SCO GROUP INC

FORM 10-Q
(Quarterly Report)

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Industry	Software & Programming
Sector	Technology
Fiscal Year	10/31

UNITED STATES
SECURITIES AND EXCHANGE COMMISSION

WASHINGTON, D.C. 20549

FORM 10-Q

(Mark one)

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

For the quarterly period ended July 31, 2004

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 0-29911

THE SCO GROUP, INC.

(Exact name of registrant as specified in its charter)

Delaware (State or other jurisdiction of incorporation or organization)	**87-0662823** (I.R.S. Employer Identification Number)

355 South 520 West
Suite 100
Lindon, Utah 84042
(Address of principal executive offices and zip code)

(801) 765-4999
(Registrant's telephone number, including area code)

Indicate by check mark whether the Registrant (1) has filed all reports required to be filed by Section 13 or 15(d) of the Securities Exchange Act of 1934 during the preceding 12 months (or for such shorter period that the registrant was required to file such reports), and (2) has been subject to filing requirements for the past 90 days.

YES ☒ NO ☐

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

YES ☒ NO ☐

As of September 13, 2004, there were 17,484,473 shares of the Registrant's common stock, $0.001 par value per share, outstanding.

The SCO Group, Inc.

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THE SCO GROUP, INC. AND SUBSIDIARIES

CONDENSED CONSOLIDATED BALANCE SHEETS
(unaudited, in thousands)

	July 31, 2004	October 31, 2003
ASSETS		
CURRENT ASSETS:		
Cash and cash equivalents	$ 15,982	$ 64,428
Restricted cash	13,506	2,025
Available-for-sale securities	27,045	4,095
Accounts receivable, net of allowance for doubtful accounts of $126 and $230, respectively	5,954	9,282
Other current assets	2,466	2,450
Total current assets	64,953	82,280
PROPERTY AND EQUIPMENT:		
Computer and office equipment	3,608	3,482
Leasehold improvements	565	608
Furniture and fixtures	186	189
	4,359	4,279
Less accumulated depreciation and amortization	(3,560)	(3,131)
Net property and equipment	799	1,148
OTHER ASSETS:		
Goodwill	—	1,166
Intangibles, net	6,090	9,286
Other assets, net	1,390	1,072
Total other assets	7,480	11,524
Total assets	$ 73,232	$ 94,952
LIABILITIES AND STOCKHOLDERS' EQUITY		
CURRENT LIABILITIES:		
Accounts payable	$ 1,825	$ 1,978
Payable to BayStar II, LLP	13,000	—
Royalty payable to Novell, Inc.	506	2,025
Accrued compensation to law firms	7,956	10,556
Accrued payroll and benefits	3,075	4,752
Accrued liabilities	10,749	3,754
Derivative related to redeemable convertible preferred stock	—	15,224
Deferred revenue	5,936	5,501
Other royalties payable	171	523
Taxes payable	1,361	799
Total current liabilities	44,579	45,112
LONG-TERM LIABILITIES	501	508
MINORITY INTEREST	—	145
SERIES A REDEEMABLE CONVERTIBLE PREFERRED STOCK, $0.001 par value, 0 and 50 shares outstanding, respectively (Note 5)	—	29,671
COMMITMENTS AND CONTINGENCIES (Note 6)		
STOCKHOLDERS' EQUITY:		
Preferred stock, $0.001 par value; 5,000 shares authorized,	—	—
Common stock, $0.001 par value; 45,000 shares authorized, 17,750 and 13,824 shares outstanding, respectively	18	14
Additional paid-in capital	246,440	218,690
Common stock held in treasury	(2,414)	—
Warrants outstanding	1,099	1,099
Deferred compensation	(73)	(347)

Accumulated other comprehensive income		782		926
Accumulated deficit		(217,700)		(200,866)
Total stockholders' equity		28,152		19,516
Total liabilities and stockholders' equity	$	73,232	$	94,952

See notes to condensed consolidated financial statements.

THE SCO GROUP, INC. AND SUBSIDIARIES

CONDENSED CONSOLIDATED STATEMENTS OF OPERATIONS AND COMPREHENSIVE INCOME (LOSS)
(unaudited, in thousands, except per share data)

	Three Months Ended July 31, 2004	Three Months Ended July 31, 2003	Nine Months Ended July 31, 2004	Nine Months Ended July 31, 2003
REVENUE:				
Products	$ 8,929	$ 10,804	$ 27,056	$ 33,016
SCOsource licensing	678	7,280	709	15,530
Services	1,598	1,971	4,969	6,418
Total revenue	11,205	20,055	32,734	54,964
COST OF REVENUE:				
Products	741	1,200	2,364	3,422
SCOsource licensing	7,396	1,796	15,486	4,129
Services	878	1,538	3,273	5,008
Total cost of revenue	9,015	4,534	21,123	12,559
GROSS MARGIN	2,190	15,521	11,611	42,405
OPERATING EXPENSES:				
Sales and marketing (exclusive of stock-based compensation of $15, $31, $61 and $98, respectively)	4,233	5,930	13,952	18,421
Research and development (exclusive of stock-based compensation of $12, $29, $36 and $82, respectively)	2,592	2,950	8,167	8,142
General and administrative (exclusive of stock-based compensation of $243, $249, $771 and $747, respectively)	1,889	1,413	6,475	4,525
Restructuring charges	—	614	—	498
Amortization of intangibles	593	895	1,973	2,295
Loss on impairment of long-lived assets	—	—	2,139	—
Stock-based compensation	270	309	868	927
Total operating expenses	9,577	12,111	33,574	34,808
INCOME (LOSS) FROM OPERATIONS	(7,387)	3,410	(21,963)	7,597
EQUITY IN INCOME (LOSSES) OF AFFILIATES	41	(71)	115	(171)
OTHER INCOME (EXPENSE):				
Interest income	186	42	698	92
Change in fair value of derivative (Note 5)	—	—	5,924	—
Other expense, net	(87)	(97)	(338)	(151)
Total other income (expense), net	99	(55)	6,284	(59)
INCOME (LOSS) BEFORE INCOME TAXES	(7,247)	3,284	(15,564)	7,367
PROVISION FOR INCOME TAXES	(176)	(188)	(1,270)	(495)
NET INCOME (LOSS)	(7,423)	3,096	(16,834)	6,872
DIVIDENDS ON REDEEMABLE CONVERTIBLE PREFERRED STOCK	14,924	—	7,123	—
NET INCOME (LOSS) APPLICABLE TO COMMON STOCKHOLDERS	$ 7,501	$ 3,096	$ (9,711)	$ 6,872
BASIC NET INCOME (LOSS) PER COMMON SHARE	$ 0.49	$ 0.25	$ (0.67)	$ 0.58
DILUTED NET INCOME (LOSS) PER COMMON SHARE	$ 0.38	$ 0.19	$ (0.67)	$ 0.47
WEIGHTED AVERAGE BASIC COMMON SHARES OUTSTANDING	15,242	12,469	14,389	11,753
WEIGHTED AVERAGE DILUTED COMMON SHARES OUTSTANDING	19,912	16,180	14,389	14,744

