REALNETWORKS INC
Form 10-Q
August 02, 2018

UNITED STATES
SECURITIES AND EXCHANGE COMMISSION
Washington, D.C. 20549
FORM 10-Q
(Mark One)
ý QUARTERLY REPORT PURSUANT TO SECTION 13 OR 15(d) OF THE SECURITIES EXCHANGE ACT OF 1934
For the Quarterly Period Ended June 30, 2018
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 1-37745

RealNetworks, Inc.
(Exact name of registrant as specified in its charter)

Washington	91-1628146
(State of incorporation)	(I.R.S. Employer Identification Number)
1501 First Avenue South, Suite 600 Seattle, Washington	98134
(Address of principal executive offices)	(Zip Code)

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

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

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

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

If an emerging growth company, indicate by check mark if the registrant has elected not to use the extended transition period for complying with any new or revised financial accounting standards provided pursuant to Section 13(a) of the Exchange Act. ¨

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

The number of shares of the registrant’s Common Stock outstanding as of July 31, 2018 was 37,611,849.

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REALNETWORKS, INC. AND SUBSIDIARIES
UNAUDITED CONDENSED CONSOLIDATED BALANCE SHEETS
(In thousands, except per share data)

	June 30, 2018	December 31, 2017
ASSETS		
Current assets:		
Cash and cash equivalents	$39,080	$ 51,196
Short-term investments	3,053	8,779
Trade accounts receivable, net of allowances of $660 and $937	13,127	12,689
Deferred costs, current portion	375	426
Prepaid expenses and other current assets	5,250	3,715
Current assets of discontinued operations	—	17,456
Total current assets	60,885	94,261
Equipment, software, and leasehold improvements, at cost:		
Equipment and software	41,793	46,417
Leasehold improvements	3,511	3,536
Total equipment, software, and leasehold improvements, at cost	45,304	49,953
Less accumulated depreciation and amortization	42,083	46,093
Net equipment, software, and leasehold improvements	3,221	3,860
Restricted cash equivalents	1,880	2,400
Other assets	5,844	5,588
Deferred costs, non-current portion	679	955
Deferred tax assets, net	1,036	1,047
Other intangible assets, net	215	325
Goodwill	17,120	13,060
Total assets	$90,880	$ 121,496
LIABILITIES AND SHAREHOLDERS' EQUITY		
Current liabilities:		
Accounts payable	$2,744	$ 3,785
Accrued and other current liabilities	12,261	12,365
Commitment to Napster	2,750	2,750
Deferred revenue, current portion	2,155	3,097
Current liabilities of discontinued operations	—	17,107
Total current liabilities	19,910	39,104
Deferred revenue, non-current portion	353	443
Deferred rent	1,023	982
Deferred tax liabilities, net	170	19
Other long-term liabilities	1,054	1,775
Total liabilities	22,510	42,323
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	—	—
	37	37

Common stock, $0.001 par value authorized 250,000 shares; issued and outstanding 37,612 shares in 2018 and 37,341 shares in 2017		
Additional paid-in capital	640,212	638,727
Accumulated other comprehensive loss	(60,752)	(59,547)
Retained deficit	(511,127)	(500,044)
Total shareholders' equity	68,370	79,173
Total liabilities and shareholders' equity	$ 90,880	$ 121,496

See accompanying notes to unaudited condensed consolidated financial statements.

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

	Quarter Ended June 30,		Six Months Ended June 30,	
	2018	2017	2018	2017
Net revenue (A)	$15,724	$21,605	$35,374	$41,296
Cost of revenue (B)	4,625	6,287	9,761	12,856
Gross profit	11,099	15,318	25,613	28,440
Operating expenses:				
Research and development	7,652	7,584	15,346	14,933
Sales and marketing	4,883	5,496	10,880	12,651
General and administrative	5,339	5,254	10,940	10,557
Restructuring and other charges	187	150	688	1,714
Lease exit and related benefit	(129)	—	(454)	—
Total operating expenses	17,932	18,484	37,400	39,855
Operating loss	(6,833)	(3,166)	(11,787)	(11,415)
Other income (expenses):				
Interest income, net	111	109	198	237
Equity in net loss of Napster investment	—	(349)	—	(1,097)
Other income (expense), net	(42)	(13)	(83)	(239)
Total other income (expenses), net	69	(253)	115	(1,099)
Loss from continuing operations before income taxes	(6,764)	(3,419)	(11,672)	(12,514)
Income tax expense	166	360	436	815
Net loss from continuing operations	(6,930)	(3,779)	$(12,108)	$(13,329)
Net income from discontinued operations, net of tax	—	393	—	519
Net loss	$(6,930)	$(3,386)	$(12,108)	$(12,810)
Net income (loss) per share - Basic:				
Continuing operations	$(0.18)	(0.10)	$(0.32)	(0.36)
Discontinued operations	—	0.01	—	0.01
Net loss per share - Basic	$(0.18)	$(0.09)	$(0.32)	$(0.35)
Net income (loss) per share - Diluted				
Continuing operations	$(0.18)	$(0.10)	$(0.32)	(0.36)
Discontinued operations	—	0.01	—	0.01
Net loss per share - Diluted	$(0.18)	$(0.09)	$(0.32)	$(0.35)
Shares used to compute basic net income (loss) per share	37,577	37,103	37,514	37,067
Shares used to compute diluted net income (loss) per share	37,577	37,103	37,514	37,067
Comprehensive income (loss):				
Unrealized investment holding gains, net of reclassification adjustments	$2	$6	$3	$10
Foreign currency translation adjustments, net of reclassification adjustments	(1,604)	646	(1,208)	1,240
Total other comprehensive income (loss)	(1,602)	652	(1,205)	1,250
Net loss	(6,930)	(3,386)	(12,108)	(12,810)
Comprehensive loss	$(8,532)	$(2,734)	$(13,313)	$(11,560)

(A) Components of net revenue:

License and product revenue	$4,529	$9,651	$11,943	$16,804
Service revenue	11,195	11,954	23,431	24,492

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	$15,724	$21,605	$35,374	$41,296
(B) Components of cost of revenue:				
License and product revenue	$1,465	$2,611	$3,220	$4,520
Service revenue	3,160	3,676	6,541	8,336
	$4,625	$6,287	$9,761	$12,856

See accompanying notes to unaudited condensed consolidated financial statements.

