

REALNETWORKS INC  
Form 10-Q  
November 04, 2016

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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 September 30, 2016

OR

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

For the transition period from \_\_\_\_\_ to \_\_\_\_\_

Commission file number 0-23137

RealNetworks,  
Inc.

(Exact name of  
registrant as  
specified in its  
charter)

Washington 91-1628146

(State of incorporation) (I.R.S. Employer Identification Number)

1501  
First  
Avenue  
South, Suite 98134

600  
Seattle,  
Washington  
(Address of principal executive offices) (Zip Code)

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

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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 October 31, 2016 was 36,971,291.

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## PART I. FINANCIAL INFORMATION

## Item 1. Financial Statements

## REALNETWORKS, INC. AND SUBSIDIARIES

## UNAUDITED CONDENSED CONSOLIDATED BALANCE SHEETS

(In thousands, except per share data)

	September 30, 2016	December 31, 2015
<b>ASSETS</b>		
Current assets:		
Cash and cash equivalents	\$ 38,284	\$ 47,315
Short-term investments	42,465	51,814
Trade accounts receivable, net of allowances	25,287	22,511
Deferred costs, current portion	852	460
Prepaid expenses and other current assets	5,166	7,140
Total current assets	112,054	129,240
Equipment, software, and leasehold improvements, at cost:		
Equipment and software	57,014	66,702
Leasehold improvements	3,204	3,122
Total equipment, software, and leasehold improvements, at cost	60,218	69,824
Less accumulated depreciation and amortization	54,339	61,024
Net equipment, software, and leasehold improvements	5,879	8,800
Restricted cash equivalents and investments	2,700	2,890
Available for sale securities	2,041	1,721
Other assets	1,908	2,307
Deferred costs, non-current portion	1,236	212
Deferred tax assets, net	1,015	957
Other intangible assets, net	1,224	2,136
Goodwill	12,974	13,080
Total assets	\$ 141,031	\$ 161,343
<b>LIABILITIES AND SHAREHOLDERS' EQUITY</b>		
Current liabilities:		
Accounts payable	\$ 18,379	\$ 17,050
Accrued and other current liabilities	16,547	17,320
Deferred revenue, current portion	3,883	3,497
Total current liabilities	38,809	37,867
Deferred revenue, non-current portion	343	105
Deferred rent	504	620
Deferred tax liabilities, net	100	88
Other long-term liabilities	1,935	1,980
Total liabilities	41,691	40,660
Commitments and contingencies		
Shareholders' equity:		
Preferred stock, \$0.001 par value, no shares issued and outstanding:		
Series A: authorized 200 shares	—	—
Undesignated series: authorized 59,800 shares	—	—
Common stock, \$0.001 par value authorized 250,000 shares; issued and outstanding 36,829 shares in 2016 and 36,298 shares in 2015	37	36
Additional paid-in capital	631,824	627,316

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Accumulated other comprehensive loss	(58,758	)	(59,480	)
Retained deficit	(473,763	)	(447,189	)
Total shareholders' equity	99,340		120,683	
Total liabilities and shareholders' equity	\$ 141,031		\$ 161,343	

See accompanying notes to unaudited condensed consolidated financial statements.

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REALNETWORKS, INC. AND SUBSIDIARIES  
 UNAUDITED CONDENSED CONSOLIDATED STATEMENTS OF OPERATIONS  
 AND COMPREHENSIVE INCOME (LOSS)

(In thousands, except per share data)

	Quarters Ended		Nine Months Ended	
	September 30,		September 30,	
	2016	2015	2016	2015
Net revenue (A)	\$31,051	\$30,823	\$89,015	\$95,374
Cost of revenue (B)	16,740	18,090	47,610	54,469
Gross profit	14,311	12,733	41,405	40,905
Operating expenses:				
Research and development	6,699	10,501	23,185	34,681
Sales and marketing	7,183	11,938	24,157	38,822
General and administrative	7,086	7,021	21,380	21,312
Restructuring and other charges	499	3,114	1,297	5,563
Lease exit and related charges	1,233	2,121	2,191	2,208
Total operating expenses	22,700	34,695	72,210	102,586
Operating income (loss)	(8,389 )	(21,962 )	(30,805 )	(61,681 )
Other income (expenses):				
Interest income, net	119	147	316	597
Gain (loss) on investments, net	6,021	(615 )	5,978	(222 )
Equity in net loss of Rhapsody investment	(233 )	(735 )	(629 )	(13,831 )
Other income (expense), net	(243 )	297	(515 )	628
Total other income (expenses), net	5,664	(906 )	5,150	(12,828 )
Income (loss) before income taxes	(2,725 )	(22,868 )	(25,655 )	(74,509 )
Income tax expense (benefit)	331	(1,684 )	919	(1,075 )
Net income (loss)	\$(3,056 )	\$(21,184 )	\$(26,574 )	\$(73,434 )
Basic net income (loss) per share	\$(0.08 )	\$(0.59 )	\$(0.72 )	\$(2.03 )
Diluted net income (loss) per share	\$(0.08 )	\$(0.59 )	\$(0.72 )	\$(2.03 )
Shares used to compute basic net income (loss) per share	36,805	36,191	36,693	36,134
Shares used to compute diluted net income (loss) per share	36,805	36,191	36,693	36,134
Comprehensive income (loss):				
Unrealized investment holding gains (losses), net of reclassification adjustments	\$72	\$(596 )	\$239	\$(881 )
Foreign currency translation adjustments, net of reclassification adjustments	428	(1,144 )	483	(3,141 )
Total other comprehensive income (loss)	500	(1,740 )	722	(4,022 )
Net income (loss)	(3,056 )	(21,184 )	(26,574 )	(73,434 )
Comprehensive income (loss)	\$(2,556 )	\$(22,924 )	\$(25,852 )	\$(77,456 )
(A) Components of net revenue:				
License fees	\$7,850	\$7,049	\$20,305	\$21,259
Service revenue	23,201	23,774	68,710	74,115
	\$31,051	\$30,823	\$89,015	\$95,374
(B) Components of cost of revenue:				
License fees	\$1,755	\$1,877	\$4,458	\$5,048
Service revenue	14,985	16,213	43,152	49,421

\$16,740 \$18,090 \$47,610 \$54,469

See accompanying notes to unaudited condensed consolidated financial statements.

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

	Nine Months Ended September 30,	
	2016	2015
Cash flows from operating activities:		
Net income (loss)	\$(26,574)	\$(73,434)
Adjustments to reconcile net income (loss) to net cash provided by (used in) operating activities:		
Depreciation and amortization	5,897	7,952
Stock-based compensation	4,557	3,761
Equity in net loss of Rhapsody	629	13,831
Deferred income taxes, net	(198 )	(1,531 )
Loss (gain) on investments, net	(5,978 )	222
Realized translation loss (gain)	272	(264 )
Fair value of warrants granted in 2015, net of subsequent mark to market adjustments in 2016 and 2015	112	(1,078 )
Trade accounts receivable	(1,744 )	(6,279 )
Prepaid expenses and other assets	1,155	3,851
Accounts payable	450	(1,628 )
Accrued and other liabilities	(872 )	(1,372 )
Net cash provided by (used in) operating activities	(22,294 )	(55,969 )
Cash flows from investing activities:		
Purchases of equipment, software, and leasehold improvements	(2,009 )	(1,110 )
Proceeds from sale of equity and other investments	2,110	459
Purchases of short-term investments	(59,124 )	(52,475 )
Proceeds from sales and maturities of short-term investments	68,473	60,516
Decrease (increase) in restricted cash equivalents and investments, net	190	—
Acquisitions	(150 )	(161 )
Advance to Rhapsody	—	(5,000 )
Repayment from Rhapsody	—	5,000
Proceeds from the sale of Slingo and social casino business	4,000	10,000
Net cash provided by (used in) investing activities	13,490	17,229
Cash flows from financing activities:		
Proceeds from issuance of common stock (stock options and stock purchase plan)	166	297
Tax payments from shares withheld upon vesting of restricted stock	(843 )	(69 )
Net cash provided by (used in) financing activities	(677 )	228
Effect of exchange rate changes on cash and cash equivalents	450	(2,910 )
Net increase (decrease) in cash and cash equivalents	(9,031 )	(41,422 )
Cash and cash equivalents, beginning of period	47,315	103,253
Cash and cash equivalents, end of period	\$38,284	\$61,831
Supplemental disclosure of cash flow information:		
Cash received from income tax refunds	\$531	\$1,035
Cash paid for income taxes	\$1,876	\$1,136
Non-cash investing activities:		
Increase (decrease) in accrued purchases of equipment, software, and leasehold improvements	\$(6 )	\$(124 )
Acquisition of intangible assets	\$—	\$312
See accompanying notes to unaudited condensed consolidated financial statements.		





REALNETWORKS, INC. AND SUBSIDIARIES

NOTES TO UNAUDITED CONDENSED CONSOLIDATED FINANCIAL STATEMENTS

Quarters and Nine Months Ended September 30, 2016 and 2015

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". "RealPlayer®" and other trademarks of ours appearing in this report are our property.

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 nine months ended September 30, 2016 are not necessarily indicative of the results that may be expected for any subsequent period or for the year ending December 31, 2016. 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, 2015 (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.

Reportable Segments. In the first quarter of 2016, we reorganized the management of our businesses and as a result, we changed our reportable segments. See Note 18, Segment Information, for details. The historical financial information presented has been recast to reflect the new segments and the new corporate expense presentation.

Note 2 Recent Accounting Pronouncements

In August 2014, the Financial Accounting Standards Board (FASB) issued a new standard, "Disclosure of Uncertainties About an Entity's Ability to Continue as a Going Concern". This standard provides guidance around management's responsibility to evaluate whether there is substantial doubt about an entity's ability to continue as a going concern and to provide related footnote disclosures in certain circumstances. The new guidance is effective for the first annual period ending after December 15, 2016 and interim periods thereafter. We are currently evaluating the impact, if any, the adoption of this standard will have on our consolidated financial statements.

In May 2014, the FASB issued new revenue recognition guidance. The guidance will require 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. The new guidance will replace most existing revenue recognition guidance in U.S. GAAP when it becomes effective. The new guidance is effective for us on January 1, 2018; with early adoption permitted beginning January 1, 2017. The guidance permits the use of either the retrospective or cumulative effect transition method. We are evaluating the

effect that the guidance will have on our consolidated financial statements and related disclosures. We have not yet selected a transition method nor determined the effect of the standard on our ongoing financial reporting.

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In February 2016, the FASB issued new guidance related to the accounting for leases by lessees. 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. We will be evaluating the effect that the guidance will have on our consolidated financial statements and related disclosures.

In March 2016, the FASB issued new guidance that is intended to simplify several aspects of the accounting for stock-based compensation, including the treatment of forfeitures, income taxes and statutory tax withholding requirements. The new guidance will be effective for us on January 1, 2017; with early adoption permitted beginning January 1, 2016. We will be evaluating the effect that the guidance will have on our consolidated financial statements and related disclosures.

There have been no other recent accounting pronouncements or changes in accounting pronouncements to be implemented that are of significance or potential significance to RealNetworks.

### Note 3 Acquisitions & Disposals

2015 Sale of Slingo and social casino business. On July 24, 2015, we entered into an agreement to sell the Slingo and social casino portion of our games business, including substantially all of the related assets and liabilities, as well as the stock of Backstage Technologies Incorporated, to Gaming Realms plc. Of the total transaction price of \$18.0 million, \$10.0 million was paid in cash at closing on August 10, 2015 and \$4.0 million was paid in cash on August 10, 2016. The remaining \$4.0 million will be payable either all in cash or a mix of cash and Gaming Realms plc stock, at our election, on August 10, 2017. We recognized the gain related to the 2016 payment in Gain (loss) on investments, net on the statement of operations. Based on several factors, including the timing of the receipt of the remaining \$4.0 million consideration, we deferred the remaining gain of \$4.0 million and will recognize that gain upon realization.

### 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):

	Quarters Ended September 30,		Nine Months Ended September 30,	
	2016	2015	2016	2015
Total stock-based compensation expense	\$778	\$1,178	\$4,557	\$3,761

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

	Quarters Ended September 30,		Nine Months Ended September 30,	
	2016	2015	2016	2015
Expected dividend yield	0 %	0 %	0 %	0 %
Risk-free interest rate	1.00 %	1.27 %	1.25 %	1.26 %
Expected life (years)	3.8	3.8	4.6	4.3
Volatility	32 %	35 %	35 %	37 %

The total stock-based compensation amounts for 2016 and 2015 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 nine months ended September 30, 2016 was stock compensation expense recorded in the first quarter of 2016 related to our 2015 incentive bonuses paid in fully vested restricted stock units which were authorized and granted in the first quarter of 2016.

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As of September 30, 2016, \$4.6 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 2 years.

#### Stock Option Exchange

As previously disclosed in our SEC filings, on September 19, 2016 our shareholders approved amendments to our stock plans to allow for an option exchange program. The program, which launched on November 3, 2016, offers eligible employees and certain other service providers an opportunity to exchange certain outstanding options, with a per share exercise price in excess of \$4.33, for new awards. We currently expect to incur additional stock based compensation due to this exchange beginning in the fourth quarter of fiscal year 2016, which will be determined based upon participation in the program.

