcomes and effects of claims and legal proceedings on our business, prospects, financial condition or results of operations;*
- our financial position and the availability of resources;*
- our expectations regarding acquisition activity in 2009 and our focus on the integration of completed acquisitions;*

- *our relationships with our employees;*
- *the effects of U.S. and foreign income taxes on our business, prospects, financial condition or results of operations;*
- *the impairment of our assets and anticipated effects on our customers, business, prospects, financial condition or results of operations;*
- *the effect of economic and market conditions on our business, prospects, financial condition or results of operations;*
- *the effect of Microsoft's obligations under the settlement agreement and commercial agreements between us and Microsoft on our business, prospects, financial condition or results of operations;*
- *the effect of volatility in foreign exchange rates on our business, prospects, financial condition or results of operations;*
- *the effect of accounting standards on our business, prospects, financial condition or results of operations;*
- *future competition; and*
- *the degree of seasonality in our revenue.*

These statements are not guarantees of future performance and actual actions or results may differ materially. These statements are subject to certain risks, uncertainties and assumptions that are difficult to predict, including those noted in the documents incorporated herein by reference. Particular attention should also be paid to the cautionary language included or referred to in the section of Item 1 entitled "Competition," in Item 1A entitled "Risk Factors" and in Item 3 entitled "Legal Proceedings." RealNetworks undertakes no obligation to update publicly any forward-looking statements as a result of new information, future events or otherwise, unless required by law. Readers should, however, carefully review the risk factors included in other reports or documents filed by RealNetworks from time to time with the Securities and Exchange Commission, particularly the Quarterly Reports on Form 10-Q and any Current Reports on Form 8-K.

Item 1. Business

Overview

RealNetworks, Inc. enables consumers to enjoy digital entertainment whenever and wherever they want. We pioneered the development of technology for the broadcast of digital media over the Internet and have sustained a long heritage and a continued focus in creating and delivering digital media content such as music, games and video to consumers around the world.

We sell digital entertainment services to consumers for use with a variety of platforms such as PCs, portable music players, mobile phones, home entertainment systems and other consumer electronic devices. We are a market leader in providing pioneering products and services, including: RealPlayer[®], the first mainstream media player to enable one-click downloading and recording of Internet video; the award-winning Rhapsody[®] digital music service, which delivers more than one billion song plays per year; RealArcade[®], one of the largest casual games services on the Internet; and a variety of mobile entertainment services, such as ringback tones, music-on-demand and video-on-demand, offered to consumers through leading mobile operators around the world. We also developed and provide a suite of software and services for Internet media delivery for business customers, including our Helix servers and the Helix product portfolio. We manage our business and report segment revenue and profit (loss) based on three segments: Music, Consumer, which includes our Games and Media Software and Services businesses, and Technology Products and Solutions.

Our strategy is to continue to (1) develop technology that provides meaningful differentiation to our chosen markets in digital entertainment services, (2) build a direct relationship with, and grow, our worldwide user base and use feedback from our customers to rapidly innovate and improve our products and (3) create strong business partnerships with device makers, media companies, service providers and other distribution

channels and leverage those partnerships to drive scale and profitability. We intend to continue to expand our products and services beyond the PC to mobile devices and to create compelling digital media experiences on a variety of entertainment devices.

We also intend to use our strong cash position to continue to seek acquisition opportunities to further our strategic initiatives, to make selective internal investments in new products or technologies and to enhance our competitive position. In recent years, we have focused our acquisition efforts principally on the identification and acquisition of targets (1) with technologies and products complementary to ours in order to accelerate and supplement our research and development efforts, (2) to increase the distribution of our products and services into new geographies, (3) to gain significant new customers and (4) with existing or a reasonably expected ability to achieve profitability. For example, our Technology Products and Solutions business acquired WiderThan Co. Ltd. (WiderThan) in 2006 to obtain a new set of products and technologies including ringback tone and businesses for mobile carriers. The WiderThan acquisition also expanded our geographic reach into South Korea and brought us a new relationship with SK Telecom, a leading mobile carrier in South Korea. Subsequent to our acquisition of WiderThan, we acquired Sony NetServices in 2007 to expand our presence in Europe for our ringback tone and music-on-demand products and to enhance our strategic relationship with many of the larger Vodafone operating companies. Similarly, in our Games business, we acquired Zylom in 2006 to expand our presence in Europe and Trymedia in 2008 to expand the distribution of our casual games to a wide variety of new customers through Trymedia's existing syndication business.

In May 2008, we announced our intent to separate our casual Games business into an independent company and to distribute shares of the newly created games company to our shareholders. We also announced that we may precede the spin-off with an initial public offering and sale of up to 20% of the shares of the new games company. In February 2009, we announced that we postponed work with our outside advisors, stopped external spending on the proposed transaction and wrote off the capitalized transaction-related costs in the fourth quarter of 2008. While we still intend to create a separate games company, current conditions do not support a separation transaction.

We were incorporated in 1994 in the State of Washington. Our common stock is listed on the Nasdaq Global Select Market under the symbol "RNWK."

Music

We own and manage a comprehensive set of digital music products and services designed to provide consumers with broad access to digital music. Our goal is to enable consumers to access digital music content anytime, anywhere and from a variety of devices. Our primary music service is Rhapsody, a subscription and advertising-supported music service offering conditional downloads and on demand streaming services through unlimited access to a catalog of millions of music tracks. The Rhapsody service provided in the United States is now operated through our Rhapsody America joint venture with MTV Networks, a division of Viacom International Inc. (MTVN). Rhapsody America, formed in August 2007, also operates Rhapsody.com, a free Web-based version of our digital music service, and the Rhapsody MP3 music store, which enables consumers to purchase and permanently download individual digital music tracks. Our other music services include RadioPass, an Internet radio subscription service, and RealMusic, an offering to consumers outside the U.S. that includes Internet radio and other music content. We generate revenue in the U.S. and internationally primarily through subscriptions to our music services, purchases of tracks and advertising.

Subscription Revenue. The Rhapsody service and jukebox software operated by Rhapsody America is the centerpiece of our music offerings in the U.S. Rhapsody allows consumers to manage their entire digital music collection in one application, and subscribers to our Rhapsody Unlimited service receive legal, unlimited, streaming access to over seven million music tracks for a monthly fee. Rhapsody Unlimited enables subscribers to stream or conditionally download songs "on-demand" to their PC or to other devices, features significant editorial content and provides user-friendly ways for subscribers to explore, organize, listen to and share music. Rhapsody Unlimited subscribers can build and share playlists, create customized radio stations, and customize their own homepage within Rhapsody to receive recommendations, new release information and other content specific to their music tastes and listening history. Rhapsody Unlimited subscribers can use the

Rhapsody jukebox software to download an unlimited number of songs to their computer to listen to offline as long as they remain subscribers. Rhapsody To Go, a premium service also operated by Rhapsody America, provides subscribers all of the benefits of Rhapsody Unlimited in addition to the ability to transfer their music to portable devices. Rhapsody DNA is the proprietary software developed by us that enables the Rhapsody To Go service on a number of third party MP3 players and other digital music products.

In 2008, we expanded the distribution of our Rhapsody subscription music service into the mobile carrier market through an agreement with Verizon Wireless. Rhapsody America exclusively provides the music service offered to Verizon customers as V CAST Music with Rhapsody, which gives customers unlimited access to music on V CAST enabled mobile handsets that support subscriptions.

Advertising Revenue. Rhapsody America also offers a free version of Rhapsody over the Internet called Rhapsody.com that is monetized through advertising related revenue. Rhapsody.com enables consumers in the U.S. to listen to up to 25 songs per month for free utilizing their web browser. This service is offered primarily as a marketing program for the premium version of Rhapsody.

Revenue from Other Music Products and Services. In 2008, Rhapsody America launched a new MP3 music store, which allows consumers to purchase tracks and albums from Rhapsody America and its partners that are free of the digital rights management (DRM) software that limits how and where people can play their music. The MP3 music store offers a catalog of more than seven million tracks from all of the major and many independent music labels and enables customers to purchase individual digital music tracks without subscribing to one of our music subscription services. Rhapsody America also powers the music websites operated by MTVN and Yahoo!, Inc. (Yahoo!), enabling visitors to websites such as MTV.com, VHI.com, and CMT.com to seamlessly play and purchase DRM-free music from Rhapsody America's catalog. Rhapsody America also manages the Rollingstone.com website pursuant to a licensing agreement.

International Revenue. We offer international consumers a subscription-based Internet radio product called RadioPass. RadioPass subscribers gain access to more than 90 pre-programmed, ad-free, high fidelity digital music radio stations in addition to simulcasts of more than 3,000 worldwide broadcast stations for a monthly subscription fee. We also operate Rhapsody Radio, a version of our Internet radio service for distribution to customers via the PC and through certain wireless phone carriers. We have agreements with broadband service providers to provide our radio services on a wholesale basis in order to expose their customers to our online music services. We also generate revenue from selling display and other advertising through the music services we offer to international consumers.

Consumer

Games

We own and operate a comprehensive digital games service that includes a broad range of downloadable and online games products and subscription services focused primarily on casual games for PC and other platforms. Casual games are typically designed to have simple graphics, rules and controls and to be easily downloaded, quick-to-learn and fun to play. Casual games include board, card, puzzle, word and hidden-object games. In addition, casual games typically can be easily adopted for most interactive devices including mobile phones.

Our Games business is actively involved in game development, publishing, licensing, and distribution. We have a diverse portfolio of games created from original games developed by our GameHouse and Mr. Goodliving game studios, games developed by us from content we license from affiliated studios and other intellectual property holders located around the world, and games licensed to us by third parties that we distribute to our customers. We provide game publishing services to certain game developers that give these developers access to our large distribution network and gives us exclusive distribution rights for their games. We distribute games in North America, Europe, Latin America and Japan through our own websites, which are operated under the RealArcade, GameHouse, Zylom and Atrativa brands, and through websites owned or managed by third parties, including other games companies and portals such as Yahoo! and AOL LLC (AOL).

In 2008, we expanded our third party distribution through our acquisition of Trymedia's syndication business assets.

PC Games. Consumers can play and purchase games from our catalog of more than 800 downloadable PC games and over 200 online games across a variety of popular casual game genres, including puzzle, word, hidden object and arcade type games. We also offer Internet-based games subscription services that make it easy for consumers to discover, manage and play both online and downloadable PC games and allow consumers to purchase game credits at a discount or to have unlimited access to our downloadable games in exchange for a monthly subscription fee. Games are typically made available with a free trial and can be purchased on an individual basis or as part of our subscription services. In 2008, we re-launched our GameHouse.com website, which was redesigned to enable a more customizable and easy-to-enjoy game experience. Among other things, the new GameHouse.com website features new games offerings, including one free downloadable game daily, FunTickets, a subscription service that allows consumers to purchase game credits at a discount, and improved features for FunPass subscribers.

We believe that the PC platform is especially appropriate for generating advertising-based revenue. Our online games generate revenue from display advertising that is shown to consumers during online play, and our downloadable games generate revenue from in-game advertising. In 2008, we launched more than 50 casual downloadable games supported by in-game advertising on RealArcade and GameHouse.com. We intend to continue to launch more advertising-supported games through our own family of websites as well as through syndicated distribution channels.

We continue to grow our PC games business through our own development efforts and through strategic acquisitions. In the past three years we have made four acquisitions to improve the geographic reach and product offerings of our Games business. In January 2006, we acquired Zylom Media Group B.V., a distributor and developer of casual online games in Europe, to strengthen our Games business in Europe. In November 2006, we acquired Atrativa Latin America Ltd., a distributor of casual downloadable and online games in Latin America. In October 2007, we acquired Game Trust, Inc. (Game Trust), a casual game infrastructure company that develops and operates innovative community, social networking and commerce tools designed to more deeply engage casual games players. In April 2008, we acquired substantially all of the assets of Trymedia, a distributor of games through a large network of portals, online retailers and game developers. The Trymedia acquisition increased the scale of our syndication business and provided a technology that enables the secure distribution of PC games that we plan to utilize across our games distribution network.

Mobile Games and Other Games Platforms. We have also grown our Games business through the development and distribution of our games for other platforms, including mobile phones, other handheld devices and consoles. We develop and publish original content that consumers can purchase individually or packaged through a subscription mobile games service available through wireless network carriers in the U.S. and Europe. Under our Mr. Goodliving brand, we have created a technology development platform, called EMERGE, that enables us to adapt our games for use on more than 1,400 mobile handsets. In 2008, we launched several of our popular games for games consoles, including the Nintendo Wii and Nintendo DS, and the iPhone.

Media Software and Services

Our Media Software and Services (MSS) products and services include the following:

RealPlayer. Our RealPlayer media player software includes features and services that enable consumers to discover, play and manage audio and video programming on the Internet. RealPlayer plays nearly all major digital media types. Consumers can stream audio and video, save CDs to their personal music collection, burn CDs and transfer their audio and video content to portable devices. With the latest version of our RealPlayer software, RealPlayer 11, consumers can download web video from thousands of websites and transfer them to portable devices or burn them to DVDs as well as easily share video links with friends.

RealPlayer is available to consumers as a free download from the Real.com and RealPlayer.com websites. A premium version of RealPlayer is also available which includes enhanced functionality for CD and DVD burning, enhanced playback controls and additional media library features.

Subscription Revenue SuperPass is our premier MSS subscription service that provides consumers with a broad range of digital entertainment, including a simple way to access popular news and music online. For a monthly fee, a subscriber can download 10 songs from Rhapsody America's MP3 store or a free game from RealArcade as well as view a wide range of movie and television content. In addition, SuperPass subscribers have access to all of the premium RealPlayer features.

Additionally, we utilize our MSS subscription services in direct product and marketing partnerships with content owners to offer consumers exclusive access to content online and to deliver additional distribution and revenue opportunities for content owners. For example, we have offered for a number of years a subscription for exclusive live video feeds from CBS's Big Brother house through our SuperPass service.

Advertising and Third-Party Software. We sell advertising on our Real.com family of websites including our Film.com website. These sites offer a wide range of free entertainment news and content. In addition, we distribute third-party software products, such as the Google toolbar, to consumers who wish to download additional applications when downloading our software products.

Technology Products and Solutions

Our Technology Products and Solutions business primarily consists of application service provider (ASP) services, which include ringback tones, music-on-demand, video-on-demand and messaging services, system software license sales and intellectual property licensing. We develop and market services and technologies that enable wireless carriers, cable companies and other media and communications companies to deliver entertainment experiences to their customers. We believe that we are at the forefront of innovation in digital entertainment delivery, creating new ways for mobile carriers and other businesses to provide their customers with digital media.

Our Technology Products and Solutions segment has increasingly focused on sales of application services to wireless carriers. We believe that the ASP business model will create a more stable, recurring, and scalable revenue stream compared with our traditional system software license sales model. In October 2006, we significantly increased our ASP service offerings through our acquisition of WiderThan, a global leader for delivering integrated digital entertainment solutions to communications service providers. WiderThan has a rich technology background and history of innovation, including assisting SK Telecom's launch of one of the world's first commercial ringback tone services in South Korea, as well as creating a leading, integrated mobile and on-line music-on-demand service.

In 2007, we made two additional acquisitions to grow our Technology Products and Solutions segment. In May 2007, we further increased our ASP service offerings in Europe through our acquisition of Sony NetServices GmbH (SNS). SNS provides digital music services primarily to several of the Vodafone mobile operators throughout Europe. In June 2007, we acquired Exomi Oy, a Finland-based provider of mobile messaging services and wireless data.

Following these three acquisitions, our ASP services are currently deployed with more than 80 communications service providers in more than 42 countries globally, including AT&T, Sprint Nextel Corp., T-Mobile USA and Verizon Wireless in the Americas, Bharti Airtel, Globe, SK Telecom and Telstra in Asia and Vodafone in Europe.

The application services that we provide are described below.

Ringback Tones. We sell our ringback tone (RBT) service to wireless carriers and communications service providers throughout the world on an ASP basis. Our RBT service enables callers to hear music chosen by the subscriber, instead of the traditional electronic ringing sound, while waiting for the subscriber to answer. Our RBT service enables subscribers to select from a variety of high-quality ringback content, including music, pre-recorded messages by celebrities, and sound effects. Carriers generally offer the RBT

service to their subscribers through monthly subscriptions and/or on a per RBT basis. In return for providing, operating and managing the RBT service for carriers, we generally enter into revenue-sharing arrangements with our carrier customers typically based on monthly subscription fees, content download fees or a combination of such fees paid by subscribers.

Music-On-Demand. Our music-on-demand (MOD) service allows carriers to enable their subscribers to listen to a wide range of song titles by downloading or streaming to PCs, certain MP3-enabled mobile phones, and certain portable audio players that are equipped with approved digital rights management systems. Users typically pay carriers for MOD service through monthly subscriptions or on a per-download basis, and we generally receive from the carriers some combination of a monthly fixed fee, a percentage of monthly subscription fees and a percentage of content download fees for providing the service. To date, we have primarily provided our MOD service only to large, global carriers, including SK Telecom in Korea and many of the larger Vodafone operating companies in Europe.

Video-On-Demand. Our video-on-demand (VOD) service allows wireless carriers and other telecom providers to enable their subscribers to view a wide range of video clips by downloading or streaming to video-enabled mobile phones that are equipped with approved digital rights management systems. Users typically pay for VOD services through monthly subscriptions and/or content download fees paid to the carriers, and we generally receive from the carriers some combination of a monthly fixed fee, a percentage of monthly subscription fees and a percentage of content download fees for providing the service.

Messaging. Our principal messaging service is our inter-carrier messaging (ICM) service, which routes and delivers SMS messages between wireless carriers within the U.S. and internationally to multiple wireless devices, under the brand name of Metcalf. We provide this service to carriers in partnership with VeriSign, Inc. The ICM service allows subscribers with any text messaging capable handset to send and receive text messages to and from subscribers on other networks. We earn revenue from this service from fees paid by the carriers based on the number of messages handled for them through the ICM service, subject to our revenue-sharing arrangement with VeriSign. Our messaging services also include e-mail messaging, multi-media messaging, voice messaging, and multimedia application gateway management, primarily to wireless carriers.

We also sell licensed technology within Technology Products and Solutions, which are described below.

Helix Server. Our Helix server software allows companies to broadcast live and on-demand audio, video and other multimedia programming to large numbers of simultaneous users over the Internet. We market and sell our Helix Server software to carriers, media companies and other enterprises that typically pay upfront fees for either a perpetual or term-based license plus annual fees for upgrades and support.

OEM Licensing. We have created enhanced versions of our media player and server products for use in wireless applications, and we license our server software and products to a variety of mobile network operators on a worldwide basis. For example, our RealPlayer Mobile Player and related media server enable consumers to access streaming or downloaded content via 2.5G and 3G mobile networks. We have entered into agreements with wireless carriers to use our mobile platform and with mobile handset manufacturers, including Motorola, Nokia, Qualcomm, and Sony Ericsson, to preinstall our mobile player software on mobile phones. We have also developed and license our enhanced media player and server and software products for use on non-mobile devices such as DVD players and netbooks.

Other Software Licensing. We also license gateway product solutions to wireless carriers. The Helix Messaging Gateway provides a solution for the delivery and management of value-added short messaging service and multimedia messaging service (MMS) services for carriers, offering a single point of management for all applications and services and simple application program interfaces (APIs) for other media companies and service providers to connect to a carrier's network. The Helix wireless application protocol (WAP) Gateway is a complete WAP infrastructure solution for carriers that enables a carrier's subscribers to browse via WAP, send and receive MMS messages, perform application downloads and access entertainment services.

In connection with our Technology Products and Solutions business, we also provide professional services and specialized technical support to certain customers. The nature of these services varies from customer to customer and from period to period. In general, these services are designed to customize and integrate our

technology with our customers' existing systems and technology. We have continued to de-emphasize our systems integration business, including the sale of systems integration services to SK Telecom, primarily because it has lower margins and does not generate consistent recurring revenue streams, which does not fit with our current business model.

See "Notes to Consolidated Financial Statements — Segment Information" (Note 19) for information regarding our reporting segments and geographic regions.

Research and Development

We devote a substantial portion of our resources to developing new products, enhancing existing products, expanding and improving our fundamental technology, and strengthening our technological expertise in all our businesses. During the years ended December 31, 2008, 2007 and 2006, we expended 19%, 18%, and 20%, respectively, of our net revenue on research and development activities.

Customers and Seasonality

Our customers include consumers and businesses located throughout the world. Sales to customers outside the U.S., primarily in Asia and Europe, were 33%, 36%, and 28% of our net revenue during the years ended December 31, 2008, 2007, and 2006, respectively. Sales to one of our international Technology Products and Solutions customers, SK Telecom, accounted for approximately 13% of our consolidated revenues in the year ended December 31, 2007. No one customer accounted for more than 10% of total revenue during the years ended December 31, 2008 and 2006.

We are experiencing seasonality in our business, particularly with respect to the fourth quarter of our fiscal year. Our consumer businesses, which include advertising revenue, make up a large percentage of our revenue, and the fourth quarter has traditionally been the seasonally strongest quarter for Internet advertising. In addition, as we have begun partnering more closely with device manufacturers for our consumer music services, we expect sales of these devices to follow typical consumer buying patterns with a majority of consumer electronics being sold in the fourth quarter. Finally, our Technology Products and Solutions business has seen a concentration of system sales, deployments, and consulting revenue in the fourth quarter.