REALNETWORKS, INC. AND SUBSIDIARIES
UNAUDITED CONDENSED CONSOLIDATED STATEMENTS OF CASH FLOWS
(In thousands)

	Six Months Ended June 30,	
	2018	2017
Cash flows from operating activities:		
Net loss	$(12,108)	$(12,810)
Adjustments to reconcile net loss to net cash used in operating activities:		
Depreciation and amortization	1,231	1,757
Stock-based compensation	1,614	2,297
Equity in net loss of Napster	—	1,097
Deferred income taxes, net	(12)	(40)
Fair value of warrants granted in 2015 and 2017, net of subsequent mark to market adjustments in 2018 and 2017	50	(417)
Net change in certain operating assets and liabilities:		
Trade accounts receivable	16,960	(4,346)
Prepaid expenses and other assets	(1,633)	667
Accounts payable	(16,601)	(376)
Accrued and other liabilities	(2,231)	(1,775)
Net cash used in operating activities	(12,730)	(13,946)
Cash flows from investing activities:		
Purchases of equipment, software, and leasehold improvements	(580)	(417)
Purchases of short-term investments	—	(13,905)
Proceeds from sales and maturities of short-term investments	5,726	32,617
Acquisition, net of cash acquired	(4,192)	—
Advance to Napster	—	(1,500)
Net cash provided by investing activities	954	16,795
Cash flows from financing activities:		
Proceeds from issuance of common stock (stock options and stock purchase plan)	114	130
Tax payments from shares withheld upon vesting of restricted stock	(243)	(192)
Net cash used in financing activities	(129)	(62)
Effect of exchange rate changes on cash, cash equivalents and restricted cash	(731)	1,347
Net increase (decrease) in cash, cash equivalents and restricted cash	(12,636)	4,134
Cash, cash equivalents and restricted cash, beginning of period	53,596	36,421
Cash, cash equivalents, and restricted cash end of period	$40,960	$40,555
Supplemental disclosure of cash flow information:		
Cash received from income tax refunds	$71	$323
Cash paid for income taxes	$503	$913
Non-cash investing activities:		
Increase (decrease) in accrued purchases of equipment, software, and leasehold improvements	$(112)	$32
Acquisition of intangible assets	$100	$—

See accompanying notes to unaudited condensed consolidated financial statements.

REALNETWORKS, INC. AND SUBSIDIARIES
NOTES TO UNAUDITED CONDENSED CONSOLIDATED FINANCIAL STATEMENTS
Quarters and Six Months Ended June 30, 2018 and 2017

Note 1 Description of Business and Summary of Significant Accounting Policies

Description of Business. RealNetworks, Inc. and subsidiaries is a 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 our business are various risks and uncertainties, including a limited history of certain of our product and service offerings. RealNetworks' success will depend on the acceptance of our technology, products and services and the ability to generate related revenue.

In this Quarterly Report on Form 10-Q (10-Q or Report), RealNetworks, Inc. and Subsidiaries is referred to as “RealNetworks”, the “Company”, “we”, “us”, or “our”.

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

The unaudited condensed consolidated financial statements reflect all adjustments, consisting only of normal, recurring adjustments that, in the opinion of management, are necessary for a fair presentation of the results of operations for the periods presented. Operating results for the quarter and six months ended June 30, 2018 are not necessarily indicative of the results that may be expected for any subsequent period or for the year ending December 31, 2018. Certain information and disclosures normally included in financial statements prepared in conformity with accounting principles generally accepted in the United States of America (GAAP) 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 our Annual Report on Form 10-K for the year ended December 31, 2017 (the 10-K).

Use of Estimates. The preparation of financial statements in conformity with GAAP requires management to make estimates and assumptions that affect the reported amounts of assets and liabilities, disclosure of contingent assets and liabilities at the date of the financial statements and the reported amounts of revenues and expenses during the reporting period. Actual results could differ from those estimates.

Note 2 Recent Accounting Pronouncements

Recently adopted accounting pronouncements

In May 2014, and subsequently updated and amended in 2015 and 2016, the Financial Accounting Standards Board (FASB) issued new revenue recognition guidance (Topic 606), which replaced most existing revenue recognition guidance in U.S. GAAP. The guidance requires an entity to recognize the amount of revenue to which it expects to be entitled for the transfer of promised goods or services to customers. We adopted Topic 606 as of January 1, 2018 using the modified retrospective transition method. Refer to Note 3 Revenue Recognition for further details.

In November 2016, the FASB issued guidance on the classification and presentation of changes in restricted cash on the statement of cash flows. We adopted this guidance on January 1, 2018, and retroactively applied the changes to the Statement of Cash Flows for all periods presented. As a result, we no longer classify changes in restricted cash within the investing section of our Statement of Cash flows, and instead include restricted cash with unrestricted cash as a combined total. The impact of the adoption did not have a material impact on the Condensed Consolidated Financial Statements.

Recently issued accounting pronouncements not yet adopted

In February 2016, the FASB issued new guidance related to the accounting for leases. A major change in the new guidance is that lessees will be required to present right-of-use assets and lease liabilities on the balance sheet. The new guidance will be effective for us on January 1, 2019, including interim periods within 2019. We continue to evaluate the effect that the guidance will have on our consolidated financial statements and related disclosures. We expect that the guidance will result in a material change to our Consolidated Balance Sheet as a result of capitalizing our operating leases.

In January 2017, the FASB issued new guidance simplifying the test for goodwill impairment. The new guidance eliminates Step 2 from the goodwill impairment test, instead requiring an entity to recognize a goodwill impairment charge for the amount by which the reporting unit's carrying amount exceeds the reporting unit's fair value. This guidance is effective for interim and annual goodwill impairment tests beginning on December 15, 2019, with early adoption permitted. We will be evaluating the impact of the guidance, but do not currently expect the adoption to have a material impact on our consolidated financial statements and related disclosures.

Note 3 Revenue Recognition

Adoption of New Revenue Standard

On January 1, 2018 we adopted the new revenue recognition standard by applying the modified retrospective approach to those contracts which were not completed as of January 1, 2018. Results for reporting periods beginning after January 1, 2018 are presented under the new revenue recognition standard, while prior period amounts are not adjusted and continue to be reported under the accounting standards in effect for the prior periods.

We recorded a net decrease to opening retained deficit of $1.0 million as of January 1, 2018 due to the cumulative impact of adopting the new revenue recognition standard, with the impact primarily related to licensing of our RealPlayer product and full recognition of non-recurring engineering fees which were previously deferred and amortized over the life of the contract. The net impact to revenues as a result of adopting the new standard was a decrease of $1.1 million for the three months ended June 30, 2018 and an increase of $2.4 million for the six months ended June 30, 2018.

Performance Obligations

We generate all of our revenue through contracts with customers. Revenue is either recognized over time as the service is provided, or at a point in time when the product is transferred to the customer, depending on the contract type. Our performance obligations typically have an original duration of one year or less.

Our software licensing revenue stream generates revenue through the on-premises licensing of our codec technologies and integrated RealTimes platform. We recognize revenue upfront at the point in time when the software is made available to the customer. In cases where a sale or usage-based royalty is promised in exchange for a license of our codec technologies, revenue is recognized as the subsequent usage occurs for the contractual amount owed by the customer for that usage, as is allowed under the licensing of intellectual property section of Topic 606. Software licensing in our Mobile Services segment is invoiced on a monthly basis either based on usage of the respective product, or on a fixed fee basis. Our Consumer Media licensing is invoiced either quarterly or annually based on the usage of the respective product, or on a fixed fee basis. For each of these, the timing of payment generally does not vary significantly from the timing of invoice, however, certain of our long-term Consumer Media licensing contracts have extended payment schedules which may exceed one year.

Our subscription services revenue stream allows customers to use hosted software over the respective contract period without taking possession of the technology. The stream is primarily comprised of our intercarrier messaging service, ringback tones, PC-based games subscriptions and our RealPlayer and SuperPass services. Revenues related to subscription service products are recognized ratably over the contract period, or as we have the right to invoice as a practical expedient when that amount corresponds directly with the value to the customer of our performance completed to date. Consumer subscription products are paid in advance, typically on a monthly or quarterly basis. Subscription services offered to businesses are invoiced on a monthly basis, generally based upon the amount of usage for the previous month, and the timing of payment generally does not vary significantly from the timing of invoice.

