

REALNETWORKS INC
Form 10-Q
August 09, 2011
Table of Contents

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 June 30, 2011

OR

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

For the transition period from to

Commission file number 0-23137

RealNetworks, Inc.

(Exact name of registrant as specified in its charter)

Edgar Filing: REALNETWORKS INC - Form 10-Q

Washington
(State of incorporation)

91-1628146
(I.R.S. Employer

Identification Number)

2601 Elliott Avenue, Suite 1000

Seattle, Washington
(Address of principal executive offices)

98121
(Zip Code)

(206) 674-2700

(Registrant's telephone number, including area code)

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

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

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

Large accelerated filer Accelerated filer

Non-accelerated filer (Do not check if a smaller reporting company) Smaller reporting company

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

The number of shares of the registrant's Common Stock outstanding as of July 29, 2011 was 136,791,347.

Table of Contents

TABLE OF CONTENTS

	Page
<u>Part I. Financial Information</u>	3
<u>Item 1. Financial Statements</u>	3
<u>Item 2. Management's Discussion and Analysis of Financial Condition and Results of Operations</u>	22
<u>Item 3. Quantitative and Qualitative Disclosures About Market Risk</u>	38
<u>Item 4. Controls and Procedures</u>	39
<u>Part II. Other Information</u>	40
<u>Item 1. Legal Proceedings</u>	40
<u>Item 1A. Risk Factors</u>	40
<u>Item 2. Unregistered Sales of Equity Securities and Use of Proceeds</u>	48
<u>Item 3. Default Upon Senior Securities</u>	48
<u>Item 4. Removed and Reserved</u>	48
<u>Item 5. Other Information</u>	48
<u>Item 6. Exhibits</u>	48
<u>Signature</u>	50

Table of Contents**PART I. FINANCIAL INFORMATION****Item 1. Financial Statements****REALNETWORKS, INC. AND SUBSIDIARIES****UNAUDITED CONDENSED CONSOLIDATED BALANCE SHEETS****(In thousands, except per share data)**

	June 30, 2011	December 31, 2010
ASSETS		
Current assets:		
Cash and cash equivalents	\$ 236,730	\$ 236,018
Short-term investments	91,142	98,303
Trade accounts receivable, net of allowances for doubtful accounts and sales returns	46,011	48,324
Deferred costs, current portion	9,882	9,173
Related party receivable Rhapsody	527	351
Prepaid expenses and other current assets	24,845	30,441
Total current assets	409,137	422,610
Equipment, software, and leasehold improvements, at cost:		
Equipment and software	146,744	144,623
Leasehold improvements	25,454	25,367
Total equipment, software, and leasehold improvements, at cost	172,198	169,990
Less accumulated depreciation and amortization	131,193	126,619
Net equipment, software, and leasehold improvements	41,005	43,371
Restricted cash equivalents and investments	10,141	10,000
Equity method investments	11,397	15,486
Available for sale securities	26,150	27,541
Other assets	3,064	3,316
Deferred costs, non-current portion	16,443	18,401
Deferred tax assets, net, non-current portion	12,943	12,805
Other intangible assets, net	9,837	6,952
Goodwill	6,502	4,960
Total assets	\$ 546,619	\$ 565,442
LIABILITIES AND SHAREHOLDERS EQUITY		
Current liabilities:		
Accounts payable	\$ 22,194	\$ 30,413
Accrued and other liabilities	82,199	85,702
Deferred revenue, current portion	18,010	19,036
Accrued loss on excess office facilities, current portion	1,391	1,144
Total current liabilities	123,794	136,295
Deferred revenue, non-current portion	88	460
Accrued loss on excess office facilities, non-current portion	2,430	3,380
Deferred rent	3,032	3,514

Edgar Filing: REALNETWORKS INC - Form 10-Q

Deferred tax liabilities, net, non-current portion	2,015	1,049
Other long-term liabilities	11,231	7,999
Total liabilities	142,590	152,697
Commitments and contingencies		
Shareholders' equity:		
Preferred stock, \$0.001 par value, no shares issued and outstanding:		
Series A: authorized 200 shares	0	0
Undesignated series: authorized 59,800 shares	0	0
Common stock, \$0.001 par value authorized 1,000,000 shares; issued and outstanding 136,783 shares in 2011 and 136,083 shares in 2010	137	136
Additional paid-in capital	705,344	697,430
Accumulated other comprehensive loss	(30,018)	(32,543)
Retained deficit	(271,434)	(252,278)
Total shareholders' equity	404,029	412,745
Total liabilities and shareholders' equity	\$ 546,619	\$ 565,442

See accompanying notes to unaudited condensed consolidated financial statements.