#### Note 5 Rhapsody Joint Venture

As of September 30, 2016 we owned approximately 42% of the issued and outstanding stock of Rhapsody and account for our investment using the equity method of accounting.

Rhapsody 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 known as Rhapsody.

Following certain restructuring transactions effective March 31, 2010, we began accounting for our investment in Rhapsody 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 Rhapsody of \$0.2 million and \$0.6 million for the quarter and nine months ended September 30, 2016 and \$0.7 million and \$13.8 million for the quarter and nine months ended September 30, 2015. Because of the \$10.0 million liquidation preference on the preferred stock we hold in Rhapsody, under the equity method of accounting we did not record any share of Rhapsody losses that would reduce our carrying value of Rhapsody, which is impacted by Rhapsody equity transactions, below \$10.0 million, until Rhapsody's book value was reduced below \$10.0 million. This occurred in the first quarter of 2015. As of September 30, 2016, the carrying value of our Rhapsody equity investment is zero, as we do not record any share of Rhapsody losses that would reduce our carrying value of Rhapsody below zero unless we commit to provide financial support for Rhapsody.

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

	Quarters Ended		Nine Months Ended	
	September 30,		September 30,	
	2016	2015	2016	2015
Net revenue	\$54,306	\$52,769	\$160,269	\$149,156
Gross profit	15,195	9,552	29,288	25,395
Net income (loss)	1,632	(6,335)	(11,421)	(27,320)

## 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 September 30, 2016 and December 31, 2015, and indicates the fair value hierarchy of the valuation inputs utilized to determine such fair value (in thousands).

	Fair Value Measurements as of				Amortized Cost as of September 30, 2016
	September 30, 2016				
	Level 1	Level 2	Level 3	Total	
Cash and cash equivalents:					
Cash	\$27,401	\$—	\$—	\$27,401	\$27,401
Money market funds	49	—	—	49	49
Corporate notes and bonds	—	10,834	—	10,834	10,834
Total cash and cash equivalents	27,450	10,834	—	38,284	38,284
Short-term investments:					
Corporate notes and bonds	—	42,465	—	42,465	42,460
Total short-term investments	—	42,465	—	42,465	42,460
Restricted cash equivalents and investments	—	2,700	—	2,700	2,700
Equity investment in publicly traded securities	2,041	—	—	2,041	362
Warrant issued by Rhapsody (included in Other assets)	—	—	941	941	—
Total	\$29,491	\$55,999	\$941	\$86,431	\$83,806

  

	Fair Value Measurements as of				Amortized Cost as of December 31, 2015
	December 31, 2015				
	Level 1	Level 2	Level 3	Total	
Cash and cash equivalents:					
Cash	\$23,152	\$—	\$—	\$23,152	\$23,152
Money market funds	5,061	—	—	5,061	5,061
Corporate notes and bonds	—	19,102	—	19,102	19,102
Total cash and cash equivalents	28,213	19,102	—	47,315	47,315
Short-term investments:					
Corporate notes and bonds	—	51,814	—	51,814	51,862
Total short-term investments	—	51,814	—	51,814	51,862
Restricted cash equivalents and investments	—	2,890	—	2,890	2,890
Equity investment in publicly traded securities	1,721	—	—	1,721	362
Warrant issued by Rhapsody (included in Other assets)	—	—	1,053	1,053	—
Total	\$29,934	\$73,806	\$1,053	\$104,793	\$102,429

Restricted cash equivalents and investments as of September 30, 2016 and December 31, 2015 relate 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 nine months ended September 30, 2016 and 2015 were not significant. Gross unrealized gains and gross unrealized losses on short-term investment securities as of September 30, 2016 and December 31, 2015 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 September 30, 2016 (in thousands):

	Estimated Fair Value
Within one year	\$ 39,565
Between one year and five years	2,900
Total short-term investments	\$ 42,465

Our equity investment in a publicly traded company as of September 30, 2016 and December 31, 2015 consisted of J-Stream Inc., a Japanese media services company. This equity investment is accounted for as available for sale.

During the nine months ended September 30, 2015, we sold a portion of J-Stream shares we held, resulting in cash proceeds of \$0.5 million and a pre-tax gain of \$0.4 million.

In October 2016, we completed the sale of the remaining investment in J-Stream, Inc, resulting in cash proceeds of \$3.3 million and a realized pre-tax gain of \$3.0 million. The impact of this transaction will be reflected in our fourth quarter financial statements.

In February 2015, Rhapsody issued warrants to purchase Rhapsody common shares to each of RealNetworks and Rhapsody's one other 43% stockholder. The warrants were issued as compensation for past services provided by RealNetworks and the other 43% stockholder, and both warrants covered the same number of underlying shares. 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. During the nine months ended September 30, 2016, 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 nine months ended September 30, 2016 and 2015, we did not record any impairments on those assets required to be measured at fair value on a non-recurring basis.

See Note 12, 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 Allowance for Doubtful Accounts Receivable and Sales Returns

Activity in the allowance for doubtful accounts receivable and sales returns (in thousands):

	Allowance For Doubtful Accounts Receivable		Sales Returns	
Balances, December 31, 2015	\$765		\$158	
Addition (reduction) to allowance	52		15	
Amounts written off	(6	)	(3	)
Foreign currency translation	29		—	
Balances, September 30, 2016	\$840		\$170	

One customer accounted for 57% and one other customer accounted for 14% of trade accounts receivable as of September 30, 2016. At December 31, 2015, one customer accounted for 52% and one other customer accounted for 12% of trade accounts receivable.

One customer accounted for 32% or \$9.9 million of consolidated revenue during the quarter ended September 30, 2016 and 31% or \$27.9 million during the nine months ended September 30, 2016, which is reflected in our Mobile Services segment.

One customer accounted for 28% of consolidated revenue or \$8.7 million during the quarter ended September 30, 2015 and for 25% of consolidated revenue or \$24.2 million during the nine months ended September 30, 2015, which is reflected in our Mobile Services segment.

## Note 8 Other Intangible Assets

Other intangible assets (in thousands):

	September 30, 2016			December 31, 2015		
	Gross Amount	Accumulated Amortization	Net	Gross Amount	Accumulated Amortization	Net
Amortizing intangible assets:						
Customer relationships	\$31,476	\$30,851	\$625	\$30,182	\$29,236	\$946
Developed technology	24,725	24,253	472	24,047	23,244	803
Patents, trademarks and tradenames	3,801	3,674	127	3,717	3,398	319
Service contracts	5,447	5,447	—	5,269	5,201	68
Total	\$65,449	\$64,225	\$1,224	\$63,215	\$61,079	\$2,136

An asset purchase relating to our Games business was completed in the second quarter of 2016 and resulted in an intangible asset of \$0.2 million.

In the third quarter of 2016 we recognized a gain of \$2.0 million, net of transaction costs, to Gain (loss) on investments, net, as the result of a sale of a domain name to a third party.

No impairments of other intangible assets were recognized in either of the nine months ended September 30, 2016 or 2015.

## Note 9 Goodwill

Changes in goodwill (in thousands):

Balance, December 31, 2015	\$13,080
Effects of foreign currency translation (106 )	
Balance, September 30, 2016	\$12,974

Goodwill by segment (in thousands):

	September 30, 2016
Consumer Media	\$ 580
Mobile Services	2,096
Games	10,298
Total goodwill	\$ 12,974

No impairment of goodwill was recognized in either of the nine months ended September 30, 2016 or in 2015.

## Note 10 Accrued and Other Current Liabilities

Accrued and other current liabilities (in thousands):

	September 30, 2016	December 31, 2015
Royalties and other fulfillment costs	\$ 2,515	\$ 3,094
Employee compensation, commissions and benefits	5,381	5,958
Sales, VAT and other taxes payable	3,281	2,976
Other	5,370	5,292
Total accrued and other current liabilities	\$ 16,547	\$ 17,320

## Note 11 Restructuring Charges

Restructuring and other charges in 2016 and 2015 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 nine months ended September 30, 2016	\$ 1,297
Costs incurred and charged to expense for the nine months ended September 30, 2015	\$ 5,563

Changes to the accrued restructuring liability (which is included in Accrued and other current liabilities) for 2016 (in thousands) are as follows:

	Employee Separation Costs	
Accrued liability at December 31, 2015	\$	1,404
Costs incurred and charged to expense for the nine months ended September 30, 2016	1,297	
Cash payments	(2,279	)
Accrued liability at September 30, 2016	\$	422

Note 12 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 quarter ended September 30, 2016, we recorded additional losses relating to a further reduction of office space at our corporate headquarters in Seattle, Washington. 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 2016 (in thousands) are as follows:

Accrued loss at December 31, 2015	\$2,595
Additions and adjustments to the lease loss accrual, including estimated sublease income	2,287
Less amounts paid, net of sublease amounts	(1,257 )
Accrued loss at September 30, 2016	3,625
Less current portion (included in Accrued and other current liabilities)	(1,824 )
Accrued loss, non-current portion (included in Other long term liabilities)	\$1,801

## Note 13 Shareholders' Equity

## Accumulated Other Comprehensive Income (Loss)

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

	Quarters Ended		Nine Months Ended	
	September 30,		September 30,	
	2016	2015	2016	2015
<b>Investments</b>				
Accumulated other comprehensive income (loss), beginning of period	\$1,464	\$1,967	\$1,297	\$2,252
Unrealized gains (losses), net of tax effects of \$42, \$(56), \$141 and \$0	72	(596)	239	(488)
Reclassification adjustments for losses (gains) included in other income (expense), net of tax effects of \$0, \$0, \$0 and \$(1)	—	—	—	(393)
Net current period other comprehensive income (loss)	72	(596)	239	(881)
Accumulated other comprehensive income (loss) balance, end of period	\$1,536	\$1,371	\$1,536	\$1,371
<b>Foreign currency translation</b>				
Accumulated other comprehensive income (loss), beginning of period	\$(60,722)	\$(59,501)	\$(60,777)	\$(57,504)
Translation adjustments	156	(880)	211	(2,877)
Reclassification adjustments for losses (gains) included in other income (expense)	272	(264)	272	(264)
Net current period other comprehensive income (loss)	428	(1,144)	483	(3,141)
Accumulated other comprehensive income (loss) balance, end of period	\$(60,294)	\$(60,645)	\$(60,294)	\$(60,645)
Total accumulated other comprehensive income (loss), end of period	\$(58,758)	\$(59,274)	\$(58,758)	\$(59,274)

## Note 14 Income Taxes

As of September 30, 2016, there have been no material changes to RealNetworks' uncertain tax positions disclosures as provided in Note 14 of the 2015 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 15 Earnings (Loss) Per Share

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

	Quarters Ended		Nine Months Ended	
	September 30,		September 30,	
	2016	2015	2016	2015
Net income (loss)	\$(3,056)	\$(21,184)	\$(26,574)	\$(73,434)
Weighted average common shares outstanding used to compute basic EPS	36,805	36,191	36,693	36,134
Dilutive effect of stock based awards	—	—	—	—
Weighted average common shares outstanding used to compute diluted EPS	36,805	36,191	36,693	36,134
Basic EPS	\$(0.08 ) \$(0.59 )		\$(0.72 ) \$(2.03 )	
Diluted EPS	\$(0.08 ) \$(0.59 )		\$(0.72 ) \$(2.03 )	

During the quarter and nine months ended September 30, 2016, 4.6 million and 4.8 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 the quarter and nine months ended September 30, 2015, 5.7 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.

## Note 16 Commitments and Contingencies

We could in the future become 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. 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

In the first quarter of 2016, we reorganized the management of our businesses and as a result, we now report three segments: (1) Consumer Media, which includes our PC-based RealPlayer products, including RealPlayer Plus and related products and intellectual property licensing; (2) Mobile Services, which includes our SaaS services, our LISTEN® product, and our mobile RealTimes® product that is primarily sold through mobile carriers; and (3) Games, which includes all our games-related businesses, including sales of games licenses, online games subscription services, advertising on games sites and social network sites, microtransactions from online and social games, and sales of mobile games.

We allocate 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, to our reportable segments. 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 compensation charges. Concurrent with the first quarter of 2016 segment change described above, we also changed our corporate expense allocation methodology to increase accountability, resulting in an increase in costs allocated to the Consumer Media and Mobile Services businesses.

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.