Our product sales revenue stream includes purchases of mobile and wholesale games, as well as our RealPlayer product. Retail purchases are recognized and paid for at the point in time the product is made available to the end user. For games which are sold through third-party application storefronts, we evaluate the transaction for gross or net revenue recognition. As we typically are the primary obligor in our third-party transactions, we recognize revenues gross of any app store fees. We then receive monthly payments from the respective app store for all purchases within the respective month.

Other revenues consist primarily of advertising and the distribution of third-party products, which are recognized and paid on a cost per impression or cost per download basis.

Disaggregation of Revenue

The following table presents our disaggregated revenue by source and segment (in thousands):

	Quarter Ended June 30, 2018			Six months ended June 30, 2018		
	Consumer Media	Mobile Services	Games	Consumer Media	Mobile Services	Games
Business Line						
Software License	$1,808	$ 469	$—	$5,145	$ 1,804	$ —
Subscription Services	1,225	6,250	2,689	2,510	13,619	5,382
Product Sales	299	—	1,953	639	—	4,355
Advertising and Other	552	—	479	1,073	—	847
Total	$3,884	$ 6,719	$5,121	9,367	15,423	10,584

The following table presents our disaggregated revenue by sales channel (in thousands):

	Quarter Ended June 30, 2018			Six months ended June 30, 2018		
	Consumer Media	Mobile Services	Games	Consumer Media	Mobile Services	Games
Sales Channel						
Business to Business	$2,360	$ 6,573	$836	$6,218	$15,103	$1,587
Direct to Consumer	1,524	146	4,285	3,149	320	8,997
Total	$3,884	$ 6,719	$5,121	$9,367	$15,423	$10,584

Contract Balances

The timing of revenue recognition may differ from the timing of invoicing to our customers. We record accounts receivable when the right to consideration becomes unconditional, except for the passage of time. For certain contracts, payment schedules may exceed one year; for those contracts we recognize a long-term receivable. As of June 30, 2018, our balance of long-term accounts receivable was $0.3 million, and is included in other long-term assets on our condensed consolidated balance sheets. During the quarter and six months ended June 30, 2018, we recorded no impairments to our contract assets.

We record deferred revenue when cash payments are received or due in advance of our completion of the underlying performance obligation. As of June 30, 2018 we had a deferred revenue balance of $2.5 million, a decrease of $1.0 million from December 31, 2017. The decrease is due primarily to our transition to Topic 606, with $0.8 million recorded to retained earnings on January 1, 2018. The decrease is further due to $0.2 million of revenues recognized which were included in the deferred balance at December 31, 2017.

Significant Estimates

For certain of our contracts, we recognize revenues using the sales- and usage-based exception as defined in the licensing guidance of Topic 606. For these contracts, we typically receive reporting of actual usage a quarter in arrears, and as such, we are required to estimate the current quarter's usage. To make these estimates, we utilize historical reporting information, as well as industry trends and interim reporting to quantify total quarterly usage. As actual usage information is received, we record a true-up in the following quarter to reflect any variance from our estimate. Our true-up on our first quarter estimates recorded in the second quarter of 2018 was not material to our condensed consolidated financial statements.

Practical Expedients

For those contracts for which we recognize revenue at the amount to which we have the right to invoice for service performed, we do not disclose the value of any unsatisfied performance obligations. We also do not disclose the remaining unsatisfied performance obligations which have an original duration of one year or less. Additionally, we immediately expense sales commissions when incurred as the amortization period would have been less than one year. These costs are recorded within sales and marketing expense.

Note 4 Stock-Based Compensation

Total stock-based compensation expense recognized in our unaudited condensed consolidated statements of operations and comprehensive income (loss) includes amounts related to stock options, restricted stock, and employee stock purchase plans and was as follows (in thousands):

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	Quarter Ended June 30,		Six Months Ended June 30,	
	2018	2017	2018	2017
Total stock-based compensation expense	$457	$863	$1,614	$2,297

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

	Quarter Ended June 30,		Six Months Ended June 30,	
	2018	2017	2018	2017
Expected dividend yield	0 %	0 %	0 %	0 %
Risk-free interest rate	2.72%	1.62%	2.59%	1.76%
Expected life (years)	3.8	3.7	4.0	4.4
Volatility	35 %	34 %	35 %	35 %

The total stock-based compensation amounts for 2018 and 2017 disclosed above are recorded in their respective line items within operating expenses in the unaudited condensed consolidated statements of operations and comprehensive income (loss). Included in the expense for the six months ended June 30, 2018 and 2017 was stock compensation expense recorded in the first quarter of 2018 and 2017 related to our 2017 and 2016 incentive bonuses paid in fully vested restricted stock units, which were authorized and granted in the first quarter of 2018 and 2017, respectively.

As of June 30, 2018, $2.9 million of total unrecognized compensation cost, net of estimated forfeitures, related to stock awards. The unrecognized compensation cost is expected to be recognized over a weighted-average period of approximately 3.8 years.

Note 5 Napster Joint Venture

As of June 30, 2018 we owned approximately 42% of the issued and outstanding stock of Rhapsody International Inc., doing business as Napster, and account for our investment using the equity method of accounting.

Rhapsody America LLC was initially formed in 2007 as a joint venture between RealNetworks and MTV Networks, a division of Viacom International Inc. (MTVN), to own and operate a business-to-consumer digital audio music service originally branded as Rhapsody. The service was re-branded in 2016 as Napster. In this Note, we refer to the business as Napster, although the legal entity in which we hold our investment is Rhapsody International, Inc.

Following certain restructuring transactions effective March 31, 2010, we began accounting for our investment using the equity method of accounting. As part of the 2010 restructuring transactions, 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.

We recorded our share of losses of Napster of $0.0 million for the quarter and six months ended June 30, 2018; and $0.3 million and $1.1 million for the quarter and six months ended June 30, 2017. Because of the $10.0 million liquidation preference on the preferred stock we hold in Napster, under the equity method of accounting we did not record any share of Napster losses that would reduce our carrying value of Napster, which is impacted by Napster equity transactions, below $10.0 million, until Napster's book value was reduced below $10.0 million. This occurred in the first quarter of 2015. As of June 30, 2018, the carrying value of our Napster equity investment was zero, as we did not have any further commitment to provide future support to Napster, with the exception of the guaranty discussed below. Unless we commit to provide future financial support to Napster, we do not record any further share of Napster losses that would reduce our carrying value of Napster below zero; in accordance with GAAP, we currently track those suspended losses outside of our financial statements.

In December 2016, RealNetworks entered into an agreement to loan up to $5 million to Napster for general operating purposes, as did Napster's other 42% owner. Each entity fully funded its loan, providing $3.5 million each in December 2016 and the remaining $1.5 million each in January 2017. These loans are subordinate to senior creditors, and bear an interest rate of 10% per annum, which is added to the outstanding principal balance. At the time of signing the agreement we recognized previously suspended Napster losses, and, consequently, we did not record a receivable related to this loan.