OTHER COMPREHENSIVE INCOME (LOSS):								
Net income (loss)	$	(7,423)	$	3,096	$	(16,834)	$	6,872
Unrealized loss on available-for-sale securities		(42)		—		(160)		—
Foreign currency translation adjustment		(132)		204		16		430
COMPREHENSIVE INCOME (LOSS)	$	(7,597)	$	3,300	$	(16,978)	$	7,302

See notes to condensed consolidated financial statements.

THE SCO GROUP, INC. AND SUBSIDIARIES

CONDENSED CONSOLIDATED STATEMENTS OF CASH FLOWS
(unaudited, in thousands)

	Nine Months Ended July 31, 2004	Nine Months Ended July 31, 2003
CASH FLOWS FROM OPERATING ACTIVITIES:		
Net income (loss)	$ (16,834)	$ 6,872
Adjustments to reconcile net income (loss) to net cash provided by (used in) operating activities:		
Change in fair value of derivative	(5,924)	—
Loss on impairment of long-lived assets	2,139	—
Amortization of intangibles (including $250 and $253 classified as cost of revenue)	2,223	2,548
Depreciation and other amortization	629	815
Stock-based compensation	868	927
Equity in (income) losses of affiliates	(115)	171
Issuance of a warrant included as cost of SCOsource licensing revenue	—	94
Changes in operating assets and liabilities		
Accounts receivable, net	3,328	1,047
Other current assets	(16)	854
Other assets	(204)	1,140
Accounts payable	(153)	(407)
Accrued payroll and benefits	(1,677)	(325)
Accrued compensation to law firms	(2,600)	—
Accrued liabilities	6,995	(2,286)
Deferred revenue	435	(3,234)
Other royalties payable	(352)	(1)
Taxes payable	562	137
Long-term liabilities	(7)	(1,576)
Net cash provided by (used in) operating activities	(10,703)	6,776
CASH FLOWS FROM INVESTING ACTIVITIES:		
Purchase of property and equipment	(331)	(524)
Purchase of available-for-sale securities	(28,866)	—
Proceeds from available-for-sale securities	5,756	—
Purchase of minority interest in Japanese subsidiary	(209)	—
Investment in non-marketable securities	—	(950)
Net cash used in investing activities	(23,650)	(1,474)
CASH FLOWS FROM FINANCING ACTIVITIES:		
Proceeds from sale of common stock through ESP program	810	236
Costs incurred in connection with Series A-1 issuance	(211)	—
Repurchase and retirement of Series A-1 convertible preferred stock	(13,000)	—
Purchase of common stock	(2,414)	—
Net proceeds from the issuance of a warrant	—	650
Proceeds from exercise of common stock options	591	1,443
Net cash provided by (used in) financing activities	(14,224)	2,329
NET INCREASE (DECREASE) IN CASH AND CASH EQUIVALENTS	(48,577)	7,631
EFFECT OF FOREIGN EXCHANGE RATES ON CASH	131	441
CASH AND CASH EQUIVALENTS, beginning of period	64,428	6,589
CASH AND CASH EQUIVALENTS, end of period	$ 15,982	$ 14,661
SUPPLEMENTAL DISCLOSURE OF CASH FLOW INFORMATION:		
Cash paid for taxes	$ 652	$ 297
SUPPLEMENTAL SCHEDULE OF NONCASH INVESTING AND FINANCING ACTIVITIES:		
Accretion of dividends	$ 2,047	$ —
Capital contribution in connection with repurchase and cancellation of Series A-1 shares	$ (15,475)	$ —
Dividend in connection with exchange of Series A-1 for Series A	$ 6,305	$ —

Acquisition of Vultus, Inc.:				
Common stock issued	$	—	$	2,461
Accrued liabilties assumed	$	—	$	215

See notes to condensed consolidated financial statements.

NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS
(Unaudited)

(1) ORGANIZATION AND DESCRIPTION OF BUSINESS

The business of The SCO Group, Inc. (the "Company") focuses on marketing reliable, cost-effective UNIX software products and related services for the small-to-medium sized business market. In January 2003, the Company established its SCOsource business and launched its first of several SCOsource initiatives to review and enforce its intellectual property surrounding the UNIX operating system. The Company acquired certain intellectual property rights surrounding UNIX and UNIX System V source code from The Santa Cruz Operation (now Tarantella, Inc.) in May 2001.