The historical financial information presented has been recast to reflect the new segments and the new corporate expense presentation. Segment results for the quarters and nine months ended September 30, 2016 and 2015 (in thousands):

#### Consumer Media

	Quarters Ended		Nine Months	
	September 30,		Ended	
	2016	2015	2016	2015
Revenue	\$6,482	\$6,495	\$18,608	\$21,765
Cost of revenue	1,507	3,142	5,485	10,173
Gross profit	4,975	3,353	13,123	11,592
Operating expenses	4,271	6,421	13,940	19,882
Operating income (loss)	\$704	\$(3,068)	\$(817)	\$(8,290)

#### Mobile Services

	Quarters Ended		Nine Months Ended	
	September 30,		September 30,	
	2016	2015	2016	2015
Revenue	\$17,683	\$16,484	\$51,445	\$49,566
Cost of revenue	13,026	12,512	36,347	36,802
Gross profit	4,657	3,972	15,098	12,764
Operating expenses	8,075	11,093	26,653	35,153
Operating income (loss)	\$(3,418)	\$(7,121)	\$(11,555)	\$(22,389)





## Games

	Quarters Ended		Nine Months	
	September 30,		Ended	
	2016	2015	2016	2015
Revenue	\$6,886	\$7,844	\$18,962	\$24,043
Cost of revenue	2,203	2,513	5,865	7,593
Gross profit	4,683	5,331	13,097	16,450
Operating expenses	4,649	6,431	14,669	23,833
Operating income (loss)	\$34	\$(1,100)	\$(1,572)	\$(7,383)

## Corporate

	Quarters Ended		Nine Months Ended	
	September 30,		September 30,	
	2016	2015	2016	2015
Cost of revenue	\$4	\$(77)	\$(87)	\$(99)
Operating expenses	5,705	10,750	16,948	23,718
Operating income (loss)	\$(5,709)	\$(10,673)	\$(16,861)	\$(23,619)

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

	Quarters Ended		Nine Months	
	September 30,		Ended	
	2016	2015	2016	2015
United States	\$10,642	\$11,460	\$31,379	\$36,112
Europe	3,288	3,670	10,002	11,561
Republic of Korea	10,582	9,569	30,227	28,268
Rest of the World	6,539	6,124	17,407	19,433
Total net revenue	\$31,051	\$30,823	\$89,015	\$95,374

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

	September 30, December 31,	
	2016	2015
United States	\$ 13,626	\$ 16,821
Europe	4,194	4,898
Republic of Korea	211	282
Rest of the World	2,046	2,015
Total long-lived assets	\$ 20,077	\$ 24,016

Note 19 Related Party Transactions

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

## 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 entitled "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. Following a reorganization that took effect in the first quarter of 2016, 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 derived from the sales of our PC-based RealPlayer® products, including RealPlayer Plus and related products, and from the licensing of our intellectual property, primarily our codec technology, including our recently introduced RealMedia High Definition, or RMHD, technology. Distribution of 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 our SaaS services, which include ringback tones, music on demand, intercarrier messaging and our LISTEN platform, which we recently launched with a new carrier partner in Brazil. This business also includes revenue related to mobile RealTimes®, our recently introduced photo and video sharing application that is primarily sold through mobile carriers and related partners. Our Games business, through the GameHouse and Zylom brands, derives revenue from sales of games licenses, online games subscription services, sales of mobile games and advertising on games sites and social networks.

We allocate 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, to our reportable segments. Remaining expenses, which are not directly attributable to supporting the business, are reported as corporate items. These corporate items include restructuring charges, lease exit and related charges, as well as stock compensation expense. Concurrent with the first quarter 2016 segment change described above, we also changed our expense allocation methodology to increase accountability, resulting in an increase in corporate costs allocated to the Consumer Media and Mobile Services businesses. The historical financial information presented below has been recast to reflect the new corporate expense allocation.

As of September 30, 2016, we had \$80.7 million in unrestricted cash, cash equivalents and short-term investments, compared to \$99.1 million as of December 31, 2015. The 2016 decrease of cash, cash equivalents, and short-term investments was due primarily to cash used in operating activities during the nine months of \$22.3 million.

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

	Quarters ended September 30,				Nine months ended September 30,			
	2016	2015	\$ Change	% Change	2016	2015	\$ Change	% Change
Total revenue	\$31,051	\$30,823	\$228	1 %	\$89,015	\$95,374	\$(6,359)	(7)%
Cost of revenue	16,740	18,090	(1,350)	(7)%	47,610	54,469	(6,859)	(13)%
Gross profit	14,311	12,733	1,578	12 %	41,405	40,905	500	1 %
Gross margin	46 %	41 %			47 %	43 %		
Operating expenses	22,700	34,695	(11,995)	(35)%	72,210	102,586	(30,376)	(30)%
Operating income (loss)	\$(8,389)	\$(21,962)	\$13,573	62 %	\$(30,805)	\$(61,681)	\$30,876	50 %

In the third quarter of 2016, our total consolidated revenue was flat as compared with the year-earlier period. Stable revenue resulted from an increase of \$1.2 million in Mobile Services due to increased, low-margin music on demand revenue in Korea, offset in part by a decrease of \$1.0 million in Games, due primarily to the sale of the Slingo and social casino games business in the third quarter of 2015. Although revenue was flat compared with the prior-year period, gross margin increased from 41% to 46% during the quarter ended September 30, 2016 driven mainly from an increase in gross margins due to efficiencies in our Consumer Media segment.

Cost of revenues decreased by \$1.4 million for the three months ended September 30, 2016, due primarily from savings of \$1.1 million from lower bandwidth costs in our Consumer Media business, as well as savings of \$0.4 million realized following the sale of the Slingo and the social casino games business.

Operating expenses decreased by \$12.0 million in the quarter ended September 30, 2016 compared with the prior year due, in part, to savings of \$1.9 million realized from the sale of the Slingo and the social casino games business. Other factors contributing to the decrease in operating expenses were significant reductions in salaries and related personnel costs, professional service fees, marketing expenses and restructuring costs totaling \$10.1 million, as described more fully below.

For the nine months ended September 30, 2016, our total consolidated revenue declined by \$6.4 million, compared with the year-earlier period. Revenue decreased by \$3.2 million in our Consumer Media business due to lower intellectual property licensing and subscriptions revenue. Additionally, Games revenue decreased by \$5.1 million, primarily due to the \$4.9 million decrease from the sale of the Slingo and social casino games business in the third quarter of 2015. The revenue from our continuing games business did not significantly fluctuate from the prior year. Revenues increased in our Mobile Services segment by \$1.9 million, mainly due to increases in our low-margin music on demand businesses in Korea and the signing of new distribution agreements for our RealTimes mobile services which were partially offset by decreases in our ringback tones products. Overall gross margin increased to 47% from 43% for the year-earlier period driven by increased margin in our Consumer Media and Mobile Services segments as described in Segment Operating Results below.

Cost of revenues decreased by \$6.9 million for the nine months ended September 30, 2016, due to lower bandwidth costs and lower licensing royalties in Consumer Media of \$4.7 million, as well as savings of \$2.0 million realized

following the sale of the Slingo and the social casino games business.

Operating expenses decreased by \$30.4 million in the nine months ended September 30, 2016, compared with the prior year due to our cost reduction efforts and to savings of \$11.1 million realized from the sale of the Slingo and social casino games business. Other factors contributing to this decrease were reductions in personnel and related costs of \$6.2 million, marketing expenses of \$6.4 million and professional services costs of \$2.1 million. These reductions were offset in part by the benefit recognized in the first quarter of 2015 relating to warrants received from Rhapsody, and higher stock compensation

expense in 2016 resulting from the first quarter 2016 authorization and grant of fully vested equity awards as payment for 2015 incentive bonuses.

#### Segment Operating Results

##### Consumer Media

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

	Quarters ended September 30,				Nine months ended September 30,			
	2016	2015	\$ Change	% Change	2016	2015	\$ Change	% Change
Revenue	\$6,482	\$6,495	\$ (13 )	— %	\$18,608	\$21,765	\$(3,157)	(15 )%
Cost of revenue	1,507	3,142	(1,635 )	(52 )%	5,485	10,173	(4,688 )	(46 )%
Gross profit	4,975	3,353	1,622	48 %	13,123	11,592	1,531	13 %
Gross margin	77 %	52 %			71 %	53 %		
Operating expenses	4,271	6,421	(2,150 )	(33 )%	13,940	19,882	(5,942 )	(30 )%
Operating income (loss)	\$704	\$(3,068)	\$3,772	123 %	\$(817 )	\$(8,290 )	\$7,473	90 %

Total Consumer Media revenue for the quarter ended September 30, 2016 was flat as compared to the same quarter of fiscal 2015. Total Consumer Media revenue for the nine months ended September 30, 2016 declined \$3.2 million when compared with the year-earlier period. Intellectual property licensing revenue declined by \$2.2 million for the nine month period due primarily to the timing of contracts and contract renewals, of which \$1.7 million occurred in the first quarter. Continuing declines in our subscription products of \$1.1 million also contributed to the decline in Consumer Media revenue.

Cost of revenue decreased by \$1.6 million during the quarter ended September 30, 2016, compared with the year-earlier period resulting in an increase in gross margin of 25 percentage points. The decrease in cost of revenue was primarily due to lower bandwidth costs of \$1.1 million directly resulting from our ongoing efforts to optimize functionality and increase efficiencies.

Cost of revenue decreased by \$4.7 million during the nine months ended September 30, 2016, compared with the year-earlier period resulting in an increase in gross margin of 18 percentage points. The decrease in cost of revenue was driven mainly by lower bandwidth costs of \$2.8 million, as well as lower licensing royalties and support service costs.

Operating expenses decreased by \$2.2 million in the quarter ended September 30, 2016, compared with the year-earlier period. The decrease was primarily due to reductions in salaries and related personnel costs of \$0.9 million, marketing costs of \$0.8 million, and professional services costs of \$0.3 million.

Operating expenses decreased by \$5.9 million in the nine months ended September 30, 2016, compared with the year-earlier period. The decrease was primarily due to reductions in salaries and related personnel costs of \$3.8 million, marketing costs of \$1.8 million, and professional services costs of \$1.1 million. These declines were offset, in part, by an acceleration of depreciation expense in the first quarter related to the obsolescence of e-commerce assets as we moved the platform to a third party cloud service.

##### Mobile Services

Mobile Services segment results of operations were as follows (dollars in thousands):

	Quarters ended September 30,				Nine months ended September 30,			
	2016	2015	\$ Change	% Change	2016	2015	\$ Change	% Change
Revenue	\$17,683	\$16,484	\$ 1,199	7 %	\$51,445	\$49,566	\$1,879	4 %
Cost of revenue	13,026	12,512	514	4 %	36,347	36,802	(455 )	(1 )%
Gross profit	4,657	3,972	685	17 %	15,098	12,764	2,334	18 %
Gross margin	26 %	24 %			29 %	26 %		
Operating expenses	8,075	11,093	(3,018 )	(27 )%	26,653	35,153	(8,500 )	(24 )%
Operating income (loss)	\$(3,418 )	\$(7,121 )	\$3,703	52 %	\$(11,555)	\$(22,389)	\$10,834	48 %





Total Mobile Services revenue increased by \$1.2 million in the quarter ended September 30, 2016 compared with the prior-year period. This increase was driven by increases of \$1.2 million in our low-margin music on demand business in Korea, as well as an increase of \$0.4 million from sales of system integration services. These increases were offset in part by a decline of \$0.7 million from our ringback tones services.

Total Mobile Services revenue increased by \$1.9 million in the nine months ended September 30, 2016, compared with the prior-year period. This increase was driven by increases of \$3.7 million in our low-margin music on demand business in Korea, as well as an increase of \$1.5 million from system implementations for our carrier partners. These increases were offset in part by decreases in revenue from our ringback tones business of \$2.1 million and \$0.7 million from our Helix product, which we no longer sell.

Cost of revenue increased by \$0.5 million in the quarter ended September 30, 2016 compared with the prior-year period. Higher costs of \$1.1 million due to higher sales from our music on demand business were offset by savings from our other SaaS service offerings.

Cost of revenue decreased by \$0.5 million in the nine months ended September 30, 2016 compared with the prior-year period, primarily from savings related to our SaaS service offerings, such as professional services, ringback tones and from our RealTimes mobile services. These declines were offset in part by an increase in music on demand service costs directly related to the higher revenue during the nine months ended September 30, 2016.

Operating expenses decreased by \$3.0 million and \$8.5 million for the quarter and nine months ended September 30, 2016 compared with the year-earlier periods. These decreases were primarily due to reductions in salaries and related personnel costs of \$1.5 million and \$4.3 million, as well as lower marketing expense of \$1.3 million and \$3.8 million for the quarter and nine months ended September 30, 2016, respectively.

#### Games

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

	Quarters ended September 30,				Nine months ended September 30,			
	2016	2015	\$ Change	% Change	2016	2015	\$ Change	% Change
Revenue	\$6,886	\$7,844	\$(958)	(12)%	\$18,962	\$24,043	\$(5,081)	(21)%
Cost of revenue	2,203	2,513	(310)	(12)%	5,865	7,593	(1,728)	(23)%
Gross profit	4,683	5,331	(648)	(12)%	13,097	16,450	(3,353)	(20)%
Gross margin	68	% 68	%		69	% 68	%	
Operating expenses	4,649	6,431	(1,782)	(28)%	14,669	23,833	(9,164)	(38)%
Operating income (loss)	\$34	\$(1,100)	\$1,134	103%	\$(1,572)	\$(7,383)	\$5,811	79%

Total Games revenue decreased by \$1.0 million in the quarter ended September 30, 2016, compared with the year-earlier period primarily due to the sale of our Slingo and social casino games business in the third quarter of 2015. Revenue from this business was \$1.0 million in the third quarter of 2015. The revenue from our continuing casual games business was flat as compared to the prior-year period, as a \$0.5 million increase to our mobile games revenue was offset by a decrease in our other games revenue.