Table of Contents**REALNETWORKS, INC. AND SUBSIDIARIES****UNAUDITED CONDENSED CONSOLIDATED STATEMENTS OF OPERATIONS****AND COMPREHENSIVE INCOME (LOSS)****(In thousands, except per share data)**

	Quarters Ended		Six Months Ended	
	June 30,		June 30,	
	2011	2010	2011	2010
Net revenue (A)	\$ 83,752	\$ 88,884	\$ 171,053	\$ 217,484
Cost of revenue (B)	30,666	29,149	62,732	78,308
Gross profit	53,086	59,735	108,321	139,176
Operating expenses:				
Research and development	17,809	27,583	37,704	62,258
Sales and marketing	28,853	27,382	57,333	65,209
Advertising with related party	0	0	0	1,065
General and administrative	10,874	14,590	16,496	29,511
Restructuring and other charges	508	4,792	7,412	10,407
Loss (gain) on excess office facilities	(174)	7,082	(174)	7,082
Total operating expenses	57,870	81,429	118,771	175,532
Operating loss	(4,784)	(21,694)	(10,450)	(36,356)
Other income (expenses):				
Interest income, net	311	551	690	931
Equity in net loss of Rhapsody and other equity method investments	(1,018)	(5,427)	(4,299)	(5,427)
Loss on sale of equity investments, net	0	(50)	0	(50)
Gain on deconsolidation of Rhapsody	0	0	0	10,929
Other income (expense), net	(311)	994	(433)	1,093
Total other income (expenses), net	(1,018)	(3,932)	(4,042)	7,476
Loss before income taxes	(5,802)	(25,626)	(14,492)	(28,880)
Income tax benefit (expense)	(1,047)	(281)	(4,662)	3,291
Net loss	(6,849)	(25,907)	(19,154)	(25,589)
Net loss attributable to noncontrolling interest in Rhapsody				2,910
Net loss attributable to common shareholders	\$ (6,849)	\$ (25,907)	\$ (19,154)	\$ (22,679)
Basic net income (loss) per share available to common shareholders	\$ (0.05)	\$ (0.19)	\$ (0.14)	\$ (0.14)
Diluted net income (loss) per share available to common shareholders	\$ (0.05)	\$ (0.19)	\$ (0.14)	\$ (0.14)
Shares used to compute basic net income (loss) per share available to common shareholders	136,539	135,277	136,266	135,209
Shares used to compute diluted net income (loss) per share available to common shareholders	136,539	135,277	136,266	135,209
Comprehensive income (loss):				
Net loss	\$ (6,849)	\$ (25,907)	\$ (19,154)	\$ (25,589)

Edgar Filing: REALNETWORKS INC - Form 10-Q

Unrealized holding gains (losses) on short-term and equity, investments net of income taxes	5,679	(3,160)	(1,387)	(1,609)
Foreign currency translation gains (losses)	1,357	(4,743)	3,910	(6,354)
Comprehensive income (loss)	187	(33,810)	(16,631)	(33,552)
Net loss attributable to noncontrolling interest in Rhapsody	0	0	0	2,910
Comprehensive income (loss) attributable to common shareholders	\$ 187	\$ (33,810)	\$ (16,631)	\$ (30,642)
(A) Components of net revenue:				
License fees	\$ 16,817	\$ 16,644	\$ 35,232	\$ 40,816
Service revenue	66,935	72,240	135,821	176,668
	\$ 83,752	\$ 88,884	\$ 171,053	\$ 217,484
(B) Components of cost of revenue:				
License fees	\$ 4,800	\$ 5,668	\$ 10,046	\$ 13,217
Service revenue	25,866	23,481	52,686	65,091
	\$ 30,666	\$ 29,149	\$ 62,732	\$ 78,308

See accompanying notes to unaudited condensed consolidated financial statements.

Table of Contents**REALNETWORKS, INC. AND SUBSIDIARIES****UNAUDITED CONDENSED CONSOLIDATED STATEMENTS OF CASH FLOWS**

(in thousands)