(2) SIGNIFICANT ACCOUNTING POLICIES

Basis of Presentation

The accompanying unaudited condensed consolidated financial statements of the Company have been prepared by the Company pursuant to the rules and regulations of the Securities and Exchange Commission ("SEC") on a basis consistent with the Company's audited annual financial statements and, in the opinion of management, reflect all adjustments, consisting of normal recurring adjustments, necessary to present fairly the financial information set forth therein. Certain information and footnote disclosures normally included in financial statements prepared in accordance with accounting principles generally accepted in the United States of America have been condensed or omitted pursuant to SEC rules and regulations, although the Company believes that the following disclosures, when read in conjunction with the audited annual financial statements and the notes thereto included in the Company's most recent annual report on Form 10-K, are adequate to make the information presented not misleading. Operating results for the three and nine months ended July 31, 2004 are not necessarily indicative of the results that may be expected for the year ending October 31, 2004.

Use of Estimates in the Preparation of Financial Statements

The preparation of financial statements in conformity with accounting principles generally accepted in the United States of America requires management to make estimates and assumptions that affect the reported amounts of assets and liabilities and disclosure of contingent assets and liabilities at the date of the financial statements and the reported amounts of revenue and expenses during the reporting period. Actual results could differ from these estimates. The Company's critical accounting policies and estimates include, among others, revenue recognition, allowances for doubtful accounts receivable, determination of fair value of the derivative previously associated with the Company's retired Series A Convertible Preferred Stock and fair value of the Company's retired Series A-1 Convertible Preferred Stock, impairment of long-lived assets, and valuation allowances against deferred income tax assets.

Revenue Recognition

The Company recognizes revenue in accordance with Statement of Position ("SOP") 97-2, as modified by SOP 98-9, and Staff Accounting Bulletin ("SAB") No. 104. Revenue recognition in accordance with these pronouncements can be complex due to the nature and variability of the Company's sales transactions. The Company's revenue is primarily from three sources: (i) product license revenue, primarily from product sales to resellers and end users, and royalty revenue from product sales to original equipment manufacturers ("OEMs"); (ii) service and support revenue, primarily from providing support, education and consulting services to end users; and (iii) licensing revenue from its SCOsource intellectual property initiative.

The Company recognizes product revenue upon shipment if a signed contract exists, the fee is fixed and determinable, collection of the resulting receivable is probable and product returns are reasonably estimable, except for sales to distributors, which are recognized upon sale by the distributor to resellers or end users.

The majority of the Company's revenue transactions relate to product-only sales. On occasion, the Company has revenue transactions that have multiple elements (such as delivered and undelivered products, maintenance and other services). For software agreements that have multiple elements, the Company allocates revenue to each component of the contract based on the relative fair value of the elements. The fair value of each element is based on vendor specific objective evidence ("VSOE"). VSOE is established when such elements are sold separately. The Company recognizes revenue allocated to undelivered products when the criteria for product revenue recognition set forth above have been met. If VSOE of all undelivered elements exists, but VSOE does not exist for one or more delivered elements, then revenue is recognized using the residual method. Under the residual method, the fair value of the undelivered elements is deferred and recognized in future periods and the remaining portion of the license fee is recognized in the current period as product revenue.

The Company recognizes product revenue from OEM's upon receipt of sales-out royalty reports and recognizes revenue for ongoing customer support ratably over the period of the contract. Payments for fees are generally made in advance and are non-refundable. Revenue from consulting services is recognized as the related services are performed.

The Company's SCOsource licensing revenue to date has been primarily generated from license agreements to utilize the Company's UNIX source code as well as from intellectual property compliance licenses. The Company recognizes revenue from SCOsource licensing agreements when a signed contract exists, the fee is fixed and determinable, collection of the receivable is probable and delivery has occurred. If the payment terms extend beyond the Company's normal payment terms, revenue is recognized as the payments become due.

Pro Forma Fair Value of Stock-based Compensation

The Company accounts for stock options issued to directors, officers and employees under Accounting Principles Board ("APB") No. 25. Under APB No. 25, compensation expense is recognized if an option's exercise price on the measurement date is below the fair market value of the Company's common stock.

Statements of Financial Accounting Standards ("SFAS") No. 148, "Accounting for Stock-Based Compensation," requires pro forma information regarding net income (loss) to common stockholders as if the Company had accounted for its stock options granted under the fair value method. The fair value for the Company's stock options is estimated on the date of grant using the Black-Scholes option-pricing model.

With respect to stock options, restricted stock awards granted and employee stock purchase program ("ESPP") shares purchased during the three and nine months ended July 31, 2004 and 2003, the assumptions used are listed in the following table:

	Three Months Ended July 31,		Nine Months Ended July 31,	
	2004	2003	2004	2003
Risk-free interest rate	3.1%	3.4%	2.8%	3.4%
Expected dividend yield	0.0%	0.0%	0.0%	0.0%
Volatility	87.6%	157%	84.2%	132%
Expected life (in years)	2.9	2.6	3.0	2.6

For purposes of the pro forma disclosure, the estimated fair value of the stock options, restricted stock awards and ESPP shares are amortized over the vesting period of the award. The following is the pro forma disclosure and the related impact on net income (loss) and the net income (loss) per diluted common share for the three and nine months ended July 31, 2004 and 2003 (in thousands, except per share amounts):

	Three Months Ended July 31,		Nine Months Ended July 31,	
	2004	2003	2004	2003
Net income (loss) applicable to common stockholders:				
As reported	$ 7,501	$ 3,096	$ (9,711)	$ 6,872
Stock-based compensation as reported	270	309	868	927
Stock-based compensation under fair value method	(197)	(507)	(1,126)	(1,446)
Pro forma net income (loss)	$ 7,574	$ 2,898	$ (9,969)	$ 6,353
Net income (loss) applicable to common stockholders per diluted common share:				
As reported	$ 0.38	$ 0.19	$ (0.67)	$ 0.47
Pro forma	$ 0.38	$ 0.18	$ (0.69)	$ 0.43

Cash and Cash Equivalents and Available-for-Sale Securities

The Company considers all highly liquid debt instruments purchased with original maturities of three or fewer months to be cash equivalents. Cash equivalents were $12,565,000 as of July 31, 2004 and $61,701,000 as of October 31, 2003, which primarily consisted of investments in money market funds, commercial paper, corporate notes and agencies.