Sales, Marketing and Distribution

Our marketing programs are aimed at increasing brand awareness of our products and services and stimulating market demand. Across all of our businesses, we use a variety of methods to market our products and services, including paid search advertising, affiliate marketing programs, advertising in print, electronic and other online media, television, direct mail and e-mail offers to qualified potential and existing customers and providing product specific information through our websites. We also cross-market products and services offered by each of our businesses throughout the RealNetworks marketing and distribution channels, so that, for example, Rhapsody America's music products and services are advertised and marketed through our games distribution network and vice versa. We have a substantial number of employees focused on marketing our Technology Products and Solutions to companies and organizations around the world. We also have subsidiaries and offices in several countries that market and sell our products outside the U.S.

Music and Consumer Marketing

Our Rhapsody music services are sold and marketed through a family of websites, including Rhapsody.com, as well as by our partner MTVN. In addition, pursuant to one of the commercial agreements between Rhapsody America and MTVN, Rhapsody America has committed to purchase \$213.8 million in advertising and integrated marketing on MTVN cable channels over the term of the agreement. Our music products and services are also offered through our client software and a variety of third-party distribution channels, such as broadband service providers, retailers, and other partners. These websites and client software provide us with a low-cost, globally accessible sales channel that is generally available 24 hours per day, seven days per week. Our Rhapsody music services are also distributed through a variety of other third-party

distribution channels, including mobile carriers (Verizon Wireless), home entertainment hardware providers (Sonos, Logitech and TiVo) and MP3 manufacturers (SanDisk, Haier and Samsung).

We market and sell our other consumer products and services directly through our own websites (*www.real.com*, *www.realarcade.com*, *www.gamehouse.com*, *www.zylom.com* , etc.). We also have an advertising sales force that markets and sells advertising on our websites and client software and conducts other activities such as developing live events and advertising for print and other media and creating original content for ads. We sell our international advertising inventory directly to clients and through agencies in foreign markets and third-party advertising representation firms. In addition, we market our games products through third-party distribution channels, such as broadband service providers, online portals and content publishers. See "Consumer-Games" above for a description of how our Games products and services are distributed.

Technology Products and Solutions Marketing

Our sales, marketing and business development team works closely with many of our enterprise, infrastructure, wireless, broadband and media customers to identify new business opportunities for our entertainment applications, services and systems. Through ongoing communications with product and marketing divisions of our customers, we tailor our ASP services to the strategic direction of the carriers and the preferences of their subscribers. Our market channels consist of various online and offline methods of promoting our products and services, media relations, industry trade shows, speaking opportunities and other events. We also market and sell our Technology Products and Solutions directly through our websites and through other distributors, including hardware server companies, content aggregators, Internet service providers (ISPs) and other hosting providers that redistribute or provide end users access to our streaming technology from their websites and systems. We also have agreements with many popular software and hardware companies and websites to distribute our products as a click-through or to bundle our player products into their applications and software.

Customer Support

Customer support is integral to the provision of nearly all of our consumer products and services. Consumers who purchase our consumer software products and services, including games, music, and entertainment services, can get assistance via the Internet, e-mail or telephone. We contract with third-party outsource support vendors to provide the primary staffing for our first-tier customer support globally. We also provide various support service options for our business customers and for software developers using our software products and associated services. Support service options include hotline telephone support, online support services, and on-site support personnel covering technical and business-related support topics.

Competition

The market for software and services for digital media delivery over the Internet and wireless networks is intensely competitive. Many of our current and potential competitors have longer operating histories, greater name recognition or brand awareness, more employees and/or significantly greater resources than we do.

We compete in the market for delivery of online content services primarily on the basis of the quality and quantity of the content available in our services, the quality and usability of our software products, the reach of our media formats, and the price and perceived value of our products and services to consumers.

Music

The Rhapsody music subscription services and MP3 music store operated by Rhapsody America face competition from traditional offline music distribution companies and from other online digital music services, including Apple's iTunes music store, Pandora Media's Internet radio services and Napster's music subscription services that may experience enhanced distribution opportunities following its acquisition by Best Buy Co., Inc. (Best Buy), as well as a wide variety of other competitors that are now offering digital music for sale over the Internet. Microsoft Corporation (Microsoft) also offers premium music services in conjunction with its Zune product line, Windows Media Player and MSN services. We also expect increasing competition from

media companies, online retailers such as Amazon.com, Inc. (Amazon.com), online community companies such as MySpace, Inc. and Facebook, and emerging companies such as Spotify Ltd. that offer consumers free, advertising-supported music content and applications through their websites. Our music offerings also face substantial competition from the illegal use of “free” peer-to-peer services. The ongoing presence of these “free” services substantially impairs the marketability of legitimate services such as Rhapsody America’s Rhapsody music subscription service and MP3 music store.

Our Rhapsody subscription services compete primarily on the basis of the overall quality and perceived value of the user experience and on the effectiveness of our distribution network and marketing programs. We believe that Rhapsody’s subscription-based services offer customers a superior value compared to the purchase of individual digital music tracks through competing online music download sites. We also believe that Rhapsody’s tools to search for and discover music, as well as its editorial content, organization of music and related artists, and overall ease of use differentiates Rhapsody from other online digital music services. As the market for purchasing music online grows, we expect that competition for subscribers and purchasers will be intense. In particular, Apple Inc. (Apple) heavily markets and promotes its brand and digital music download services in order to drive sales of its higher margin hardware products. We expect that Apple will continue to spend significantly to market and promote its brand and the sale of downloadable music to further its business model. We also expect that other competitors will continue to spend heavily to promote their brands and to attract and retain consumers for their services. We further believe that our ability to compete in the digital music business has been negatively impacted by the historical lack of a compelling portable device solution for our music subscription services. We have attempted to address this competitive problem by introducing our Rhapsody DNA software and Rhapsody optimization specification and enabling portable wireless players, such as the ibiza Rhapsody by Haier America Trading, LLC, that can connect directly to the Rhapsody service without the use of a PC. Sales of our Rhapsody To Go subscription service will be increasingly dependent on the sales of our partners’ MP3 players.

Consumer

Games

Our Games business competes with a variety of distributors, publishers and developers of “casual” games for the PC and mobile wireless platforms. Our family of websites serving the PC casual games market competes with other high volume distribution channels for downloadable games including Yahoo! Games, MSN Gamezone, Pogo.com and Big Fish Games, Inc., Amazon.com has also recently introduced value-priced game downloads to its website. We compete in this market primarily on the basis of the quality and convenience of our services, the reach and quality of our distribution arrangements and the quality and breadth of our game catalog. In addition, the market for casual games has become increasingly price competitive. We have responded by launching new game offerings on our GameHouse.com website, including one free downloadable game daily and a new subscription service that allows consumers to purchase game credits at a discount. Our GameHouse and Mr. Goodliving content development studios compete with other developers and publishers of downloadable PC and mobile games. Our studios compete based on our ability to develop and publish high quality games that resonate with consumers, our effectiveness at building our brands, our ability to license and execute digital games based on popular third-party intellectual properties like Monopoly, Scrabble and Uno, and our ability to secure broad distribution relationships for our titles, including distribution of mobile titles through mobile carriers.

Media Software and Services

Our media software and services business, including our SuperPass subscription service, faces competition from existing competitive alternatives and other emerging services and technologies. We face significant 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!, Google’s YouTube service as well as broadband Internet service providers, many of which provide similar or alternative services for free or bundle these types of services with other offerings. We also face competition from alternative streaming media playback technologies such as Microsoft Windows Media Player and Adobe Flash. We expect

this competition to continue to be intense as the markets and business models for Internet video content mature and more competitors enter these new markets. Our video services compete primarily on the basis of the quality and perceived value of the content and services we provide, and on the effectiveness of our distribution network and marketing programs.

Technology Products and Solutions

Carrier Application Services

We compete with a large number of domestic and international companies in our carrier application services. We compete largely based on time-to-market, feature sets, operational expertise, customer care as well as price. Many of the carrier application services we provide require a high degree of integration with carrier or service provider networks and thus require a high degree of operational expertise. Those companies, like us, that can understand the intricacies of deploying highly sophisticated carrier-grade services quickly and efficiently generally have an advantage. In addition, the ability to enhance services with new features as the digital entertainment market develops is critical.

Our principal competitors in the ringback tone service market are NMS Technologies, Converse Technology and Huawei Technologies. Our principal competitors in the music-on-demand service market include Groove Mobile, Omnipone, Musiwave (acquired by Microsoft) and Napster, LLC (acquired by Best Buy). Our principal competitors in the video-on-demand service market include MobiTV, Inc., QuickPlay Media Inc. and Comcast's thePlatform. And our principal competitors in the mobile messaging market are Sybase365, a division of Sybase, Inc., and Syniverse Technologies.

Technology Licensing

We currently compete primarily with Adobe Systems Incorporated (Adobe) and Microsoft in the market for digital media servers, players, encoders, digital rights management, codecs and other technology and services related to digital distribution of media. We also compete with Apple in this area. We believe that the primary competitive factors in the media delivery market include the quality, reliability, price and licensing terms of the overall media delivery solution, ubiquitous and easy consumer accessibility to media playback capability, access to distribution channels necessary to achieve broad distribution and use of products, and the ability to license and support popular and emerging media formats for digital media delivery. Microsoft distributes its competing streaming media server, player, tools and digital rights management products by bundling them with its Windows operating systems, including Windows NT, and Windows XP and Windows Vista, at no additional cost or otherwise making them available free of charge. We expect that by leveraging its monopoly position in operating systems and tying streaming of digital media into its operating systems and its Web browser, Microsoft will in the future distribute substantially more copies of its Windows Media Player, which competes with our media player products, than it has in the past and may be able to attract more users and content providers to use its streaming or digital media products.

Intellectual Property

As of December 31, 2008, we had 68 U.S. patents, 51 patents in South Korea, 14 patents in other countries and over 200 pending patent applications worldwide relating to various aspects of our technology. We are continuously preparing additional patent applications on other current and anticipated features of our technology in various jurisdictions across the world. As of December 31, 2008, we had 57 registered U.S. trademarks or service marks, 25 registered South Korea trademarks or service marks, and had applications pending for several more trademark or service marks in various jurisdictions across the world. We also have several unregistered trademarks. In addition, we have several foreign trademark registrations and pending applications. Many of our marks begin with the word "Real" (such as RealPlayer, RealAudio and RealVideo). We are aware of other companies that use "Real" in their marks alone or in combination with other words, and we do not expect to be able to prevent all third-party uses of the word "Real" for all goods and services.

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. These efforts to protect our intellectual property rights may not be effective in preventing misappropriation of our technology, or may not prevent the development and design by others of products or technologies similar to or competitive with those we develop.

Employees

At December 31, 2008, we had 1,774 full-time employees and 219 part-time and contingent employees, of which 1,259 were based in the Americas, 396 were based in Asia, and 338 were based in Europe. In December 2008, we reported a reduction in force affecting 130 employees and 30 contract employees. All of the affected employees were still employed as of December 31, 2008, and accordingly are included in the foregoing total number of employees as of December 31, 2008. None of our employees are subject to a collective bargaining agreement, and we believe that our relations with our employees are good.

Position on Charitable Responsibility

In periods where we achieve profitability, we intend to donate 5% of our net income to charitable organizations, which will reduce our net income for those periods. The non-profit RealNetworks Foundation manages our charitable giving efforts. We attempt to encourage employee giving by using a portion of our intended contribution to match charitable donations made by employees.

Available Information

Our corporate Internet address is www.realnetworks.com. We make available free of charge on www.investor.realnetworks.com our annual reports on Form 10-K, quarterly reports on Form 10-Q and current reports on Form 8-K, and amendments to these reports, as soon as reasonably practicable after we electronically file such material with, or furnish it to, the Securities and Exchange Commission (SEC). However, the information found on our corporate website is not part of this or any other report.

Executive Officers of the Registrant

The executive officers of RealNetworks as of February 27, 2009 were as follows:

<u>Name</u>	<u>Age</u>	<u>Position</u>
Robert Glaser	47	Chairman of the Board and Chief Executive Officer
Michael Eggers	37	Senior Vice President, Chief Financial Officer and Treasurer
John Barbour	49	President, Games Division
Savino (Sid) Ferrales	58	Senior Vice President, Human Resources
John Giamatteo	42	Chief Operating Officer
Robert Kimball	45	Executive Vice President, Corporate Development and Law, General Counsel and Corporate Secretary
Michael Lunsford	41	Executive Vice President, Strategic Ventures
Harold Zeitz	45	Chief Operating Officer, Games Division

ROBERT GLASER has served as Chairman of the Board and Chief Executive Officer of RealNetworks since its inception in February 1994, and as Treasurer from 1994 to 2000. Mr. Glaser's professional experience also includes ten years of employment with Microsoft where he focused on the development of new businesses related to the convergence of the computer, consumer electronics and media industries. Mr. Glaser holds a B.A. and an M.A. in Economics and a B.S. in Computer Science from Yale University.

MICHAEL EGGERS has served as Senior Vice President, Chief Financial Officer and Treasurer of RealNetworks since February 2006. Prior to that, Mr. Eggers served as Vice President of Finance since September 2003. Mr. Eggers joined RealNetworks in 1997 as the Manager of Financial Reporting and has held various positions leading to his appointment as Vice President of Finance. Prior to RealNetworks,

Mr. Eggers was employed by KPMG in the audit practice division. Mr. Eggers holds a B.A., *magna cum laude*, in Business Administration with a concentration in accounting from the University of Washington.

JOHN BARBOUR has served as President of the Games Division of RealNetworks since October 2008. From October 2006 to October 2008, Mr. Barbour served as the Managing Partner of Volta Capital, LLC, a strategy and investment consulting firm. From 1999 to June 2006, Mr. Barbour was employed by Toys "R" Us, Inc., a leading retailer of children's toys and products, serving as Executive Vice President — President Toys "R" Us U.S. from August 2004 to June 2006 and Executive Vice President - President Toys "R" Us International and Chairman — Toys "R" Us Japan from February 2002 to August 2004. From 1999 to 2002, Mr. Barbour served as President and Chief Executive Officer of Toysrus.com, a subsidiary of Toys "R" Us, Inc. Mr. Barbour holds a B.Sc. in Chemistry, with Honours, from the University of Glasgow.

SAVINO "SID" FERRALES has served as Senior Vice President, Human Resources of RealNetworks since April 2004. From 1998 to April 2004, Mr. Ferrales served as Senior Vice President and Chief Human Resources Officer of Interland, Inc., a provider of Web hosting and online solutions to small businesses. Over the past twenty-five years, Mr. Ferrales has been employed as a human resources executive at several high technology companies, including Power Computing Corporation, Digital Equipment Corporation, Dell Computer Corporation, and Motorola, Inc. Mr. Ferrales holds a B.A. in Sociology from Texas State University and an M.A. in Social Rehabilitation from Sam Houston State University.

JOHN GIAMATTEO has served as Chief Operating Officer of RealNetworks since June 2008. Mr. Giamatteo joined RealNetworks in June 2005 and served as President, Technology Products and Solutions and International Operations from November 2006 to June 2008 and as Executive Vice President, Worldwide Business Products and Services and International Operations from June 2005 to October 2006. From 1988 to June 2005, Mr. Giamatteo was employed by Nortel Networks Corporation, a provider of communications solutions, where he held various management positions, most recently serving as President, Asia Pacific. Mr. Giamatteo holds a B.S. in Accounting and an M.B.A. from St. John's University.

ROBERT KIMBALL has served as Executive Vice President, Corporate Development and Law, General Counsel and Corporate Secretary since January 2009. From January 2005 to January 2009, Mr. Kimball served as Senior Vice President, Legal and Business Affairs, General Counsel and Corporate Secretary of RealNetworks and from January 2003 to January 2005, Mr. Kimball served as Vice President, Legal and Business Affairs, General Counsel and Corporate Secretary. Mr. Kimball held the positions of Vice President, Legal and Business Affairs of RealNetworks from May 2001 to January 2003 and Associate General Counsel from March 1999 to April 2001. Mr. Kimball holds a B.A. with distinction from the University of Michigan and a J.D., *magna cum laude*, from the University of Michigan Law School.

MICHAEL LUNSFORD joined RealNetworks as a strategic advisor in January 2008 and has served as Executive Vice President, Strategic Ventures since June 2008. From 1999 to December 2007, Mr. Lunsford was employed by Earthlink, Incorporated, a provider of communications services, serving as Executive Vice President from June 2007 to December 2007, as interim President and Chief Executive Officer from November 2006 to June 2007, as Executive Vice President and President, Access and Voice from September 2005 to November 2006, as Executive Vice President, Marketing and Products from March 2004 to September 2005, and as Executive Vice President, Products from 2002 to March 2004. Mr. Lunsford holds an A.B. in Economics and an M.B.A. from the University of North Carolina.

HAROLD ZEITZ has served as Chief Operating Officer of the Games Division of RealNetworks since June 2008. Mr. Zeitz joined RealNetworks in June 2006 and served as Senior Vice President, Games and Media Software and Services from January 2007 to June 2008 and as Senior Vice President, Media Software and Services from June 2006 to January 2007. From March 2002 to June 2006, Mr. Zeitz served as the Chief Operating Officer and Chief Marketing Officer of ShareBuilder Corporation, an online securities brokerage company. Mr. Zeitz holds a B.A. in Economics from Northwestern University and an M.B.A. from the Stanford Graduate School of Business.

Item 1A. Risk Factors

You should carefully consider the risks described below together with all of the other information included in this annual report on Form 10-K. 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 Music and Consumer Businesses

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

Many of our current and potential competitors in our Music and Consumer businesses have longer operating histories, greater name recognition, more employees and significantly greater resources than we do. Our competitors across the breadth of our product lines in these businesses include a number of large and powerful companies, such as Microsoft, Amazon.com and Apple. To effectively compete in the markets for our Music and Consumer businesses, we may experience the following consequences, any of which would adversely affect our operating results and the trading price of our stock:

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

In addition, we face the following risks relating to our Music, Media Software and Services and Games businesses:

Music. Our online music services now offered through our Rhapsody America joint venture with MTVN face significant competition from traditional offline music distribution competitors and from other online digital music services, as well as online theft or “piracy.” Some of these competing online services have spent substantial amounts on marketing and have received significant media attention, including Apple’s iTunes music download service, which it markets closely with its popular iPod line of portable digital audio players and its iPhone. Microsoft also offers premium music services in conjunction with its Windows Media Player and also markets a portable music player and related download software and music service called Zune. We also expect increasing competition from online retailers such as Amazon.com, online community companies such as MySpace and Facebook, as well as other providers of free, ad-supported music services, some of whom are successfully growing consumer awareness of their services. Our online music services also face significant competition from “free” peer-to-peer services which allow consumers to directly access a wide variety of unlicensed content. Enforcement efforts have not effectively shut down these services and the ongoing presence of these “free” services substantially impairs the marketability of legitimate services like ours. To compete in this crowded market, we develop and work with partners to develop new and often unique marketing programs designed to build awareness of our music products and services and to attract subscribers. However, many of these marketing programs are unproven and may result in significant expenses we may not recoup due to the program’s failure to increase awareness or the number of subscribers to our music services. Rhapsody America may not be able to compete effectively in this highly competitive and rapidly evolving market, which may negatively impact the future growth of our Music business.

Games. Our RealArcade, GameHouse, and Zylom branded services compete with other online aggregators and distributors of online and downloadable casual PC games. Some of these competitors

have high volume distribution channels and greater financial resources than we do. Our Games business also competes with many other smaller companies that may be able to adjust to market conditions faster than us. We also face an increasingly price competitive casual games market, and some of our competitors may be able to compete on price more effectively than us. We expect competition to intensify in this market from these and other competitors and no assurance can be made that we will be able to continue to grow our revenue. Our development studios compete primarily with other developers of online, downloadable and mobile casual PC games and must continue to develop popular and high-quality game titles and to execute on opportunities to expand the play of our games on a variety of non-PC platforms to maintain our competitive position and help maintain the growth of our Games business.

Media Software and Services. Our media software and services (primarily our SuperPass subscription service) face competition from existing competitive alternatives and other emerging services and technologies, such as user generated content services like YouTube and alternative streaming media playback technologies including Microsoft Windows Media Player and Adobe Flash. Content owners are increasingly marketing their content on their own websites rather than licensing to other distributors such as us. 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, NBC Universal, Microsoft, Apple, Adobe, Yahoo! and broadband ISPs. We expect this competition to continue to be intense as the market and business models for Internet video content mature and more competitors enter these new markets. Competing services may be able to obtain better or more favorable access to compelling video content than us, may develop better offerings than us and may be able to leverage other assets or technologies to promote or distribute their offerings successfully. If we are unable to compete successfully, the future growth of our Media Software and Services business will be negatively impacted. In addition, our overall ability to sell subscription services depends in part on the use of RealNetworks' formats on the Internet, and declines in the use of our formats may negatively affect our subscription revenue and increase costs of obtaining new subscribers. Both Microsoft and Adobe are aggressively seeking to grow their format usage.