As discussed in Note 4 to our 2017 Form 10-K, during November 2017, Napster entered into an amendment to its revolving credit facility. In conjunction with the amendment, both RealNetworks and Napster's other 42% owner entered into an arrangement to guarantee up to $2.75 million each of Napster's outstanding indebtedness on the credit facility. As a result of this guaranty, in December 2017 we recognized previously suspended Napster losses up to the full $2.75 million guaranty in our consolidated statement of operations. As of the date of this filing, RealNetworks has not been required to pay any amounts under the guaranty, and the amount is reflected on our condensed consolidated balance sheets as Commitment to Napster.

Summarized financial information for Napster, which represents 100% of its financial information, is as follows (in thousands):

	Quarter Ended June 30,		Six Months Ended June 30,	
	2018	2017	2018	2017
Net revenue	$36,239	$44,136	$76,529	$91,598
Gross profit	9,383	6,099	18,661	12,682
Operating income (loss)	3,895	(4,760)	10,310	(9,871)
Net income (loss)	2,134	(7,693)	6,582	(13,333)

Note 6 Fair Value Measurements

Items Measured at Fair Value on a Recurring Basis

The following table presents information about our financial assets that have been measured at fair value on a recurring basis as of June 30, 2018 and December 31, 2017, and indicates the fair value hierarchy of the valuation inputs utilized to determine such fair value (in thousands).

	Fair Value Measurements as of June 30, 2018				Amortized Cost as of June 30, 2018
	Level 1	Level 2	Level 3	Total	
Cash and cash equivalents:					
Cash	$21,538	$—	$ —	$21,538	$ 21,538
Money market funds	17,542	—	—	17,542	17,542
Total cash and cash equivalents	39,080	—	—	39,080	39,080
Short-term investments:					
Corporate notes and bonds	—	3,053	—	3,053	3,049
Total short-term investments	—	3,053	—	3,053	3,049
Restricted cash equivalents	—	1,880	—	1,880	1,880
Warrants issued by Napster (included in Other assets)	—	—	939	939	—
Total	$39,080	$4,933	$ 939	$44,952	$ 44,009

	Fair Value Measurements as of December 31, 2017				Amortized Cost as of December 31, 2017
	Level 1	Level 2	Level 3	Total	
Cash and cash equivalents:					
Cash	$31,065	$—	$ —	$31,065	$ 31,065
Money market funds	20,131	—	—	20,131	20,131
Total cash and cash equivalents	51,196	—	—	51,196	51,196
Short-term investments:					
Corporate notes and bonds	—	8,779	—	8,779	8,779
Total short-term investments	—	8,779	—	8,779	8,779
Restricted cash equivalents	—	2,400	—	2,400	2,400
Warrants issued by Napster (included in Other assets)	—	—	989	989	—
Total	$51,196	$11,179	$ 989	$63,364	$ 62,375

Restricted cash equivalents as of June 30, 2018 and December 31, 2017 relates to cash pledged as collateral against letters of credit in connection with lease agreements.
Realized gains or losses on sales of short-term investment securities for the quarters and six months ended June 30, 2018 and 2017 were not significant. Gross unrealized gains and gross unrealized losses on short-term investment securities as of June 30, 2018 and December 31, 2017 were also not significant.
Investments with remaining contractual maturities of five years or less are classified as short-term because the investments are marketable and highly liquid, and we have the ability to utilize them for current operations.
Contractual maturities of short-term investments as of June 30, 2018 (in thousands):

	Estimated Fair Value
Within one year	$ 3,053
Between one year and five years	—
Total short-term investments	$ 3,053

In February 2015, Napster issued warrants to purchase Napster common shares to both RealNetworks and Napster's other 42% owner. The warrants were issued as compensation for past services provided by RealNetworks and the other 42% owner, and both warrants covered the same number of underlying shares, with a 10 year contractual term. The exercise price of the warrants was equal to the fair value of the underlying shares on the issuance date, and we used the Black-Scholes option-pricing model to calculate the fair value of the warrant, using an expected term of 5 years and expected volatility of 55%. On the date of issuance, we recognized and recorded the $1.2 million fair value of the warrant issued to RealNetworks within Other assets in the unaudited condensed consolidated balance sheets, and as an expense reduction within General and administrative expense in the unaudited condensed consolidated statements of operations. The warrants are free-standing derivatives and as such their fair value is determined each quarter using updated inputs in the Black-Scholes option-pricing model. At December 31, 2017 due to the management change and strategic shift undertaken by Napster, we determined that a change to the expected term was necessary. As a result, we extended the expected term by 3.25 years, resulting in a total expected term for the warrant of 8.25 years. During the six months ended June 30, 2018, the decrease in the fair value of the warrants was insignificant.
In February 2017, Napster issued additional warrants to purchase Napster common shares to both RealNetworks and Napster's other 42% owner. Consistent with the warrants issued in 2015, the 2017 warrants were issued as compensation for past services provided by RealNetworks and the other 42% owner, and both warrants covered the same number of underlying shares, with a 10 year contractual term. The exercise price of the warrants exceeded the fair value of the underlying shares on the issuance date, and we used the Black-Scholes option-pricing model to calculate the fair value of the warrant, using an expected term of 5 years and expected volatility of 55%, resulting in a

recognized fair value of $0.5 million in Other assets in the unaudited condensed consolidated balance sheets, and as an expense reduction within general and administrative expense in the unaudited condensed consolidated statements of operations. At December 31, 2017, due to the management change and strategic shift undertaken by Napster, we determined that a change to the expected term was necessary. As a result, we extended the expected term by 1 year, resulting in a total expected term for the warrant of 6 years. During the six months ended June 30, 2018, the decrease in the fair value of the warrants was insignificant.

Items Measured at Fair Value on a Non-recurring Basis

Certain of our assets and liabilities are measured at estimated fair value on a non-recurring basis, using Level 3 inputs. These instruments are subject to fair value adjustments only in certain circumstances (for example, when there is evidence of impairment). During the six months ended June 30, 2018 and 2017, we did not record any impairments on those assets required to be measured at fair value on a non-recurring basis.

See Note 11, Lease Exit and Related Charges, for a discussion of the losses related to reductions in the use of RealNetworks' office space, which were recorded at the estimated fair value of remaining lease obligations, less expected sub-lease income.

Note 7 Other Intangible Assets

Other intangible assets (in thousands):

	June 30, 2018			December 31, 2017		
	Gross Amount	Accumulated Amortization	Net	Gross Amount	Accumulated Amortization	Net
Amortizing intangible assets:						
Customer relationships	$31,166	$ 31,025	$141	$32,286	$ 31,997	$289
Developed technology	24,598	24,598	—	25,177	25,177	—
Patents, trademarks and tradenames	3,792	3,792	—	3,932	3,896	36
Service contracts	5,548	5,474	74	5,576	5,576	—
Total	$65,104	$ 64,889	$215	$66,971	$ 66,646	$325

In conjunction with our acquisition of a Netherlands-based game development studio in the second quarter of 2018, we recorded $0.1 million in intangibles. Refer to Note 8 Goodwill for further details about the acquisition.

No impairments of other intangible assets were recognized in either of the six months ended June 30, 2018 or 2017.