Available-for-sale securities consist primarily of securities that either mature within the next 12 months or have characteristics of short-term investments. All available-for-sale securities are available for working capital purposes as necessary. Available-for-sale securities are recorded at fair market value based on quoted market prices and any unrealized gains and losses are included as a component of other comprehensive income until realized. Any declines in market value that are considered to be other than temporary are charged to earnings.

Net Income (Loss) per Common Share

Basic net income (loss) per common share ("Basic EPS") is computed by dividing net income (loss) by the weighted average number of common shares outstanding. Diluted net income (loss) per common share ("Diluted EPS") is computed by dividing net income (loss) by the sum of the weighted average number of common shares outstanding and the dilutive potential common share equivalents then outstanding. Potential common share equivalents consist of the weighted average of shares issuable upon the exercise of outstanding stock options, restricted stock awards, warrants to acquire common stock and preferred stock convertible into common shares. The excluded anti-dilutive common share equivalents are not included in the computation of Diluted EPS as their effect would have decreased Diluted EPS.

The following table is a reconciliation of the numerator and denominator of Basic EPS to the numerator and denominator of Diluted EPS (in thousands, except per share amounts):

	Three Months Ended July 31,		Nine Months Ended July 31,	
	2004	2003	2004	2003
Numerator:				
Basic and diluted net income (loss) applicable to common stockholders	$ 7,501	$ 3,096	$ (9,711)	$ 6,872
Denominator:				
Weighted average common basic shares outstanding	15,242	12,469	14,389	11,753
Effect of convertible preferred stock	2,657	—	—	—
Effect of stock options	1,740	3,032	—	2,485
Effect of restricted stock awards	125	515	—	433
Effect of warrants	148	164	—	73
Weighted average common diluted shares outstanding	19,912	16,180	14,389	14,744
Basic EPS	$ 0.49	$ 0.25	$ (0.67)	$ 0.58
Diluted EPS	$ 0.38	$ 0.19	$ (0.67)	$ 0.47
Excluded anti-dilutive common share equivalents	998	212	397	360

Reclassifications

Certain reclassifications have been made to the prior period amounts to conform to the current period presentation. The reclassifications had no effect on net income for the prior periods.

(3) GOODWILL AND INTANGIBLE ASSETS

The following table shows the activity related to amortized intangible assets for the nine months ended July 31, 2004 and remaining unamortized balances as of July 31, 2004 (in thousands):

	As of October 31, 2003	Nine Months Ended July 31, 2004		As of July 31, 2004
	Net Book Value	Amortization Expense	Impairment Loss	Net Book Value
Amortizable intangible assets:				
Distribution/reseller channel	$ 6,954	$ 1,739	$ —	$ 5,215
Acquired technology	1,009	252	—	757
Acquired technology	1,166	193	973	—
Trade name	157	39	—	118
Total intangible assets	$ 9,286	$ 2,223	$ 973	$ 6,090

Of the $2,223,000 in amortization expense, $250,000 was classified as amortization of intangible assets in operating expenses and the remaining $1,973,000 was classified as cost of products revenue.

The Company recorded a loss on impairment of long-lived assets totaling $2,139,000, which related to an impairment on intangible assets of $973,000 and an impairment of goodwill of $1,166,000 for the nine months ended July 31, 2004. The impairment related to goodwill and intangible assets acquired in connection with the acquisition of Vultus, Inc. ("Vultus") in June 2003. The Company concluded that an impairment-triggering event occurred during the three months ended April 30, 2004 as an impending partnership that would solidify the Vultus revenue and cash flow opportunities did not materialize. Additionally, the Company had a reduction in force that impacted the Company's ability to move the Vultus initiative forward on a stand-alone basis. Consequently, the Company has concluded that no significant future cash flows related to its Vultus assets would be realized. The Company performed an impairment analysis of its recorded goodwill related to the Vultus reporting unit in accordance with SFAS No. 142. Additionally, an impairment analysis of the intangible assets was performed in accordance with SFAS No. 144. As a result of these analyses, the Company wrote-down the carrying value of its goodwill related to the Vultus acquisition from $1,166,000 to $0 and wrote-down intangible assets related to its Vultus acquisition from $973,000 to $0.

(4) RESTRUCTURING PLANS

The Company's board of directors and management has adopted restructuring plans to reduce facilities and personnel. These restructuring plans resulted in the Company recording expense and accruals for the costs associated with the reduction in facilities and for severance costs of affected employees.

During the three months ended April 30, 2004, in connection with management's plan to reduce operating expenses, the Company announced a plan which resulted in a charge of $682,000 that has been included in general and administrative expense. The plan principally included the elimination of approximately 16 percent of the Company's workforce. It impacted all operating departments and closed one small facility.

The following table summarizes the activity related to the Company's restructuring accruals as of July 31, 2004 (in thousands):

	Balance as of October 31, 2003	Additions	Payments	Balance as of July 31, 2004
Facilities	$ 348	$ 39	$ (196)	$ 191
Employees	—	643	(643)	—
Total	$ 348	$ 682	$ (839)	$ 191

The remaining restructuring accrual at July 31, 2004 relates to costs associated with one facility that has future lease payments extending through June 2005.

(5) REDEEMABLE CONVERTIBLE PREFERRED STOCK

On October 16, 2003, the Company issued 50,000 shares of its redeemable Series A Convertible Preferred Stock (the "Series A") for $1,000 per share. The net proceeds from the sale of the Series A were $47,740,000. The value of the Series A was classified outside of permanent equity because of certain redemption features that were outside the control of the Company.