The success of our subscription services businesses depends upon our ability to increase subscription revenue and to license compelling content on commercially reasonable terms.

Our operating results could be adversely impacted by the loss of subscription revenue, including the revenue generated from the online music services offered by our Rhapsody America joint venture. Internet subscription businesses are a relatively new media delivery model, and we cannot predict with accuracy our long-term ability to maintain or increase subscription revenue. Subscribers may cancel their subscriptions to our services for many reasons, including a perception that they do not use the services sufficiently or that the service does not provide enough value, a lack of attractive or exclusive content generally or as compared with competitive service offerings (including Internet piracy), or because customer service issues are not satisfactorily resolved. In recent periods, we have seen an increase in the number of gross customer cancellations of our subscription services due in part to an increasingly large subscriber base, an increase in involuntary credit card cancellations resulting in termination of service and increased prevalence and awareness of alternative "free" on-demand streaming music services. In addition, we must continue to obtain compelling digital media content for our video, music, and games services in order to maintain and increase usage and overall customer satisfaction for these products. Our online music service offerings available through our Rhapsody America venture depend on music licenses from the major music labels and publishers, and the failure to renew these licenses under terms that are commercially reasonable and acceptable to us would harm Rhapsody America's ability to generate revenues from its subscription services.

Music publishing royalty rates for music subscription services offered through RealNetworks and Rhapsody America are not yet fully established; an unexpected modification or application of settlement terms could negatively impact our operating results.

Publishing royalty rates associated with music subscription services in the U.S. and abroad are not fully established and public performance licenses are negotiated individually with performance rights organizations (PROs). On July 16, September 10, December 8 and December 12, 2008, a court issued rulings that set forth how royalties are to be calculated and address other matters relating to the application of the new rates to be paid to one of the PROs, the American Society of Composers, Authors and Publishers (ASCAP). After working with ASCAP to make a final determination of amounts owed under the court's rulings, we reached a partial agreement with ASCAP on January 12, 2009. While we believe we have sufficiently accrued for expected royalties to be paid under the agreement, we are appealing some aspects of the court's rulings that underlie the agreement, and the rulings remain subject to appeal and challenge by other participants. We also have license agreements to reproduce musical compositions with the Harry Fox Agency, an agency that represents music publishers, and with many independent music publishers as required in the creation and delivery of on-demand streams and tethered downloads, but these license agreements generally do not include final royalty rates. The license agreements anticipate industry-wide agreement on rates, which was reached among the Digital Media Association (DiMA), the Recording Industry Association of America (RIAA) and the National Music Publishers Association (NMPA), among others. This settlement was published by the Copyright Royalty Board (CRB) following an administrative judicial proceeding supervised by the U.S. Copyright Office. This settlement, with some modifications, is part of the CRB's final determination as published in the Federal Register but it may be appealed. In addition, the U.S. Copyright Office has raised legal challenges to the CRB's final determination, creating some uncertainty as to the application of the settlement terms set forth in CRB's final determination. If terms of the settlement are modified or applied in a manner that we do not expect, we could incur increased expenses that 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.

An appeal of, or other industry settlement relating to, the April 2007 Copyright Royalty Board decision regarding Internet radio royalties and minimum payments could result in material expenses that would harm our operating results and our ability to provide popular radio services.

In April 2007, the CRB issued a decision setting new royalty rates for the use of sound recordings in Internet radio from 2006 through 2010, which are currently under appeal. The appeal may result in rates or other terms that are unfavorable to us, which could adversely impact our operating results and our ability to provide our radio services in the future.

Our RealDVD PC application is currently the subject of pending litigation, and we could incur significant expenses or be further prevented from selling RealDVD.

On September 30, 2008, we announced the availability of RealDVD, a PC application that allows consumers to store, manage and play their DVDs on their computers. On the same day, we filed a motion for declaratory judgment against the DVD Copy Control Association and Disney Enterprises, Inc., Paramount Pictures Corp., Sony Pictures Entertainment, Inc., Twentieth Century Fox Film Corp., NBC Universal, Inc., Warner Bros., Entertainment, Inc. and Viacom, Inc. seeking a determination that, among other things, our RealDVD product complies with the DVD Copy Control Association's license agreement. Various movie studios filed suit against us alleging that RealDVD violates the Digital Millennium Copyright Act and also asked for and were granted a temporary restraining order preventing us from selling RealDVD until a full preliminary injunction hearing could be held. Although we believe that our RealDVD product fully complies with the DVD Copy Control Association's license agreement and enables consumers to exercise their legitimate, fair use rights to securely store DVD content on their hard drives, we may not ultimately prevail on our claims. These claims could be costly and time-consuming to assert and defend and could require us to pay significant litigation expenses or damages or result in a preliminary or permanent injunction against the sale of RealDVD, any of which would harm our operating results.

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

We cannot predict whether consumers will continue to download and use our digital media products consistent with past usage, especially in light of the fact that Microsoft bundles its competing Windows Media Player with its Windows operating system and the popularity of the Adobe Flash format. Our inability to maintain continued high volume distribution of our digital media products could hold back the growth and development of related revenue streams from these market segments, including the distribution of third-party products and sales of our subscription services, and therefore could harm our business and our prospects.

We face risks with respect to certain matters in the governance and management of our Rhapsody America joint venture and the integration and operation of assets that have been combined to form Rhapsody America.

We and MTVN have formed Rhapsody America LLC, a Delaware limited liability company. We own, through a wholly owned subsidiary, 51% of the limited liability company membership interests of Rhapsody America and MTVN owns, through a wholly owned subsidiary, the remaining 49%. We are entitled to appoint the general manager to manage the day-to-day operations of Rhapsody America. Rhapsody America is governed by a limited liability company agreement which, among other things, requires unanimous approval of the members for certain key operational activities, such as adopting a budget and authorizing certain capital expenditures, and for significant company events, such as mergers, asset sales, distributions, affiliate transactions and issuance, sale and repurchase of membership interests of Rhapsody America. If we are not able to agree with MTVN on any of those items, if the members are unable to agree on any other significant operational or financial matter requiring approval of the members, or if there is any event that adversely impacts our relationship with MTVN, the business, results of operations and financial condition of Rhapsody America may be adversely affected and, consequently, our business may suffer. In addition, MTVN may have or develop economic or other business interests or goals that are inconsistent with our or Rhapsody America's business interests or goals.

Neither we nor the current management of Rhapsody America has extensive experience in managing and operating complex joint ventures of this nature, and the integration and operational activities may strain our internal resources, distract us from managing our day-to-day operations, and impact our ability to retain key employees in Rhapsody America. The nature of our and MTVN's contributions of services and assets to Rhapsody America required detailed cost allocation agreements that are complex to implement and manage and may result in significant costs that could adversely affect our operating results. The allocation of these support service costs is based on various measures depending on the service provided, and require significant internal resources. Many of the allocation methodologies are complicated, which may result in inaccuracies in the total charges to be billed to Rhapsody America. In addition, the variable nature of these costs to be allocated to Rhapsody America may result in fluctuations in the period-over-period results of our Music business.

We and MTVN have certain contractual rights relating to the purchase and sale of MTVN's membership interest in Rhapsody America that may be settled in part through the issuance of additional shares of our capital stock, which would dilute our other shareholders' voting and economic interests in us, and may require us to pay MTVN a price that exceeds the appraised value of its proportionate interest in Rhapsody America.

Pursuant to the terms of the Rhapsody America limited liability company agreement, we have a right to purchase from MTVN, and MTVN has a right to require us to purchase, MTVN's membership interest in Rhapsody America. These call and put rights are exercisable upon the occurrence of certain events and during certain periods in each of 2012, 2013 and 2014 and every two years thereafter and may be settled, in part, through the issuance of shares of our capital stock, subject to specified limitations. If a portion of the purchase price for MTVN's membership interest is payable in shares of our capital stock, such shares could represent up to 15% of the outstanding shares of our common stock immediately prior to the transaction. In addition, we may also be obligated to issue shares of our non-voting stock representing up to an additional 4.9% of the outstanding shares of our common stock immediately prior to the transaction. If we pay a portion of the

purchase price for MTVN's membership interest in shares of our common stock and non-voting stock, our other shareholders' voting and economic interests in us will be diluted, and MTVN will become one of our significant shareholders. In certain situations, if MTVN exercises its right to require us to purchase its membership interests in Rhapsody America, we may be required to pay MTVN a price that provides a return to MTVN over the appraised value of MTVN's proportionate interest in Rhapsody America, and as a result, we would pay greater than fair value to acquire MTVN's interest.

Risks Related to Our Technology Products and Solutions Business

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

We derive a material portion of our revenue from carrier application services. Many of our carrier application services contracts provide for revenue sharing arrangements, but we have little control over the pricing decisions of our carrier customers. Furthermore, most of these contracts do not provide for guaranteed minimum payments or usage levels. Because most of our carrier customer contracts are nonexclusive, it is possible that our wireless carriers could purchase similar application services from third parties, and cease to use our services in the future. As a result, our revenue derived under these agreements could be substantially reduced depending on the pricing and usage decisions of our carrier customers.

In addition, none of our carrier application services contracts obligates our carrier customers to market or distribute any of our applications. Despite the lack of marketing commitments, revenue related to our application services is, to a large extent, dependent upon the marketing and promotion activities of our carrier customers. In addition, many of our carrier contracts are short term and allow for early termination by the carrier with or without cause. These contracts are therefore subject to renegotiation of pricing or other key terms that could be adverse to our interests, and leave us vulnerable to non-renewal by the carriers. The loss of carrier customers, a reduction in marketing or promotion of our applications, or the termination, non-renewal or renegotiation of contract terms that are less favorable to us would likely result in the loss of future revenues from our carrier application services.

Finally, certain of our carrier contracts obligate us to indemnify the carrier customer for certain liabilities and losses incurred by them, including liabilities resulting from third party claims for damages that arise out of the use of our technology. These indemnification terms provide us with certain procedural safeguards, including the right to control the defense of the indemnified party. We have accepted tenders of indemnification from two of our carrier customers related to one pending patent infringement proceeding, and we are vigorously defending them. This pending proceeding or future claims against which we may be obligated to defend our carrier customers could result in paying amounts pursuant to these obligations that could materially harm our operating results.

The mobile entertainment market is highly competitive.

The market for mobile entertainment services, including ringback tone and music-on-demand solutions, is highly competitive. Current and potential future competitors include major media companies, Internet portal companies, content aggregators, wireless software providers and other pure-play wireless entertainment publishers. In connection with music-on-demand in particular, we may in the future compete with current providers of music-on-demand services for online or other non-mobile platforms, some of which have greater financial resources than we do. In addition, the major music labels may demand more aggressive revenue sharing arrangements or impose an alternative business model less favorable to us. In addition, while most of our carrier customers do not offer internally developed application services that compete with ours, if our carrier customers begin developing these application services internally, we could be forced to lower our prices or increase the amount of service we provide in order to maintain our business with those carrier customers. Increased competition has in the past resulted in pricing pressure, forcing us to lower the selling price of our services.

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

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

Our traditional system software licensing business has been negatively impacted by competitive factors, and we may not experience improved sales of our system software products.

We believe that our traditional system software sales have been negatively impacted primarily by the competitive effects of Microsoft, which markets and often bundles its competing technology with its market leading operating systems and server software. Although the settlement agreement we entered into with Microsoft relating to our claims regarding Microsoft's anticompetitive practices contained substantial cash payments to us and a series of technology agreements, Microsoft will continue to be an aggressive competitor with our traditional systems software business. We cannot be sure whether the portions of the settlement agreement designed to limit Microsoft's ability to leverage its market power will be effective, and we cannot predict when, or if, we will experience increased demand for our system software products in a way that improves our operating results or shareholder return on an investment in our stock.

Risks Related to Our Business in General

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

The trading price for our common stock has been volatile, ranging from \$2.93 to \$7.61 per share during the 52-week period ended December 31, 2008. As a result of the rapidly changing markets in which we compete, our operating results may fluctuate from period-to-period, which may continue to contribute to the volatility of our stock price. In past periods, our operating results have been affected by personnel reductions and related charges, charges relating to losses on excess office facilities, and impairment charges for certain of our equity investments, goodwill and other long-lived assets. Our operating results may be adversely affected by similar or other charges or events in future periods, including, but not limited to:

- impairments of goodwill and other long-lived assets,
- integrating and operating newly acquired businesses and assets,
- the seasonality of our business, which has experienced increased revenues in the fourth quarter of our fiscal year, and
- the general difficulty in forecasting our operating results and metrics, which could result in actual results that differ significantly from expected results.

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

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

The national and global economic downturn has resulted in a decline in overall consumer and corporate spending, declines in consumer and corporate access to credit, fluctuations in foreign exchange rates, declines in the value of assets and increased liquidity risks, all of which could materially impact our business, financial condition and results of operations. We provide digital entertainment services to consumers, and payment for our products and services may be considered discretionary on the part of many of our current and potential customers. As a result, consumers considering whether to purchase our products or services may be influenced by macroeconomic factors that affect consumer spending such as unemployment, continuing increases in fuel costs, conditions in the residential real estate and mortgage markets and access to credit. To the extent conditions in the economy remain uncertain or the economy continues to deteriorate, our business could be impacted as customers choose to leave our services, to reduce their service level or to stop purchasing our products. In addition, our efforts to attract new customers may be adversely affected. Declines in consumer spending may also negatively impact our business customers, including our mobile carrier customers, who may experience decreases in demand for the services we provide that are offered to their subscribers. We are also experiencing a decline in advertising revenue as businesses are reducing their sales and marketing spending in response to the contracting economy. A significant decrease in the demand for our products or services or declines in our advertising revenue could have a material adverse impact on our operating results and financial condition.

Uncertainty and adverse economic conditions may also lead to a decreased ability to collect payment for our products and services due primarily to a decline in the ability of consumers to use or access credit, including through credit cards, which is how most of our customers pay for our products and services. We also expect to continue to experience volatility in foreign exchange rates, which could negatively impact the amount of revenue and net assets we record in future periods. The functional currency of our foreign subsidiaries is the local currency of the country in which each subsidiary operates. We translate our subsidiaries' revenues into U.S. dollars in our financial statements, and continued volatility in foreign exchange rates, particularly if the U.S. dollar strengthens against the euro or the Korean won, may result in lower reported revenue. If economic conditions continue to deteriorate, we may also record additional impairments to our assets in future periods, particularly goodwill, other intangible assets and long-lived assets, which are discussed in more detail below. Economic conditions may also negatively impact our liquidity due to (1) declines in interest income, (2) an increased risk that we may not be able to access cash balances held in U.S. or foreign financial institutions or that our investments in debt securities issued by financial institutions may become worthless due to the nationalization or failure of such financial institutions, and (3) decreased ability to sell the securities and the institutional money market funds we hold as short-term investments. In addition, the decline in the trading price of shares of our common stock may make it difficult to use our common stock as purchase price consideration for future acquisitions and to raise funds through equity financings. If any of these risks are realized, we may experience a material adverse impact on our financial condition and results of operations.

New products and services may not achieve market acceptance or may be subject to legal challenge that could negatively affect our operating results.

The process of developing new, and enhancing existing, products and services is complex, costly and uncertain. Our business depends on providing products and services that are attractive to subscribers and consumers, which, in part, is subject to unpredictable and volatile factors beyond our control, including end-user preferences and competing products and services. Any failure by us to timely respond to or accurately anticipate consumers' changing needs and emerging technological trends could significantly harm our current market share or result in the loss of market opportunities. In addition, we must make long-term investments, develop or obtain appropriate intellectual property and commit significant resources before knowing whether our predictions will accurately reflect consumer demand for our products and services, which may result in no return or a loss on our investments. Furthermore, new products and services may be subject to legal challenge. Responding to these potential claims may require us to enter into royalty and licensing agreements on

unfavorable terms, require us to stop distributing or selling, or to redesign our products or services, or to pay damages.

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

Our success depends on the continued employment of certain executive officers and key employees, including 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.

Our success is also dependent upon our ability to identify, attract and retain highly skilled management, technical, and sales personnel, both in our domestic operations and as we expand internationally. Qualified individuals are in high demand and competition for such qualified personnel in our industry is intense, and we may incur significant costs to retain or attract them. There can be no assurance that we will be able to attract and retain the key personnel necessary to sustain our business or support future growth.

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

As part of our business strategy, we have acquired technologies and businesses in the past and expect that we will continue to do so in the future. Since late 2006 through the second quarter of 2008, we completed the acquisition of substantially all of WiderThan and the acquisitions of Sony NetServices GmbH, Exomi Oy, Game Trust and substantially all of the assets of Trymedia Systems, Inc. The failure to adequately manage the costs and address the financial, legal and operational risks raised by acquisitions of technology and businesses could harm our business and prevent us from realizing the benefits of the acquisitions.

Acquisition-related costs and financial risks related to completed and potential future acquisitions may harm our financial position, reported operating results, or stock price. Previous acquisitions have resulted in significant expenses, including amortization of purchased technology, amortization of acquired identifiable intangible assets and the incurrence of non-cash charges for the impairment of goodwill and other intangible assets in the fourth quarter of 2008, which are reflected in our operating expenses. New acquisitions and any potential additional future impairment of the value of purchased assets could have a significant negative impact on our future operating results.

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

- difficulties and expenses in assimilating the operations, products, technology, information systems, and/or personnel of the acquired company;
- retaining key management or employees of the acquired company;
- entrance into unfamiliar markets, industry segments, or types of businesses;
- operating and integrating acquired businesses in remote locations;
- integrating and managing businesses based in countries in which we have little or no prior experience;
- diversion of management time and other resources from existing operations to integration activities for acquired businesses;
- impairment of relationships with employees, affiliates, advertisers or content providers of our business or acquired business; and
- assumption of known and unknown liabilities of the acquired company, including intellectual property claims.

An impairment in the carrying value of our goodwill or other intangible assets could adversely affect our financial condition and results of operations.

In accordance with SFAS No. 142, *Goodwill and Other Intangible Assets*, we are required to annually test goodwill and intangible assets with indefinite lives, including the goodwill associated with past acquisitions and any future acquisitions, to determine if impairment has occurred. Additionally, interim reviews must be performed whenever events or changes in circumstances indicate that impairment may have occurred. If the testing performed indicates that an impairment has occurred, we are required to record a non-cash impairment charge for the difference between the carrying value of the goodwill or other intangible assets and the implied fair value of the goodwill or other intangible assets in the period the determination is made. During the quarter ended December 31, 2008, we revised our long term operating plan. Our operating plan was a significant input in evaluating the fair value of our reporting units for the purpose of assessing goodwill for possible impairment. The expected impact resulting from the significant declines observed in the broader economy during the fiscal fourth quarter of 2008 were reflected in the plan. Additionally, in light of the uncertainty regarding the extent of future economic declines, we applied discount rates in our cash flow analysis that appropriately reflected the possibility that cash flows from future operations may not be fully realized. As a result, we determined that the carrying value for our Games and Technology Products and Solutions reporting units exceeded their respective fair values, indicating that goodwill within each reporting unit was potentially impaired. No impairments were indicated under the first step for our Music and Media Software and Services reporting units. As required, we initiated the second step of the goodwill impairment test for our Games and Technology Products and Solutions reporting units. We determined that the implied fair value of goodwill for our Technology Products and Solutions and Games reporting units was less than the carrying value by approximately \$97.0 million and \$38.1 million, respectively, which was recorded as an impairment of goodwill during the quarter ended December 31, 2008. The testing of goodwill and other intangible assets for impairment requires us to make significant estimates about our future performance and cash flows, as well as other assumptions. These estimates can be affected by numerous factors, including changes in economic, industry or market conditions, changes in business operations, changes in competition or potential changes in the share price of our common stock and market capitalization. Significant and sustained declines in our stock price and market capitalization, a significant decline in our expected future cash flows or a significant adverse change in our business climate, among other factors, could result in the need to perform an impairment analysis under SFAS No. 142 in future interim periods. We cannot accurately predict the amount and timing of any impairment of goodwill or other intangible asset. Should the value of goodwill or other intangible assets become impaired, we would record the appropriate charge, which could have an adverse effect on our financial condition and results of operations.

An impairment in the carrying value of our long-lived assets could adversely affect our financial condition and results of operations.

Long-lived assets consist primarily of equipment, software and leasehold improvements, as well as amortizable intangible assets acquired in business combinations. Long-lived assets are amortized on a straight line basis over their estimated useful lives. In accordance with SFAS No. 144, *Accounting for the Impairment or Disposal of Long-Lived Assets*, we review long-lived assets for impairment whenever events or changes in circumstances indicate the carrying amount of such assets may not be recoverable. If the carrying amount of an asset is not recoverable, an impairment loss is recognized based on the excess of the carrying amount of the long-lived asset over its respective fair value, which is generally determined as the present value of estimated future undiscounted cash flows. The impairment analysis is based on significant assumptions of future results made by management, including operating and cash flow projections. During the quarter ended December 31, 2008, we revised our long term operating plan. Our operating plan was a significant input in assessing the recoverability of our long-lived assets. The expected impact resulting from the significant declines observed in the broader economy during the fiscal fourth quarter of 2008 were reflected in our plan. Additionally, in light of the uncertainty regarding the extent of future economic declines, we applied discount rates in our discounted cash flow analysis that appropriately reflected the possibility that cash flows from future operations may not be fully realized. Based on this assessment, we concluded that the net book value related to certain intangible assets exceeded the fair value attributable to such intangible assets. As a result, we

recorded charges of \$57.6 million as impairments of long-lived assets within our consolidated statements of operations and comprehensive income in 2008. No such impairments were recognized in either 2007 or 2006.