	Six Months Ended June 30,	
	2011	2010
Cash flows from operating activities:		
Net loss	\$ (19,154)	\$ (25,589)
Adjustments to reconcile net income (loss) to net cash used in operating activities:		
Depreciation and amortization	8,116	13,973
Stock-based compensation	6,129	6,692
Loss (gain) on disposal of equipment, software, and leasehold improvements	85	(3)
Equity in net loss of Rhapsody and other investments	4,299	5,427
Loss on sale of equity investments, net	0	50
Excess tax benefit from stock option exercises	(57)	(18)
Gain on deconsolidation of Rhapsody	0	(10,929)
Accrued loss (gain) on excess office facilities	(174)	6,470
Deferred income taxes, net	(351)	(1,609)
Accrued restructuring and other charges	131	3,581
Other	62	22
Net change in certain operating assets and liabilities, net of acquisitions, disposals and deconsolidation of Rhapsody:		
Trade accounts receivable	3,661	7,649
Prepaid expenses and other assets	7,837	(7,336)
Accounts payable	(10,593)	(2,417)
Accrued and other liabilities	(5,481)	(52,300)
Net cash used in operating activities	(5,490)	(56,337)
Cash flows from investing activities:		
Purchases of equipment, software, and leasehold improvements	(3,134)	(9,507)
Purchases of short-term investments	(54,844)	(65,754)
Proceeds from sales and maturities of short-term investments	62,005	16,559
Decrease (increase) in restricted cash equivalents and investments, net	(141)	3,700
Payment in connection with the restructuring of Rhapsody	0	(18,000)
Payment of acquisition costs, net of cash acquired	(2,888)	0
Repayment of temporary funding upon deconsolidation of Rhapsody	0	5,869
Net cash provided by (used in) investing activities	998	(67,133)
Cash flows from financing activities:		
Net proceeds from sale of common stock under employee stock purchase plan and exercise of stock options	1,610	1,272
Excess tax benefit from stock option exercises	57	18
Net proceeds from sales of interest in Rhapsody	0	1,213
Net cash provided by financing activities	1,667	2,503
Effect of exchange rate changes on cash and cash equivalents	3,537	92
Net increase (decrease) in cash and cash equivalents	712	(120,875)
Cash and cash equivalents, beginning of period	236,018	277,030

Edgar Filing: REALNETWORKS INC - Form 10-Q

Cash and cash equivalents, end of period	\$ 236,730	\$ 156,155
--	------------	------------

Supplemental disclosure of cash flow information:

Cash received from income tax refunds	\$ 3,534	\$ 131
Cash paid for income taxes	\$ 3,459	\$ 1,818

See accompanying notes to unaudited condensed consolidated financial statements.

Table of Contents

REALNETWORKS, INC. AND SUBSIDIARIES

NOTES TO UNAUDITED CONDENSED CONSOLIDATED FINANCIAL STATEMENTS

Quarters and Six Months Ended June 30, 2011 and 2010

Note 1. Summary of Significant Accounting Policies

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

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

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

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

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

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

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

Table of Contents

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

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

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

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

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

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

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

Noncontrolling Interests. The Company records noncontrolling interest expense (benefit) which reflects the portion of the earnings (losses) of majority-owned entities which are applicable to the noncontrolling interest holders in the consolidated statements of operations. Redeemable noncontrolling interests that are redeemable at either fair value or are based on a formula that is intended to approximate fair value follow the Company's historical disclosure only policy for the redemption feature. Redeemable noncontrolling interests that are redeemable at either a fixed price or are based on a formula that is not akin to fair value are reflected as an adjustment to income attributable to common shareholders based on the difference between accretion as calculated using the terms of the redemption feature and the accretion entry for a hypothetical fair value redemption feature with the remaining amount of accretion to redemption value recorded directly to equity. Net loss attributable to the noncontrolling interest in Rhapsody is included within the consolidated statements of operations and comprehensive income (loss). The Company applied this accounting policy to the noncontrolling interest in

Table of Contents

Rhapsody that was held by MTVN for periods beginning when Rhapsody was formed in August 2007 through the quarter ended March 31, 2010. Due to the completion of the restructuring of Rhapsody on March 31, 2010, which resulted in the Company holding approximately 47% of the outstanding shares of capital stock of Rhapsody, this accounting policy no longer applies with respect to the Company's investment as the Company no longer consolidates Rhapsody and no longer reports a noncontrolling interest.

Note 2. Recent Accounting Pronouncements

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

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

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

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

Note 3. Stock-Based Compensation

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

The expected term of the options represents the estimated period of time until exercise and is based on historical experience of similar awards, including the contractual terms, vesting schedules, and expectations of future employee behavior. Expected stock price volatility is based on a combination of historical volatility of the Company's stock for the related expected term and the implied volatility of its traded options. The risk-free interest rate is based on the implied yield available on U.S. Treasury zero-coupon issues with a term equivalent to the expected term of the stock options. Notwithstanding the special dividend described in Note 19, dividend yield is estimated at zero because the Company does not anticipate paying regular dividends in the foreseeable future.