The terms of the Series A included a number of conversion provisions that represented a derivative financial instrument under SFAS No. 133, "Accounting for Derivative Instruments and Hedging Activities." The Company determined that the conversion feature allowing Series A holders to acquire common shares was an embedded derivative that did not qualify as a scope exemption under the provisions of EITF 00-19, "Accounting for Derivative Financial Instruments Indexed to, and Potentially Settled in a Company's Own Stock." This required the Company to separately account for and record at fair value and mark-to-market the fair value of the derivative . Changes in the fair value of the derivative were recorded in the Company's statement of operations. As of October 16, 2003, the Company, through the assistance of an independent valuation firm, determined the initial fair value of the derivative was $18,069,000. As of October 31, 2003, the fair value of the derivative was $15,224,000 and the decrease in fair value of $2,845,000 was recorded as change in fair value of derivative in other income in the statement of operations for fiscal year 2003.

As of January 31, 2004, the fair value of the derivative was $11,600,000, and the decrease in fair value of $3,624,000 was recorded as change in fair value of derivative in other income in the statement of operations for three months ended January 31, 2004. On February 5, 2004, all outstanding Series A shares were exchanged for shares of the Company's Series A-1 Convertible Preferred Stock (the "Series A-1"), and, as a result, no Series A shares remained outstanding as of February 5, 2004. The exchange did not result in the Company receiving any additional proceeds. As of February 5, 2004, the fair value of the derivative was $9,300,000 and the decrease in fair value of $2,300,000 from January 31, 2004 was recorded as change in fair value of derivative in other income in the statement of operations for the three months ended April 30, 2004.

As of February 5, 2004, the Company, through the assistance of an independent valuation firm, determined the fair value of the Series A-1 was $45,276,000. The Company incurred $211,000 in offering costs in connection with the issuance of the Series A-1 in the exchange for Series A, resulting in a net fair value of $45,065,000. The difference of $6,305,000 in the fair value of the Series A-1 and the combined carrying value of the Series A and the related derivative was recorded as a non-cash dividend in the statements of operations for the three months ended April 30, 2004.

Conversion of Series A-1 Shares and Transfer of Series A-1 Shares to BayStar

On May 5, 2004, the Company received a notice from Royal Bank of Canada ("RBC") one of the holders of the Series A-1 shares, that RBC had elected to convert 10,000 Series A-1 shares into a total of 740,740 shares of the Company's common stock. The converted Series A-1 shares were purchased at a price of $1,000 per share and were converted into shares of common stock based on a conversion price of $13.50 per share. A total of $9,013,000 was recorded as permanent equity as a result of this conversion. Additionally, RBC informed the Company that it had sold its remaining 20,000 Series A-1 shares to BayStar Capital II, L.P. ("BayStar"), which following such transfer held a total of 40,000 Series A-1 shares.

Agreement to Repurchase BayStar Capital Series A-1 Shares

On May 31, 2004, the Company entered into an agreement with BayStar to repurchase and retire BayStar's 40,000 Series A-1 shares. Terms of the agreement required the Company to pay to BayStar $13,000,000 in cash and issue 2,105,263 shares of the Company's common stock. The repurchase price was payable and issuable upon the effectiveness of a shelf registration statement covering the resale of the shares of common stock that would be issued to BayStar upon the closing of the repurchase. On July 21, 2004, the SEC declared the Company's registration statement on Form S-3 effective, and, in accordance with the terms of the repurchase agreement, the closing of the repurchase with BayStar closed as of that date (see Note 10). The fair value of the cash and common shares delivered to BayStar was less than the carrying value of the remaining value of the Series A-1 shares and the Company recorded a capital contribution for this difference as outlined in the following table (in thousands):

Fair value of 2,105,263 common shares	$	9,747
Cash consideration		13,000
Total value to BayStar		22,747
Carrying value of Series A-1 including dividends		38,222
Capital contribution	$	(15,475)

Dividends

If the repurchase had not occurred, dividends on the Series A-1 shares would have been paid after October 16, 2004, the first anniversary of the original Series A private placement, quarterly at a rate of 8 percent per annum, subject to annual increases of 2 percent per annum, not to exceed 12 percent per annum. Although the Company accrued dividends of $551,000 and $2,047,000 for the three and nine months ended July 31, 2004, respectively, which reduced earnings to common stockholders, the Company will no longer accrue dividends on preferred stock because the repurchase transaction with BayStar closed. The Company never paid any dividends on the Series A or Series A-1 shares.

(6) COMMITMENTS AND CONTINGENCIES

Litigation

IBM Corporation

On or about March 6, 2003, the Company filed a complaint against IBM Corporation ("IBM"). The action is currently pending in the United States District Court for the District of Utah. The initial complaint included claims for breach of contract, misappropriation of trade secrets, tortious interference, and unfair competition. The initial complaint also alleged that IBM obtained information concerning the UNIX source code and derivative works from the Company and inappropriately used and distributed that information in connection with its efforts to promote the Linux operating system. As a result of IBM's actions, the Company is requesting damages in an amount to be proven at trial, together with additional damages through and after the time of trial. Additionally, on or about June 13, 2003, the Company delivered to IBM a notice of termination of IBM's UNIX license agreement with the Company, which license underlies IBM's AIX software.

On or about June 16, 2003, the Company filed an amended complaint in the IBM case. The amended complaint essentially restated and re-alleged the allegations of the initial complaint and expanded on those claims. Most importantly, the amended complaint raised new allegations regarding IBM's actions and breaches through the actions of Sequent Computer Systems, Inc. ("Sequent"), which IBM acquired. The Company alleged its license agreement with Sequent was breached in several ways similar to those set forth above and it seeks damages for those breaches. The Company also seeks injunctive relief on several of its claims.