The impairment analysis for long-lived assets is based on significant assumptions of future results made by management, including revenue and cash flow projections. Significant or sustained declines in future revenue or cash flows, or adverse changes in our business climate, among other factors, could result in the need to perform an impairment analysis under SFAS No. 144 in future interim periods. We cannot accurately predict the amount and timing of any impairment of long-lived assets. Should the value of our long-lived assets become impaired, we would record the appropriate charge, which could have an adverse effect on our financial condition and results of operations.

We need to develop relationships and technical standards with manufacturers of non-PC media and communication devices and interoperability of our services with these devices to grow our business.

Access to the Internet through devices other than a PC, such as personal digital assistants, cellular phones, television set-top devices, game consoles, Internet appliances and portable music and games devices has increased dramatically and is expected to continue to increase. If a substantial number of alternative device manufacturers do not license and incorporate our technology and services into their devices, we may fail to capitalize on the opportunity to deliver digital media to non-PC devices which could harm our business prospects. In addition, in order for our services, in particular, the digital music services offered through Rhapsody America, to continue to grow, we must design services that interoperate effectively with a variety of hardware devices. To achieve this interoperability, we and Rhapsody America 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 objectives. If we do not successfully make our products and technologies compatible with emerging standards and the most popular devices used to access digital media or successfully design our service to interoperate with the music playback devices that our customers own, we may miss market opportunities and our business and results will suffer.

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

Our ability to compete partly depends on the superiority, uniqueness and value of our patent portfolio and other technology, including both internally developed technology and technology licensed from third parties. To protect our proprietary rights, we rely on a combination of patent, trademark, copyright and trade secret laws, confidentiality agreements with our employees and third parties, and protective contractual provisions. However, our efforts to protect our intellectual property rights may not assure our ownership rights in our intellectual property, protect or enhance the competitive position of our products and services or effectively prevent misappropriation of our technology. As disputes regarding the validity and scope of patents or the ownership of technologies and rights associated with streaming media, digital distribution, and online businesses are common and likely to arise in the future, we may be forced to litigate to enforce or defend our patents and other intellectual property rights or to determine the validity and scope of other parties' proprietary rights, enter into royalty or licensing agreements on unfavorable terms or redesign our product features and services. Any such dispute would likely be costly and distract our management, and the outcome of any such dispute could fail to improve our business prospects or otherwise harm our business.

From time to time we receive claims and inquiries from third parties alleging that our technology may infringe the third parties' proprietary rights, especially patents. Third parties have also asserted and most likely will continue to assert claims against us alleging infringement of copyrights, trademark rights, trade secret rights or other proprietary rights, or alleging unfair competition or violations of privacy rights. Currently we are investigating or litigating a variety of such pending claims, some of which are described in Note 17 to the financial statements included in this report.

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

Our ability to provide our products and services to our customers and operate our business depends on the continued operation and security of our information systems and networks. A significant or repeated reduction in the performance, reliability, security or availability of our information systems and network infrastructure could harm our ability to conduct our business, and harm our reputation and ability to attract and retain users, customers, advertisers and content providers. We have on occasion experienced system errors and failures that caused interruption in availability of products or content or an increase in response time. Problems with our systems and networks could result from our failure to adequately maintain and enhance these systems and networks, natural disasters and similar events, power failures, HVAC failures, intentional actions to disrupt our systems and networks and many other causes. The vulnerability of a large portion of our computer and communications infrastructure is enhanced because much of it is located at a single leased facility in Seattle, Washington, an area that is at heightened risk of earthquake, flood, and volcanic events. Many of our services do not currently have fully redundant systems or a formal disaster recovery plan, and we may not have adequate business interruption insurance to compensate us for losses that may occur from a system outage.

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

Our international 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, taxes, and exchange rate fluctuations. Any of these factors could harm operating results and financial condition. Our foreign currency exchange risk management program reduces, but does not eliminate, the impact of currency exchange rate movements.

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 have 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 assessment of sales and other taxes for the sale of our products, license of technology or provision of services.

Currently we do not collect sales, value-added tax (VAT), transactional 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, employees or other taxable presence. However, one or more states or foreign countries may seek to impose sales, VAT, transactional or other tax collection obligations on us in the future. A successful assertion by one or more states or foreign countries that we should be collecting sales, VAT, transactional or other taxes on the sale of our products, licenses of technology, provision of services or from our Internet commerce activities could result in substantial tax liabilities for past sales, discourage customers from purchasing our products from us or otherwise substantially harm our business.

Currently, decisions of the U.S. Supreme Court restrict the ability of states to collect state and local sales and use taxes with respect to sales made over the Internet. However, a number of states and the U.S. Congress have been considering various initiatives that could limit or supersede the Supreme Court's position regarding sales and use taxes on products and services sold through the Internet. If these initiatives are successful, we

could be required to collect and remit sales and use taxes in additional states. States are also continuing to define the taxability of digital goods. Taxation of digital goods is subject to complex evolving tax rules that could result in additional taxation of our products and services. The imposition of additional tax obligations related to our business activities by state and local governments could materially adversely affect our operating results, create administrative burdens for us and decrease our future sales.

In those countries where we have taxable presence, we collect 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. The collection and remittance of VAT subjects us to additional currency fluctuation risks.

We may be subject to additional income tax assessments.

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

Risks Related to Our Previously Announced Separation of Our Games Business

We announced our intention to separate our global Games business into an independent company and to distribute shares of the newly created games company to our shareholders. If such transactions are postponed for a significant period of time or not completed, our stock price and business may be adversely affected, and we may not realize the anticipated benefits of the separation transactions.

In May 2008, we announced our intention to separate our global Games business into an independent company and to distribute shares of the newly created games company to our shareholders. We also indicated that we may precede the spin-off with an initial public offering and sale of up to 20% of the shares of the new games company. In February 2009, we announced that we postponed work with our outside advisors, stopped external spending on the proposed transaction and wrote off the capitalized transaction-related costs in the fourth quarter of 2008. While we still intend to create a separate games company, current conditions do not support a separation transaction.

In addition, our business and operations may be harmed to the extent there is customer or employee uncertainty surrounding the future direction of our product and service offerings and strategy for our Games business. Even if we resume working with our outside advisors on the separation transaction, we may not complete the transaction, which is subject to a number of factors including market conditions, the final approval of our board of directors, the effectiveness of a registration statement, the receipt of a favorable letter ruling from the Internal Revenue Service and the execution of inter-company agreements. If the separation transactions are not completed, we and our shareholders will not realize the anticipated financial, operational and other benefits from such transactions.

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

Our directors and executive officers beneficially own more than 38% 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 38% of our common stock. Robert Glaser, our Chief Executive Officer and Chairman of the Board, beneficially owns more than

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38% of our common stock himself. As a result, our executive officers, directors and affiliated persons will have significant influence to:

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

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

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

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

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

In addition, Mr. Glaser has special rights under our articles of incorporation to appoint or remove members of the strategic transaction committee at his discretion that could make it more difficult for RealNetworks to be sold or to complete another change of control transaction without Mr. Glaser's consent.

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

We have adopted a shareholder rights plan, which was amended and restated in December 2008, 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, and Washington law, as well as our charter provisions that provide for a classified board of directors and the availability of "blank check" preferred stock, could have the effect of making it more difficult or more expensive for a third-party to acquire, or of discouraging a third-party from attempting to acquire, control of us. These provisions may therefore have the effect of limiting the price that investors might be willing to pay in the future for our common stock.

Item 1B. *Unresolved Staff Comments*

None.

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Item 2. Properties

Our corporate and administrative headquarters and certain research and development and sales and marketing personnel are located at our facility in Seattle, Washington.

We lease properties primarily in the following locations that are utilized by all of our business segments, unless otherwise noted below, to house our research and development, sales and marketing, and general and administrative personnel:

<u>Location</u>	<u>Area leased (sq. feet)</u>	<u>Monthly rent</u>	<u>Lease expiration</u>
Seattle, Washington	264,000	\$500,000	September 2014, with an option to renew for two five-year periods
Seattle, Washington(1)	133,000	425,000	September 2010
Seoul, Republic of Korea(2)	62,000	85,000	October 2011
Reston, Virginia(2)	35,000	80,000	September 2012

(1) In 2001, we re-evaluated our facilities requirements and as a result, decided to sublet all of this office space for the remainder of the term of our lease.

(2) This facility is utilized only by our Technology Products and Solutions segment.

In addition, we lease smaller facilities with multi-year terms in the U.S. and foreign countries, some of which support the operations of all of our business segments while others are dedicated to a specific business segment. We also lease various other smaller facilities in the U.S. and foreign countries primarily for our sales and marketing personnel. A majority of these other leases are for a period of less than one year. We believe that our properties are in good condition, adequately maintained and suitable for the conduct of our business. For additional information regarding our obligations under leases, see "Notes to Consolidated Financial Statements — Commitments and Contingencies" (Note 17).

Item 3. Legal Proceedings

See "Notes to Consolidated Financial Statements — Commitments and Contingencies" (Note 17) for information regarding legal proceedings.

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

No matters were submitted to a vote of our shareholders during the fourth quarter of our fiscal year ended December 31, 2008.

PART II.

Item 5. Market for Registrant’s Common Equity, Related Shareholder Matters and Issuer Purchases of Equity Securities

Our common stock has been traded on the Nasdaq Stock Market LLC under the symbol “RNWK” since our initial public offering in November 1997. There is no assurance that any quantity of the common stock could be sold at or near reported trading prices.

The following table sets forth for the periods indicated the high and low sale prices for our common stock, as reported on the Nasdaq Stock Market LLC. These quotations represent prices between dealers and do not include retail markups, markdowns or commissions and may not necessarily represent actual transactions.

	Years Ended December 31,			
	2008		2007	
	High	Low	High	Low
First Quarter	\$6.58	\$5.07	\$11.17	\$7.55
Second Quarter	7.61	5.82	8.76	7.42
Third Quarter	7.28	4.89	8.27	5.45
Fourth Quarter	5.12	2.93	7.35	5.74

As of January 31, 2009, there were approximately 688 holders of record of our common stock. Most shares of our common stock are held by brokers and other institutions on behalf of shareholders. We have not paid any cash dividends. Payment of dividends in the future will depend on our continued earnings, financial condition and other factors.

Our Board of Directors authorized a share repurchase program for the repurchase of our outstanding common stock in May 2008. Below is a summary of share repurchases during the quarter ended December 31, 2008, all of which were made through the Board of Directors authorized share repurchase program. No purchases were made in December 2008. The purchases made during the quarter ended December 31, 2008 completed the authorized amount for the repurchase program.

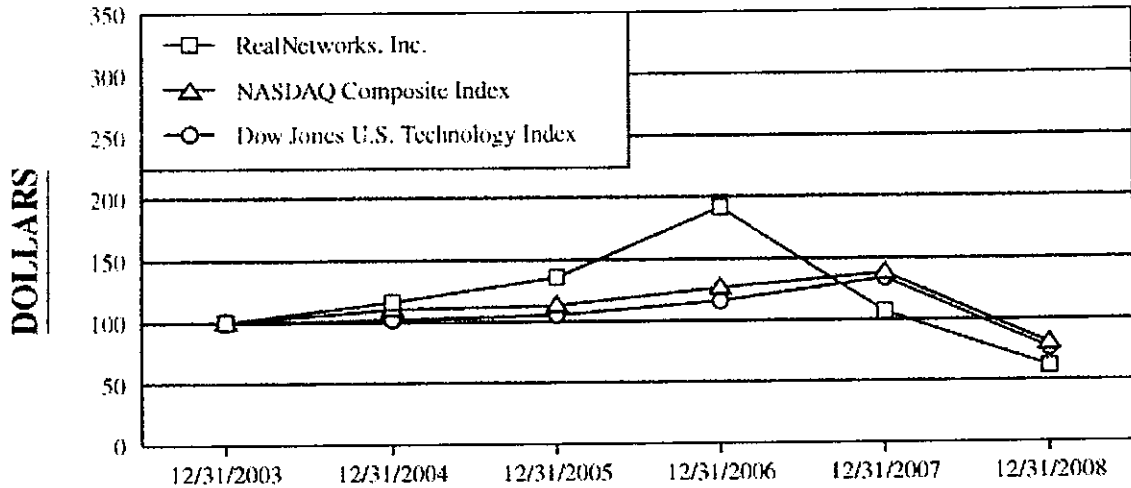
Period	Total Number of Shares Repurchased	Average Price Paid Per Share
	(In thousands)	
10/1/2008 — 10/31/2008	5,166	\$4.18
11/1/2008 — 11/30/2008	960	4.32
Total	6,126	\$4.20

For further information regarding our share repurchase plan see Note 15 of Notes to Consolidated Financial Statements.

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Set forth below is a graph comparing the cumulative total return to shareholders on our common stock with the cumulative total return of the Nasdaq Composite Index and the Dow Jones U.S. Technology Index for the period beginning on December 31, 2003 and ended on December 31, 2008.

**Comparison of 5 Year Cumulative Total Return Among RealNetworks, Inc.,
the NASDAQ Composite Index and the Dow Jones U.S. Technology Index**



	December 31, 2003	December 31, 2004	December 31, 2005	December 31, 2006	December 31, 2007	December 31, 2008
RealNetworks, Inc.	\$100	\$115.94	\$135.90	\$191.59	\$106.65	\$61.82
NASDAQ Composite Index	\$100	\$110.08	\$112.88	\$126.51	\$138.13	\$80.47
Dow Jones U.S. Technology Index	\$100	\$101.76	\$105.13	\$115.75	\$133.92	\$76.51

The total return on our common stock and each index assumes the value of each investment was \$100 on December 31, 2003, and that all dividends were reinvested, although dividends have not been declared on our common stock. Return information is historical and not necessarily indicative of future performance.

Item 6. Selected Financial Data

The following selected consolidated financial data should be read in conjunction with "Management's Discussion and Analysis of Financial Condition and Results of Operations" and the Consolidated Financial Statements and Notes to Consolidated Financial Statements included elsewhere in this report.

	Years Ended December 31,				
	2008	2007	2006	2005	2004
	(In thousands, except per share data)				
Consolidated Statements of Operations Data:					
Net revenue	\$ 604,810	\$567,620	\$ 395,261	\$ 325,059	\$266,719
Cost of revenue	233,244	213,491	124,108	98,249	97,145
Impairment of deferred costs and prepaid royalties	19,666	—	—	—	—
Gross profit	351,900	354,129	271,153	226,810	169,574
Operating expenses:					
Research and development	113,680	102,731	77,386	70,731	52,066
Sales and marketing	211,922	209,412	165,602	130,515	96,779
Advertising with related party	44,213	24,360	—	—	—
General and administrative	69,981	67,326	57,332	50,697	31,538
Impairment of goodwill and long-lived assets	192,676	—	—	—	—
Restructuring and other charges	6,833	3,748	—	—	—
Loss on excess office facilities	—	—	738	—	866
Subtotal operating expenses	639,305	407,577	301,058	251,943	181,249
Antitrust litigation (benefit) expenses, net	—	(60,747)	(220,410)	(422,500)	11,048
Total operating expenses (benefit)	639,305	346,830	80,648	(170,557)	192,297
Operating income (loss)	(287,405)	7,299	190,505	397,367	(22,723)
Other income, net	69,355	68,472	37,248	32,176	248
Income (loss) before income taxes	(218,050)	75,771	227,753	429,543	(22,475)
Income taxes	(25,828)	(27,456)	(82,537)	(117,198)	(522)
Net income (loss)	\$(243,878)	\$ 48,315	\$ 145,216	\$ 312,345	\$(22,997)
Basic net income (loss) per share	\$ (1.74)	\$ 0.32	\$ 0.90	\$ 1.84	\$ (0.14)
Diluted net income (loss) per share	\$ (1.74)	\$ 0.29	\$ 0.81	\$ 1.70	\$ (0.14)
Shares used to compute basic net income (loss) per share	140,432	151,665	160,973	169,986	168,907
Shares used to compute diluted net income (loss) per share	140,432	166,410	179,281	184,161	168,907

	As of December 31, 2008				
	2008	2007	2006	2005	2004
	(In thousands)				
Consolidated Balance Sheets Data:					
Cash, cash equivalents, and short-term investments	\$370,734	\$ 556,629	\$ 678,920	\$ 781,327	\$363,621
Working capital	266,990	351,066	584,125	710,804	287,599
Other intangible assets, net	18,727	107,677	105,109	7,337	8,383
Goodwill	175,264	353,153	309,122	123,330	119,217
Total assets	789,013	1,275,442	1,303,416	1,112,997	602,502
Convertible debt	—	100,000	100,000	100,000	100,000
Shareholders' equity	553,558	875,104	969,766	841,733	380,805

Item 7. Management's Discussion and Analysis of Financial Condition and Results of Operations**Overview**

We are a leading creator of digital media services and software. Our mission is to deliver world class digital entertainment experiences — music, games or video — wherever and whenever consumers want them. Consumers use our services and software, such as Rhapsody, RealArcade, and RealPlayer to find, play, purchase, and manage free and premium digital content, including music, games, and video. Broadcasters, cable and wireless communication companies, media companies and enterprises, such as AT&T and Verizon Wireless in the U.S., Vodafone in Europe, and SK Telecom in Korea, use our digital media applications and services to create, secure and deliver digital media to PCs, mobile phones, portable music players and other consumer electronics devices and to provide entertainment services to their subscribers.

Our strategy is to continue to (1) develop technology that provides meaningful differentiation to our chosen markets in digital entertainment services; (2) build a direct relationship with, and grow, our worldwide user base and use feedback from our customers to rapidly innovate and improve our products; and (3) create strong business partnerships with device makers, media companies, service providers and other distribution channels and leverage those partnerships to drive scale and profitability. We intend to continue to expand our products and services beyond the PC to mobile devices and to create compelling digital media experiences on a variety of entertainment devices.

We also intend to use our strong cash position to continue to seek acquisition opportunities to further our strategic initiatives, to make selective internal investments in new products or technologies and to enhance our competitive position. In recent years, we have focused our acquisition efforts principally on the identification and acquisition of targets (1) with technologies and products complementary to ours in order to accelerate and supplement our research and development efforts, (2) to increase the distribution of our products and services into new geographies, (3) to gain significant new customers and (4) with existing or a reasonably expected ability to achieve profitability. For example, our Technology Products and Solutions business acquired WiderThan in 2006 to obtain a new set of products and technologies including ringback tone and music-on-demand businesses for mobile carriers. The WiderThan acquisition also expanded our geographic reach into South Korea and brought us a new relationship with SK Telecom, a leading mobile carrier in South Korea. Subsequent to our acquisition of WiderThan, we acquired Sony NetServices in 2007 to expand our presence in Europe for our ringback tone and products and to enhance our strategic relationship with many of the larger Vodafone operating companies. Similarly, in our Games business, we acquired Zylom in 2006 to expand our presence in Europe and Trymedia in 2008 to expand the distribution of our casual games to a wide variety of new customers through Trymedia's existing syndication business.

We have recently focused our efforts on building our Music and Consumer businesses through internal initiatives, third party distribution and strategic acquisitions of businesses and technologies. Through our agreement with Verizon Wireless, we have expanded our Rhapsody subscription music service, which is provided through Rhapsody America, into the mobile carrier market. We have also increased our focus on "free-to-consumer" products and services, such as providing free music streaming for top music websites and downloadable games monetized through advertising. These products and services generate advertising revenue and are also designed to increase the exposure of our paid digital music and games products and services to consumers. As a result, combined revenue in our Music and Consumer segments grew 10% and 12% during the years ended December 31, 2008 and 2007, respectively, and we recorded the highest total annual revenue in our history in each year. The growth in our Consumer businesses, as compared with 2007, was driven primarily by increased revenue from our Games and Music businesses, which was aided by the inclusion of the operating results from our acquisition of Trymedia, completed in April 2008. This growth was partially offset by a decline in revenue in our Media Software and Services business from 2007 to 2008, due primarily to a decline in revenue from our SuperPass subscription service.

Our Technology Products and Solutions business consists primarily of application service provider (ASP) services, which include ringback tones, music-on-demand, video-on-demand and messaging services, system software sales and intellectual property licensing. Our traditional system software sales have been negatively impacted primarily by the competitive efforts of Microsoft, which bundles its competing technology with its

market leading operating systems and server software. In December 2003, we filed suit against Microsoft in U.S. District Court to redress what we believed were illegal, anticompetitive practices by Microsoft. In October 2005, we entered into a settlement agreement with Microsoft regarding the settlement of all antitrust disputes worldwide and two commercial agreements related to our digital music and casual games businesses. The settlement agreement provided for cash payments to us totaling approximately \$761 million, the final installment of which we received in the quarter ended March 31, 2007. The transactions under the commercial agreements have also concluded. While the payments we received under the settlement agreement have significantly enhanced our cash position and impact the comparability of our overall results of operations in 2007 and the results of operations in 2008, we do not expect that the completion of Microsoft's obligations under the settlement agreement and the commercial agreements will materially impact our prospects or business strategies in future periods.