Note 8 Goodwill

Changes in goodwill (in thousands):

Balance, December 31, 2017	$13,060
Increases due to current year acquisitions	4,367
Effects of foreign currency translation	(307)
Balance, June 30, 2018	$17,120

On April 16, 2018, in order to acquire a full workforce, we purchased 100% of the shares of a small, privately-held Netherlands-based game development studio for net cash consideration of $4.2 million. All tangible and intangible assets and liabilities recognized are reported within the Games segment. As a result of our preliminary purchase price allocation, we recorded $0.1 million of identifiable intangible assets relating to an existing customer contract. We also recorded goodwill of $4.4 million, representing the intangible assets that do not qualify for separate recognition for accounting purposes, primarily related to the assembled workforce and expected synergies in development of our Original Stories titles. The goodwill is not deductible for income tax purposes. We did not recognize significant revenue or loss before income taxes from this acquired business from the date of acquisition through June 30, 2018.

Goodwill by segment (in thousands):

	June 30, 2018
Consumer Media	$580
Mobile Services	2,106
Games	14,434
Total goodwill	$17,120

No impairment of goodwill was recognized in either of the six months ended June 30, 2018 or in 2017.

Note 9 Accrued and Other Current Liabilities

Accrued and other current liabilities (in thousands):

	June 30, 2018	December 31, 2017
Royalties and other fulfillment costs	$3,226	$ 2,965
Employee compensation, commissions and benefits	3,856	4,384
Sales, VAT and other taxes payable	1,495	1,782
Other	3,684	3,234
Total accrued and other current liabilities	$12,261	$ 12,365

Note 10 Restructuring Charges

Restructuring and other charges in 2018 and 2017 consist of costs associated with the ongoing reorganization of our business operations and our ongoing expense re-alignment efforts. The expense amounts in both years relate primarily to severance costs due to workforce reductions.

Restructuring charges are as follows (in thousands):

	Employee Separation Costs
Costs incurred and charged to expense for the six months ended June 30, 2018	$ 688
Costs incurred and charged to expense for the six months ended June 30, 2017	$ 1,714

Changes to the accrued restructuring liability (which is included in Accrued and other current liabilities) for 2018 (in thousands) are as follows:

	Employee Separation Costs
Accrued liability at December 31, 2017	$ 244
Costs incurred and charged to expense for the six months ended June 30, 2018	688
Cash payments	(638)
Accrued liability at June 30, 2018	$ 294

Note 11 Lease Exit and Related Charges

As a result of the reduction in use of RealNetworks' office space, lease exit and related charges have been recognized representing rent and contractual operating expenses over the remaining life of the leases, including estimates of sublease income expected to be received. In the first quarter of 2018, we renegotiated the lease for our Seattle headquarters, reducing our total leased space by 15%. Consequently, we recorded a reduction to our lease loss accrual to reflect our reduced future obligations. This reduction has also been recorded as a benefit of $0.3 million in our condensed consolidated statement of operations for the six months ended June 30, 2018. We continue to regularly evaluate the market for office space. If the market for such space changes further in future periods, we may have to revise our estimates which may result in future adjustments to expense for excess office facilities.

Changes to accrued lease exit and related charges (which is included in Accrued and other current liabilities) for 2018 (in thousands) are as follows:

Accrued loss at December 31, 2017	$2,058
Additions and adjustments to the lease loss accrual, including estimated sublease income	(454)
Less amounts paid, net of sublease amounts	(433)
Accrued loss at June 30, 2018	1,171
Less current portion (included in Accrued and other current liabilities)	(181)
Accrued loss, non-current portion (included in Other long term liabilities)	$990

Note 12 Shareholders' Equity

Accumulated Other Comprehensive Income (Loss)

Changes in components of accumulated other comprehensive income (loss) (in thousands):

	Quarter Ended June 30,		Six Months Ended June 30,	
	2018	2017	2018	2017
Investments				
Accumulated other comprehensive income (loss), beginning of period	$3	$(2)	$2	$(6)
Unrealized gains, net of tax effects of $1, $3, $1 and $5	2	6	3	10
Net current period other comprehensive income	2	6	3	10
Accumulated other comprehensive income balance, end of period	$5	$4	$5	$4
Foreign currency translation				
Accumulated other comprehensive loss, beginning of period	$(59,153)	$(61,045)	$(59,549)	$(61,639)
Translation adjustments	(1,604)	646	(1,208)	1,240
Net current period other comprehensive income (loss)	(1,604)	646	(1,208)	1,240
Accumulated other comprehensive loss balance, end of period	$(60,757)	$(60,399)	$(60,757)	$(60,399)
Total accumulated other comprehensive loss, end of period	$(60,752)	$(60,395)	$(60,752)	$(60,395)

Note 13 Income Taxes

As of June 30, 2018, there have been no material changes to RealNetworks' uncertain tax positions disclosures as provided in Note 14 of the 2017 10-K. We do not anticipate that the total amount of unrecognized tax benefits will significantly change within the next twelve months.

We file numerous consolidated and separate income tax returns in the U.S. including federal, state and local, as well as foreign jurisdictions. With few exceptions, we are no longer subject to U.S. federal income tax examinations for tax years before 2013 or state, local, or foreign income tax examinations for years before 1993. We are currently under audit by various states and foreign jurisdictions for certain tax years subsequent to 1993.

Note 14 Loss Per Share

Basic net loss per share (EPS) is computed by dividing net loss by the weighted average number of common shares outstanding during the period. Diluted EPS is computed by dividing net loss by the weighted average number of common and dilutive potential common shares outstanding during the period. Basic and diluted EPS (in thousands, except per share amounts):

	Quarter Ended June 30,		Six Months Ended June 30,	
	2018	2017	2018	2017
Net loss from continuing operations	$(6,930)	$(3,779)	$(12,108)	$(13,329)
Weighted average common shares outstanding used to compute basic EPS	37,577	37,103	37,514	37,067
Dilutive effect of stock based awards	—	—	—	—
Weighted average common shares outstanding used to compute diluted EPS	37,577	37,103	37,514	37,067
Basic EPS from continuing operations	$(0.18)	$(0.10)	$(0.32)	$(0.36)
Diluted EPS from continuing operations	$(0.18)	$(0.10)	$(0.32)	$(0.36)

During the quarter and six months ended June 30, 2018, 5.9 million and 6.0 million shares of common stock, respectively, of potentially issuable shares from stock awards were excluded from the calculation of diluted EPS because of their antidilutive effect.

During both the quarter and six months ended June 30, 2017, 5.2 million shares of common stock of potentially issuable shares from stock awards were excluded from the calculation of diluted EPS because of their antidilutive effect.

Note 15 Discontinued Operations

On December 31, 2017, our contract with our low-margin music on demand customer LOEN expired. The activity for this contract represented our only revenue source relating to music on demand services, and we did not renew the sole contract for this service, resulting in the abandonment of the related business. As the exit of the music on demand business represented a strategic shift, and the amounts were financially significant to our consolidated results, at December 31, 2017 we determined this business should be reported as a discontinued operation, and treated it as such beginning in our fourth quarter of 2017.