IBM filed a response and counterclaim to the complaint, including a demand for a jury trial. The Company has filed an answer to the IBM counterclaim denying the claims and asserting affirmative defenses. On February 4, 2004, the Company filed a motion for leave to file amended pleadings in the case proposing to amend its complaint against IBM and to modify its affirmative defenses against IBM's counterclaims. On February 25, 2004, the court granted the Company's motion for leave to amend. The second amended complaint, which was filed on February 27, 2004, alleges nine causes of action that are similar to those set forth above, adds a new claim for copyright infringement and removes the claim for misappropriation of trade secrets. IBM has filed an answer and counterclaim. The counterclaim filed by IBM asserts 14 claims against the Company. In its counterclaim, as amended, IBM asserts that the Company does not have the right to terminate IBM's UNIX license or assert claims based on the Company's ownership of UNIX intellectual property against IBM or others in the Linux community. In addition, IBM asserts that the Company has breached the GNU General Public License and has infringed certain patents held by IBM. IBM's counterclaims include claims for breach of contract, violation of the Lanham Act, unfair competition, intentional interference with prospective economic relations, unfair and deceptive trade practices, promissory estoppel, copyright infringement for a declaratory judgment of non-infringement of copyrights, and patent infringement.

On March 3, 2004, the U.S. Magistrate Judge issued an order addressing certain discovery matters relating to both the Company and IBM. The Company filed a motion to dismiss IBM's tenth counterclaim for a declaratory judgment of non-infringement of copyrights. The Company has also filed a motion to amend the scheduling order and a motion to bifurcate IBM's patent counterclaims into another action. The Company filed, on May 28, 2004, a reply brief in connection with its motion to amend the scheduling order, in which the Company sets forth detailed and specific responses to IBM's claims made in connection with that motion. A hearing for these motions was held on June 8, 2004, and the court issued its ruling on June 10, 2004.

The court granted the Company's motion to amend the scheduling order, with certain changes. The amended scheduling order now provides, among other things, that the deadline for completing fact discovery is February 11, 2005 (previously August 4, 2004), the deadline for completing expert discovery is April 22, 2005 (previously October 22, 2004), and the trial will begin on November 1, 2005 (previously April 11, 2005). The court also denied the Company's motion to bifurcate IBM's patent counterclaims without prejudice to the Company's right to request a bifurcation again at a later date. IBM has also filed a motion for partial summary judgment on its tenth counterclaim for a declaration of non-infringement of the Company's copyrights. A hearing regarding the Company's motion to dismiss and IBM's motion for partial summary judgment on IBM's tenth counterclaim for a declaration of non-infringement is currently scheduled for September 15, 2004. The Company plans to vigorously oppose IBM's motion. The Company has filed various motions seeking additional discovery from IBM. IBM has filed two additional motions for summary judgment which the Company will vigorously oppose. In addition to the materials that have been publicly filed with the court, certain information has been filed under seal in accordance with the protective order entered in the case.

Red Hat, Inc.

On or about August 4, 2003, Red Hat, Inc. ("Red Hat") filed a complaint against the Company in the United States District Court for the District of Delaware. Red Hat asserts that the Linux operating system does not infringe on the Company's UNIX intellectual property rights and seeks a declaratory judgment for non-infringement of copyrights and no misappropriation of trade secrets. In addition, Red Hat claims the Company has engaged in false advertising in violation of the Lanham Act, deceptive trade practices, unfair competition, tortious interference with prospective business opportunities, trade libel and disparagement.

On or about September 15, 2003, the Company filed a motion to dismiss the Red Hat complaint. The motion to dismiss asserts that Red Hat lacks standing and that no case or controversy exists with respect to the claims seeking a declaratory judgment of non-infringement. The motion to dismiss further asserts that Red Hat's claims under the Lanham Act and related state laws are barred by the First Amendment to the U.S. Constitution and the common law privilege of judicial immunity. On April 6, 2004, the court issued an order denying the Company's motion to dismiss; however, the court stayed the case and requested status reports every 90 days regarding the case against IBM. Red Hat has filed a motion for reconsideration. The Company intends to continue to vigorously defend this action.

Novell, Inc.

On or about January 20, 2004, the Company brought suit in Utah state court against Novell, Inc. ("Novell") for slander of title seeking relief for Novell's alleged bad faith efforts to interfere with the Company's ownership of copyrights related to its UNIX source code and derivative works and its UnixWare product. In the lawsuit, the Company requested preliminary and permanent injunctive relief as well as damages. Through these claims, the Company seeks to require Novell to assign to the Company all copyrights that it believes Novell has wrongfully registered, prevent Novell from representing any ownership interest in those copyrights and require Novell to retract or withdraw all representations it has made regarding its purported ownership of those copyrights. Novell also filed a motion to dismiss the Company's complaint claiming it never transferred the copyrights to The Santa Cruz Operation (now Tarantella, Inc.). The Company filed a response to Novell's motion to dismiss and also filed a motion to remand the case back to the state court. On June 10, 2004, the court issued a memorandum decision and order which denied the Company's motion to remand the case to state court. The memorandum decision also denied Novell's motion to dismiss in part on claims of falsity. However, the court granted Novell's motion to dismiss regarding the Company's allegations of special damages, but granted the Company 30 days leave to amend its complaint to plead special damages with more specificity. The Company has filed its amended complaint and Novell has responded with another motion to dismiss claiming that Novell's alleged slanderous statements are privileged under the law. The Company plans to continue to vigorously pursue its claims against Novell.

DaimlerChrysler Corporation

On or around March 3, 2004, the Company brought suit against DaimlerChrysler Corporation ("DaimlerChrysler") for its alleged violations of its UNIX software agreement with the Company. Specifically, the lawsuit alleges that DaimlerChrysler breached its UNIX software agreement with the Company by failing to certify by January 31, 2004 its compliance with the UNIX software agreement as required by the Company. The lawsuit, filed in Oakland County Circuit Court in the State of Michigan, requests the court to declare that DaimlerChrysler has violated the certification requirements of its UNIX software agreement, permanently enjoin DaimlerChrysler from further violations of the UNIX software agreement, issue a mandatory injunction requiring DaimlerChrysler to remedy the effects of its past violations of the UNIX software agreement and award the Company damages in an amount to be determined at trial together with costs, attorneys' fees and any such other or different relief that the Court may deem to be equitable and just. On April 15, 2004, DaimlerChrysler filed a motion to dismiss the Company's claims. DaimlerChrysler's motion was heard on July 21, 2004 and the court granted DaimlerChrysler's motion as to the substance of DaimlerChrysler's certification, but denied the motion as to whether the certification was timely. The Company is currently evaluating this matter and any further actions it may take.