In response to the slowing growth of our system software sales business, we began to shift our focus to growing our ASP services, which we significantly enhanced by acquiring WiderThan in 2006. We believe that the transition to an ASP business model will create a more stable, recurring and scalable revenue stream compared with our traditional system software license sales model. In addition, we have continued to de-emphasize our systems integration business, including the sale of systems integration services to SK Telecom, primarily because it has lower margins and does not generate consistent recurring revenue streams, which does not fit our current business model. This shift away from the systems integration business to our ASP business resulted in a slight decrease in our Technology Products and Solutions revenue, including a decline in revenue from sales of systems integration services to SK Telecom, in 2008 compared with 2007. This decrease was partially offset by increases in revenue from our ASP business.

In May 2008, we announced our intent to separate our casual Games business into an independent company and to distribute shares of the newly created games company to our shareholders. We also announced that we may precede the spin-off with an initial public offering and sale of up to 20% of the shares of the new games company. In February 2009, we announced that we postponed work with our outside advisors, stopped external spending on the proposed transaction and wrote off the capitalized transaction-related costs in the fourth quarter of 2008. While we still intend to create a separate games company, current conditions do not support a separation transaction.

We believe our operating results for the second half of 2008 were impacted by, and our operating results in future periods may continue to be impacted by, the uncertainty and adverse conditions in the economy. The economic downturn has resulted in a decline in overall consumer and corporate spending, declines in consumer access to credit, fluctuations in foreign exchange rates, declines in the value of assets and increased liquidity risks, all of which could materially impact our business, financial condition and results of operations. The digital entertainment products and services we provide may be considered discretionary items for consumers. As a result, we may experience decreases in consumer demand for our products and services, including the products and services we provide to our business customers who sell them to their subscribers, increased price-sensitivity by consumers, softening of new subscriber sign-ups and changes in consumers' use of credit cards, which is how they pay for our services. Any of these changes could materially adversely affect our revenue in future periods. In addition, we may continue to experience a decline in advertising revenue as corporate spending has decreased due to the contracting economy. We also expect our revenue to continue to be impacted by the increased volatility in foreign exchange rates, particularly if the U.S. dollar continues to gain strength against the euro and the Korean won. The continued downturn in the economy may result in additional impairments to our assets in future periods, particularly goodwill, other intangible assets and long-lived assets. Economic conditions may also negatively impact our liquidity due to (1) declines in interest income, (2) increased risk that we may not be able to access cash balances held in U.S. or foreign financial institutions or that our investments in debt securities issued by financial institutions may become worthless if such financial institutions nationalize or fail, and (3) decreased ability to sell the securities or institutional money market funds we hold as short-term investments. These risks and the potential impact of these risks on our financial condition and results of operations are discussed further above in "Risk Factors — Risks Related to Our Business in General." If any of these risks are realized, we may experience a material adverse impact on our financial condition and results of operations in future periods.

We manage our business, and correspondingly report segment revenue and profit (loss), based on three segments: Music, Consumer and Technology Products and Solutions, each of which is described further below under "Revenue by Segment" and "Costs of Revenue by Segment."

The following table sets forth certain financial data for the periods indicated as a percentage of total net revenue:

	<u>Years Ended December 31,</u>		
	<u>2008</u>	<u>2007</u>	<u>2006</u>
Net revenue	100.0%	100.0%	100.0%
Cost of revenue	38.6	37.6	31.4
Impairment of deferred costs and prepaid royalties	<u>3.2</u>	<u>—</u>	<u>—</u>
Gross profit	58.2	62.4	68.6
Operating expenses:			
Research and development	18.8	18.1	19.6
Sales and marketing	35.0	36.9	41.9
Advertising with related party	7.3	4.3	—
General and administrative	11.6	11.9	14.5
Impairment of goodwill and long-lived assets	31.9	—	—
Restructuring and other charges	1.1	0.6	—
Loss on excess office facilities	<u>—</u>	<u>—</u>	<u>0.2</u>
Subtotal operating expenses	105.7	71.8	76.2
Antitrust litigation benefit, net	<u>—</u>	<u>(10.7)</u>	<u>(55.8)</u>
Total operating expenses	<u>105.7</u>	<u>61.1</u>	<u>20.4</u>
Operating income (loss)	(47.5)	1.3	48.2
Other income, net	<u>11.5</u>	<u>12.0</u>	<u>9.4</u>
Income (loss) before income taxes	(36.0)	13.3	57.6
Income taxes	<u>(4.3)</u>	<u>(4.8)</u>	<u>(20.9)</u>
Net income (loss)	<u>(40.3)%</u>	<u>8.5%</u>	<u>36.7%</u>

Critical Accounting Policies and Estimates

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

- Revenue recognition;
- Estimating music publishing rights and music royalty accruals;
- Recoverability of deferred costs and prepaid royalties;
- Estimating allowances for doubtful accounts and sales returns;
- 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 long-lived assets;
- Valuation of goodwill;

- Stock-based compensation;
- Minority interest;
- Accounting for gains on sale of subsidiary stock;
- Accounting for taxes collected from customers; and
- Accounting for income taxes.

Revenue Recognition. We recognize revenue in accordance with the following authoritative literature: AICPA Statement of Position (SOP) No. 97-2, *Software Revenue Recognition*; SOP No. 98-9, *Software Revenue Recognition with Respect to Certain Arrangements*; SOP No. 81-1, *Accounting for Performance of Construction-Type and Certain Production-Type Contracts*; Securities and Exchange Commission (SEC) Staff Accounting Bulletin (SAB) No. 104, *Revenue Recognition in Financial Statements*; Financial Accounting Standards Board's Emerging Issues Task Force (EITF) Issue No. 00-21, *Revenue Arrangements with Multiple Deliverables*; and EITF Issue No. 99-19, *Reporting Revenue Gross as a Principal versus Net as an Agent*. Generally we recognize revenue when there is persuasive evidence of an arrangement, the fee is fixed or determinable, the product or services have been delivered and collectability of the resulting receivable is reasonably assured.

Consumer subscription products are paid in advance, typically for monthly, quarterly or annual periods. Subscription revenue is recognized ratably over the related subscription period. Revenue from sales of downloaded individual music tracks, albums and games are recognized at the time the music or game is made available, digitally, to the end user.

We recognize revenue under the residual method for multiple element software arrangements when vendor-specific objective evidence (VSOE) 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, under SOP No. 97-2. 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 post contract support (PCS), and recognize revenue for the remainder of the arrangement fee attributable to the elements initially delivered, such as software licenses. VSOE for PCS is established on standard products for which no installation or customization is required based upon amount charged when PCS is sold separately. For multiple element software arrangements involving significant production, modification, or customization of the software, which are accounted for in accordance with the provisions of SOP No. 81-1, VSOE for PCS is established if customers have an optional renewal rate specified in the arrangement and the rate is substantive.

We have arrangements whereby customers pay one price for multiple products and services and in some cases, involve a combination of products and services. For arrangements with multiple deliverables, revenue is recognized upon the delivery of the individual deliverables in accordance with EITF Issue No. 00-21. In the event that there is no objective and reliable evidence of fair value of the delivered items, the revenue recognized upon delivery is the total arrangement consideration less the fair value of the undelivered items. We apply significant judgment in establishing the fair value of multiple elements within revenue arrangements.

We recognize revenue on a gross or net basis in accordance with EITF Issue No. 99-19. In many arrangements, we contract directly with end user customers, are the primary obligor and carry all collectability risk. In such arrangements we report the revenue on a gross basis. In some cases, we utilize third-party distributors to sell products or services directly to end user customers and carry no collectability risk. In such instances we report the revenue on a net basis.

Revenue generated from advertising appearing on our websites and from advertising included in our products is recognized as revenue as the delivery of the advertising occurs.

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 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 we base our 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.

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

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

Allowances for Doubtful Accounts and Sales Returns. We must make estimates of the uncollectability of our accounts receivable. We specifically analyze the age of accounts receivable and historical bad debts, customer credit-worthiness and current economic trends when evaluating the adequacy of the allowance for doubtful accounts. Similarly, we 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 allowance. Significant judgments and estimates must be made and used in connection with establishing allowances for doubtful accounts and sales returns in any accounting period. Material differences may result in the amount and timing of our revenue for any period if we were to make different judgments or utilize different estimates.

Accrued Loss on Excess Office Facilities. We 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. Our original estimate has been revised in previous periods in response to changes in market conditions for commercial real estate in the area where the excess office facilities are located, or to reflect negotiated changes in sublease rates charged to occupying tenants.

Impairment of Investments. 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. Material differences may result in the amount and timing of any impairment charge if we were to make different judgments or utilize different estimates.

Valuation of Long-Lived Assets. Long-lived assets consist primarily of property, plant and equipment, as well as amortizable intangible assets acquired in business combinations. Long-lived assets are amortized on a straight line basis over their estimated useful lives. We review long-lived assets for impairment whenever events or changes in circumstances indicate that the carrying amount of an asset may not be recoverable. Recoverability of a long-lived asset is measured by comparing its carrying value to the undiscounted projected future cash flows that the asset is expected to generate. If the carrying amount of an asset is not recoverable, we recognize an impairment loss based on the excess of the carrying amount of the long-lived asset over its

respective fair value, which is generally determined as the present value of estimated future cash flows or at the appraised value. The impairment analysis is based on significant assumptions of future results made by management, including revenue and cash flow projections.

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

- poor economic performance relative to historical or projected future operating results;
- significant negative industry, economic or company specific trends;
- 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 the goodwill of the reporting unit. To the extent the carrying amount of reporting unit goodwill is greater than the implied fair value of reporting unit goodwill, we would record an impairment charge for the difference. Judgment is required in determining our reporting units and assessing fair value of the reporting units.

Stock-Based Compensation. We account for stock-based compensation in accordance with Statement of Financial Accounting Standards (SFAS) No. 123R, *Share-Based Payment*. Under the provisions of SFAS No. 123R, which we adopted as of January 1, 2006, stock-based compensation cost is estimated at the grant date based on the award's fair-value as calculated by the Black-Scholes option-pricing model and is recognized as expense over the requisite service period, which is the vesting period. The Black-Scholes model requires various highly judgmental assumptions including volatility in our common stock price and expected option life. If any of the assumptions used in the Black-Scholes model change significantly, stock-based compensation expense may differ materially in the future from the amounts recorded in our consolidated statement of operations. We are required to estimate forfeitures at the time of grant and revise those estimates in subsequent periods if actual forfeitures differ from those estimates. We use historical data to estimate pre-vesting option forfeitures and record stock-based compensation expense only for those awards that are expected to vest. Prior to the adoption of SFAS No. 123R, we measured compensation expense for our employee stock-based compensation plans using the intrinsic value method prescribed by Accounting Principles Board Opinion (APB) No. 25, *Accounting for Stock Issued to Employees*. Under APB No. 25, when the exercise price of our employee stock options was equal to the market price of the underlying stock on the date of the grant, no compensation expense was recognized.

Minority Interests. We record minority interest expense (benefit) which reflects the portion of the earnings (losses) of majority-owned entities which are applicable to the minority interest partners in accordance with Accounting Research Bulletin No. 51, *Consolidated Financial Statements* (ARB 51) and EITF Topic No. D-98, *Classification and Measurement of Redeemable Securities* (EITF D-98). Redeemable minority interests that are redeemable at either fair value or are based on a formula that is intended to approximate fair value follow our historical disclosure only policy for the redemption feature and the current redemption amount of the redeemable minority interests is disclosed on the face of the balance sheet. Redeemable minority interests that are redeemable at either a fixed price or are based on a formula that is not akin to fair value are reflected as an adjustment to income attributable to common shareholders based on the difference between accretion as calculated using the terms of the redemption feature and the accretion entry for a hypothetical fair value redemption feature with the remaining amount of accretion to redemption value recorded directly to equity. Minority interest expense (benefit) is included within the consolidated statement of operations and comprehensive income for 2008 and 2007.

As of December 31, 2008 and 2007, our minority interests solely related to redeemable minority interests in Rhapsody America. See Note 3 for further discussion of the redeemable minority interest treatment.

Accounting for Gains on Sale of Subsidiary Stock. We account for any changes in our ownership interest resulting from the issuance of equity capital by consolidated subsidiaries as either a gain or loss in the statement of operations pursuant to SAB No. 51 *Accounting for the Sales of Stock of a Subsidiary*. SAB No. 51 requires that the difference between the carrying amount of the parent's investment in a subsidiary and the underlying net book value of the subsidiary after the issuance of stock by the subsidiary be reflected as either a gain or loss in the statement of operations if the appropriate recognition criteria has been met or reflected as an equity transaction. We have elected to reflect SAB No. 51 gains or losses in our consolidated statement of operations and comprehensive income when the appropriate criteria have been met. As described in Note 3 to our consolidated financial statements, the sales of stock in Rhapsody America met the gain recognition criteria for all periods through September 30, 2008 and the gains from these sales were included in the consolidated statement of operations. Beginning in the fourth quarter of 2008, the gain recognition criteria in SAB No. 51 were no longer met and the sales of ownership interests in Rhapsody America were accounted for as equity transactions.

Accounting for Taxes Collected from Customers. We collect various types of taxes from our customers, assessed by governmental authorities, which are imposed on and concurrent with revenue-producing transactions. Such taxes are recorded on a net basis and are not included in our net revenue.

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

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

We have not provided for U.S. deferred income taxes or withholding taxes on certain non-U.S. subsidiaries' undistributed earnings. These earnings are intended to be permanently reinvested in operations outside of the U.S. If these amounts were distributed to the U.S., in the form of dividends or otherwise, we could be subject to additional U.S. income taxes. It is not practicable to determine the U.S. federal income tax liability or benefit on such earnings due to the availability of foreign tax credits and the complexity of the computation if such earnings were not deemed to be permanently reinvested.

A reconciliation of the beginning and ending balances of the total amounts of unrecognized tax benefits is as follows (in thousands):

	Years Ended December 31,	
	2008	2007
Balance, beginning of year	\$ 8,931	\$7,501
Increases related to prior year tax positions	586	—
Decreases related to prior year tax positions	(241)	—
Increases related to current year tax positions	1,179	1,430
Settlements	—	—
Expiration of the statute of limitations	—	—
Balance, end of year	<u>\$10,455</u>	<u>\$8,931</u>

We file numerous consolidated and separate income tax returns in the United States Federal, as well as state, local, and foreign jurisdictions. With few exceptions, we are no longer subject to United States Federal, state, local, or foreign income tax examinations for years before 1993. We are currently under audit by the California Franchise Tax Board for the consolidated group RealNetworks, Inc. and subsidiaries for the years ended December 31, 2005 and 2006. During the third quarter of 2008, an income tax audit by the United States Internal Revenue Service for our wholly-owned subsidiary WiderThan Americas, Inc. for the period ended December 31, 2005 was closed with no adjustments.

Revenue by Segment

Revenue by segment is as follows (dollars in thousands):

	2008	Change	2007	Change	2006
Music	\$160,721	8%	\$149,126	21%	\$123,033
Consumer	237,522	12	211,851	6	199,739
Technology products and solutions	<u>206,567</u>	(0)	<u>206,643</u>	185	<u>72,489</u>
Total net revenue	<u>\$604,810</u>	7%	<u>\$567,620</u>	44%	<u>\$395,261</u>

Revenue by segment as a percentage of total net revenue is as follows:

	2008	2007	2006
Music	27%	26%	31%
Consumer	39	37	51
Technology products and solutions	<u>34</u>	<u>37</u>	<u>18</u>
Total net revenue	<u>100%</u>	<u>100%</u>	<u>100%</u>

Music. Music revenue primarily includes revenue from our Rhapsody and RadioPass subscription services; sales of digital music content through Rhapsody America’s MP3 music store and Rhapsody service; and advertising from our music websites. These products and services are sold and provided primarily through our distribution partners and the Internet and we charge customers’ credit cards at the time of sale. Billings for subscription services typically occur monthly, quarterly or annually, depending on the service purchased.

During the first six months of 2008, our Music revenue growth slowed due primarily to continuing challenges facing our subscription music business, including low consumer awareness of subscription music services, Apple’s dominance of the portable MP3 player business, limited distribution of music devices that are compatible with our subscription services, and the persistent availability of unlicensed music content from peer-to-peer services. In response, we have shifted our business strategy and marketing efforts toward new initiatives including the launches of Rhapsody America’s new online MP3 store and Rhapsody subscription service with Verizon Wireless, as well as the development of music-discovery services for consumer music

websites operated by Yahoo! and MTVN. These initiatives were launched on June 30, 2008 and contributed to an increase in the rate of growth of our Music revenue for the six months ended December 31, 2008. Additionally, as part of a strategic relationship between Yahoo! and us, Yahoo! Music Unlimited subscribers that chose to migrate to Rhapsody's digital music service were converted from Yahoo! Music Unlimited subscribers to Rhapsody subscribers during the year ended December 31, 2008.

Music revenue increased by \$11.6 million, or 8%, during the year ended December 31, 2008, compared with the year ended December 31, 2007. Growth in revenue from our Rhapsody subscription music service accounted for \$17.6 million of the increase for the year ended December 31, 2008. Subscriber and related revenue growth were primarily driven by our launch of a new distribution channel with Verizon Wireless and the one-time migration of Yahoo! Music Unlimited subscribers who chose to convert to our Rhapsody music service. An increase in the number of digital music tracks sold during the year ended December 31, 2008 contributed approximately \$1.2 million to the increase. The increase in sales of digital music tracks was due primarily to the launch of Rhapsody America's new MP3 music store on June 30, 2008. These increases were offset by a decline in revenue from our RadioPass music subscription services of approximately \$5.5 million for the year ended December 31, 2008 due primarily to a decline in subscribers to these services. No other single factor contributed materially to the change during the period.

Music revenue increased by \$26.1 million, or 21%, during the year ended December 31, 2007, compared with the year ended December 31, 2006. Growth in revenue from our Rhapsody subscription music service accounted for \$21.5 million of the increase for the year ended December 31, 2007 due primarily to an increase in the price for our Rhapsody Unlimited music service as well as an increase of subscribers contributed by MTVN into the Rhapsody America joint venture. An increase in advertising sold during the year ended December 31, 2007 contributed approximately \$3.0 million to the increase. No other single factor contributed materially to the change during the period.

Consumer. Consumer revenue primarily includes revenue from digital media subscription services such as GamePass, FunPass, SuperPass and stand-alone subscriptions; sales and distribution of third-party software and services; sales of digital content such as game downloads; sales of premium versions of our RealPlayer and related products; and advertising. These products and services are sold and provided primarily through the Internet and we charge customers' credit cards at the time of sale. Billings for subscription services typically occur monthly, quarterly or annually, depending on the service purchased.

Consumer revenue increased by \$25.7 million, or 12%, during the year ended December 31, 2008, compared with the year ended December 31, 2007. Consumer revenue increased by \$12.1 million, or 6%, during the year ended December 31, 2007, compared with the year ended December 31, 2006. Factors contributing to the changes in revenue are discussed below in "Consumer Revenue."

Technology Products and Solutions. Technology Products and Solutions revenue is derived from products and services that enable wireless carriers, cable companies, and other media and communications companies to distribute digital media content to PCs, mobile phones, and other non-PC devices. Application services revenue consists of ringback tones, music-on-demand, video-on-demand, and inter-carrier messaging services, and are primarily sold to wireless carriers. Software revenue consists of Helix system software and related authoring and publishing tools, digital rights management technology, messaging gateways, and support and maintenance services that we sell to customers who purchase these products. We also offer broadcast hosting and consulting services 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.

Technology Products and Solutions revenue decreased by \$0.1 million, or less than 1%, during the year ended December 31, 2008, compared with the year ended December 31, 2007. The decrease during the year was due primarily to a decrease in systems integration revenue of approximately \$17.0 million, offset by an increase in revenue from application services provided to wireless carriers, including ringback tones, music-on-demand, inter-carrier messaging, and video-on-demand services of approximately \$18.7 million

during the year. We have de-emphasized our systems integration business, including sales of business integration services to SK Telecom, primarily because it has lower margins and does not generate consistent recurring revenue streams, which does not fit our current business model. As a result, we experienced a decline in systems integration revenue during the year due primarily to a decline in sales of our lower-margin systems integration services to SK Telecom. The increase in revenue from our application services was primarily due to increased usage and the number of users of the services we provide. No other single factor contributed materially to the change during the period. The rise in the value of the U.S. dollar against the Korean won negatively affected 2008 revenue by approximately \$8.2 million.

Technology Products and Solutions revenue increased by \$134.2 million, or 185%, during the year ended December 31, 2007, compared with the year ended December 31, 2006. The increase in revenue was primarily the result of incremental revenue from our acquisitions of WiderThan (acquired in October 2006) of approximately \$123.9 million, Sony NetServices GmbH (acquired in May 2007) of approximately \$12.9 million and Exomi (acquired in June 2007) of approximately \$2.2 million. No other single factor contributed materially to the change during the period.