The following table summarizes the results of operations, which were recorded in our Mobile Services segment, relating to the discontinued operation (in thousands):

	Quarter Ended June 30,		Six Months Ended June 30,	
	2018	2017	2018	2017
Net revenue	$—	$11,507	$—	$22,392
Cost of revenue	—	11,003	—	21,727
Gross profit	—	504	—	665
Income taxes	—	111	—	146
Income from discontinued operations, net of tax	$—	$393	$—	$519

The following table summarizes the remaining carrying amounts of major classes of assets and liabilities of the discontinued operation (in thousands). These assets and liabilities relate to final settlements of prior year activity between various parties. These balances were fully settled prior to the end of the second quarter of 2018.

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	June 30, 2018	December 31, 2017
Trade accounts receivable, net	$ —	$ 17,456
Total current assets of discontinued operations	—	17,456
Accounts payable	$ —	$ 15,836
Accrued and other current liabilities	—	1,271
Total current liabilities of discontinued operations	$ —	$ 17,107

The cash flows related to the discontinued operation have not been segregated, and are included in the Consolidated Statements of Cash Flows. For all periods presented, depreciation and amortization, capital expenditures and significant operating non-cash items from the discontinued operation were not material.

Note 16 Commitments and Contingencies

From time to time we are and may be subject to legal proceedings, governmental investigations and claims in the ordinary course of business, including employment claims, contract-related claims, and claims of alleged infringement of third-party patents, trademarks and other intellectual property rights. Although we believe that resolving such claims, individually or in aggregate, will not have a material adverse impact on our business or financial condition, these matters are subject to inherent uncertainties. Such claims, even if not meritorious, could force us to expend significant financial and managerial resources. In addition, given the broad distribution of some of our consumer products, any individual claim related to those products could give rise to liabilities that may be material to us. In the event of a determination adverse to us, we may incur substantial monetary liability, and/or be required to change our business practices. Either of these could have a material adverse effect on our consolidated financial statements.

Note 17 Guarantees

In the ordinary course of business, RealNetworks is subject to potential obligations for standard warranty and indemnification provisions that are contained within many of our customer license and service agreements. Our warranty provisions are consistent with those prevalent in our industry, and we do not have a history of incurring losses on warranties; therefore, we do not maintain accruals for warranty-related obligations. With regard to indemnification provisions, nearly all of our carrier contracts obligate us to indemnify our carrier customers for certain liabilities that may be incurred by them. We have received in the past, and may receive in the future, claims for indemnification from some of our carrier customers.

In relation to certain patents and other technology assets we sold to Intel in the second quarter of 2012, we have specific obligations to indemnify Intel for breaches of the representations and warranties that we made and covenants that we agreed to in the asset purchase agreement for certain potential future intellectual property infringement claims brought by third parties against Intel. The amount of any potential liabilities related to our indemnification obligations to Intel will not be determined until a claim has been made, but we are obligated to indemnify Intel up to the amount of the gross purchase price that we received in the sale.

Note 18 Segment Information

We manage our business and report revenue and operating income (loss) in three segments: (1) Consumer Media, which includes licensing of our codec technology and our PC-based RealPlayer products, including RealPlayer Plus and related products; (2) Mobile Services, which includes our subscription services and our integrated RealTimes platform which is sold to mobile carriers; and (3) Games, which includes all our games-related businesses, including sales of mobile games, sales of games licenses, games subscription services, advertising on games sites and social network sites, and microtransactions from online and social games.

We allocate to our reportable segments certain corporate expenses which are directly attributable to supporting our businesses, including but not limited to a portion of finance, legal, human resources and headquarters facilities. Remaining expenses, which are not directly attributable to supporting the business, are reported as corporate items. Also reported in our corporate segment are restructuring charges, lease exit and related charges, as well as stock-based compensation expense.

RealNetworks reports three reportable segments based on factors such as how we manage our operations and how our Chief Operating Decision Maker (CODM) reviews results. The CODM reviews financial information presented on both a

consolidated basis and on a business segment basis. The accounting policies used to derive segment results are the same as those described in Note 1, Description of Business and Summary of Significant Accounting Policies, in the 10-K.
Segment results for the quarters and six months ended June 30, 2018 and 2017 (in thousands):
Consumer Media

	Quarter Ended June 30,		Six Months Ended June 30,	
	2018	2017	2018	2017
Revenue	$3,884	$6,951	$9,367	$12,620
Cost of revenue	1,028	1,159	2,021	2,564
Gross profit	2,856	5,792	7,346	10,056
Operating expenses	3,439	3,730	7,357	7,740
Operating income (loss)	$(583)	$2,062	$(11)	$2,316

Mobile Services

	Quarter Ended June 30,		Six Months Ended June 30,	
	2018	2017	2018	2017
Revenue	$6,719	$7,720	$15,423	$15,919
Cost of revenue	2,134	2,426	4,450	5,616
Gross profit	4,585	5,294	10,973	10,303
Operating expenses	6,969	6,705	14,335	14,824
Operating loss	$(2,384)	$(1,411)	$(3,362)	$(4,521)

Games

	Quarter Ended June 30,		Six Months Ended June 30,	
	2018	2017	2018	2017
Revenue	$5,121	$6,934	$10,584	$12,757
Cost of revenue	1,456	2,679	3,273	4,616
Gross profit	3,665	4,255	7,311	8,141
Operating expenses	5,095	5,090	10,012	10,037
Operating loss	$(1,430)	$(835)	$(2,701)	$(1,896)

Corporate

	Quarter Ended June 30,		Six Months Ended June 30,	
	2018	2017	2018	2017
Cost of revenue	$7	$23	$17	$60
Operating expenses	2,429	2,959	5,696	7,254
Operating loss	$(2,436)	$(2,982)	$(5,713)	$(7,314)

Our customers consist primarily of consumers and corporations located in the U.S., Europe, and various foreign countries (Rest of the World). Revenue by geographic region (in thousands):

	Quarter Ended June 30,		Six Months Ended June 30,	
	2018	2017	2018	2017
United States	$7,646	$10,889	$19,080	$20,629
Europe	3,010	3,205	6,035	6,399
Rest of the World	5,068	7,511	10,259	14,268
Total net revenue	$15,724	$21,605	$35,374	$41,296

Long-lived assets (which consist of primarily of goodwill, but also includes equipment, software, leasehold improvements, and other intangible assets) by geographic region (in thousands) are as follows:

	June 30, 2018	December 31, 2017
United States	$11,915	$ 12,236
Europe	7,287	3,437
Rest of the World	1,354	1,572
Total long-lived assets	$20,556	$ 17,245

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Note 19 Related Party Transactions

See Note 5, Napster Joint Venture, and Note 6, Fair Value Measurements, for details on transactions involving Napster.

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

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

- the expected benefits and other consequences of our growth plans, strategic initiatives, and restructurings;
- our expected introduction, distribution and monetization, of new and enhanced products, services and technologies across our businesses;
- future revenues, operating expenses, income and other taxes, tax benefits, net income (loss) per diluted share available to common shareholders, acquisition costs and related amortization, and other measures of results of operations;
- the effects of our past acquisitions and expectations for future acquisitions and divestitures;
- plans, strategies and expected opportunities for future growth, increased profitability and innovation;
- the expected financial position, performance, growth and profitability of, and investment in, our businesses and the availability of resources;
- the effects of legislation, regulations, administrative proceedings, court rulings, settlement negotiations and other factors that may impact our businesses;
- the continuation and expected nature of certain customer relationships;
- impacts of competition and certain customer relationships on the future financial performance and growth of our businesses;
- our involvement in potential claims, legal proceedings and government investigations, and the potential outcomes and effects of such potential claims, legal proceedings and governmental investigations on our business, prospects, financial condition or results of operations;
- the effects of U.S. and foreign income and other taxes on our business, prospects, financial condition or results of operations; and
- the effect of economic and market conditions on our business, prospects, financial condition or results of operations.