AutoZone, Inc.

On or about March 2, 2004, the Company brought suit against AutoZone, Inc. ("AutoZone") for its alleged violations of the Company's UNIX copyrights through its use of Linux. Specifically, the lawsuit alleges that AutoZone is infringing the Company's UNIX copyrights by, among other things, running versions of the Linux operating system that contain code, structure, sequence and/or organization from the Company's proprietary UNIX System V code in violation of its copyrights. The lawsuit filed in U.S. District Court in Nevada requests injunctive relief against AutoZone's further use or copying of any part of the Company's copyrighted materials and also requests damages as a result of AutoZone's infringement in an amount to be proven at trial. On April 23, 2004, AutoZone filed a motion to transfer the case to Tennessee or to stay the case. On August 6, 2004, the federal court in Nevada entered an order granting AutoZone's motion to stay the case with 90-day status reports to the court. The court denied without prejudice AutoZone's motion for a more definite statement and its motion to transfer the case to Tennessee. The court also is allowing the parties to take limited expedited discovery relating to the issue of preliminary injunctive relief requested by the Company. The Company is undertaking that discovery process.

IPO Class Action Matter

The Company is an issuer defendant in a series of class action lawsuits involving over 300 issuers that have been consolidated under one action. The plaintiffs, the issuers and the insurance companies have negotiated an agreement to settle the dispute between the plaintiffs and the issuers. All parties, including the plaintiffs, issuers and insurance companies, have executed this settlement agreement and the settlement agreement has been submitted to the court for approval. If the settlement agreement is approved by the court, and if no cross-claims, counterclaims or third party claims are later asserted, this action will be dismissed with respect to the Company and its directors.

The Company has notified its underwriters and insurance companies of the existence of the claims. Management believes, after consultation with legal counsel, that the ultimate outcome of this matter will not have a material adverse effect on the Company's results of operations or financial position. As of July 31, 2004, the Company has paid or accrued the full retention amount of $200,000 under its insurance coverage.

Other Matters

In April 2003, a former Indian distributor of the Company filed a claim in India, requesting summary judgment for payment of $1,428,000, and an order that the Company trade in India only through the distributor and/or to give a security deposit until the claim is paid. The distributor claims that the Company is responsible to repurchase certain software products and to reimburse the distributor for certain other operating costs. Management does not believe that the Company is responsible to reimburse the distributor for any operating costs and also believes that the return rights related to any remaining inventory have lapsed. Management has engaged local counsel who has advised it that such claims will likely fail, but that the distributor will continue to pursue its claims either in the Indian courts or in the U.S. courts. Discovery has commenced and hearings have been held and are ongoing. The Company intends to vigorously defend this action.

Pursuit and defense of the above-mentioned matters will be costly, and management expects the costs for legal fees and related expenses may be substantial. The ultimate outcome or potential effect on the Company's results of operations or financial position of the above-mentioned matters is not currently known or determinable.

The Company is a party to certain other legal proceedings arising in the ordinary course of business including legal proceedings arising from its SCOsource initiatives. Management believes, after consultation with legal counsel, that the ultimate outcome of such legal proceedings will not have a material adverse effect on the Company's results of operations or financial position.

Arrangement with Law Firms

On or about February 26, 2003, the Company entered into an arrangement with Boies, Schiller & Flexner LLP and other firms to investigate and review the Company's UNIX intellectual property rights. This arrangement was later modified on November 17, 2003 and December 8, 2003. The engagement with the law firms now includes the defense work related to counter suits and other retaliatory actions against the Company and lawsuits against end users violating the Company's intellectual property and contractual rights. The law firms are also representing the Company in its lawsuits against IBM, Red Hat, Novell, AutoZone, and DaimlerChrysler.

In addition to receiving fees at reduced hourly rates, the Company's agreement with the law firms provides that the law firms will receive a contingency fee of 20 percent of the proceeds from specified events related to the protection of the Company's intellectual property rights.

These events may include settlements, judgments, licensing fees, subject to certain exceptions, and a sale of the Company during the pendancy of litigation or through settlement, subject to agreed upon credits for amounts received as discounted hourly fees and unused retainer fees. Additionally, the Company's agreement with the law firms may also be construed to include contingency fee payments in connection with the Company's issuance of equity securities. Future payments payable to the law firms under this arrangement may be significant.

As described in more detail in Note 10, the Company and Boies Schiller & Flexner, LLP ("BSF") have entered into a nonbinding letter of intent to enter into a revised definitive fee agreement. The revised definitive fee agreement has not yet been completed.

Tax Assessment on the Company's Indian Branch

During the three months ended April 30, 2004, the Indian branch of the Company's United Kingdom subsidiary, The SCO Group, Ltd. received a withholding tax assessment from the Government of India Income Tax Department ("Tax Department") in the amount of $477,000. In the assessment the Tax Department deemed revenue transactions to customers in India as royalty revenue which was subject to a 15 percent withholding tax. The Company believes that the Tax Department may pursue similar assessments for the 2002 and 2003 periods, and has accrued the full amount of the withholding tax of $314,000 for those periods. These amounts have been recorded in the Company's provision for income taxes during the nine months ended July 31, 2004. Since the initial assessment, the Company has filed various appeals with the Tax Department objecting to the assessment and will continue to vigorously oppose to the assessment.

