SCHOLASTIC CORP
Form 10-Q
October 06, 2006

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

FORM 10-Q

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

For the quarterly period ended August 31, 2006 Commission File No. 000-19860

SCHOLASTIC CORPORATION

(Exact name of Registrant as specified in its charter)

Delaware	**13-3385513**
(State or other jurisdiction of incorporation or organization)	(IRS Employer Identification No.)
557 Broadway, New York, New York	**10012**
(Address of principal executive offices)	(Zip Code)

Registrant's telephone number, including area code (212) 343-6100

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

Indicate by check mark whether the Registrant is a large accelerated filer, an accelerated filer, or a non-accelerated filer. See definition of accelerated filer and large accelerated filer in Rule 12b-2 of the Exchange Act. (Check one):
Large accelerated filer X Accelerated filer _ Non-accelerated filer _

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

Indicate the number of shares outstanding of each of the issuer's classes of common stock, as of the latest practicable date.

Title of each class	Number of shares outstanding as of September 30, 2006
Common Stock, $.01 par value	40,589,045
Class A Stock, $.01 par value	1,656,200

SCHOLASTIC CORPORATION
FORM 10-Q FOR THE QUARTERLY PERIOD ENDED AUGUST 31, 2006
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PART I - FINANCIAL INFORMATION

Item 1. Financial Statements

SCHOLASTIC CORPORATION
CONDENSED CONSOLIDATED STATEMENTS OF OPERATIONS - UNAUDITED
(Dollar amounts in millions, except per share data)

	Three months ended August 31,	
	2006	**2005**
Revenues	**$ 334.9**	**$ 498.4**
Operating costs and expenses:		
Cost of goods sold	171.8	293.0
Selling, general and administrative expenses	196.6	202.4
Bad debt expense	15.7	12.6
Depreciation and amortization	16.9	15.6
Total operating costs and expenses	401.0	523.6
Operating loss	**(66.1)**	**(25.2)**
Interest expense, net	7.4	8.5
Loss before income taxes	(73.5)	(33.7)
Benefit from income taxes	26.6	12.5
Net loss	**$ (46.9)**	**$ (21.2)**
Basic and diluted loss per Share of Class A and Common Stock	**$ (1.12)**	**$ (0.52)**

See accompanying notes

SCHOLASTIC CORPORATION
CONDENSED CONSOLIDATED BALANCE SHEETS
(Dollar amounts in millions, except per share data)

	August 31, 2006	May 31, 2006	August 31, 2005
ASSETS	(Unaudited)		(Unaudited)
Current Assets:			
Cash and cash equivalents	$ 19.7	$ 205.3	$ 18.4
Accounts receivable, net	249.8	266.8	411.7
Inventories	548.0	431.5	509.2
Deferred promotion costs	57.0	49.8	41.8
Deferred income taxes	100.7	73.1	84.5
Prepaid expenses and other current assets	66.6	52.4	53.3
Total current assets	1,041.8	1,078.9	1,118.9
Property, plant and equipment, net	387.7	397.0	398.3
Prepublication costs	111.7	115.9	119.4
Installment receivables, net	10.8	11.2	11.2
Royalty advances	46.7	46.0	56.8
Production costs	5.1	5.9	9.3
Goodwill	253.5	253.1	254.1
Other intangibles	78.3	78.4	78.6
Other assets and deferred charges	69.4	65.8	64.5
Total assets	**$ 2,005.0**	**$ 2,052.2**	**$ 2,111.1**
LIABILITIES AND STOCKHOLDERS EQUITY			
Current Liabilities:			
Lines of credit, short-term debt and current portion of long-term debt	$ 301.5	$ 329.2	$ 33.8
Capital lease obligations	6.7	7.5	10.3
Accounts payable	164.3	141.7	179.3
Accrued royalties	47.7	36.6	127.2
Deferred revenue	33.6	19.3	29.7
Other accrued expenses	136.0	154.7	115.9
Total current liabilities	689.8	689.0	496.2
Noncurrent Liabilities:			
Long-term debt	174.3	173.2	546.0
Capital lease obligations	61.0	61.4	67.7
Other noncurrent liabilities	80.0	79.3	75.2
Total noncurrent liabilities	315.3	313.9	688.9
Commitments and Contingencies	-	-	-

Stockholders Equity:			
Preferred Stock, $1.00 par value	-	-	-
Class A Stock, $.01 par value	0.0	0.0	0.0
Common Stock, $.01 par value	0.4	0.4	0.4
Additional paid-in capital	461.6	458.7	440.2
Deferred compensation	-	(1.6)	(1.9)
Accumulated other comprehensive loss	(27.1)	(20.1)	(34.8)
Retained earnings	565.0	611.9	522.1
Total stockholders equity	999.9	1,049.3	926.0
Total liabilities and stockholders equity	**$ 2,005.0**	**$ 2,052.2**	**$ 2,111.1**