Total Games revenue decreased by \$5.1 million in the nine months ended September 30, 2016, compared with the prior-year period primarily due to the sale of our Slingo and social casino games business in the third quarter of 2015. Revenue from this business was \$4.9 million in the first nine months of 2015. The revenue from our casual games business did not significantly fluctuate. Our mobile games revenue increased by \$2.0 million which was offset by a decrease in our other games revenue.

Cost of revenue decreased by \$0.3 million and \$1.7 million in the quarter and nine months ended September 30, 2016 compared with the prior-year periods. Decreases of \$0.4 million and \$2.0 million were primarily due to savings realized following the sale of the Slingo and social casino games business offset, in part, by an increase in app store fees related to our mobile revenue growth in the casual games business.

Operating expenses declined by \$1.8 million and \$9.2 million in the quarter and nine months ended September 30, 2016, compared with the prior-year period. The decreases in expense were due to savings of \$1.9 million and \$11.1 million in the quarter and nine month periods from the 2015 sale of our Slingo and social casino games business.

These decreases were



partially offset by increases in research and development salaries and related personnel costs from our continuing casual games business.

#### Corporate

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

	Quarters ended September 30,				Nine months ended September 30,			
	2016	2015	\$ Change	% Change	2016	2015	\$ Change	% Change
Cost of revenue	\$4	\$(77)	\$81	105 %	\$(87)	\$(99)	\$12	12 %
Operating expenses	5,705	10,750	(5,045)	(47)%	16,948	23,718	(6,770)	(29)%
Operating income (loss)	\$(5,709)	\$(10,673)	\$4,964	47 %	\$(16,861)	\$(23,619)	\$6,758	29 %

Operating expenses decreased by \$5.0 million in the quarter ended September 30, 2016 compared with the year-earlier period. The decrease was primarily due to \$3.5 million lower restructuring charges in 2016 compared to 2015 and reductions in salary, benefit and professional service expenses of \$0.6 million as well as lower expenses for facilities and support services as a result of our reduction of office space at our corporate headquarters and ongoing cost reduction efforts.

Operating expenses decreased by \$6.8 million in the nine months ended September 30, 2016 compared with the year-earlier period. The decrease from the prior-year period was due to a decrease of \$4.3 million relating to restructuring charges, as well as a reduction of \$1.6 million in salary, benefit and professional service expenses and lower expenses for facilities and support services as a result of our reduction of office space at our corporate headquarters and ongoing cost reduction efforts. These decreases were offset in part by the benefit of \$1.2 million relating to the warrants received from Rhapsody in the first quarter of 2015 and an increase in stock compensation expense of \$0.8 million in 2016 due in part to the authorization and granting of fully vested equity awards for our 2015 incentive bonuses in the first quarter of 2016.

#### Consolidated Operating Expenses

Our operating expenses consist primarily of salaries and related personnel costs including stock based compensation, consulting fees associated with product development, sales commissions, amortization of certain intangible assets capitalized in our acquisitions, professional service fees, advertising costs, restructuring charges and lease exit costs. Operating expenses were as follows (dollars in thousands):

	Quarters ended September 30,				Nine months ended September 30,			
	2016	2015	\$ Change	% Change	2016	2015	\$ Change	% Change
Research and development	\$6,699	\$10,501	\$(3,802)	(36)%	\$23,185	\$34,681	\$(11,496)	(33)%
Sales and marketing	7,183	11,938	(4,755)	(40)%	24,157	38,822	(14,665)	(38)%
General and administrative	7,086	7,021	65	1 %	21,380	21,312	68	— %
Restructuring and other charges	499	3,114	(2,615)	(84)%	1,297	5,563	(4,266)	(77)%
Lease exit and related charges	1,233	2,121	(888)	(42)%	2,191	2,208	(17)	(1)%
Total consolidated operating expenses	\$22,700	\$34,695	\$(11,995)	(35)%	\$72,210	\$102,586	\$(30,376)	(30)%

Research and development expenses decreased by \$3.8 million in the quarter ended September 30, 2016, compared with the year-earlier period. The decrease was primarily due to \$1.5 million from an overall reduction in salaries and benefits costs and professional service fees, a \$0.8 million reduction from the sale of our Slingo and social casino games business, and lower expenses for facilities and support services as a result of our reduction of office space at our corporate headquarters and ongoing cost reduction efforts.

Research and development expenses decreased by \$11.5 million in the nine months ended September 30, 2016 compared with the year-earlier period. The decrease was primarily due to a \$5.0 million reduction from the sale of our Slingo and social casino games business and \$4.3 million from a reduction in salaries and benefits costs and professional service fees.



Sales and marketing expenses decreased by \$4.8 million in the quarter ended September 30, 2016 compared with the year-earlier period. The decrease was due to a \$2.5 million reduction in marketing expense, a \$0.9 million reduction from the sale of our Slingo and social casino games business, as well as an overall decrease of \$0.7 million in salaries, benefits, and professional service fees.

Sales and marketing expenses decreased by \$14.7 million in the nine months ended September 30, 2016 compared with the year-earlier period. The decrease was primarily due to a \$4.9 million reduction from the sale of our Slingo and social casino games business, \$2.3 million of decreases in salaries and benefits costs and professional service fees and a decrease in marketing expenses of \$6.2 million. These decreases were offset in part by an increase in stock compensation expenses for the fully vested equity awards authorized and granted for our 2015 incentive bonuses in the first quarter of 2016.

General and administrative expenses were flat for the quarter ended September 30, 2016, compared with the year-earlier period, primarily due to the sale of our Slingo and social casino games business in 2015 and an overall decrease in salaries, benefits and professional fees, offset by accelerated depreciation expense in the quarter, due in part to a reduction in space at our corporate headquarters.

General and administrative expenses were also flat for the nine months ended September 30, 2016 compared with the year-earlier period. In the current year, we recognized savings from the sale of our Slingo and social casino games business, as well as savings due to decreased salaries, benefits and professional services fees. These decreased costs were offset by the benefit recognized in 2015 relating to warrants received from Rhapsody and accelerated depreciation expense in 2016 due in part to a reduction in space at our corporate headquarters.

Restructuring and other charges and Lease exit and related charges consist of costs associated with the ongoing reorganization of our business operations and expense re-alignment efforts. Restructuring expense primarily relates to severance costs due to workforce reductions. For additional details on these charges see Note 11, Restructuring Charges and Note 12, Lease Exit and Related Charges, to the unaudited condensed consolidated financial statements included in Item 1 of Part I of this 10-Q.

#### Other Income (Expenses)

Other income (expenses), net was as follows (dollars in thousands):

	Quarters ended September 30,				Nine months ended September 30,			
	2016	2015	\$ Change	% Change	2016	2015	\$ Change	% Change
Interest income, net	\$119	\$147	\$(28)	(19)%	\$316	\$597	\$(281)	(47)%
Gain (loss) on investments, net	6,021	(615)	6,636	NM	5,978	(222)	6,200	NM
Equity in net loss of Rhapsody	(233)	(735)	502	68%	(629)	(13,831)	13,202	95%
Other income (expense), net	(243)	297	(540)	(182)%	(515)	628	(1,143)	(182)%
Total other income (expense), net	\$5,664	\$(906)	\$6,570	725%	\$5,150	\$(12,828)	\$17,978	140%

Gain (loss) on investments, net, increased \$6.6 million and \$6.2 million for the three- and nine-months ended September 30, 2016, respectively. The increases were due to the collection and recognition of the first anniversary payment of \$4.0 million from our 2015 sale of Slingo and social casino business and to the receipt of proceeds of \$2.0 million, net of transaction costs, from the sale of a domain name, both in the third quarter of 2016.

We account for our investment in Rhapsody under the equity method of accounting, as described in Note 5, Rhapsody Joint Venture, to the unaudited condensed consolidated financial statements included in Item 1 of Part I of this Form 10-Q. The net carrying value of our investment in Rhapsody is not necessarily indicative of the underlying fair value of our investment.

Other income (expense), net, for the three and nine months ended September 30, 2016 reflected an expense of \$0.2 million and \$0.5 million, respectively, compared with income reflected in the same periods of 2015. The expense in the current year periods was due primarily to the release in the current period of a \$0.3 million cumulative foreign exchange translation loss out of other comprehensive income related to the liquidation of an investment in one of our foreign entities. In the the third quarter of 2015, we recognized a net gain of \$0.2 million due to liquidation of

investments in foreign entities.

Income Taxes

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During the quarters ended September 30, 2016 and 2015, we recognized an income tax expense of \$0.3 million and an income tax benefit of \$1.7 million, respectively, related to U.S. and foreign income taxes. During the nine months ended September 30, 2016 and 2015, we recognized income tax expense of \$0.9 million, and an income tax benefit of \$1.1 million, respectively, related to U.S. and foreign income taxes. The change in income tax expense during the quarter and nine months ended September 30, 2016 was largely the result of an income tax benefit related to the sale of the Slingo and social casino games business recognized in the quarter ending September 30, 2015 and changes in our jurisdictional income.

As of September 30, 2016, there have been no material changes to RealNetworks' uncertain tax positions disclosures as provided in Note 14 of the 2015 10-K. We do not anticipate that the total amount of unrecognized tax benefits will significantly change within the next twelve months.

The majority of our tax expense is due to income in our foreign jurisdictions and we have not benefitted from losses in the U.S. and certain foreign jurisdictions in the third quarter of 2016. We generate income in a number of foreign jurisdictions, some of which have higher or lower tax rates relative to the U.S. federal statutory rate. Our tax expense could fluctuate significantly on a quarterly basis to the extent income is less than anticipated in countries with lower statutory tax rates and more than anticipated in countries with higher statutory tax rates. For the quarter and nine months ended September 30, 2016, decreases in tax expense from income generated in foreign jurisdictions with lower tax rates in comparison to the U.S. federal statutory rate was offset by increases in tax expense from income generated in foreign jurisdictions having comparable, or higher tax rates in comparison to the U.S. federal statutory rate. The effect of differences in foreign tax rates on the Company's tax expense for the third quarter of 2016 is minimal.

As of September 30, 2016, we have not provided for U.S. federal and state income taxes on certain undistributed earnings of our foreign subsidiaries, since such earnings are considered indefinitely reinvested outside the U.S. or may be remitted tax-free to the U.S. If these amounts were distributed to the U.S., in the future in the form of dividends or otherwise, we could be subject to additional U.S. income and foreign withholding taxes. It is not practicable to determine the foreign withholding and U.S. income tax liability or benefit on such earnings due to the timing of such future distributions, the availability of foreign tax credits, and the complexity of the computation if such earnings were not deemed to be permanently reinvested. If future events, including material changes in estimates of cash, working capital, and long-term investment requirements necessitate that these earnings be distributed, an additional provision for U.S. income and foreign withholding taxes may be necessary.

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

#### Geographic Revenue

Revenue by geographic region was as follows (dollars in thousands):

	Quarters ended September 30,				Nine months ended September 30,			
	2016	2015	\$ Change	% Change	2016	2015	\$ Change	% Change
United States	\$10,642	\$11,460	\$ (818)	(7)%	\$31,379	\$36,112	\$(4,733)	(13)%
Europe	3,288	3,670	(382)	(10)%	10,002	11,561	(1,559)	(13)%
Republic of Korea	10,582	9,569	1,013	11%	30,227	28,268	1,959	7%
Rest of world	6,539	6,124	415	7%	17,407	19,433	(2,026)	(10)%
Total net revenue	\$31,051	\$30,823	\$ 228	1%	\$89,015	\$95,374	\$(6,359)	(7)%

Revenue in the United States declined by \$0.8 million in the quarter ended September 30, 2016 compared with the year-earlier period. The decline was primarily due to the sale of our Slingo and social casino business in the third quarter of 2015.

Revenue in the United States declined by \$4.7 million in the nine months ended September 30, 2016 compared with the year-earlier period. The decline was primarily due to the sale of our Slingo and social casino business in the third



quarter of 2015. In addition, we had a decrease of \$1.5 million from our Consumer Media business offset by increases in both our Mobile Services and continuing Games businesses.

Revenue in Europe declined by \$0.4 million and \$1.6 million in the quarter and nine months ended September 30, 2016, respectively, compared with the year-earlier periods. The decreases were due to similar declines in both our Games revenue and our Mobile Services revenue in each of the periods.

Revenue in Korea increased by \$1.0 million in the quarter ended September 30, 2016 compared with the year-earlier period. Of this increase, \$1.1 million was generated from our Mobile Services business from our low-margin music on demand services.

Revenue in Korea increased by \$2.0 million in the nine months ended September 30, 2016 compared with the year-earlier period. The increase, which was in our Mobile Services business, was due primarily to a \$3.8 million increase in low-margin music on demand revenue offset in part by a \$1.2 million decrease from our Consumer Media business.

Revenue in the rest of world increased by \$0.4 million in the quarter ended September 30, 2016 compared with the year-earlier period. The increase was due to higher revenue in our Consumer Media business.