(7) STOCKHOLDERS' EQUITY

Stock-Based Compensation

The following table details the components of stock-based compensation for the three and nine months ended July 31, 2004 and 2003 (in thousands):

	Three Months Ended July 31,		Nine Months Ended July 31,	
	2004	2003	2004	2003
Amortization of stock-based compensation	$ 51	$ 235	$ 274	$ 631
Options and shares for services	219	74	502	296
Modifications to options	—	—	92	—
Total	$ 270	$ 309	$ 868	$ 927

During the three and nine months ended July 31, 2004, the Company granted options to purchase 346,000 and 878,000 shares of common stock with an average exercise price of $4.76 and $7.56 per share, respectively. None of these stock options was granted with an exercise price below the quoted market price on the date of grant. During the three and nine months ended July 31, 2004, options to purchase approximately 32,000 and 400,000 shares of common stock were exercised with an average exercise price of $1.00 and $1.48 per share, respectively. As of July 31, 2004, there were 3,548,000 stock options outstanding with a weighted average exercise price of $4.11 per share.

During the three months ended January 31, 2004, the Company modified an option grant to one of its board members. The Company recognized compensation expense of approximately $92,000 related to the modification of this option.

Options to Consultants

During the three months ended April 30, 2004, the Company entered into an agreement with a consultant to provide financial consulting and investor relations services to the Company.

The agreement was for a period of three months and was renewable for additional three-month periods. The Company paid the consultant a fixed fee of $10,000 per month. As part of the agreement, the Company granted to the consultant an option to acquire 200,000 shares of the Company's common stock at a price of $10.03 per share, the fair value of the Company's common stock on the date the agreement was finalized. The option expired unexercised and the agreement with the consultant was not renewed.

The Company used the Black-Scholes option pricing model to determine the fair value of the option of $269,000, of which $50,000 was recorded as expense in the three months ended April 30, 2004 and the remaining $219,000 was recorded as expense in the three months ended July 31, 2004. Assumptions used in the Black-Scholes option pricing model to determine the fair value of the option were the following: risk free interest rate of 2.9 percent, volatility of 66 percent, dividend yield of 0 percent, and a contractual term of three months.

Stock Buyback Program

On March 10, 2004, the Company's board of directors authorized management, in its discretion, to purchase up to 1,500,000 shares of the Company's common stock over the 24-month period following March 10, 2004, the time at which the repurchase program was effective. Any repurchased shares will be held in treasury and will be available for general corporate purposes. The repurchase program will allow the Company to repurchase its shares from time to time in accordance with the requirements of the Securities and Exchange Commission on the open market, in block trades and in privately negotiated transactions, depending on market conditions and other factors. During the three months ended April 30, 2004, the Company purchased approximately 290,000 shares of its common stock at a total cost of approximately $2,414,000. There were no repurchases of common stock during the three months ended July 31, 2004.

(8) SIGNIFICANT CUSTOMERS

During the three and nine months ended July 31, 2004, no single customer accounted for more than 10 percent of total revenue. During the three months ended July 31, 2003, Microsoft Corporation ("Microsoft") accounted for approximately 25 percent of total revenue and Sun Microsystems, Inc. ("Sun") accounted for approximately 12 percent of total revenue. During the nine months ended July 31, 2003, Microsoft accounted for approximately 16 percent of total revenue and Sun accounted for approximately 12 percent of total revenue.

(9) SEGMENT INFORMATION

The Company's resources are allocated and operating results managed to the operating income (loss) level for each of the Company's segments: UNIX and SCOsource. Both segments are based on the Company's UNIX intellectual property. The UNIX business sells and distributes UNIX products and services through an extensive distribution channel and to corporate end-users and the SCOsource business enforces and protects the Company's UNIX intellectual property.

During fiscal year 2004, in an effort to maximize the assets and resources of the UNIX and SCOsource business segments and to best represent management's view of business operations, the Company began allocating resources and reviewing financial information for its UNIX and SCOsource segment. The following table presents the results of the SCOsource segment had it existed during the three and nine months ended July 31, 2003. All costs associated with the SCOsource segment were classified as cost of revenue for the three and nine months ended July 31, 2003 and there were no direct sales or marketing efforts during these periods. Segment disclosures for the Company are as follows for the three and nine months ended July 31, 2004 and 2003 (in thousands):

	Three Months Ended July 31, 2004		
	UNIX	SCOsource	Total
Revenue	$ 10,527	$ 678	$ 11,205
Cost of revenue	1,619	7,396	9,015
Gross margin	8,908	(6,718)	2,190
Sales and marketing	3,740	493	4,233
Research and development	2,361	231	2,592
General and administrative	1,761	128	1,889
Other	863	—	863
Total operating expenses	8,725	852	9,577
Income (loss) from operations	$ 183	$ (7,570)	$ (7,387)

	Three Months Ended July 31, 2003		
	UNIX	SCOsource	Total
Revenue	$ 12,775	$ 7,280	$ 20,055
Cost of revenue	2,738	1,796	4,534
Gross margin	10,037	5,484	15,521
Sales and marketing	5,930	—	5,930
Research and development	2,950	—	2,950
General and administrative	1,413	—	1,413
Other	1,818	—	1,818
Total operating expenses	12,111	—	12,111
Income (loss) from operations	$ (2,074)	$ 5,484	$ 3,410

	Nine Months Ended July 31, 2004		
	UNIX	SCOsource	Total
Revenue	$ 32,025	$ 709	$ 32,734
Cost of revenue	5,637	15,486	21,123
Gross margin	26,388	(14,777)	11,611
Sales and marketing	12,868	1,084	13,952
Research and development	7,838	329	8,167
General and administrative	6,325	150	6,475
Other	4,980	—	4,980
Total operating expenses	32,011	1,563	33,574
Loss from operations	$ (5,623)	$ (16,340)	$ (21,963)

	Nine Months Ended July 31, 2003		
	UNIX	SCOsource	Total
Revenue	$ 39,434	$ 15,530	$ 54,964
Cost of revenue	8,430	4,129	12,559
Gross margin	31,004	11,401	42,405
Sales and marketing	18,421	—	18,421
Research and development	8,142	—	8,142
General and administrative	4,525	—	4,525
Other	3,720	—	3,720
Total operating expenses	34,808	—	34,808
Income (loss) from operations	$ (3,804)	$ 11,401	$ 7,597