Consumer Revenue

A further analysis of our Consumer revenue is as follows (dollars in thousands):

	<u>2008</u>	<u>Change</u>	<u>2007</u>	<u>Change</u>	<u>2006</u>
Games	\$134,649	24%	\$108,503	26%	\$ 86,236
Media software and services	<u>102,873</u>	(0)	<u>103,348</u>	(9)	<u>113,503</u>
Total consumer products and services revenue	<u>\$237,522</u>	12%	<u>\$211,851</u>	6%	<u>\$199,739</u>

Games. Games revenue primarily includes revenue from the sale of individual games through our RealArcade service and our games related websites including GameHouse and Zylom (acquired in January 2006); our games subscription services; advertising through RealArcade and our games related websites; and sales of games through wireless carriers.

Games revenue increased by \$26.1 million, or 24%, during the year ended December 31, 2008, compared with the year ended December 31, 2007. Revenue associated with our Trymedia acquisition, which was consummated on April 1, 2008, accounted for approximately \$11.7 million of the increase during the year ended December 31, 2008. Increases in subscription revenue accounted for approximately \$8.2 million of the increase during the year ended December 31, 2008. Increases in the number of subscribers to our games subscription services, accounted for a significant portion of the increase in subscription revenue for the year ended December 31, 2008. Revenue associated with the distribution of third-party products increased approximately \$3.1 million during the year ended December 31, 2008, due primarily to an increased focus on the distribution of these products. Growth in revenue from sales of individual games accounted for \$3.0 million of the increase for the year ended December 31, 2008. No other single factor contributed materially to the change during the period.

While our Games revenue grew in 2008 compared with 2007, during the second half of 2008 our Games revenue experienced quarterly sequential declines. We believe these declines were due primarily to challenges associated with integrating recent acquisitions into our games business and increased price sensitivity of our customers. In the fourth quarter of 2008, we re-launched our GameHouse.com website to feature offerings such as a free game every day and value pricing for our premium version casual games.

Games revenue increased by \$22.3 million, or 26%, during the year ended December 31, 2007, compared with the year ended December 31, 2006. Increases in subscription revenue accounted for approximately \$10.1 million of the increase during the year ended December 31, 2007 due primarily to additional subscribers to our services. Increases in advertising revenue generated through our games related websites accounted for approximately \$7.1 million of the increase during the year ended December 31, 2007. An increase in the

number of individual games sold accounted for \$1.9 million of the increase for the year ended December 31, 2007. No other single factor contributed materially to the change during the period.

Media Software and Services. Media Software and Services revenue primarily includes revenue from our SuperPass premium subscription service; RealPlayer Plus and related products; sales and distribution of third-party software products; and all advertising other than that related directly to our Music and Games businesses.

Media Software and Services revenue decreased by \$0.5 million, or less than 1%, during the year ended December 31, 2008, compared with the year ended December 31, 2007. This decrease was due primarily to a decline of subscribers to, and related revenue from, our SuperPass subscription service totaling approximately \$6.5 million. This decrease was primarily due to a shift in our marketing and promotional efforts towards our Music and Games businesses which we believe represent a greater growth opportunity for us. The decrease was offset by an increase of approximately \$5.4 million in revenue generated from the distribution of third-party products related to our campaign to encourage consumers to upgrade to our RealPlayer 11 media player software. No other single factor contributed materially to the change during the period.

Media Software and Services revenue decreased by \$10.2 million, or 9%, during the year ended December 31, 2007, compared with the year ended December 31, 2006. This decrease was due primarily to a decline of subscribers to, and related revenue from, our SuperPass subscription service totaling approximately \$10.2 million, offset by an increase in revenue generated from the distribution of third-party products totaling approximately \$2.9 million. No other single factor contributed materially to the change during the period.

Geographic Revenue

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

	<u>2008</u>	<u>Change</u>	<u>2007</u>	<u>Change</u>	<u>2006</u>
United States	\$403,799	12%	\$360,676	27%	\$283,433
Europe	107,223	27	84,368	35	62,270
Republic of Korea	50,443	(39)	82,549	344	18,597
Rest of the World	43,345	8	40,027	29	30,961
Total	<u>\$604,810</u>	<u>7%</u>	<u>\$567,620</u>	<u>44%</u>	<u>\$395,261</u>

Revenue in the U.S. increased by \$43.1 million, or 12%, for the year ended December 31, 2008 compared with the year ended December 31, 2007. The increase was due primarily to growth in our Games and Technology Products and Solutions businesses, including the acquisition of Trymedia in April 2008. Trymedia contributed approximately \$11.7 million of the increase during the year ended December 31, 2008. The growth in our Technology Products and Solutions business was due primarily to increased subscribers and increased usage of our application services to wireless carriers that accounted for approximately \$24.5 million of the revenue increase in the U.S. during the year ended December 31, 2008. See the sections “Revenue by Segment — Technology Products and Solutions and Consumer Revenue — Games” above for further discussion of these changes.

Revenue in the U.S. increased by \$77.2 million, or 27%, for the year ended December 31, 2007 compared with the year ended December 31, 2006. The increase was due primarily to growth in our Games and Technology Products and Solutions businesses. The growth in our Technology Products and Solutions business was due primarily to increased subscribers and increased usage of our application services to wireless carriers that accounted for approximately \$53.3 million of the revenue increase in the U.S. during the year ended December 31, 2008. See the sections “Revenue by Segment — Technology Products and Solutions” and “Consumer Revenue — Games” above for further discussion of these changes.

Revenue in Europe increased by \$22.9 million, or 27%, during the year ended December 31, 2008 compared with the year ended December 31, 2007. The increase was due primarily to the continued growth of our Games and Technology Products and Solutions businesses in Europe. The growth in our Games business was due primarily to increased subscription revenue of approximately \$4.3 million in Europe during the year

ended December 31, 2008. The growth in our Technology Products and Solutions business was due primarily to increased subscribers and increased usage of our application services to wireless carriers that accounted for approximately \$10.2 million of the revenue increase in Europe during the year ended December 31, 2008. See the sections "Revenue by Segment — Technology Products and Solutions" and "Consumer Revenue — Games" above for further discussion of these changes.

Revenue in Europe increased \$22.1 million, or 35%, during the year ended December 31, 2007 compared with the year ended December 31, 2006. The increase was due primarily to the continued growth of our Games and Technology Products and Solutions businesses in Europe. The growth in our Games business was due primarily to increased subscription revenue of approximately \$6.7 million. The growth in our Technology Products and Solutions business was due primarily to increased subscribers and increased usage of our application services to wireless carriers, including increases attributable to our acquisition of SNS in May 2007 that accounted for approximately \$14.2 million of the revenue increase in Europe during the year ended December 31, 2007. See the sections "Revenue by Segment — Technology Products and Solutions" and "Consumer Revenue-Games" above for further discussion of these changes.

Revenue in the Republic of Korea decreased by \$32.1 million, or 39%, for the year ended December 31, 2008 compared with the year ended December 31, 2007, due primarily to a decrease in our Technology Products and Solutions business in Korea. The decline in our Technology Products and Solutions business was due primarily to a decline in subscribers and reduced usage of our application services to wireless carriers in Korea that accounted for approximately \$16.1 million as well as a decline within our systems integration revenue business of approximately \$15.3 million during the year ended December 31, 2008. We have de-emphasized our systems integration business, including sales of business integration services to SK Telecom, because it has lower margins and does not generate consistent recurring revenue streams, which does not fit our current business model. The rise in the value of the U.S. dollar against the Korean won negatively affected 2008 revenue by approximately \$8.2 million.

Revenue in the Republic of Korea increased by \$64.0 million, or 344%, for the year ended December 31, 2007 compared with the year ended December 31, 2006. The increase was due to the inclusion of a full year of WiderThan (acquired in the fourth quarter of 2006).

License and Service Revenue

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

	<u>2008</u>	<u>Change</u>	<u>2007</u>	<u>Change</u>	<u>2006</u>
License fees	\$113,990	23%	\$ 92,718	2%	\$ 90,684
Service revenue	490,820	3	474,902	56	304,577
Total net revenue	<u>\$604,810</u>	7%	<u>\$567,620</u>	44%	<u>\$395,261</u>

License fees and Service revenue as a percentage of total revenue is as follows:

	<u>2008</u>	<u>2007</u>	<u>2006</u>
License fees	19%	16%	23%
Service revenue	81	84	77
Total net revenue	<u>100%</u>	<u>100%</u>	<u>100%</u>

License Fees. License fees primarily include revenue from sales of content such as game licenses and digital music tracks; our media delivery system software; premium versions of our RealPlayer and related products and messaging gateways to mobile carriers. License fees include revenue from all of our reporting segments.

License revenue increased by \$21.3 million, or 23%, during the year ended December 31, 2008 compared with the year ended December 31, 2007. The increase was due primarily to revenue generated from our Trymedia acquisition totaling approximately \$11.6 million. An increase in the number of licenses sold for our premium versions of RealPlayer totaling approximately \$3.0 million, as well as increase in the sales of

individual games of 3.0 million, also contributed to the increase during the year ended December 31, 2008. No other single factor contributed materially to the change during the period.

License revenue increased by \$2.0 million, or 2%, during the year ended December 31, 2007 compared with the year ended December 31, 2006. The increase was due primarily to revenue generated from sales of individual games accounting for \$1.9 million of the increase during the year ended December 31, 2007. No other single factor contributed materially to the change during the period.

Service Revenue. Service revenue primarily includes revenue from digital media subscription services such as SuperPass, Rhapsody, RadioPass, GamePass, FunPass and stand-alone subscriptions; sales of application services sold to wireless carriers to deliver ringback tones, music-on-demand, video-on-demand and messaging services to wireless carriers' customers; support and maintenance services that we sell to customers who purchase our software products; broadcast hosting and consulting services that we offer to our customers; distribution of third-party software; and advertising. Service revenue includes revenue from all of our reporting segments.

Service revenue increased by \$15.9 million, or 3%, during the year ended December 31, 2008 compared with the year ended December 31, 2007. Growth in revenue from our application services provided to wireless carriers accounted for \$19.1 million of the increase for the year ended December 31, 2008. Increased revenue from Rhapsody America's Rhapsody subscription music service accounted for \$17.6 million of the increase for the year ended December 31, 2008. These increases were offset by a decrease in system integration revenue of approximately \$17.0 million, as well as a decrease in subscription revenue from our SuperPass subscription service totaling approximately \$6.5 million during the year ended December 31, 2008. No other single factor contributed materially to the change during the period.

Service revenue increased by \$170.3 million, or 56%, during the year ended December 31, 2007 compared with the year ended December 31, 2006. Growth in revenue from our application services provided to wireless carriers and our systems integration business accounted for \$117.1 million and \$18.3 million, respectively, of the increase for the year ended December 31, 2007. These increases were primarily driven by our acquisition of WiderThan. Increases in revenue from the Rhapsody subscription music service and our Games subscription services accounted for \$21.5 million and \$10.1 million, respectively, of the increase for the year ended December 31, 2007. These increases were offset by a decrease in subscription revenue from our SuperPass subscription service totaling approximately \$10.2 million during the year ended December 31, 2007. No other single factor contributed materially to the change during the period.

Deferred Revenue

Deferred revenue consists of unrecognized revenue and prepayments related to application services, unearned subscription services, support contracts, prepayments under OEM arrangements and other prepayments for which the earnings process has not been completed. Total deferred revenue at December 31, 2008 was \$41.8 million compared with \$42.2 million at December 31, 2007. The change in deferred revenue was due primarily to a decrease in unearned revenue from our application services business, offset by an increase in unearned music and games subscription revenue. No other single factor contributed materially to the change during the period.

Cost of Revenue by Segment

Cost of revenue by segment is as follows (dollars in thousands):

	<u>2008</u>	<u>Change</u>	<u>2007</u>
Music	\$ 92,067	13%	\$ 81,462
Consumer	64,180	61	39,840
Technology products and solutions	96,663	5	92,189
Total cost of revenue	<u>\$252,910</u>	18%	<u>\$213,491</u>

Cost of revenue as a percentage of segment revenue is as follows:

	<u>2008</u>	<u>2007</u>
Music	57%	55%
Consumer	27	19
Technology Products and Solutions	47	45
Total cost of revenue	42%	38%

Cost of Music. Cost of Music revenue consists primarily of cost of content and delivery of the content included in our music subscription service offerings; royalties paid on sales and streams of music; hardware devices and accessories; and fees paid to third-party vendors for support services.

Cost of Music revenue increased by \$10.6 million, or 13%, during the year ended December 31, 2008 compared with the year ended December 31, 2007. Additional subscribers to our music subscription services were primarily responsible for the increased content costs including royalty payments of approximately \$8.3 million. In addition to the increased content costs, a charge of \$1.0 million was recorded related to the impairment of certain prepaid royalties (see "Impairment of Deferred Costs and Prepaid Royalties" below for more information). The impairments recognized were the primary cause of the increase of cost of Music revenue as a percentage of Music revenue for the year ended December 31, 2008. No other single factor contributed materially to the change during the period.

Cost of Consumer. Cost of Consumer revenue consists primarily of cost of content and delivery of the content included in our digital media subscription service offerings; royalties paid on sales of games and other third-party products; amounts paid for licensed technology; costs of product media; and fees paid to third-party vendors for support services.

Cost of Consumer revenue increased by \$24.3 million, or 61%, during the year ended December 31, 2008, compared with the year ended December 31, 2007. The increase was due primarily to cost of revenue associated with the operations of Trymedia, which accounted for approximately \$7.1 million of the increase. Increases in costs related to subscriber growth in our Consumer subscription services contributed an additional \$4.2 million during the year ended December 31, 2008. In addition, we recorded \$7.8 million in charges related to the impairment of certain prepaid royalties (see "Impairment of Deferred Costs and Prepaid Royalties" below for more information). No other single factor contributed materially to the changes during the period. Cost of Consumer revenue as a percentage of Consumer revenue for the year ended December 31, 2008, was negatively impacted by the impairments recognized as well as the operations of Trymedia because Trymedia's gross margins are generally lower than our other Consumer segment products.

Cost of Technology Products and Solutions. Cost of Technology Products and Solutions revenue includes amounts paid for licensed technology, costs of product media, fees paid to service carriers and third-party vendors for order fulfillment, cost of personnel providing support and consulting services, and expenses incurred in providing our ASP hosting services.

Cost of Technology Products and Solutions revenue increased by \$4.5 million, or 5%, during the year ended December 31, 2008, compared with the year ended December 31, 2007, due primarily to decreased costs associated with system integration revenue of approximately \$11.9 million. This decrease was offset by an increase in cost of revenue from application services provided to wireless carriers of approximately \$6.4 million during the year ended December 31, 2008, due primarily to increased usage and users of the services we provide. In addition, a charge of \$10.8 million was recorded related to the impairment of certain deferred costs (see "Impairment of Deferred Costs and Prepaid Royalties" below for more information). No other single factor contributed materially to the changes during the period. Cost of Technology Products and Solutions revenue as a percentage of Technology Products and Solutions revenue for the year ended December 31, 2008, was negatively impacted primarily by the impairments.

We have not provided comparative results for the year ended December 31, 2006 for cost of revenue by segment as we changed our allocation methodology in the third quarter of 2007 to accommodate the formation of Rhapsody America. We were able to use the new allocation methodology for amounts incurred since

January 1, 2007, however we do not have the data available to perform the allocation of amounts incurred prior to January 1, 2007. We deemed it impracticable to perform the allocation under the old method for the current period to provide comparative information due to the complexity of the calculations required.

Cost of License Fees and Service Revenue

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

	<u>2008</u>	<u>Change</u>	<u>2007</u>	<u>Change</u>	<u>2006</u>
License fees	\$ 50,097	43%	\$ 34,927	(6)%	\$ 37,089
Service revenue	202,813	14	178,564	105	87,019
Total cost of revenue	<u>\$252,910</u>	18%	<u>\$213,491</u>	72%	<u>\$124,108</u>

Cost of revenue as a percentage of related revenue is as follows:

	<u>2008</u>	<u>2007</u>	<u>2006</u>
License fees	44%	38%	41%
Service revenue	41	38	29
Total cost of revenue	42%	38%	31%

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, amortization of acquired technology.

Cost of license fees increased by \$15.2 million, or 43%, during the year ended December 31, 2008 compared with the year ended December 31, 2007, due primarily to charges of \$7.8 million from the impairments of certain prepaid royalties (see “Impairment of Deferred Costs and Prepaid Royalties” below for more information). Also contributing to the increase in cost of license revenue was increased costs of content related to revenue associated with the operations of Trymedia which totaled approximately \$6.6 million. No other single factor contributed materially to the changes during the period. Cost of license revenue as a percentage of license revenue for the year ended December 31, 2008, was negatively impacted primarily by the impairments mentioned above.

Cost of license fees decreased by \$2.2 million, or 6%, during the year ended December 31, 2007, compared with the year ended December 31, 2006, due primarily to the decrease in online sales of individual songs through the Rhapsody subscription service and our RealPlayer Music Store (now known as Rhapsody America’s MP3 music store). Decreases in these costs accounted for approximately \$1.8 million of the decline. No other single factor contributed materially to the changes during the period.

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

Cost of service revenue increased by \$24.2 million, or 14%, during the year ended December 31, 2008 compared with the year ended December 31, 2007. The increase was due primarily to increased content costs resulting from increased subscribers to our Music and Consumer subscription services totaling approximately \$13.2 million as well as costs associated with increased sales of application services of approximately \$7.4 million. A charge of \$11.8 million was also recorded related to the impairment of certain deferred costs and prepaid royalties (see “Impairment of Deferred Costs and Prepaid Royalties” below for more information). These increases were offset by a decrease in costs of approximately \$11.9 million resulting from a decrease in systems integration revenue. No other single factor contributed materially to the changes during the period. Cost of service revenue as a percentage of service revenue for the year ended December 31, 2008 was negatively impacted primarily by the impairments mentioned above.

Cost of service revenue increased by \$91.5 million, or 105%, during the year ended December 31, 2007 compared with the year ended December 31, 2006. The increase was due primarily to increased content costs resulting from increased subscribers to our Music and Consumer subscription services totaling approximately \$20.4 million as well as increased costs of sales of applications services and systems integration revenue related to the acquisition of WiderThan. Increases in the costs related to the sales of application services provided to wireless carriers and systems integration revenue contributed approximately \$55.7 million and \$13.0 million, respectively, to the increases for the year ended December 31, 2007. No other single factor contributed materially to the changes during the period.

Impairment of Deferred Costs and Prepaid Royalties

We assess the recovery of all deferred project costs and any royalty advances paid to content providers on a quarterly basis. As of December 31, 2008, we determined that the total estimated costs associated with certain projects exceeded the total estimated revenues expected to be recognized on those projects. As a result, we impaired approximately \$10.8 million in deferred project costs. In addition, we assessed the recovery of recoupable royalty advances paid to certain content providers. As of December 31, 2008, we determined that approximately \$8.8 million in royalty advances was not recoverable and therefore charged to expense. The total impairment of deferred costs and prepaid royalties was mentioned throughout the section above entitled "Cost of Revenue by Segment" and "Cost of License Fees and Service Revenue." See Note 8 of Notes to Consolidated Financial Statements for more information. No such charges existed in 2007 or 2006.

Assessing the recoverability of deferred project costs and prepaid royalty advances is based on significant assumptions and estimates, including future revenue and cost of sales. Significant or sustained decreases in revenue or increases in cost of sales in future periods could result in additional impairments of deferred project costs and prepaid royalty advances. We cannot accurately predict the amount and timing of such impairments. Should the value of deferred project costs or prepaid royalty advances become impaired, we would record the appropriate charge, which could have a material adverse effect on our financial condition or results of operations.

Other Segment and Geographical Information

Operating expenses of our Music, Consumer and Technology Products and Solutions segments include costs directly attributable to those segments and an allocation of general and administrative and other corporate overhead costs. In conjunction with the formation of Rhapsody America in August of 2007, we changed the method by which corporate overhead and general and administrative costs are allocated. We were able to use the new allocation methodology for amounts incurred after January 1, 2007. However, we do not have data available to perform the allocation of amounts incurred prior to January 1, 2007. Therefore comparative data from 2006 is not presented.