Revenue in the rest of world decreased by \$2.0 million in the nine months ended September 30, 2016 compared with the year-earlier period. The decrease was primarily due to lower Mobile Services revenue of \$1.4 million and lower revenue in our Consumer Media business of \$0.3 million.

#### New Accounting Pronouncements

See Note 2, Recent Accounting Pronouncements, to the unaudited condensed consolidated financial statements included in Item 1 of Part I of this 10-Q.

#### Liquidity and Capital Resources

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

	September 30, 2016	December 31, 2015
Working capital	\$ 73,245	\$ 91,373
Cash, cash equivalents, and short-term investments	80,749	99,129
Restricted cash equivalents and investments	2,700	2,890

The 2016 decrease of cash, cash equivalents, and short-term investments from December 31, 2015 was due primarily to our ongoing negative cash flows used in operating activities, which totaled \$22.3 million in the first nine months of 2016.

The following summarizes cash flow activity (in thousands):

	Nine months ended September 30,	
	2016	2015
Cash provided by (used in) operating activities	\$(22,294)	\$(55,969)
Cash provided by (used in) investing activities	13,490	17,229
Cash provided by (used in) financing activities	(677)	228

Cash used in operating activities consisted of net income (loss) adjusted for certain non-cash items such as depreciation and amortization, and the effect of changes in certain operating assets and liabilities.

Cash used in operating activities was \$33.7 million less in the nine months ended September 30, 2016 as compared to the same period in 2015. Cash used in operations was less due primarily to a lower operating loss in 2016 than the same period in the prior year, driven mainly by our ongoing cost reduction efforts, as previously discussed.

For the nine months ended September 30, 2016, cash provided by investing activities of \$13.5 million was due to sales and maturities, net of purchases, of short-term investments, which totaled \$9.3 million, the receipt of proceeds of \$4.0 million from the first anniversary payment relating to the 2015 sale of the Slingo and social casino games business, and the receipt of \$2.1 million relating to the sale of a domain name, both of which occurred in the third quarter of

2016. These increases were partially offset by purchases of equipment, software and leasehold improvements of \$2.0 million.

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For the nine months ended September 30, 2015, cash provided by investing activities of \$17.2 million was primarily due to sales and maturities, net of purchases, of short-term investments of \$8.0 million and the \$10 million cash received from the 2015 sale of the Slingo and social casino games business, partially offset by purchases of equipment, software and leasehold improvements of \$1.1 million.

Cash used in financing activities for the nine months ended September 30, 2016 was \$0.7 million. This cash outflow was due mainly to tax payments on shares withheld upon vesting of restricted stock.

Financing activities for the nine months ended September 30, 2015 provided cash totaling \$0.2 million primarily from the issuance of common stock during the period.

While we currently have no planned significant capital expenditures for the remainder of 2016 other than those in the ordinary course of business, we do have contractual commitments for future payments related to office leases.

We believe that our current unrestricted cash, cash equivalents, and short-term investments will be sufficient to meet our anticipated cash needs for working capital and capital expenditures for at least the next 12 months.

In the future, we may seek to raise additional funds through public or private equity financing, or through other sources such as credit facilities. Such sources of funding may or may not be available to us at commercially reasonable terms. The sale of additional equity securities could result in dilution to our shareholders. In addition, in the future, we may enter into cash or stock acquisition transactions or other strategic transactions that could reduce cash available to fund our operations or result in dilution to shareholders.

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

We conduct our operations primarily in five functional currencies: the U.S. dollar, the Korean won, the Japanese yen, the British pound and the euro. We currently do not hedge the majority of our foreign currency exposures and are therefore subject to the risk of exchange rate fluctuations. We are exposed to foreign exchange rate fluctuations as the financial results of foreign subsidiaries are translated into U.S. dollars in consolidation. Our exposure to foreign exchange rate fluctuations also arises from intercompany payables and receivables to and from our foreign subsidiaries.

As of September 30, 2016, approximately \$16.4 million of unrestricted cash, cash equivalents, and short-term investments was held by our foreign subsidiaries. If these funds are needed for our operations in the U.S., we may be required to accrue and pay U.S. income and foreign withholding taxes to repatriate these funds. However, our intent is to permanently reinvest these funds outside of the U.S. and our current plans do not demonstrate a need to repatriate them to fund our U.S. operations. Additionally, the Company currently has significant net operating losses and other tax attributes that could be used to offset potential U.S. income tax that could result if these amounts were distributed to the U.S. We utilize a variety of tax planning and financing strategies in an effort to ensure that our worldwide cash is available in the locations in which it is needed. We do not expect restrictions or potential taxes on repatriation of amounts held outside of the U.S to have a material effect on our overall liquidity, financial condition or results of operations.

#### Off-Balance Sheet Arrangements

We have operating lease obligations for office facility leases with future cash commitments that are not required to be recorded on our consolidated balance sheet. Accordingly, these operating lease obligations constitute off-balance sheet arrangements. In addition, since we do not maintain accruals associated with certain guarantees, as discussed in Note 17, Guarantees, to the unaudited condensed consolidated financial statements included in Item 1 of Part I of this 10-Q, those guarantee obligations also constitute off-balance sheet arrangements.

#### Critical Accounting Policies and Estimates

The preparation of our financial statements requires us to make estimates and assumptions that affect the reported amounts of assets and liabilities and disclosure of contingent assets and liabilities at the date of the financial statements and the

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reported amounts of revenue and expenses during the reported period. Our critical accounting policies and estimates are as follows:

- Revenue recognition;
- Estimating music publishing rights and music royalty accruals;
- Estimating recoverability of deferred costs;
- Estimating allowances for doubtful accounts and sales returns;
- Estimating losses on excess office facilities;
- Valuation of equity method investments;
- Valuation of definite-lived assets;
- Valuation of goodwill;
- Stock-based compensation; and
- Accounting for income taxes.

**Revenue Recognition.** We recognize 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 product or services are made available, digitally, to the end user.

We recognize revenue on a gross or net basis. In most arrangements, we contract directly with end user customers, and are the primary obligor. In such arrangements, we recognize revenue on a gross basis. In some cases, we utilize third-party distributors who are the primary obligor to sell products or services directly to end user customers. In such instances, we recognize revenue on a net basis.

In our direct to consumer operations, we derive revenue primarily through (1) subscriptions sold by our Games segment and subscriptions of SuperPass within our Consumer Media segment, (2) sales of content downloads, software and licenses offered by our Consumer Media, Mobile Services, and Games segments and (3) the sale of advertising and the distribution of third-party products on our websites and in our games.

Consumer subscription products are paid in advance, typically for 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 our websites and from advertising and the distribution of third-party products included in our products is recognized as revenue at the time of delivery.

We also generate revenue through business-to-business channels by providing services within our Mobile Services 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.

Non-software revenue arrangements containing multiple elements are divided into separate units of accounting, after being evaluated for specific criteria. If the criteria for separation are met, revenue is allocated to the individual units using the relative price method. If the criteria are not met, the elements are treated as one unit of accounting and revenue recognition is delayed until all elements have been delivered. In the case of revenue arrangements containing software, elements are divided into separate units of accounting only when vendor-specific objective evidence has been established. In cases where vendor-specific objective evidence has not been established, undelivered elements are combined into one unit of accounting and are not recognized in revenue until all elements have been delivered.

**Estimating Music Publishing Rights and Music Royalty Accruals.** We have made estimates of amounts that may be owed related to music royalties for our historical domestic and international music services. Material differences may impact the amount and timing of our expense for any period if management made different judgments or utilized different estimates. Under copyright law, we may be required to pay licensing fees for digital sound recordings and compositions we have delivered. Copyright law generally does not specify the rate and terms of the licenses, which are determined by voluntary negotiations among the parties or, for certain compulsory licenses where voluntary

negotiations are unsuccessful, by arbitration. Our estimates are based on contracted or statutory rates, when established, or management's best estimates based on facts and circumstances regarding the specific music services and agreements in similar geographies or with similar agencies. While we have based our estimates on historical experience and on various other assumptions that management believes to be reasonable under the circumstances, actual results may differ materially from these estimates under different assumptions or conditions.

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

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

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

Estimating Allowances for Doubtful Accounts and Sales Returns. We make estimates of the uncollectible portion of our accounts receivable. We specifically analyze the age of accounts receivable and historical bad debts, customer credit-worthiness and current economic trends when evaluating the adequacy of the allowance for doubtful accounts. Similarly, we make estimates of potential future product returns related to current period revenue. We analyze historical returns, current economic trends, and changes in customer demand and acceptance of our products when evaluating the adequacy of the sales returns allowance. Significant judgments and estimates are made and used in connection with establishing allowances for doubtful accounts and sales returns. Material differences may result in the amount and timing of our revenue for any period if we were to make different judgments or utilize different estimates or actual future experience was different from the judgments and estimates.

Estimating losses on excess office facilities. We make significant estimates in determining the appropriate amount of accrued loss on excess office facilities, including estimates of sublease income expected to be received. If we make different estimates, our loss on excess office facilities could be significantly different from that recorded, which could have a material impact on our operating results.

Valuation of Equity Method Investments. We use the equity method of accounting for investments in circumstances where we have the ability to exert significant influence, but not control, over an investee or joint venture. We record our percentage interest in the investee's recorded income or loss and changes in the investee's capital under this method, which will increase or decrease the reported value of our investment. See Note 5, Rhapsody Joint Venture, to the unaudited condensed consolidated financial statements included in Item 1 of Part I of this 10-Q, for additional information. We initially record our investment based on a fair value analysis of the investment.

We evaluate impairment of an investment valued under the equity method if events and circumstances warrant. An impairment charge would be recorded if a decline in value of an equity investment below its carrying amount were determined to be other than temporary. In determining if a decline is other than temporary, we consider factors such as the length of time and extent to which the fair value of the investment has been less than the carrying amount of the investee or joint venture, the near-term and longer-term operating and financial prospects of the investee or joint venture and our intent and ability to hold the investment for a period of time sufficient to allow for any anticipated recovery.

Valuation of Definite-Lived Assets. Definite-lived assets consist primarily of property, plant and equipment, as well as amortizable intangible assets acquired in business combinations. Definite-lived assets are amortized on a straight line basis over their estimated useful lives. We review definite-lived assets for impairment whenever events or changes in circumstances indicate the carrying amount of such assets may not be recoverable. Recoverability of these assets is measured by comparison of their carrying amount to future undiscounted cash flows the assets are expected to generate. If definite-lived assets are considered to be impaired, the impairment to be recognized equals the amount by which the carrying value of the assets exceeds their fair market value.

The impairment analysis of definite-lived assets is based upon estimates and assumptions relating to our future revenue, cash flows, operating expenses, costs of capital and capital purchases. These estimates and assumptions are



complex and subject to a significant degree of judgment with respect to certain factors including, but not limited to, the cash flows of our long-term operating plans, market and interest rate risk, and risk-commensurate discount rates and cost of capital. Significant or sustained declines in future revenue or cash flows, or adverse changes in our business climate, among other factors, and their resulting impact on the estimates and assumptions relating to the value of our definite-lived assets could result in the need to perform an impairment analysis in future periods which could result in a significant impairment. While we believe our estimates and assumptions are reasonable, due to their complexity and subjectivity, these estimates and assumptions could vary from period to period. Changes in these estimates and assumptions could materially affect the estimate of future undiscounted

cash flows and related fair market values of these assets and result in significant impairments, which could have a material adverse effect on our financial condition or results of operations. For further discussion, please see the risk factor entitled, "Any impairment to our goodwill, and definite-lived assets could result in a significant charge to our earnings" under Item 1A Risk Factors.

**Valuation of Goodwill.** We test goodwill for impairment on an annual basis, in our fourth quarter, or more frequently if circumstances indicate reporting unit carrying values may exceed their fair values. Circumstances that may indicate a reporting unit's carrying value exceeds its fair value include, but are not limited to: poor economic performance relative to historical or projected future operating results; significant negative industry, economic or company specific trends; changes in the manner of our use of the assets or the plans for our business; and loss of key personnel.

When evaluating goodwill for impairment, based upon our annual test or due to changes in circumstances described above, we first perform a qualitative assessment to determine if the fair value of a reporting unit is more likely than not less than the reporting unit's carrying amount including goodwill. If this assessment indicates it is more likely than not, we then compare the carrying value of the reporting unit to the estimated fair value of the reporting unit. If the carrying value of the reporting unit exceeds the estimated fair value, we then calculate the implied estimated fair value of goodwill for the reporting unit and compare it to the carrying amount of goodwill for the reporting unit. If the carrying amount of goodwill exceeds the implied estimated fair value, an impairment charge to current operations is recorded to reduce the carrying value to implied estimated value.

Significant judgments and estimates are required in determining the reporting units and assessing the fair value of the reporting units. These estimates and assumptions are complex and subject to a significant degree of judgment with respect to certain factors including, but not limited to, the cash flows of long-term operating plans, market and interest rate risk, and risk-commensurate discount rates and cost of capital.