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

Overview

RealNetworks creates innovative applications and services that make it easy to connect with and enjoy digital media. We manage our business and report revenue and operating income (loss) in three segments: (1) Consumer Media, (2) Mobile Services, and (3) Games. See Note 18 Segment Information, to the unaudited condensed consolidated financial statements included in Item 1 of Part I of this Form 10-Q.

Within our Consumer Media segment revenue is primarily derived from the software licensing of our video compression, or codec, technology, including our latest technology, RealMedia High Definition, or RMHD. We also generate revenue from the sale of our PC-based RealPlayer products, including RealPlayer Plus and related products.

These products and services are delivered directly to consumers and through partners, such as OEMs and mobile device manufacturers.

Our Mobile Services business generates revenue primarily from the sale of subscription services, which includes our intercarrier messaging service and ringback tones, as well as through software licenses for the integration of our RealTimes platform and certain system implementations. We generate a significant portion of our revenue from sales within our Mobile

Services business to a few mobile carriers. The loss of these contracts, whether by termination or non-renewal or renegotiation of contract terms that are less favorable to us could result in the loss of future revenues and anticipated profits.

Our Games business, through the GameHouse and Zylom brands, derives revenue from product sales of mobile games, games licenses, games subscription services, and advertising on games sites and within our games.

We allocate to our reportable segments certain corporate expenses which are directly attributable to supporting our businesses, including but not limited to a portion of finance, IT, legal, human resources and headquarters facilities. Remaining expenses, which are not directly attributable to supporting the business, are reported as corporate items. These corporate items also include restructuring charges, lease exit and related charges, as well as stock compensation expense.

On December 31, 2017, our contract with LOEN Entertainment, Co, Ltd. (LOEN) for our music on demand services expired. As the profits generated from this business had significantly declined over time, we did not renew the sole contract for this service. Accordingly, we have reported the operating results and related assets and liabilities of this business as discontinued operations for all periods presented. Refer to Note 15 to our unaudited condensed consolidated financial statements for additional information on these discontinued operations. Unless otherwise noted, amounts and percentages for all periods discussed below reflect the results of operations and financial condition of our continuing operations.

As discussed in Note 3 Revenue Recognition, as a result of our transition to Topic 606, in the three months ended June 30, 2018, our net revenues were $1.1 million lower as compared to revenues which would have been recognized under previous accounting guidance. For the six months ended June 30, 2018 we accelerated the recognition of $2.4 million in revenues, the majority of which would have been recognized in future quarters of 2018 under previous accounting guidance.

As of June 30, 2018, we had $42.1 million in unrestricted cash, cash equivalents and short-term investments, compared to $60.0 million as of December 31, 2017. The 2018 decrease of cash, cash equivalents, and short-term investments was due to our ongoing cash flows used in operating activities and to the April 2018 acquisition of a game development studio, as discussed in Note 8 Goodwill.

Condensed consolidated results of operations were as follows (dollars in thousands):

	Quarter Ended June 30,				Six months ended June 30,			
	2018	2017	$ Change	% Change	2018	2017	$ Change	% Change
Total revenue	$15,724	$21,605	$(5,881)	(27)%	$35,374	$41,296	$(5,922)	(14)%
Cost of revenue	4,625	6,287	(1,662)	(26)%	9,761	12,856	(3,095)	(24)%
Gross profit	11,099	15,318	(4,219)	(28)%	25,613	28,440	(2,827)	(10)%
Gross margin	71%	71%			72%	69%		
Operating expenses	17,932	18,484	(552)	(3)%	37,400	39,855	(2,455)	(6)%
Operating loss	$(6,833)	$(3,166)	$(3,667)	(116)%	$(11,787)	$(11,415)	$(372)	(3)%

In the second quarter of 2018, our total consolidated revenue decreased $5.9 million as compared with the year-earlier period, due to decreases in revenue of $3.1 million in our Consumer Media segment, $1.8 million in our Games segment and $1.0 million in our Mobile Services segment. See below for further discussion around the fluctuations for each segment.

Cost of revenue decreased by $1.7 million for the quarter ended June 30, 2018, due primarily to declines of $1.2 million in our Games segment and $0.3 million in our Mobile Services segment.

Operating expenses decreased by $0.6 million in the quarter ended June 30, 2018 as compared with the year-earlier period, primarily due to reduced salaries, benefits and professional services costs of $0.3 million, and a benefit of $0.1 million to lease exit costs.

For the six months ended June 30, 2018, our total consolidated revenue decreased $5.9 million as compared to the prior year. The year over year decrease is due to lower revenues of $3.3 million in our Consumer Media segment, $2.2 million in our Games segment and $0.5 million in our Mobile Services segment. See below for further discussion around the fluctuations for each segment.

Cost of revenue decreased by $3.1 million in the six months ended June 30, 2018 as compared to the prior year period due to decreased costs in all three operating segments: $1.3 million in Games, $1.2 million in Mobile Services and $0.5 million in Consumer Media.

Operating expenses decreased by $2.5 million compared with the prior year primarily due to reduced restructuring costs of $1.0 million and a benefit of $0.5 million in lease exit and related charges following the renegotiation of certain leases. Also contributing to the overall decrease were reductions of $0.6 million in facilities and support services, $0.6 million in salaries, benefits, and professional services, and $0.4 million in marketing expense. These decreases were offset by certain benefits recorded in the first quarter of 2017, including: $0.5 million relating to the warrants we received from Napster and a $0.4 million release of previously accrued taxes.

Segment Operating Results

Consumer Media

Consumer Media segment results of operations were as follows (dollars in thousands):

	Quarter Ended June 30,				Six months ended June 30,			
	2018	2017	$ Change	% Change	2018	2017	$ Change	% Change
Revenue	$ 3,884	$ 6,951	$ (3,067)	(44)%	$ 9,367	$ 12,620	$ (3,253)	(26)%
Cost of revenue	1,028	1,159	(131)	(11)%	2,021	2,564	(543)	(21)%
Gross profit	2,856	5,792	(2,936)	(51)%	7,346	10,056	(2,710)	(27)%
Gross margin	74 %	83 %		Gross profit	13,201	15,555	10,863	10,947

Net income (loss)	(2,754)	6,050	(3,195)	4,077
Net income (loss) per share				
Basic	(0.04)	0.08	(0.04)	0.06
Diluted	(0.04)	0.08	(0.04)	0.05

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ART TECHNOLOGY GROUP, INC.

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)

	Year Ended December 31, 2002			
	First Quarter	Second Quarter(1)	Third Quarter	Fourth Quarter(1)
Total revenues	$27,323	$25,152	$24,502	$ 24,516
Gross profit	17,210	15,128	15,196	15,936
Net loss	(2,849)	(2,750)	(3,057)	(20,834)
Net loss per share				
Basic	(0.04)	(0.04)	(0.04)	(0.30)
Diluted	(0.04)	(0.04)	(0.04)	(0.30)

(1) Restructuring charges (benefits) were taken during these quarters, see Note 12 for complete information.