Reconciliation of segment operating income (loss) to income (loss) before income taxes for the year ended December 31, 2008 is as follows (in thousands):

	<u>Music</u>	<u>Consumer</u>	<u>Technology Products and Solutions</u>	<u>Reconciling Amounts</u>	<u>Consolidated</u>
Net revenue	\$160,721	\$237,522	\$ 206,567	\$ —	\$ 604,810
Cost of revenue	91,067	56,351	85,826	—	233,244
Impairment of deferred costs and prepaid royalties	1,000	7,829	10,837	—	19,666
Gross profit	68,654	173,342	109,904	—	351,900
Advertising with related party	44,213	—	—	—	44,213
Restructuring and other charges	—	—	—	6,833	6,833
Impairment of goodwill and long-lived assets	4,753	46,056	141,867	—	192,676
Other operating expenses	101,022	170,149	123,507	905	395,583
Operating income (loss)	(81,334)	(42,863)	(155,470)	(7,738)	(287,405)
Other income, net	56,057	—	—	13,298	69,355
Income (loss) before income taxes	<u>\$(25,277)</u>	<u>\$(42,863)</u>	<u>\$ (155,470)</u>	<u>\$ 5,560</u>	<u>\$ (218,050)</u>

Reconciliation of segment operating income (loss) to income (loss) before income taxes for the year ended December 31, 2007 is as follows (in thousands):

	<u>Music</u>	<u>Consumer</u>	<u>Technology Products and Solutions</u>	<u>Reconciling Amounts</u>	<u>Consolidated</u>
Net revenue	\$149,126	\$211,851	\$ 206,643	\$ —	\$ 567,620
Cost of revenue	81,462	39,840	92,189	—	213,491
Gross profit	67,664	172,011	114,454	—	354,129
Advertising with related party	24,360	—	—	—	24,360
Restructuring and other charges	—	—	—	3,748	3,748
Other operating expenses	103,482	142,749	130,551	(58,060)	318,722
Operating income (loss)	(60,178)	29,262	(16,097)	54,312	7,299
Other income, net	36,194	—	—	32,278	68,472
Income (loss) before income taxes	<u>\$(23,984)</u>	<u>\$ 29,262</u>	<u>\$ (16,097)</u>	<u>\$ 86,590</u>	<u>\$ 75,771</u>

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

	<u>December 31,</u>	
	<u>2008</u>	<u>2007</u>
United States	\$163,730	\$186,665
Republic of Korea	51,508	235,728
Europe	37,315	87,181
Rest of the World	4,445	7,753
Total long-lived assets	<u>\$256,998</u>	<u>\$517,327</u>

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

	December 31,	
	2008	2007
United States	\$463,209	\$557,381
Republic of Korea	64,824	228,153
Europe	20,201	79,410
Rest of the World	5,324	10,160
Total	<u>\$553,558</u>	<u>\$875,104</u>

Operating Expenses

Research and Development

Research and development expenses consist primarily of salaries and related costs of research and development personnel, expense associated with stock-based compensation, 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 costs and year-over-year changes are as follows (dollars in thousands):

	2008	Change	2007	Change	2006
Research and development	\$113,680	11%	\$102,731	33%	\$77,386
As a percentage of total net revenue	19%		18%		20%

Research and development expenses, including non-cash stock-based compensation, increased by \$10.9 million, or 11%, in 2008. The increase was due primarily to personnel and related costs from our acquisition of Trymedia (acquired in April 2008) and the inclusion of a full year of expenses from our acquisition of Game Trust (acquired in October 2007). Trymedia accounted for approximately \$3.4 million of the increased costs and Game Trust added approximately \$2.8 million to the increase over 2007. In addition, increases in costs related to temporary employees contributed an additional \$2.3 million to research and development expenses as compared with 2007. No other single factor contributed materially to the increase in costs during this period.

Research and development expenses increased by \$25.3 million, or 33%, in 2007 due primarily to the inclusion of a full year of expenses from our acquisition of WiderThan (acquired in the fourth quarter of 2006), which accounted for approximately \$15.3 million of the increase. Increases in consulting expenses contributed an additional \$4.0 million to the increase, and the acquisition of Game Trust (acquired in October 2007) added \$1.1 million to the total increase in research and development expenses in 2007 as compared with 2006. The decrease in research and development expenses as a percentage of total net revenue from 20% in 2006 to 18% in 2007 is due primarily to a higher growth in total net revenue. No other single factor contributed materially to these changes during the period.

Sales and Marketing

Sales and marketing expenses consist primarily of salaries and related costs for sales and marketing personnel, sales commissions, amortization of certain intangible assets capitalized in our acquisitions, credit card fees, subscriber acquisition costs, consulting fees, trade show expenses, advertising costs and costs of marketing collateral. Sales and marketing costs and year-over-year changes are as follows (dollars in thousands):

	2008	Change	2007	Change	2006
Sales and marketing	\$211,922	1%	\$209,412	26%	\$165,602
As a percentage of total net revenue	35%		37%		42%

Sales and marketing expenses, including non-cash stock-based compensation, increased by \$2.5 million, or 1%, in 2008 primarily due to \$10.0 million spent to promote Rhapsody America's new MP3 music store

and the Rhapsody subscription music service during the year, as well as \$4.1 million in increased personnel and related costs from our acquisition of Trymedia (acquired in April 2008) and the inclusion of a full year of expenses from our acquisition of Game Trust (acquired in October 2007). These increases were offset by reduced personnel and related costs of approximately \$11.2 million arising from a reduction in sales and marketing headcount. The decrease in sales and marketing expenses as a percentage of total net revenue from 37% in 2007 to 35% in 2008 is due primarily to a higher growth in total net revenue. No other single factor contributed materially to these changes during the period.

Sales and marketing expenses increased by \$43.8 million, or 26%, in 2007 due primarily to the inclusion of a full year of expenses from our acquisition of WiderThan (acquired in the fourth quarter of 2006), which accounted for approximately \$22.7 million of the increase. Further contributing to the year over year increase were payroll related expenses totaling \$14.1 million arising from higher average headcount during 2007 as compared with 2006. The decrease in sales and marketing expenses as a percentage of total net revenue from 42% in 2006 to 37% in 2007 is due primarily to a higher growth in total net revenue. No other single factor contributed materially to these changes during this period.

Advertising with Related Party

On August 20, 2007, RealNetworks and MTVN jointly created Rhapsody America. MTVN owns 49% of Rhapsody America. Under the joint venture agreement, as amended, Rhapsody America is obligated to purchase \$213.8 million in advertising and related integrated marketing on MTVN cable channels over the term of the agreement. During 2008 and 2007, Rhapsody America spent \$44.2 million and \$24.4 million, respectively, in advertising with MTVN.

General and Administrative

General and administrative expenses consist primarily of salaries and related personnel costs, fees for professional and temporary services and contractor costs, stock-based compensation, and other general corporate costs. General and administrative costs and year-over-year changes are as follows (dollars in thousands):

	2008	Change	2007	Change	2006
General and administrative	\$69,981	4%	\$67,326	17%	\$57,332
As a percentage of total net revenue	12%		12%		15%

General and administrative expenses, including non-cash stock-based compensation, increased by \$2.7 million, or 4%, during 2008 primarily due to an increase in professional service expenses totaling \$2.4 million. No other single factor contributed materially to the increase during the period.

General and administrative expenses increased by \$10.0 million, or 17%, in 2007 due primarily to the inclusion of a full year of expenses from WiderThan (acquired in the fourth quarter of 2006), which accounted for approximately \$11.4 million of the increase. Further contributing to the year over year increase were payroll related expenses totaling \$2.9 million arising from higher average headcount during 2007 as compared with 2006. These increases were partially offset by a reduction in charitable donation expenses of approximately \$5.1 million during 2007. The decrease in general and administrative expenses as a percentage of total net revenue from 15% in 2006 to 12% in 2007 is primarily due to a higher growth in total net revenue. No other single factor contributed materially to this change during the period.

Impairment of Goodwill and Long-Lived Assets

In accordance with SFAS No. 142, *Goodwill and Other Intangible Assets* (SFAS 142), goodwill is required to be tested for impairment annually and if an event or conditions change that would more likely than not reduce the fair value of a reporting unit below its carrying value. We perform our annual goodwill impairment test during our fiscal fourth quarter.

A two step process is used to test for goodwill impairment under SFAS 142. The first step is to determine if there is an indication of impairment by comparing the estimated fair value of each reporting unit to its

carrying value including existing goodwill. Goodwill is considered impaired if the carrying value of a reporting unit exceeds the estimated fair value. Upon an indication of impairment from the first step, a second step is performed to determine the amount of the impairment. This involves calculating the implied fair value of goodwill by allocating the fair value of the reporting unit to all assets and liabilities other than goodwill and comparing it to the carrying amount of goodwill. We have four reporting units; Music, Technology Products and Solutions, Games, and Media Software and Services.

To estimate the fair value of the reporting units for step one, we utilized a combination of income and market approaches. The income approach, specifically a discounted cash flow methodology, included assumptions for, among others, forecasted revenues, gross profit margins, operating profit margins, working capital cash flow, growth rates and long term discount rates, all of which require significant judgments by management.

During the quarter ended December 31, 2008, we revised our long term operating plan. Our operating plan was a significant input in evaluating the fair value of our reporting units for the purpose of assessing goodwill for possible impairment. The expected impact resulting from the significant declines observed in the broader economy during the fiscal fourth quarter of 2008 were reflected in the plan. Additionally, in light of the uncertainty regarding the extent of future economic declines, we applied discount rates in our income approach that appropriately reflected the possibility that cash flows from future operations may not be fully realized. As a result, it was determined that the carrying value for our Games and Technology Products and Solutions reporting units exceeded their respective fair values, indicating that goodwill within each reporting unit was potentially impaired. No impairments were indicated under the first step for our Music and Media Software and Services reporting units. As required, we initiated the second step of the goodwill impairment test for our Games and Technology Products and Solutions reporting units. We determined that the implied fair value of goodwill for our Technology Products and Solutions and Games reporting units was less than the carrying value by approximately \$97.0 million and \$38.1 million, respectively, which was recorded as an impairment of goodwill during the quarter ended December 31, 2008. No impairments were recognized in either of the years ended December 31, 2007 or 2006.

In accordance with SFAS No. 144, we review long-lived assets for impairment whenever events or changes in circumstances indicate the carrying amount of such assets may not be recoverable. If the carrying amount of an asset is not recoverable, an impairment loss is recognized based on the excess of the carrying amount of the long-lived asset over its respective fair value, which is generally determined as the present value of estimated future undiscounted cash flows. The impairment analysis is based on significant assumptions of future results made by management, including operating and cash flow projections. Our operating plan was a significant input in assessing the recoverability of our long-lived assets. In light of the uncertainty regarding the extent of future economic declines, we applied discount rates in our discounted cash flow analysis that appropriately reflected the possibility that cash flows from future operations may not be fully realized. Based on this assessment, we concluded that the net book value related to certain intangible assets exceeded the fair value attributable to such intangible assets. As a result, we recorded charges of \$57.6 million as impairments of long-lived assets within our consolidated statements of operations and comprehensive income in 2008. No such impairments were recognized in either 2007 or 2006.

The impairment analysis for goodwill and long-lived assets is based on significant assumptions of future results made by management, including revenue and cash flow projections. Significant or sustained declines in future revenue or cash flows, or adverse changes in our business climate, among other factors, could result in the need to perform an impairment analysis under SFAS No. 142 and 144 in future interim periods. We cannot accurately predict the amount and timing of any impairment of goodwill or long-lived assets. Should the value of our goodwill or long-lived assets become impaired, we would record the appropriate charge, which could have an adverse effect on our financial condition and results of operations.

Restructuring and Other Charges

During the year ended December 31, 2008, we recorded restructuring and other charges of \$6.8 million. Included in this charge was \$4.0 million in severance costs resulting from workforce reductions. We also

recorded a charge of \$2.8 million related to the write-down of capitalized transaction-related costs associated with our plan to separate our Games business from our company.

During the year ended December 31, 2007, we recorded a restructuring charge of \$3.7 million, primarily related to severance payments. These charges were a result of workforce reductions and other realized synergies among our recent acquisitions. Severance charges accounted for the majority of the 2007 amount recorded. No such amounts were incurred during the year ended December 31, 2006.

Loss on Excess Office Facilities

The accrued loss of \$7.2 million for estimated future losses on excess office facilities located near our corporate headquarters in Seattle, Washington at December 31, 2008, is shown net of expected future sublease income of \$5.0 million, which was committed under sublease contracts at the time of the estimate. We regularly evaluate the market for office space in the cities where we have operations. If the market for such space declines further in future periods, we may have to revise our estimates further, which may result in additional losses on excess office facilities.

Antitrust Litigation Benefit, net

Antitrust litigation benefit, net of \$60.7 million and \$220.4 million for the years ended December 31, 2007, and 2006, respectively, consist of settlement income, legal fees, personnel costs, communications, equipment, technology and other professional services costs incurred directly attributable to our antitrust case against Microsoft, as well as our participation in various international antitrust proceedings against Microsoft, including the European Union. On October 11, 2005, we entered into a settlement agreement with Microsoft pursuant to which we agreed to settle all antitrust disputes worldwide with Microsoft, including the U.S. litigation. The 2007 and 2006 antitrust litigation benefit, net reflects the impact of \$61.1 million and \$221.9 million, respectively, in payments and other consideration received from Microsoft under the settlement and commercial agreements with Microsoft. At December 31, 2007, all amounts due from Microsoft under the settlement agreement have been received. As a result, no antitrust litigation benefit, net was recorded during 2008. See "Notes to Consolidated Financial Statements — Commitments and Contingencies" (Note 17) for a description of this action.

Other Income, Net

Other income, net consists primarily of interest income on our cash, cash equivalents and short-term investments, which are net of interest expense from amortization of offering costs related to our convertible debt; gain related to the sale of certain of our equity investments; equity in net (income) loss of investments; minority interest in Rhapsody America; gain from the sales of interest in Rhapsody America; and impairment of certain equity investments. Other income, net and year-over-year changes are as follows (dollars in thousands):

	<u>2008</u>	<u>Change</u>	<u>2007</u>	<u>Change</u>	<u>2006</u>
Interest income, net	\$13,453	(56)%	\$30,874	(18)%	\$37,622
Gain on sale of equity investments	210	114	98	(96)	2,286
Equity in net income (loss) of investments	(695)	58	(440)	(235)	326
Impairment of equity investments	—	n/a	—	(100)	(3,116)
Minority interest in Rhapsody America	41,555	110	19,784	n/a	—
Gain on sale of interest in Rhapsody America	14,502	(12)	16,410	n/a	—
Other income (expenses)	330	(81)	1,746	1,243	130
Other income, net	<u>\$69,355</u>	1%	<u>\$68,472</u>	84%	<u>\$37,248</u>

Other income, net increased during 2008 due primarily to a gain from minority interest in Rhapsody America offset by a decrease in yields from our investments and an overall decline in our investment balances, as well as a decrease in the gain on sale of interest in Rhapsody America. During the quarter ended

December 31, 2008, we determined that we no longer met the criteria for recognizing in income the quarterly gain on the sale of 49% of Rhapsody America as permitted under Staff Accounting Bulletin 51, *Accounting for Sales of Stock of a Subsidiary*. As a result, we recorded the fourth quarter gain of \$6.6 million directly to shareholders' equity. See "Notes to Consolidated Financial Statements — Rhapsody America" (Note 3).

Other income, net increased during 2007 primarily due to minority interest in the net loss in Rhapsody America and gain related to the sale of our interest in Rhapsody America. The increase was partially offset by a decrease in interest income due to lower effective interest rates on our investment balances and an overall decrease in our investment balances.

Income Taxes

During the years ended December 31, 2008, 2007, and 2006, we recognized income tax expense of \$25.8 million, \$27.5 million, and \$82.5 million, respectively, related to U.S. and foreign income taxes. The decrease of \$1.7 million in tax expense from the year ended December 31, 2007 to 2008 was primarily due to the impairments of long-lived assets, deferred costs and prepaid royalties incurred in 2008 as well as the change in income generated from the Microsoft settlement offset by an increase in tax expense due to the change in the valuation allowance. The decrease of \$55.0 million in tax expense from the year ended December 31, 2006 to 2007 was primarily due to the change in income generated from the Microsoft settlement. We assess the likelihood that our deferred tax assets will be recovered. In making this assessment, many factors are considered including the current economic climate, our expectations of future taxable income, our ability to project such income, and the appreciation of our investments and other assets. As of December 31, 2008, we have a valuation allowance of \$91.0 million. The net change in valuation allowance since December 31, 2007 was \$51.2 million primarily due to the current economic environment in which the Company is currently not certain about its ability to recognize deferred tax assets.

Recently Issued Accounting Standards

In December 2007, the FASB issued SFAS No. 141R, *Business Combinations* (SFAS 141R), which establishes principles and requirements for how an acquirer recognizes and measures in its financial statements the identifiable assets acquired, the liabilities assumed, and any noncontrolling interest in an acquiree, including the recognition and measurement of goodwill acquired in a business combination. The requirements of SFAS 141R are effective for periods beginning after December 15, 2008. Early adoption is prohibited. The impact of the adoption of SFAS 141R on our consolidated financial statements will largely be dependent on the size and nature of the business combinations completed after the adoption of this statement.

In December 2007, the FASB issued SFAS No. 160, *Noncontrolling Interest in Consolidated Financial Statements, an amendment of ARB No. 51* (SFAS 160), which will change the accounting and reporting for minority interests, which will be recharacterized as noncontrolling interests and classified as a component of equity within the consolidated balance sheets. SFAS 160 requires that changes in a parent's ownership interest while the parent retains its controlling financial interest shall be accounted for as equity transactions. As a result, the gain on sales of interest in Rhapsody America will no longer be recorded in the statement of operations, but will be reflected as a component of shareholders equity. The requirements of SFAS 160 are effective for periods beginning after December 15, 2008. Early adoption is prohibited. We do not believe that this guidance will have a material impact on our financial position or results of operations except as noted above.

In April 2008, the FASB issued FSP No. 142-3, *Determination of the Useful Life of Intangible Assets* (FSP 142-3). FSP 142-3 amends the factors that should be considered in developing renewal or extension assumptions used to determine the useful life of a recognized intangible asset under FASB Statement No. 142, *Goodwill and Other Intangible Assets*. FSP 142-3 is effective for financial statements issued for fiscal years beginning after December 15, 2008. Early adoption is prohibited. We do not expect that FSP No. 142-3 will have a material impact on our financial position or results of operations upon adoption.

Liquidity and Capital Resources

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

	December 31,	
	2008	2007
Working capital	\$266,990	\$351,066
Cash, cash equivalents, and short-term investments	370,734	556,629
Restricted cash	14,742	15,509

Working capital, cash, cash equivalents, and short-term investments decreased primarily due to repurchases of our common stock of approximately \$50.2 million as well as the purchases of equipment, software and leasehold improvements of approximately \$29.5 million. Our cash, cash equivalents, and short-term investments also decreased due to the repayment of our \$100.0 million convertible debt obligation.

The following summarizes cash flows (in thousands):

	Years Ended December 31,		
	2008	2007	2006
Cash (used in) provided by operating activities	\$ (29,286)	\$ 68,409	\$ 170,920
Cash (used in) provided by investing activities	(113,218)	467	(294,065)
Cash used in financing activities	(95,862)	(113,620)	(4,764)

Cash used in and provided by operating activities consisted of net income (loss) adjusted for certain non-cash items including depreciation, amortization, stock-based compensation, deferred income taxes, minority interest, gain on sale of interest in Rhapsody America, impairment of goodwill and long-lived assets, accrued restructuring and other charges and the effect of changes in certain operating assets and liabilities, net of acquisitions.

Cash used in operating activities in the year ended December 31, 2008 was \$29.3 million and consisted of a net loss of \$243.9 million, adjustments for non-cash items provided by operations of \$220.2 million and cash used in activities related to certain operating assets and liabilities, net of acquisitions, of \$5.6 million. Adjustments for non-cash items primarily consisted of \$46.0 million of depreciation and amortization expense, \$23.5 million of stock-based compensation, \$192.7 million of impairment of long-lived assets, \$5.5 million of accrued restructuring and other charges and \$11.6 million of deferred income taxes, partially offset by \$41.6 million of minority interest and \$14.5 million of gain on sale of interest in Rhapsody America.

Changes in certain operating assets and liabilities, net of acquisitions, in the year ended December 31, 2008, primarily consisted of an increase of \$5.0 million in prepaid expenses and other assets due primarily to increases in prepaid royalties, and a decrease in accounts payable of \$13.7 million due primarily to a decrease in payments to third party content providers, partially offset by a decrease in accounts receivable of \$9.5 million related to decreases in revenue associated with our systems integration business.

Cash provided by operating activities in the year ended December 31, 2007 was \$68.4 million and consisted of net income of \$48.3 million, adjustments for non-cash items provided by operations of \$19.8 million. Cash provided by activities related to certain operating assets and liabilities, net of acquisitions, did not materially contribute to cash from operations. Adjustments for non-cash items primarily consisted of \$45.2 million of depreciation and amortization expense, and \$23.9 million of stock-based compensation, partially offset by \$19.8 million of minority interest, \$9.5 million of deferred income taxes, and \$16.4 million of gain on sale of interest in Rhapsody America.

Changes in certain operating assets and liabilities, net of acquisitions, in the year ended December 31, 2007, primarily consisted of an increase of \$19.7 million in prepaid expenses and other assets due primarily to increases in deferred costs and prepaid royalties, and an increase in accounts receivable of \$13.1 million due primarily to growth in revenue from application services provided to wireless carriers offset by an increase in

accrued and other liabilities of \$34.4 million primarily related to accrued advertising costs from our Rhapsody America joint venture as well as increases in deferred revenue from sales to wireless carriers.

Cash provided by operating activities in the year ended December 31, 2006 was \$170.9 million and consisted of a net income of \$145.2 million, adjustments for non-cash items provided by operations of \$52.3 million and cash used in activities related to certain operating assets and liabilities, net of acquisitions, of \$26.6 million. Adjustments for non-cash items primarily consisted of \$21.0 million of depreciation and amortization expense, \$55.0 million of deferred income taxes, and \$18.2 million of stock-based compensation, partially offset by \$39.2 million excess tax benefits from the exercise of stock options.