**Stock-Based Compensation.** Stock-based compensation cost is estimated at the grant date based on the award's fair value and is recognized as expense over the requisite service period, which is the vesting period. For stock options, the fair value is calculated using the Black-Scholes option-pricing model or other appropriate valuation models such as Monte Carlo simulation. The valuation models require various highly judgmental assumptions including volatility in our common stock price and expected option life. If any of the assumptions used in the valuation models change significantly, stock-based compensation expense for new awards may differ materially in the future from the amounts recorded in our consolidated statement of operations. For all awards, we are required to estimate forfeitures at the time of grant and revise those estimates in subsequent periods if actual forfeitures differ from those estimates. We use historical data to estimate pre-vesting forfeitures.

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

Each reporting period we must periodically assess the likelihood that our deferred tax assets will be recovered from future sources of taxable income, and to the extent that recovery is not more likely than not, a valuation allowance must be established. The establishment of a valuation allowance and increases to such an allowance result in either increases to income tax expense or reduction of income tax benefit in the statement of operations and comprehensive income. In certain instances, changes in the valuation allowance may be allocated directly to the related components of shareholders' equity on the consolidated balance sheet. Factors we consider in making such an assessment include,

but are not limited to, past performance and our expectation of future taxable income, macroeconomic conditions and issues facing our industry, existing contracts, our ability to project future results and any appreciation of our investments and other assets.

As of September 30, 2016, \$16.4 million of the \$80.7 million of cash, cash equivalents, and short-term investments was held by our foreign subsidiaries.

As of September 30, 2016, we have not provided for U.S. federal and state income taxes on certain undistributed earnings of our foreign subsidiaries, since such earnings are considered indefinitely reinvested outside the U.S. or may be remitted tax-free to the U.S. If these amounts were distributed to the U.S., in the form of dividends or otherwise, RealNetworks could be

subject to additional U.S. income and foreign withholding taxes. It is not practicable to determine the foreign withholding and U.S. federal income tax liability or benefit on such earnings due to the timing of such future distributions, the availability of foreign tax credits, and the complexity of the computation if such earnings were not deemed to be permanently reinvested. If future events, including material changes in estimates of cash, working capital, and long-term investment requirements necessitate that these earnings be distributed, an additional provision for U.S. income and foreign withholding taxes may be necessary.

### Item 3. Quantitative and Qualitative Disclosures About Market Risk

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

**Interest Rate Risk.** Our exposure to interest rate risk from changes in market interest rates relates primarily to our short-term investment portfolio. Our short-term investments consist of investment grade debt securities as specified in our investment policy. Investments in both fixed and floating rate instruments carry a degree of interest rate risk. The fair value of fixed rate securities may be adversely impacted due to a rise in interest rates, while floating rate securities may produce less income than expected if interest rates fall. Additionally, a declining rate environment creates reinvestment risk because as securities mature the proceeds are reinvested at a lower rate, generating less interest income. See Note 6, Fair Value Measurements, to the unaudited condensed consolidated financial statements included in Item 1 of Part I of this Form 10-Q, for additional information. Due in part to these factors, our future interest income may be adversely impacted due to changes in interest rates. In addition, we may incur losses in principal if we are forced to sell securities that have declined in market value due to changes in interest rates. Because we have historically had the ability to hold our short-term investments until maturity, we would not expect our operating results or cash flows to be significantly impacted by a sudden change in market interest rates. There have been no material changes in our investment methodology regarding our cash equivalents and short-term investments during the quarter ended September 30, 2016. Based on our cash, cash equivalents, short-term investments, and restricted cash equivalents as of September 30, 2016, a hypothetical 10% increase/decrease in interest rates would not increase/decrease our annual interest income or cash flows by more than a nominal amount.

**Investment Risk.** As of September 30, 2016, we had investments in voting capital stock of both publicly traded and privately held technology companies for business and strategic purposes. See Note 1, Description of Business and Summary of Significant Accounting Policies - Valuation of Equity Method Investments, and Management's Discussion and Analysis of Financial Condition and Results of Operations - Critical Accounting Policies and Estimates (Valuation of equity method investments) in our Form 10-K for details on our accounting treatment for these investments, including the analysis of other-than-temporary impairments.

**Foreign Currency Risk.** We conduct business internationally in several currencies and thus are exposed to adverse movements in foreign currency exchange rates.

Our exposure to foreign exchange rate fluctuations arise in part from: (1) translation of the financial results of foreign subsidiaries into U.S. dollars in consolidation; (2) the remeasurement of non-functional currency assets, liabilities and intercompany balances into U.S. dollars for financial reporting purposes; and (3) non-U.S. dollar denominated sales to foreign customers. We manage a portion of these risks through the use of financial derivatives, but fluctuations could impact our results of operations and financial position.

Where appropriate, we manage foreign currency risk for certain material short-term intercompany balances through the use of foreign currency forward contracts. These contracts require us to exchange currencies at rates agreed upon at the contract's inception. Because the impact of movements in currency exchange rates on forward contracts offsets the related impact on the short-term intercompany balances, these financial instruments help alleviate the risk that might otherwise result from certain changes in currency exchange rates. We do not designate our foreign exchange forward contracts related to short-term intercompany accounts as hedges and, accordingly, we adjust these instruments to fair value through results of operations. However, we may periodically hedge a portion of our foreign exchange exposures associated with material firmly committed transactions, long-term investments, highly predictable anticipated exposures and net investments in foreign subsidiaries. To the extent we continue to experience adverse

economic conditions, our unhedged exposures are impacted by movements in currency exchange rates and we may record losses related to such unhedged exposures in future periods that may have a material adverse effect on our financial condition and results of operations.

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

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We have cash balances denominated in foreign currencies which are subject to foreign currency fluctuation risk. The majority of our foreign currency denominated cash is held in Korean won and euros. A hypothetical 10% increase or decrease in the Korean won and euro relative to the U.S. dollar as of September 30, 2016 would not result in a material impact on our financial position, results of operations or cash flows.

Item 4. Controls and Procedures

(a) Evaluation of Disclosure Controls and Procedures

Our management, with the participation of our chief executive officer and chief financial officer, evaluated the effectiveness of our disclosure controls and procedures as of September 30, 2016. The term “disclosure controls and procedures,” as defined in Rules 13a-15(e) and 15d-15(e) under the Securities Exchange Act of 1934, as amended, means controls and other procedures of a company that are designed to ensure that information required to be disclosed by a company in the reports that it files or submits under the Exchange Act is recorded, processed, summarized and reported, within the time periods specified in the SEC's rules and forms. Disclosure controls and procedures include, without limitation, controls and procedures designed to ensure that information required to be disclosed by a company in the reports that it files or submits under the Exchange Act is accumulated and communicated to the company's management, including its principal executive and principal financial officers, as appropriate to allow timely decisions regarding required disclosure. Management recognizes that any controls and procedures, no matter how well designed and operated, can provide only reasonable assurance of achieving their objectives, and management necessarily applies its judgment in evaluating the cost-benefit relationship of possible controls and procedures.

Based upon that evaluation, our chief executive officer and chief financial officer concluded that, as of September 30, 2016, our disclosure controls and procedures were effective.

(b) Changes in Internal Control over Financial Reporting

There have been no changes in our internal control over financial reporting (as such term is defined in Rule 13a-15(f) and 15d-15(f) under the Exchange Act) that occurred during the third quarter of 2016 that have materially affected, or are reasonably likely to materially affect, our internal control over financial reporting.

## PART II. OTHER INFORMATION

### Item 1. Legal Proceedings

See Note 16, Commitments and Contingencies, to the unaudited condensed consolidated financial statements included in Item 1 of Part I of this Form 10-Q.

### Item 1A. Risk Factors

You should carefully consider the risks described below together with all of the other information included in this Form 10-Q. The risks and uncertainties described below are not the only ones facing our company. Additional risks and uncertainties not presently known to us or that we presently deem less significant may also impair our business operations. If any of the following risks actually occurs, our business, financial condition or operating results, and the trading price of our common stock, could be materially harmed.

Our business and financial results will be materially adversely impacted if we are unable to successfully implement our growth plans, strategic initiatives, and restructuring efforts.

Beginning in mid-2012, we developed a major new growth plan that continues to evolve. We have also embarked upon strategic initiatives intended to simplify and accelerate our operations, and restructuring efforts intended to streamline costs and bring more focus to our businesses. The simultaneous execution of all of these measures is ambitious and we have not attempted to pursue this level of transition in our history. We can provide no assurance that we will be successful in implementing our growth plans, strategic initiatives, and restructuring efforts, either in a timely manner or at all, and our failure to do so would have a material adverse impact on our business and financial results. Moreover, the implementation of our growth plans, strategic initiatives and restructuring efforts has required significant cash outlays, and we cannot guarantee that these expenditures will have the desired return or that our cash reserves will be sufficient for a successful transition.

We need to successfully monetize our products and services in order to sustain and grow our businesses.

In order to sustain our current level of operations and to implement our growth plans, we must successfully monetize our products and services. The process of developing and distributing products and services is complex, costly and uncertain, and is subject to a number of risks. Providing products and services that are attractive and useful to subscribers and consumers is in part subject to unpredictable and volatile factors beyond our control, including end-user preferences, competing products and services, and a limited number of dominant distribution partners. Any failure by us to timely respond to or accurately anticipate consumers' changing needs, emerging technological trends or important changes in the market or competition for products and services that we introduce, or that we have launched, could increase the current rate of decline in our market share or result in the loss of market opportunities. In addition, we must make long-term investments, develop or obtain appropriate intellectual property and commit significant resources before knowing whether the products and services that we are developing or have introduced will meet the needs of a large enough group of consumers, which may result in no return or a loss on our investments. Moreover, if we are unsuccessful in securing profitable distribution channels with new partners, including mobile carriers, strengthening channels with existing partners, and monetizing our products and services, our revenue will continue to decline and our business will suffer.

Over the past four years, we have invested heavily in the development of new products and enhanced features for such products, and we expect to continue to invest both in further development and in sales and marketing efforts aimed at monetizing certain of these products and services. If we are unable to generate sustained interest in these products and services, and therefore drive revenue growth, our financial results and cash position will continue to be materially negatively impacted.

Furthermore, new products and services may be subject to legal challenge. Responding to any such claims may require us to enter into royalty and licensing agreements on unfavorable terms, require us to stop distributing or selling, or to redesign our products or services, or to pay damages, any of which could materially harm our operating results and our ability to grow our businesses.





Our historically core products and services face new and continuing challenges, causing our revenues to materially decline.

Our products and services that have historically been core to the company were primarily distributed through desktop computers and feature phones. Consumer behavior and tastes continue to change and the market for such products and services has been moving to smartphones and tablets. Although we have developed newer products and services for these emerging platforms there is no guarantee that we will be successful. In addition, as new operating systems are introduced or updated for these platforms, we are likely to continue to face difficulties reaching our traditional customer base and other unknown distribution challenges.

Our restructuring efforts may not yield the anticipated benefits to our shareholders.

Since 2012, we have taken steps to restructure and simplify our business and operations. In September 2012, we announced plans to divisionalize our business, which we implemented during the first quarter of 2013, and to significantly reduce operating expenses, in part through a reduction in our workforce that was substantially concluded by the end of the second quarter of 2013. In August 2014, we announced a further reduction in our workforce and related cost reductions, and during the second and third quarters of 2015, we recorded \$2.0 million and \$3.1 million, respectively, in severance and restructuring charges relating to additional workforce reductions. We continue to assess opportunities to further streamline our operations and make our businesses more efficient. There can be no assurance, however, that our past or future restructuring efforts will be successful. Our business and operations may be harmed to the extent there is customer or employee uncertainty surrounding the future direction of our product and service offerings and strategy for our businesses. Our restructuring activities have included implementing cost-cutting initiatives, which may not lead to future profitability and which could materially impact our ability to compete in future periods. If we are unable to effectively re-align the cost structure of our businesses or streamline and simplify our operations, our stock price may continue to be adversely affected, and we and our shareholders will not realize the anticipated financial, operational and other benefits from such initiatives.

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

Many of our current and potential competitors in our businesses have longer operating histories, greater name recognition, more employees and significantly greater resources than we do. To effectively compete in the markets for our products and services, we may experience the following consequences, any of which would adversely affect our operating results and the trading price of our stock:

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

The market for our Mobile Services business, including our ringback tones and music on demand solutions, is highly competitive and evolving rapidly. Increased use of smartphones has resulted in a proliferation of applications and services that compete with our SaaS services and, in many cases, are not dependent upon our mobile partners to make them available to subscribers. Increased competition has in the past resulted in pricing pressure, forcing us to lower the selling price of our services. We expect this pricing pressure to continue to materially harm our operating results and financial condition.

Our RealTimes product faces strong competition from other technology companies and cloud service providers, including some that are firmly established in the marketplace and have access to extensive resources, as well as video and photo sharing services. In addition, as we continue to develop this product and expand its reach, we have seen and

expect to continue to see growing competition from companies offering innovative features for engaging with users' video content, some of which are offered for free. To be competitive, our RealTimes product must provide sufficiently engaging and compelling features for users' digital content, enticing consumers directly to the application and creating an appealing value proposition for our distribution partners.

Our RealPlayer software services compete with alternative streaming media playback technologies and audio and video formats which have obtained broad market penetration. Similarly, our codec technology faces strong competition, with

successful adoption of newer versions uncertain. If we are unable to compete successfully, our Consumer Media business could continue to decline.