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

	Quarters		Six Months	
	Ended June 30, 2011	2010	Ended June 30, 2011	2010
Expected dividend yield	0%	0%	0%	0%
Risk-free interest rate	1.57%	1.65%	1.73%	1.91%
Expected life (years)	4.0	4.0	4.0	4.0
Volatility	54%	62%	54%	62%

Table of Contents

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

	Quarters		Six Months	
	Ended June 30, 2011	2010	Ended June 30, 2011	2010
Cost of revenue	\$ 234	\$ 228	\$ 522	\$ 459
Research and development	306	693	803	2,290
Sales and marketing	994	811	1,928	1,807
General and administrative	1,152	1,039	2,040	2,136
Restructuring and other charges	(10)	0	836	0
Total stock-based compensation expense	\$ 2,676	\$ 2,771	\$ 6,129	\$ 6,692

No stock-based compensation was capitalized as part of the cost of an asset during the quarters or six month periods ended June 30, 2011 or 2010. As of June 30, 2011, \$14.6 million of total unrecognized compensation cost, net of estimated forfeitures, related to stock options, is expected to be recognized over a weighted-average period of 2.9 years.

Note 4. Rhapsody Joint Venture***Restructuring of Rhapsody***

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

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

Effective March 31, 2010, RealNetworks no longer has a controlling interest in Rhapsody and therefore, the operating results of Rhapsody are accounted for under the equity method of accounting for investments, and the Company's proportionate share of the income or loss is recognized as a component of Other income (expenses), net in the Company's condensed consolidated statements of operations in periods subsequent to March 31, 2010. As a result of the deconsolidation of Rhapsody's operations from the Company's financial statements, the Company no longer records any operating results for its Music segment for periods subsequent to March 31, 2010. The removal of these assets and liabilities and the creation of the initial equity method investment resulted in a one-time net gain of \$10.9 million recorded in Other income (expenses), net in the Company's unaudited condensed consolidated statements of operations for the quarter ended March 31, 2010, at which time the Company determined the fair value of its retained interest of approximately 47% to be approximately \$29.7 million as of March 31, 2010. The Company recorded its share of losses in the operations of Rhapsody of approximately \$1.0 million and \$4.3 million for the quarter and six months ended June 30, 2011, respectively, and \$5.4 million for the quarter and six months ended June 30, 2010. These losses reduced the carrying value of the investment to approximately \$11.2 million as of June 30, 2011.

As mentioned above, MTVN's preferred return rights were terminated in connection with the restructuring of Rhapsody. Prior to the restructuring, if the appraised value of Rhapsody at a redemption date was less than \$436.3 million, then the exercise price of the put right would have included a preferred return to MTVN. The Company previously elected to accrete any excess of the redemption value over the carrying amount of the noncontrolling interest as an adjustment to income attributable to common shareholders, and adjusted

Table of Contents

earnings per share for the current quarter's accretion of the difference between accretion as calculated using the terms of the redemption feature and the accretion entry for a hypothetical fair value redemption feature. Due to the termination of MTVN's preferred return rights at the completion of the restructuring, the Company decreased the noncontrolling interest that was on the unaudited condensed consolidated balance sheet at March 31, 2010, prior to the transaction above by \$10.4 million as part of the deconsolidation transactions, of which \$3.7 million was an adjustment to income attributable to common shareholders for the purposes of calculating earnings per share for the quarter ended March 31, 2010.

Noncontrolling interest rollforward

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

	Noncontrolling interest	Total Equity
Balances, December 31, 2009	\$ 7,253	\$ 375,811
Net loss	0	(25,589)
Net loss attributable to noncontrolling interest in Rhapsody	(2,910)	2,910
Contribution and other transactions with owners	616	619
Reversal of MTVN's accretion equity interest in Rhapsody	(6,736)	6,736
Reversal of MTVN's preferred return in Rhapsody	(3,700)	3,700
Deconsolidation	5,477	0
Unrealized holding losses on short-term and equity investments, net of taxes	0	(1,609)
Foreign currency translation losses	0	(6,354)
Stock-based transactions and compensation expense, net of taxes	0	7,861
Balances, June 30, 2010	\$ 0	\$ 364,085

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

	Quarter Ended June 30, 2011	Six Months Ended June 30, 2011
Statements of Operations Data:		
Net revenue	\$ 30,985	\$ 63,472
Gross profit	9,793	19,238
Net loss	(2,165)	(9,146)

Note 5. Fair Value Measurements

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

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

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

Edgar Filing: REALNETWORKS INC - Form 10-Q

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

Table of Contents

Items Measured at Fair Value on a Recurring Basis

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