Changes in certain operating assets and liabilities, net of acquisitions, in the year ended December 31, 2006, primarily consisted of an increase of \$8.0 million in accounts receivable due primarily to increases in revenue from advertising and mobile handset royalties, and a decrease in accrued and other liabilities of \$19.8 million due primarily to a reduction in liabilities related to the Microsoft litigation (settled in the fourth quarter of 2005).

In the year ended December 31, 2008, investing activities used cash primarily for purchases of equipment, software, and leasehold improvements of \$29.5 million and acquisition costs of \$10.2 million, net of cash acquired from the acquisition of Trymedia, and the payment of anniversary and performance costs relating to the acquisition of Zylom, which were previously accrued. Purchases net of sales and maturities of short-term investments used cash of \$57.8 million during 2008. In the year ended December 31, 2007, investing activities used cash primarily for purchases of equipment, software, and leasehold improvements of \$26.7 million as well as the additional purchase price paid to the selling shareholders of Zylom for the achievement of performance criteria and the purchase price paid for the acquisitions of Game Trust, SNS and Exomi of an aggregate of \$45.6 million. Sales and maturities net of purchases of short-term investments provided cash of \$73.8 million during 2007. In the year ended December 31, 2006, investing activities used cash primarily for purchases of equipment, software, and leasehold improvements of \$13.8 million as well as for the acquisitions of WiderThan and Zylom of an aggregate of \$257.8 million. Purchases net of sales and maturities of short-term investments used cash of \$23.9 million during 2008.

Financing activities used cash for the repurchase of our common stock of \$50.2 million, \$178.8 million and \$98.9 million during the year ended December 31, 2008, 2007, and 2006, respectively, in addition to payments on our convertible debt obligations of \$100.0 million during the year ended December 31, 2008. These uses of cash were offset by the proceeds of sales of interests in Rhapsody America of \$44.6 million in 2008 and \$48.7 million in 2007, as well as sales of common stock under our employee stock purchase plan and exercise of stock options of \$9.6 million, \$15.9 million, and \$54.9 million in 2008, 2007 and 2006, respectively.

Our Board of Directors has authorized share repurchase programs for the repurchase of our outstanding common stock, and all repurchases have been made pursuant to these authorized programs. During 2006, we purchased 11.8 million shares for an aggregate value of \$98.9 million at an average cost of \$8.35 per share. During 2007, we repurchased 23.8 million shares for an aggregate value of \$178.8 million at an average cost of \$7.52 per share. During 2008, we repurchased 10.0 million shares for an aggregate value of \$50.2 million at an average cost of \$5.04 per share. The purchases made through December 31, 2008 completed the authorized amount for all of the repurchase programs.

We currently have no planned significant capital expenditures for 2009 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 may enter into cash or stock acquisition transactions or other strategic transactions that could reduce cash available to fund our operations or result in dilution to shareholders.

Our principal commitments include office leases and contractual payments due to content and other service providers. We believe that our current cash, cash equivalents, and short-term investments will be

sufficient to meet our anticipated cash needs for working capital and capital expenditures for at least the next 12 months.

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

We conduct our operations in ten primary functional currencies: the U.S. dollar, the Korean won, the Japanese yen, the British pound, the euro, the Mexican peso, the Brazilian real, the Australian dollar, the Hong Kong dollar, and the Singapore dollar. Historically, changes in foreign economic conditions have not 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 Korea, Japan, Germany, France, the United Kingdom and Australia, where we invoice our customers primarily in won, yen, euros, 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.

The downturn in the economy could result in negative impacts to our liquidity arising from lower interest income in future periods due to the continued decline in interest rates, an increased risk that we may not be able to access cash balances held in U.S. or foreign financial institutions or that investments in debt securities issued by financial institutions may be rendered worthless due to the nationalization or failure of such financial institutions, and an increased inability to sell the securities and the institutional money market funds we hold as short-term investments. If any of these risks are realized, we may experience a material adverse impact on our financial condition and results of operations.

At December 31, 2008, we had commitments to make the following payments:

<u>Contractual Obligations</u>	<u>Total</u>	<u>Less than 1 Year</u>	<u>1-3 Years</u>	<u>3-5 Years</u>	<u>After 5 Years</u>
			(In thousands)		
Office leases	\$ 59,938	\$14,831	\$21,878	\$13,580	\$9,649
Other contractual obligations	43,996	32,926	11,070	—	—
Total contractual cash obligations	<u>\$103,934</u>	<u>\$47,757</u>	<u>\$32,948</u>	<u>\$13,580</u>	<u>\$9,649</u>

Other contractual obligations primarily relate to minimum contractual payments due to content and other service providers.

In addition to the amounts shown in the table above, \$10.5 million of unrecognized tax benefits have been recorded as liabilities in accordance with FIN 48, and we are uncertain as to if or when such amounts may be settled. We cannot make a reasonably reliable estimate of the amount and period of related future payments for such liability.

We have a commitment to purchase \$144.4 million in advertising over the next five years from MTVN related to the Rhapsody America venture. The \$144.4 million is excluded from the table above as the timing and amount of these payments will vary.

Off Balance Sheet Arrangements

Our only significant off-balance sheet arrangements relate to operating lease obligations for office facility leases and other contractual obligations related primarily to minimum contractual payments due to content and other service providers. Future annual minimum rental lease payments and other contractual obligations are included in the commitment schedule above.

Item 7A. Quantitative and Qualitative Disclosures About Market Risk

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

Interest Rate Risk. Our exposure to interest rate risk from changes in market interest rates relates primarily to our short-term investment portfolio. We do not hold derivative financial instruments or equity investments in our short-term investment portfolio. Our short-term investments consist of high quality debt securities as specified in our investment policy. Investments in both fixed and floating rate instruments carry a degree of interest rate risk. The fair value of fixed rate securities may be adversely impacted due to a rise in interest rates, while floating rate securities may produce less income than expected if interest rates fall. Additionally, a declining rate environment creates reinvestment risk because as securities mature the proceeds are reinvested at a lower rate, generating less interest income. Due in part to these factors, our future interest income may be adversely impacted due to changes in interest rates. In addition, we may incur losses in principal if we are forced to sell securities that have declined in market value due to changes in interest rates. Because we have historically had the ability to hold our short-term investments until maturity 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 have been no material changes in our investment methodology regarding our cash equivalents and short-term investments during the year ended December 31, 2008. Based on our cash, cash equivalents, short-term investments, and restricted cash equivalents at December 31, 2008, a hypothetical 10% increase/decrease in interest rates would increase/decrease our annual interest income and cash flows by approximately \$0.8 million.

The table below presents the amounts related to weighted average interest rates and contractual maturities of our short-term investment portfolio at December 31, 2008 (dollars in thousands):

	Weighted Average Interest Rate	Expected Maturity Dates			Amortized Cost	Estimated Fair Value
		2009	2010	2011- 2012		
Short-term investments:						
Corporate notes and bonds	2.61%	\$ 1,493	\$19,938	\$32,005	\$ 54,685	\$ 53,436
U.S. government agency securities	1.43%	<u>84,330</u>	<u>—</u>	<u>—</u>	<u>83,920</u>	<u>84,330</u>
Total short-term investments	2.18%	<u>\$85,823</u>	<u>\$19,938</u>	<u>\$32,005</u>	<u>\$138,605</u>	<u>\$137,766</u>

The table below presents the amounts related to weighted average interest rates and contractual maturities of our short-term investment portfolio at December 31, 2007 (dollars in thousands):

	Weighted Average Interest Rate	Expected Maturity Dates			Amortized Cost	Estimated Fair Value
		2008	2009	2010- 2012		
Short-term investments:						
Corporate notes and bonds	5.24%	\$19,509	\$2,260	\$20,802	\$ 43,552	\$ 42,571
U.S. government agency securities	4.71%	<u>37,361</u>	<u>—</u>	<u>—</u>	<u>37,296</u>	<u>37,361</u>
Total short-term investments	4.94%	<u>\$56,870</u>	<u>\$2,260</u>	<u>\$20,802</u>	<u>\$ 80,848</u>	<u>\$ 79,932</u>

Investment Risk. As of December 31, 2008, we had investments in voting capital stock of both publicly traded and privately-held technology companies for business and strategic purposes. Our investments in publicly traded companies are accounted for as available-for-sale, carried at current market value and are classified as long-term as they are strategic in nature. We periodically evaluate whether any declines in fair value of our investments are other-than-temporary based on a review of qualitative and quantitative factors. For investments with publicly quoted market prices, these factors include the time period and extent by which its accounting basis exceeds its quoted market price. We consider additional factors to determine whether

declines in fair value are other-than-temporary, such as the investee's financial condition, results of operations, and operating trends. The evaluation also considers publicly available information regarding the investee companies. For investments in private companies with no quoted market price, we consider similar qualitative and quantitative factors as well as the implied value from any recent rounds of financing completed by the investee. Based upon an evaluation of the facts and circumstances during 2006, we determined that an other-than-temporary decline in fair value had occurred in one of our privately-held investments resulting in an impairment charge of \$3.1 million to reflect changes in the fair value. Based upon an evaluation of the facts and circumstances during 2008 and 2007, we determined that no additional other-than-temporary decline in fair value had occurred and therefore no impairment charges were recorded.

Included in our short-term investments balance is approximately \$12 million in debt securities issued by financial institutions, and we face the risk that these investments may be rendered worthless due to the nationalization or failure of such financial institutions.

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

Our exposure to foreign exchange rate fluctuations arise 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. A portion of these risks is managed through the use of financial derivatives, but fluctuations could impact our results of operations and financial position.

Generally, our practice is to manage foreign currency risk for the majority of material short-term intercompany balances through the use of foreign currency forward contracts. These contracts require us to exchange currencies at rates agreed upon at the contract's inception. Because the impact of movements in currency exchange rates on forward contracts offsets the related impact on the short-term intercompany balances, these financial instruments help alleviate the risk that might otherwise result from certain changes in currency exchange rates. We do not designate our foreign exchange forward contracts related to short-term intercompany accounts as hedges and, accordingly, we adjust these instruments to fair value through results of operations. However, we may periodically hedge a portion of our foreign exchange exposures associated with material firmly committed transactions, long-term investments, highly predictable anticipated exposures and net investments in foreign subsidiaries. Some of our unhedged exposures are reconciled through our statement of operations on a mark-to-market basis each quarter, so to the extent we continue to experience adverse economic conditions, we may record losses related to such unhedged exposures in future periods that may have a material adverse effect on our financial condition and results of operations.

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

In aggregate, our foreign currency denominated assets are greater than our foreign currency denominated liabilities. Primarily as a result of the U.S. dollar strengthening against the Korean won and euro in 2008, we recorded a reduction to our reported net assets of approximately \$64 million as reflected in Accumulated Other Comprehensive Income as of December 31, 2008.

Additionally, we have cash balances denominated in foreign currencies which are subject to foreign currency fluctuation risk. The majority of our foreign currency denominated cash is held in Korean won and euros. A hypothetical 10% increase or decrease in the Korean won and euro relative to the U.S. dollar from December 31, 2008 would result in an unrealized gain or loss of approximately \$3.8 million.

Foreign currency transaction gains and losses were not material for the years ended December 31, 2008, 2007, and 2006.

Item 8. Financial Statements and Supplementary Data

REALNETWORKS, INC. AND SUBSIDIARIES
CONSOLIDATED BALANCE SHEETS

	<u>December 31,</u>	
	<u>2008</u>	<u>2007</u>
	(In thousands, except per share data)	
ASSETS		
Current assets:		
Cash and cash equivalents	\$232,968	\$ 476,697
Short-term investments	137,766	79,932
Trade accounts receivable, net of allowances for doubtful accounts and sales returns of \$4,631 in 2008 and \$2,455 in 2007	70,201	84,674
Deferred costs, current portion	4,026	6,408
Deferred tax assets, net, current portion	749	—
Prepaid expenses and other current assets	33,850	33,845
Total current assets	<u>479,560</u>	<u>681,556</u>
Equipment, software, and leasehold improvements, at cost:		
Equipment and software	135,788	109,621
Leasehold improvements	30,719	30,632
Total equipment, software, and leasehold improvements	166,507	140,253
Less accumulated depreciation and amortization	103,500	83,756
Net equipment, software, and leasehold improvements	63,007	56,497
Restricted cash equivalents	14,742	15,509
Equity investments	18,582	9,976
Other assets	9,895	10,161
Deferred tax assets, net, non-current portion	9,236	40,913
Other intangible assets, net of accumulated amortization of \$56,217 in 2008 and \$41,579 in 2007	18,727	107,677
Goodwill	175,264	353,153
Total assets	<u>\$789,013</u>	<u>\$1,275,442</u>
LIABILITIES AND SHAREHOLDERS' EQUITY		
Current liabilities:		
Accounts payable	\$ 36,575	\$ 56,160
Accrued and other liabilities	118,688	114,136
Deferred revenue, current portion	39,835	39,564
Related party payable	13,155	17,241
Convertible debt	—	100,000
Accrued loss on excess office facilities, current portion	4,317	3,389
Total current liabilities	212,570	330,490
Deferred revenue, non-current portion	1,961	2,663
Accrued loss on excess office facilities, non-current portion	2,893	7,311
Deferred rent	4,614	4,518
Deferred tax liabilities, net, non-current portion	1,379	22,060
Other long-term liabilities	11,660	13,683
Total liabilities	235,077	380,725
Minority interest in Rhapsody America (see Note 3 for redemption value)	378	19,613
Commitments and contingencies		
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 134,354 shares in 2008 and 142,298 shares in 2007	134	142
Additional paid-in capital	635,324	653,904
Sale of non-controlling interest in Rhapsody America	7,381	—
Deferred stock-based compensation	—	—
Accumulated other comprehensive income (loss)	(48,729)	17,732
Retained (deficit) earnings	(40,552)	203,326
Total shareholders' equity	<u>553,558</u>	<u>875,104</u>
Total liabilities and shareholders' equity	<u>\$789,013</u>	<u>\$1,275,442</u>

See accompanying notes to consolidated financial statements.

REALNETWORKS, INC. AND SUBSIDIARIES

CONSOLIDATED STATEMENTS OF OPERATIONS AND COMPREHENSIVE INCOME (LOSS)

	Years Ended December 31,		
	2008	2007	2006
	(In thousands, except per share data)		
Net revenue(A)	\$ 604,810	\$567,620	\$ 395,261
Cost of revenue(B)	233,244	213,491	124,108
Impairment of deferred costs and prepaid royalties(B)	19,666	—	—
Gross profit	<u>351,900</u>	<u>354,129</u>	<u>271,153</u>
Operating expenses:			
Research and development	113,680	102,731	77,386
Sales and marketing	211,922	209,412	165,602
Advertising with related party	44,213	24,360	—
General and administrative	69,981	67,326	57,332
Impairment of goodwill and long-lived assets	192,676	—	—
Restructuring and other charges	6,833	3,748	—
Loss on excess office facilities	—	—	738
Subtotal operating expenses	<u>639,305</u>	<u>407,577</u>	<u>301,058</u>
Antitrust litigation benefit, net	—	(60,747)	(220,410)
Total operating expenses	<u>639,305</u>	<u>346,830</u>	<u>80,648</u>
Operating income (loss)	<u>(287,405)</u>	<u>7,299</u>	<u>190,505</u>
Other income (expenses):			
Interest income, net	13,453	30,874	37,622
Gain on sale of equity investments	210	98	2,286
Equity in net income (loss) of investments	(695)	(440)	326
Minority interest in Rhapsody America	41,555	19,784	—
Gain on sale of interest in Rhapsody America	14,502	16,410	—
Impairment of equity investments	—	—	(3,116)
Other income	330	1,746	130
Other income, net	<u>69,355</u>	<u>68,472</u>	<u>37,248</u>
Income (loss) before income taxes	(218,050)	75,771	227,753
Income taxes	(25,828)	(27,456)	(82,537)
Net income (loss)	<u>\$(243,878)</u>	<u>\$ 48,315</u>	<u>\$ 145,216</u>
Basic net income (loss) per share	\$ (1.74)	\$ 0.32	\$ 0.90
Diluted net income (loss) per share	\$ (1.74)	\$ 0.29	\$ 0.81
Shares used to compute basic net income (loss) per share	140,432	151,665	160,973
Shares used to compute diluted net income (loss) per share	140,432	166,410	179,281
Comprehensive income (loss):			
Net income (loss)	\$(243,878)	\$ 48,315	\$ 145,216
Unrealized gain (loss) on investments:			
Unrealized holding losses, net of tax	(2,320)	(8,482)	(14,399)
Foreign currency translation gains (losses)	(64,141)	2,729	11,160
Comprehensive income (loss)	<u>\$(310,339)</u>	<u>\$ 42,562</u>	<u>\$ 141,977</u>
(A) Components of net revenue:			
License fees	\$ 113,990	\$ 92,718	\$ 90,684
Service revenue	<u>490,820</u>	<u>474,902</u>	<u>304,577</u>
	<u>\$ 604,810</u>	<u>\$567,620</u>	<u>\$ 395,261</u>
(B) Components of cost of revenue:			
License fees	\$ 50,097	\$ 34,927	\$ 37,089
Service revenue	<u>202,813</u>	<u>178,564</u>	<u>87,019</u>
	<u>\$ 252,910</u>	<u>\$213,491</u>	<u>\$ 124,108</u>

See accompanying notes to consolidated financial statements.

REALNETWORKS, INC. AND SUBSIDIARIES
CONSOLIDATED STATEMENTS OF CASH FLOWS

	Years Ended December 31,		
	2008	2007	2006
	(In thousands)		
Cash flows from operating activities:			
Net income (loss)	\$(243,878)	\$ 48,315	\$ 145,216
Adjustments to reconcile net income (loss) to net cash (used in) provided by operating activities:			
Depreciation and amortization	45,968	45,225	20,980
Stock-based compensation	23,531	23,918	18,151
Changes in deferred income taxes	11,583	(9,549)	54,986
Impairment of equity investments	—	—	3,116
Loss on disposal of equipment, software, and leasehold improvements	10	302	276
Excess tax benefit from stock option exercises	(127)	(562)	(39,183)
Accrued loss on excess office facilities	(3,490)	(3,801)	(3,515)
Gain on sale of equity investments	(210)	(98)	(2,286)
Purchases of trading securities	—	(270,000)	—
Sales and maturities of trading securities	—	270,000	—
Equity in net (income) loss of investments	695	440	(326)
Minority interest in Rhapsody America	(41,555)	(19,784)	—
Gain on sale of interest in Rhapsody America	(14,502)	(16,410)	—
Impairment of goodwill and long-lived assets	192,676	—	—
Accrued restructuring and other charges	5,524	—	—
Other	111	95	97
Changes in certain assets and liabilities, net of acquisitions:			
Trade accounts receivable	9,518	(13,083)	(7,962)
Prepaid expenses and other assets	(5,040)	(19,710)	(3,126)
Accounts payable	(13,709)	(1,329)	4,276
Accrued and other liabilities	3,609	34,440	(19,780)
Net cash (used in) provided by operating activities	<u>(29,286)</u>	<u>68,409</u>	<u>170,920</u>
Cash flows from investing activities:			
Purchases of equipment, software, and leasehold improvements	(29,530)	(26,658)	(13,808)
Purchases of short-term investments	(251,887)	(133,427)	(204,841)
Sales and maturities of short-term investments	194,053	207,183	180,973
Purchases of intangible and other assets	(2,839)	(2,796)	—
Decrease in restricted cash equivalents	768	1,805	—
Proceeds from sale of equity investments	1,140	1,615	2,286
Purchases of equity investments	(14,731)	(1,656)	(834)
Cash used in acquisitions, net of cash acquired	(10,192)	(45,599)	(257,841)
Net cash (used in) provided by investing activities	<u>(113,218)</u>	<u>467</u>	<u>(294,065)</u>
Cash flows from financing activities:			
Net proceeds from sales of common stock under employee stock purchase plan and exercise of stock options	9,570	15,894	54,929
Repayment of convertible debt	(100,000)	—	—
Net proceeds from sales of interest in Rhapsody America	44,640	48,716	—
Excess tax benefit from stock option exercises	127	562	39,183
Repurchase of common stock	(50,199)	(178,792)	(98,876)
Net cash used in financing activities	<u>(95,862)</u>	<u>(113,620)</u>	<u>(4,764)</u>
Effect of exchange rate changes on cash	(5,363)	(3,791)	1,170
Net decrease in cash and cash equivalents	<u>(243,729)</u>	<u>(48,535)</u>	<u>(126,739)</u>
Cash and cash equivalents, beginning of year	<u>476,697</u>	<u>525,232</u>	<u>651,971</u>
Cash and cash equivalents, end of year	<u>\$ 232,968</u>	<u>\$ 476,697</u>	<u>\$ 525,232</u>
Supplemental disclosure of cash flow information:			
Cash paid during the year for income taxes	\$ 12,110	\$ 36,615	\$ 16,487
Supplemental disclosure of non-cash investing and financing activities:			
Accrued acquisition consideration	\$ —	\$ —	\$ 2,000

See accompanying notes to consolidated financial statements.