The branded services in our Games business compete with other online aggregators and distributors of online, downloadable and social casual PC games. Some of these competitors have high volume distribution channels and greater financial resources than we do. Our Games business also competes with many other smaller companies that may be able to adjust to market conditions, including responding effectively to the growing popularity of casual games on social networks, faster than us. We also face significant price competition in the casual games market, and some of our competitors may be able to offer games for free, or reduce prices more aggressively than us. We expect competition to continue to intensify in this market from these and other competitors. Our games development studios compete primarily with other developers of online, downloadable, mobile and social casual PC games and must continue to develop popular and high-quality game titles. Our Games business must also continue to execute on opportunities to expand the play of our games on a variety of non-PC platforms, including social networks, in order to maintain our competitive position and to grow the business. If we are unable to achieve future growth in our revenue, our Games business will continue to suffer.

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

We derive a material portion of our revenue from the SaaS offerings we provide to mobile carriers, and we have begun to leverage our carrier relationships for the distribution of our photo and video sharing solution. Many of our contracts with carriers provide for revenue sharing arrangements, but we have limited control over the pricing decisions of our carrier customers. Furthermore, most of these contracts do not provide for guaranteed minimum payments or usage levels. Because most of our carrier customer contracts are nonexclusive, it is possible that our mobile carrier customers could purchase similar services from third parties and cease to use our services in the future. As a result, our revenue derived under these agreements could be substantially reduced depending on the pricing and usage decisions of our carrier customers. In addition, some of our contracts require us to incur significant set-up costs prior to the launch of services with a carrier customer. We may be required to record impairments or other charges in future periods related to our carrier customer contracts, which would negatively impact our results of operations. In addition, none of our SaaS contracts with carriers obligate our carrier customers to market or distribute any of our SaaS offerings. Despite the lack of marketing commitments, revenue related to our SaaS offerings is, to a large extent, dependent upon the marketing and promotion activities of our carrier customers. In addition, many of our carrier contracts are short term and allow for early termination by the carrier with or without cause. These contracts are therefore subject to renegotiation of pricing or other key terms that could be adverse to our interests and leave us vulnerable to non-renewal by the carriers. The loss of carrier customers, a reduction in marketing or promotion of our SaaS offerings, or the termination, non-renewal or renegotiation of contract terms that are less favorable to us would result in the loss of future revenues from our SaaS offerings.

Finally, nearly all of our carrier contracts obligate us to indemnify the carrier customer for certain liabilities and losses incurred by them, including liabilities resulting from third party claims for damages that arise out of the use of our technology. These indemnification terms provide us with certain procedural safeguards, including the right to control the defense of the indemnified party. Pursuant to these indemnifications obligations, we have in the past agreed to control the defense on behalf of certain of our carrier customers related to patent infringement proceedings. In 2013, we settled two such litigation matters. Future claims against which we may be obligated to defend our carrier customers could result in payments that could materially harm our business and financial results.

A majority of the revenue that we generate in our Mobile Services segment is dependent upon our relationships with a few customers, and any deterioration of these relationships could materially harm our revenue.

We generate a significant portion of our revenue from sales within our Mobile Services business to a few of our mobile customers and their affiliates. In the near term, we expect that we will continue to generate a significant portion of our total revenue from these customers. If these customers fail to market or distribute our services or terminate or fail to renew their business contracts with us, or if our relationships with these customers deteriorate in

any significant way, we may be unable to replace the affected business arrangements with acceptable alternatives. Failure to maintain our relationships with these customers could have a material negative impact on our revenue and financial results.

We may not be successful in maintaining and growing our distribution of digital media products. Maintaining and growing the distribution of digital media products through our websites and our other distribution channels has historically been important to our business, including growth through the introduction of new products and

services distributed through these channels. Consumers are not downloading and using our digital media products consistent with past usage, so our ability to generate revenue from those products has been, and we expect will continue to be, reduced, leading to lower than expected adoption of newly introduced products and services. Our inability to maintain continued high volume distribution of our digital media products could also continue to hold back the growth and development of related revenue streams from these market segments, including the distribution of third-party products and sales of our subscription services, and therefore harm our business and our prospects. Our revenue from the distribution of third-party products will also continue to be negatively impacted if those products are not more widely downloaded and used by consumers, including due to the relative market saturation of such products. Most of our revenue from the distribution of third-party products has historically been derived from a single customer, and the terms of this relationship have significantly changed since the third quarter of 2014. Our distribution revenue has been, and may continue to be, materially negatively impacted by these factors, and we cannot guarantee that future revenue will rebound to historical levels.

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

The trading price for our common stock has a history of volatility. Our recent stock price history shows a downward trend, with a closing price of \$4.55 on October 25, 2016, and a range from \$3.04 to \$5.10 per share during the 52-week period ended September 30, 2016. As a result of the rapidly changing markets in which we compete, our operating results may fluctuate or continue to decline from period to period, which may contribute to volatility or continued weakness of our stock price.

In past periods, our operating results have been affected by personnel reductions and related restructuring charges, lease exit and related charges, and impairment charges for certain of our equity investments, goodwill and other long-lived assets. In addition to these factors, the general difficulty in forecasting our operating results and metrics could result in actual results that differ significantly from expected results, causing volatility and continued weakness in our stock price.

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

Any impairment to our goodwill and definite-lived assets could result in a significant charge to our earnings.

In accordance with accounting principles generally accepted in the United States, we are required to test goodwill for possible impairment on an annual basis based upon a fair value approach, or more frequently in the event of certain indications of possible impairment. We review definite-lived assets for impairment whenever events or changes in circumstances indicate the carrying amount of such assets may not be recoverable. These events or circumstances could include a significant change in the business climate, including a significant sustained decline in a reporting unit's market value, changes in our operating plans and forecasts, legal factors, operating performance indicators, competition, sale or disposition of a significant portion of our business, a significant sustained decline in our market capitalization and other factors. If we were to determine that an impairment had occurred, we would be required to record an impairment charge, which could have a significant negative, and unpredicted, impact on our financial results. The total carrying value of our goodwill and definite-lived assets as of September 30, 2016 was \$20.1 million.

Continued loss of revenue from our subscription services may continue to harm our operating results.

Our operating results have been and may continue to be adversely impacted by the loss of subscription revenue related to our more traditional products and services. Subscribers may cancel their subscriptions to our services for many reasons, including a perception that they do not use the services sufficiently or that the service does not provide enough value, a lack of attractive or exclusive content generally or as compared with competitive service offerings, or because customer service issues are not satisfactorily resolved. Revenue from our SuperPass subscription service, for example, has declined in recent periods due to changes in consumer preferences and changes on our part to focus on

other products and services we offer, and we expect these trends to continue.

Government regulation of the Internet is evolving, and unfavorable developments could have an adverse effect on our operating results.

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We are subject to regulations and laws specific to the marketing, sale and delivery of goods and services over the Internet. These laws and regulations, which continue to evolve, cover taxation, user privacy, data collection and protection, copyrights, electronic contracts, sales procedures, automatic subscription renewals, credit card processing procedures, consumer protections, digital games distribution, broadband Internet access and content restrictions. We cannot guarantee that we have been or will be fully compliant in every jurisdiction, as it is not entirely clear how existing laws and regulations governing issues such as privacy, taxation and consumer protection apply or will be enforced with respect to the products and services we sell through the Internet. Moreover, as Internet commerce continues to evolve, increasing regulation and/or enforcement efforts by federal, state and foreign agencies and the prospects for private litigation claims related to our data collection, privacy policies or other e-commerce practices become more likely. In addition, the adoption of any laws or regulations or the imposition of other legal requirements that adversely affect our ability to market, sell, and deliver our products and services could decrease our ability to offer or customer demand for our service offerings, resulting in lower revenue. Future regulations, or changes in laws and regulations or their existing interpretations or applications, could also require us to change our business practices, raise compliance costs or other costs of doing business and result in additional historical or future liabilities for us, resulting in adverse impacts on our business and our operating results.

As a consumer-facing business, we receive complaints from our customers regarding our consumer marketing efforts and our customer service practices. Some of these customers may also complain to government agencies, and from time to time, those agencies have made inquiries to us about these practices. In addition, we may receive complaints or inquiries directly from governmental agencies that have not been prompted by consumers. In May of 2012, we resolved an investigation and complaint filed against us by the Washington State Office of the Attorney General, or Washington AG, relating to our consumer marketing practices through the entry of a consent decree filed in King County, Washington Superior Court. While we resolved that matter, we cannot provide assurance that the Washington AG or other governmental agencies will not bring future claims regarding our marketing, or consumer services or other practices.

Global and national economic conditions have in the past and could in the future have a material adverse impact on our business, financial condition and results of operations.

Our business and operations depend significantly on global and national economic conditions. Because consumers may consider the purchase of our digital entertainment products and services to be a discretionary expenditure, their decision whether to purchase our products and services may be influenced by macroeconomic factors that affect consumer spending such as unemployment, access to credit, negative financial news, and declines in income. In addition, our carrier customers and business partners may reduce their business or advertising spending with us in the face of adverse macroeconomic conditions, such as financial market volatility, government austerity programs, tight credit, and declines in asset values. We have in the past recorded material asset impairment charges due in part to weakness in the global economy, and we may need to record additional impairments to our assets in future periods in the event of renewed weakness and uncertainty in the global or national economy. Accordingly, any significant weakness in the national and/or global economy could materially impact our business, financial condition and results of operations in a negative manner.

Rhapsody could continue to recognize losses, which could negatively impact our results of operations and financial condition.

On March 31, 2010, we completed the restructuring of our digital audio music service joint venture, Rhapsody America LLC. As a result of the restructuring, we no longer have operational control over Rhapsody and Rhapsody's operating performance is no longer consolidated with our consolidated financial statements. Rhapsody has generated accounting losses since its inception and we have recognized losses on our investment in the convertible preferred stock of Rhapsody since the restructuring. If Rhapsody continues to incur losses, if it otherwise experiences a significant decline in its business or financial condition, or if we provide financial support to or increase our investment in Rhapsody, we could incur further losses on our investment, which could have an adverse effect on our financial condition and results of operations. See Note 5, Rhapsody Joint Venture, to the unaudited condensed consolidated financial statements included in Item 1 of Part I of this 10-Q, for further discussion.

Additionally, given the current proportion of the outstanding equity of Rhapsody that we hold, we need to receive Rhapsody's unaudited quarterly financial statements and related information in order to timely prepare our quarterly consolidated financial statements and also to report certain of Rhapsody's financial results, as may be required, in our quarterly reports on Form 10-Q. In addition, we may be required to include Rhapsody's annual audited financial statements in our annual report on Form 10-K in future periods. As we no longer exert operational control over Rhapsody, we cannot guarantee that Rhapsody will deliver its financial statements and related information to us in a timely manner, or at all, or that the unaudited financial statement information provided by Rhapsody will not contain inaccuracies that are material to our reported results. Any failure to timely obtain Rhapsody's quarterly financial statements or to include its audited financial statements in our future annual reports on Form 10-K, if required, could cause our reports to be filed in an untimely manner, which would preclude us from utilizing certain registration statements and could negatively impact our stock price.



The continued loss of key personnel, or difficulty recruiting and retaining them, could significantly harm our business or jeopardize our ability to meet our growth objectives.

Our success depends substantially on the contributions and abilities of certain key executives and employees. We have experienced a significant amount of executive-level turnover in the past several years, which has had and could continue to have a negative impact on our ability to retain key employees. Rob Glaser, our founder, Chairman and initial chief executive officer, resigned as chief executive officer in 2010, was appointed as interim chief executive officer in July 2012, and was named permanent chief executive officer in July 2014. In addition, each member of our executive team was either hired or promoted to his or her executive position within the past four years. We cannot provide assurance that we will effectively manage these executive-level transitions, which may impact our ability to retain key executives and employees and which could harm our business and operations to the extent there is customer or employee uncertainty arising from such transitions.

Our success is also substantially dependent upon our ability to identify, attract and retain highly skilled management, technical and sales personnel. Qualified individuals are in high demand and competition for such qualified personnel in our industry, particularly engineering talent, is extremely intense, and we may incur significant costs to attract or retain them. Our ability to attract and retain personnel has been and may continue to be made more difficult by the uncertainty created by our executive-level turnover and by our continued restructuring efforts, which have involved reductions in our workforce. There can be no assurance that we will be able to attract and retain the key personnel necessary to sustain our business or support future growth.