(2) The Company has reclassified an impairment charge for purchased software, which previously had been reported in restructuring, to cost of product license revenues.

PART IV

Item 15. ***Exhibits, Financial Statement Schedules, and Reports on Form 8-K***

(a)(1) *Financial Statements*

The following are included in Item 8:

Report of Independent Auditors

Consolidated Balance Sheets as of December 31, 2003 and 2002

Consolidated Statements of Operations for the years ended December 31, 2003, 2002 and 2001

Consolidated Statements of Stockholders Equity and Comprehensive Income (Loss) for the years ended December 31, 2003, 2002 and 2001

Consolidated Statements of Cash Flows for the years ended December 31, 2003, 2002 and 2001

Notes to Consolidated Financial Statements

(a)(2) *Financial Statement Schedule*

Schedule II for Valuation and Qualifying Accounts is contained in Item 8 in the Notes to the Consolidated Financial Statements. All other schedules have been omitted since the required information is not present, or not present in amounts sufficient to require submission of the schedule or because information required is included in the consolidated financial statements or the notes thereto.

(a)(3) *Exhibits*

The following exhibits are included in Item 14(c)*:

Exhibit Number	Description
3.1(1)	Amended and Restated Certificate of Incorporation of the Registrant, as amended.
3.2(2)	Amended and Restated By-Laws of the Registrant.
4.1(3)	Rights Agreement between Registrant and Equiserve Trust Company, N.A., as rights Agent.
10.1(4)	1996 Stock Option Plan of the Registrant, as amended.
10.2(5)	1999 Outside Director Stock Option Plan of the Registrant, as amended.
10.3(4)	1999 Employee Stock Purchase Plan of the Registrant.
10.4	Lease between the Registrant and Davenport Building Limited Partnership, as Landlord, dated January, 2004.
10.5	Lease Termination Agreement between the Registrant and Davenport Building Limited Partnership dated January, 2004
10.6(9)	Lease between the Registrant and Pine Street Investors I, LLC, dated October 6, 1999.
10.7(9)	First Amendment to Lease between the Registrant and Pine Street Investors I, LLC, dated December 30, 1999.
10.8(9)	Second Amendment to Lease between the Registrant and Pine Street Investors I, LLC, dated August 28, 2000.
10.9(9)	Third Amendment to Lease between the Registrant and Pine Street Investors I, LLC, dated December 22, 2000.
10.10	Fourth Amendment to Lease between the Registrant and 100 Pine Street LP, dated July 15, 2001.

10.11	Fifth Amendment to Lease between the Registrant and 100 Pine Street LP, dated March 31, 2003.
10.12(9)	Lease between the Registrant and DIFA Deutsche Immobilien Fonds AG dated, March 19, 2001.
10.13	Lease Termination Agreement between the Registrant and DIFA Deutsche Immobilen Fonds AG.

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Exhibit Number	Description
10.14(6)	Nonstatutory Option Agreement between Paul Shorthose and the Registrant dated October 23, 2001.
10.15(6)	Promissory Note issued by Edward Terino to the Registrant dated November 21, 2001.
10.16(6)	Letter of Credit Agreement between Silicon Valley Bank and the Registrant noting Amgen Cambridge Real Estate Holdings as beneficiary, dated December 21, 2001.
10.17(6)	Termination of Lease Agreement between Amgen Cambridge Real Estate Holdings, Inc., and the Registrant dated January 2, 2002.
10.18(7)	Amended and Restated Loan and Security Agreement between the Registrant and Silicon Valley Bank, dated June 13, 2002.
10.19(8)	First Loan Modification Agreement between the Registrant and Silicon Valley Bank dated September 30, 2002.
10.20(8)	Amendment Agreement between the Registrant and Silicon Valley Bank dated October 4, 2002.
10.21(9)	Edward Terino Executive Change-in-Control Agreement, dated December 1, 2002.
10.22(9)	Robert Burke offer letter dated December 4, 2002.
10.23(9)	Securities Account Control Agreement between Registrant and Silicon Valley Bank, dated December 20, 2002.
10.24(9)	Second Loan Modification Agreement between the Registrant and Silicon Valley Bank dated December 20, 2002.
10.25	Fourth Loan Modification Agreement between the Registrant and Silicon Valley Bank dated November 26, 2003.
10.26	Amended and Restated Intellectual Property Security Agreement.
21.00(6)	Subsidiaries of the Registrant.
23.1	Consent of Ernst & Young LLP.
31.1	Certification Pursuant to Rule 13a-14(a) and 15d-14(a) of the Exchange Act, as Adopted Pursuant to Section 302 of the Sarbanes-Oxley Act of 2002 (Chief Executive Officer).
31.2	Certification Pursuant to Rule 13a-14(a) and 15d-14(a) of the Exchange Act, as Adopted Pursuant to Section 302 of the Sarbanes-Oxley Act of 2002 (Chief Financial Officer).
32.1	Certification Pursuant to 18 U.S.C. Section 1350 as adopted pursuant to Section 906 of the Sarbanes-Oxley Act of 2002 (Chief Executive Officer).
32.2	Certification Pursuant to 18 U.S.C. Section 1350 as adopted pursuant to Section 906 of the Sarbanes-Oxley Act of 2002 (Chief Financial Officer).

* Copies of the exhibits to this annual report on Form 10-K/A are available to stockholders at the SEC s Web site at *http://www.sec.gov*. In addition, stockholders may obtain copies of the exhibits from us, without charge, by writing to Art Technology Group, Inc., 25 First Street, Cambridge, Massachusetts 02141, Attention: Secretary.

(1) Incorporated herein by reference to the Exhibits to the Registrant s Registration Statement on Form S-8 (File No. 333-106058)

(2) Incorporated herein by reference to the Exhibits to the Registrant s Registration Statement on Form S-3 (File No. 333-64698).

(3) Incorporated herein by reference to the Exhibits to the Registrant s Current Report on Form 8-K filed on October 2, 2001.

(4) Incorporated herein by reference to the Exhibits to the Registrant s Registration Statement on Form S-1 (File No. 333-78333).

(5) Incorporated herein by reference to the Exhibits to the Registrant s Registration Statement on Form S-8 (File No. 333-106057).

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(6) Incorporated herein by reference to the Exhibits to the Registrant s Annual Report on Form 10-K for the year ended December 31, 2001.

(7) Incorporated herein by reference to the Exhibits to the Registrant s Quarterly Report on Form 10-Q for the period ended June 30, 2002.

(8) Incorporated herein by reference to the Exhibits to the Registrant s Quarterly Report on Form 10-Q for the period ended September 30, 2002.

(9) Incorporated by reference to the Exhibits to the Registrant s Annual Report on Form 10-K for the period ended December 31, 2003

(b) Reports on Form 8-K

None.

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SIGNATURES

Pursuant to the requirements of Section 13 or 15(d) of the Securities Exchange Act of 1934, the registrant has duly caused this report to be signed on its behalf by the undersigned, thereunto duly authorized, as of July 12, 2004.

ART TECHNOLOGY GROUP, INC.
(Registrant)

By: /s/ ROBERT D. BURKE

Robert D. Burke
Chief Executive Officer
and President