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

As part of our business strategy, we have acquired and sold technologies and businesses in the past and expect that we will continue to do so in the future. For example, most recently, in August 2015 we completed the sale of our Slingo and social casino games business. The failure to adequately manage transaction costs and address the financial, legal and operational risks raised by acquisitions and divestitures of technology and businesses could harm our business and prevent us from realizing the benefits of these transactions. In addition, we may identify and acquire target companies, but those companies may not be complementary to our current operations and may not leverage our existing infrastructure or operational experience, which may increase the risks associated with completing acquisitions. Transaction-related costs and financial risks related to completed and potential future purchase or sale transactions may harm our financial position, reported operating results, or stock price. Previous acquisitions have resulted in significant expenses, including amortization of purchased technology, amortization of acquired identifiable intangible assets and the incurrence of charges for the impairment of goodwill and other intangible assets, which are reflected in our operating expenses. New acquisitions and any potential additional future impairment of the value of purchased assets, including goodwill, could have a significant negative impact on our future operating results. For example, in 2013 we acquired Slingo, Inc. pursuant to which we recorded \$8.0 million of intangible assets and \$9.9 million in goodwill, and Muzicall Limited pursuant to which we recorded \$5.4 million of intangible assets and \$1.3 million in goodwill. In compliance with accounting principles generally accepted in the United States, we evaluate these assets for impairment at least annually. Factors that may be considered a change in circumstances, indicating that our goodwill, indefinite-lived intangible assets or definite-lived assets may not be recoverable, include reduced future revenue and cash flow estimates due to changes in our forecasts, and unfavorable changes to valuation multiples and discount rates due to changes in the market. If we were to conclude that any of these assets were impaired, we would have to recognize an impairment charge that could significantly impact our financial results.

Purchase and sale transactions also involve operational risks that could harm our existing operations or prevent realization of anticipated benefits from a transaction. These operational risks include:

- difficulties and expenses in assimilating the operations, products, technology, information systems, and/or personnel of the acquired company;
- retaining key management or employees of the acquired company;
- entrance into unfamiliar markets, industry segments, or types of businesses;

- operating, managing and integrating acquired businesses in remote locations or in countries in which we have little or no prior experience;
- diversion of management time and other resources from existing operations;
- impairment of relationships with employees, affiliates, advertisers or content providers of our business or acquired business; and
- assumption of known and unknown liabilities of the acquired company, including intellectual property claims.

We may be unable to adequately protect our proprietary rights or leverage our technology assets, and may face risks associated with third-party claims relating to intellectual property rights associated with our products and services. Our ability to compete across our businesses partly depends on the superiority, uniqueness and value of our technology, including both internally developed technology and technology licensed from third parties. To protect our proprietary rights, we rely on a combination of patent, trademark, copyright and trade secret laws, confidentiality agreements with our employees and third parties, and protective contractual provisions. Our efforts to protect our intellectual property rights may not assure our ownership rights in our intellectual property, protect or enhance the competitive position of our products and services or effectively prevent misappropriation of our technology. We also routinely receive challenges to our trademarks and other proprietary intellectual property that we are using in our business activities in China. Disputes regarding the validity and scope of patents or the ownership of technologies and rights associated with streaming media, digital distribution, and online businesses are common and likely to arise in the future. While we sold to Intel Corporation in 2012 most of our patents, including patents that covered streaming media, we agreed to indemnify Intel for certain third-party infringement claims against these patents up to the purchase price we received in the sale. We may also be forced to litigate, to enforce, or defend our patents and other intellectual property rights or to determine the validity and scope of other parties' proprietary rights, enter into royalty or licensing agreements on unfavorable terms or redesign our product features and services. Any such dispute would likely be costly and distract our management, and the outcome of any such dispute could fail to improve our business prospects or otherwise harm our business.

From time to time we receive claims and inquiries from third parties alleging that our technology may infringe the third parties' proprietary rights, especially patents. Third parties have also asserted and most likely will continue to assert claims against us alleging contract breaches, infringement of copyrights, trademark rights, trade secret rights or other proprietary rights, or alleging unfair competition or violations of privacy rights. These claims, even if not meritorious, could force us to spend significant financial and managerial resources. 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. For example, in July 2012, VoiceAge Corporation brought a lawsuit against us alleging breach of our obligation to pay them licensing fees under our patent license agreement with VoiceAge and seeking a material amount in damages. While we settled the dispute with VoiceAge in the fourth quarter of 2013, similar future lawsuits could result in significant legal expenses, monetary damages, penalties or injunctive relief against us that could have a material adverse impact on our financial results. In addition, in 2012 we sold substantially all of our patent assets to Intel. We believe that our patent portfolio may have in the past discouraged third parties from bringing infringement or other claims against us relating to the use of our technologies in our business. Accordingly, we cannot predict whether the sale of these patent assets to Intel will result in additional infringement or other claims against us from third parties.

Our business and operating results will suffer if our systems or networks fail, become unavailable, unsecured or perform poorly so that current or potential users do not have adequate access to our products, services and websites. Our ability to provide our products and services to our customers and operate our business depends on the continued operation and security of our information systems and networks. A significant or repeated reduction in the performance, reliability, security or availability of our information systems and network infrastructure could harm our ability to conduct our business, and harm our reputation and ability to attract and retain users, customers, advertisers and content providers. We have on occasion experienced system errors and failures that caused interruption in availability of products or content or an increase in response time. Problems with our systems and networks, or the third party systems and networks that we utilize, could result from our failure to adequately maintain and enhance these systems and networks, natural disasters and similar events, power failures, HVAC failures, intentional actions to disrupt our systems and networks and many other causes. The vulnerability of a large portion of our computer and communications infrastructure is enhanced due to its geographic concentration in Seattle, Washington, an area that is at heightened risk of earthquake, flood, and volcanic events. Many of our services do not currently have fully redundant systems or a formal disaster recovery plan, and we may not have adequate business interruption insurance to compensate us for losses that may occur from a system outage.

The growth of our business is dependent in part on successfully managing our international operations. Our international operations involve risks inherent in doing business globally, including difficulties in managing operations due to distance, language, and cultural differences, local economic conditions, different or conflicting laws and regulations, taxes, and exchange rate fluctuations. The functional currency of our foreign subsidiaries is the local currency of the country in which each subsidiary operates. We translate our subsidiaries' revenues into U.S. dollars in our financial statements, and continued volatility in foreign exchange rates, particularly if the U.S. dollar strengthens against the euro or the Korean won, may result in lower reported revenue or net assets in future periods. If we do not effectively manage any of the risks inherent in running our international businesses, our operating results and financial condition could be harmed.

We may be subject to market risk and legal liability in connection with our data collection and data security capabilities.

Many of our products are interactive Internet applications that by their very nature require communication between a client and server to operate. For example, to provide better consumer experiences and to operate effectively, our products send information, including personally identifiable information, to our servers or servers hosted by third parties. In addition, we sell many of our products and services through online sales transactions directly with consumers, through which we collect and store credit card information. In connection with our direct sales to consumers, we may be the victim of fraudulent transactions, including credit card fraud, which presents a risk to our revenue and potentially disrupts service to our consumers. While we take measures to protect our consumer data, we have experienced unauthorized access to our consumer data in the past, and it is possible that our security controls over consumer data may not prevent future improper access or disclosure of credit card information or personally identifiable information. We have an extensive privacy policy concerning the collection, use and disclosure of user data involved in interactions between our client and server products. A security breach that leads to disclosure of consumer account information (including personally identifiable information) or any failure by us to comply with our posted privacy policy or existing or new legislation regarding privacy issues could harm our reputation, impact the market for our products and services, subject us to litigation, and require us to expend significant resources to mitigate the breach of security, comply with breach notification laws or address related matters.

Changes in regulations applicable to the Internet and e-commerce that increase the taxes on the services we provide could materially harm our business and operating results.

As Internet commerce continues to evolve, increasing taxation by state, local or foreign tax authorities becomes more likely. For example, taxation of electronically delivered products and services or other charges imposed by government agencies may also be imposed. We believe we collect transactional taxes and are compliant and current in all jurisdictions where we believe we have a collection obligation for transaction taxes. Any regulation imposing greater taxes or other fees for products and services could result in a decline in the sale of products and services and the viability of those products and services, harming our business and operating results. A successful assertion by one or more states or foreign tax authorities that we should collect and remit sales or other taxes on the sale of our products or services could result in substantial liability for past sales.

In those countries where we have a tax obligation, we collect and remit value added tax, or VAT, on sales of “electronically supplied services” provided to European Union residents. The collection and remittance of VAT subjects us to additional currency fluctuation risks.

We may be subject to additional income tax assessments and changes in applicable tax regulations could adversely affect our financial results.

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

The U.S. is considering corporate tax reform that may significantly change the corporate tax rate and U.S. international tax rules. Additionally, longstanding international tax norms that determine each country's jurisdiction to tax cross-border international trade are evolving. Given the unpredictability of these possible changes and their potential interdependency, it is very difficult to assess whether the overall effect of such potential tax changes would be cumulatively positive or negative for our earnings and cash flow, but such changes could adversely impact our financial results.

Our Chairman of the Board and Chief Executive Officer beneficially owns approximately 37% of our stock, which gives him significant control over certain major decisions on which our shareholders may vote or may discourage an acquisition of us.

Robert Glaser, our Chairman of the Board and Chief Executive Officer, beneficially owns approximately 37% of our common stock. As a result, Mr. Glaser and his affiliates will have significant influence to:

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

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

The stock ownership of Mr. Glaser and his affiliates may discourage a potential acquirer from making a tender offer or otherwise attempting to obtain control of RealNetworks, which in turn could reduce our stock price or prevent our shareholders from realizing a premium over our stock price.

Provisions of our charter documents, shareholder rights plan, and Washington law could discourage our acquisition by a third party.

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

• adopt a plan of merger;

- authorize the sale, lease, exchange or mortgage of assets representing more than 50% of the book value of our assets prior to the transaction or on which our long-term business strategy is substantially dependent;

• authorize our voluntary dissolution; or

• take any action that has the effect of any of the above.

Mr. Glaser has special rights under our articles of incorporation to appoint or remove members of a strategic transactions committee at his discretion that could make it more difficult for RealNetworks to be sold or to complete another change of control transaction without Mr. Glaser's consent. RealNetworks has also entered into an agreement providing Mr. Glaser with certain contractual rights relating to the enforcement of our charter documents and Mr. Glaser's roles and authority within RealNetworks. These rights and his role as Chairman of the Board of Directors, together with Mr. Glaser's significant beneficial ownership, create unique potential for concentrated influence of Mr. Glaser over potentially material transactions involving RealNetworks and decisions regarding the future strategy and leadership of RealNetworks.

We have adopted a shareholder rights plan, which was amended and restated in December 2008, and amended in April 2016, which provides that shares of our common stock have associated preferred stock purchase rights. The exercise of these rights would make the acquisition of RealNetworks by a third party more expensive to that party and has the effect of discouraging third parties from acquiring RealNetworks without the approval of our board of directors, which has the power to redeem these rights and prevent their exercise.

Washington law imposes restrictions on some transactions between a corporation and certain significant shareholders. The foregoing provisions of our charter documents, shareholder rights plan, our agreement with Mr. Glaser, and Washington law, as well as our charter provisions that provide for a classified board of directors and the availability of "blank check" preferred stock, could have the effect of making it more difficult or more expensive for a third party to acquire, or of discouraging a third party from attempting to acquire, control of us. These provisions may therefore have the effect of limiting the price that investors might be willing to pay in the future for our common stock.

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

(a) Not applicable

(b) Not applicable

(c) Not applicable

## Item 3. Default Upon Senior Securities

None

## Item 4. Mine Safety Disclosures

Not applicable

## Item 5. Other Information

None.

## Item 6. Exhibits

See Index to Exhibits below.

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SIGNATURE

Pursuant to the requirements of the Securities Exchange Act of 1934, the Registrant has duly caused this Form 10-Q Report to be signed on its behalf by the undersigned, thereunto duly authorized.

REALNETWORKS, INC.

By: /s/ Marjorie Thomas  
Marjorie Thomas

Title: Senior Vice President, Chief Financial Officer and Treasurer (Principal Financial and Accounting Officer)

Dated: November 4, 2016

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INDEX TO EXHIBITS

Exhibit Number	Description
10.1	Offer letter dated September 13, 2016 between RealNetworks, Inc. and William Patrizio
31.1	Certification of Robert Glaser, Chairman and Chief Executive Officer of RealNetworks, Inc., pursuant to Exchange Act Rules 13a-14(a) and 15d-14(a), as adopted pursuant to Section 302 of the Sarbanes-Oxley Act of 2002
31.2	Certification of Marjorie Thomas, Senior Vice President, Chief Financial Officer and Treasurer of RealNetworks, Inc., pursuant to Exchange Act Rules 13a-14(a) and 15d-14(a), as adopted pursuant to Section 302 of the Sarbanes-Oxley Act of 2002
32.1	Certification of Robert Glaser, Chairman and Chief Executive Officer of RealNetworks, Inc., pursuant to 18 U.S.C. Section 1350, as adopted pursuant to Section 906 of the Sarbanes-Oxley Act of 2002
32.2	Certification of Marjorie Thomas, Senior Vice President, Chief Financial Officer and Treasurer of RealNetworks, Inc., pursuant to 18 U.S.C. Section 1350, as adopted pursuant to Section 906 of the Sarbanes-Oxley Act of 2002
101.INS	XBRL Instance Document
101.SCH	XBRL Taxonomy Extension Schema Document
101.CAL	XBRL Taxonomy Extension Calculation Linkbase Document
101.LAB	XBRL Taxonomy Extension Label Linkbase Document
101.PRE	XBRL Taxonomy Extension Presentation Linkbase Document
101.DEF	XBRL Taxonomy Extension Definition Linkbase Document