See accompanying notes

SCHOLASTIC CORPORATION
CONSOLIDATED STATEMENTS OF CASH FLOWS UNAUDITED
(Dollar amounts in millions)

	Three months ended August 31,	
	2006	**2005**
Cash flows used in operating activities:		
Net loss	$ (46.9)	$ (21.2)
Adjustments to reconcile net loss to net cash used in operating activities:		
Provision for losses on accounts receivable	15.7	12.6
Amortization of prepublication and production costs	15.5	18.4
Depreciation and amortization	16.9	15.6
Royalty advances expensed	5.5	4.7
Deferred income taxes	(26.9)	(12.5)
Non-cash interest expense	0.4	0.4
Changes in assets and liabilities:		
Accounts receivable, net	2.7	(154.5)
Inventories	(115.9)	(102.3)
Prepaid expenses and other current assets	(14.2)	(8.4)
Deferred promotion costs	(7.1)	(2.2)
Accounts payable and other accrued expenses	4.2	28.2
Accrued royalties	11.1	87.1
Deferred revenue	14.2	6.0
Tax benefit realized from employee stock-based plans	0.3	2.8
Other, net	(13.6)	(13.5)
Total adjustments	(91.2)	(117.6)
Net cash used in operating activities	(138.1)	(138.8)
Cash flows used in investing activities:		
Prepublication expenditures	(9.2)	(12.3)
Additions to property, plant and equipment	(6.2)	(15.4)
Royalty advances	(6.1)	(7.2)
Production expenditures	(1.3)	(4.6)
Acquisition-related payments	-	(3.3)
Other	(1.2)	-
Net cash used in investing activities	(24.0)	(42.8)
Cash flows (used in) provided by financing activities:		
Borrowings under Credit Agreement and Revolver	13.0	104.0
Repayments of Credit Agreement and Revolver	(12.0)	(32.0)
Repurchase of 5.75% Notes	(35.4)	(2.0)
Borrowings under lines of credit	39.7	42.2
Repayments of lines of credit	(30.5)	(33.8)

Repayment of capital lease obligations	(2.6)	(2.4)
Proceeds pursuant to employee stock-based plans	4.1	13.3
Net cash (used in) provided by financing activities	(23.7)	89.3
Effect of exchange rate changes on cash and cash equivalents	0.2	0.1
Net decrease in cash and cash equivalents	(185.6)	(92.2)
Cash and cash equivalents at beginning of period	205.3	110.6
Cash and cash equivalents at end of period	**$ 19.7**	**$ 18.4**

See accompanying notes

SCHOLASTIC CORPORATION
NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS - UNAUDITED
(Dollar amounts in millions, except per share data)

1. Basis of Presentation

The accompanying condensed consolidated financial statements consist of the accounts of Scholastic Corporation (the Corporation) and all wholly-owned and majority-owned subsidiaries (collectively, Scholastic or the Company). These financial statements have not been audited but reflect those adjustments consisting of normal recurring items that management considers necessary for a fair presentation of financial position, results of operations and cash flow. These financial statements should be read in conjunction with the consolidated financial statements and related notes in the Annual Report on Form 10-K for the fiscal year ended May 31, 2006.

The Companys business is closely correlated to the school year. Consequently, the results of operations for the three months ended August 31, 2006 and 2005 are not necessarily indicative of the results expected for the full year. Due to the seasonal fluctuations that occur, the August 31, 2005 condensed consolidated balance sheet is included for comparative purposes.

The Companys condensed consolidated financial statements have been prepared in accordance with accounting principles generally accepted in the United States. The preparation of these financial statements involves the use of estimates and assumptions by management, which affect the amounts reported in the condensed consolidated financial statements and accompanying notes. The Company bases its estimates on historical experience, current business factors, and various other assumptions believed to be reasonable under the circumstances, all of which are necessary in order to form a basis for determining the carrying values of assets and liabilities. Actual results may differ from those estimates and assumptions. On an on-going basis, the Company evaluates the adequacy of its reserves and the estimates used in calculations, including, but not limited to: collectability of accounts receivable and installment receivables; sales returns; amortization periods; pension and other post-retirement obligations; and recoverability of inventories, deferred promotion costs, deferred income taxes and tax reserves, prepublication costs, royalty advances, goodwill and other intangibles.

Stock-Based Compensation

Prior to June 1, 2006, the Company applied the intrinsic value-based method of accounting prescribed by Accounting Principles Board (APB) Opinion No. 25, Accounting for Stock Issued to Employees (APB No. 25), and related interpretations in accounting for its stock-based benefit plans. Under this method, no compensation expense was recognized with respect to options granted under the Companys stock-based benefit plans, as the exercise price of each stock option issued was equal to the market price of the underlying stock on the date of grant and the exercise price and number of shares subject to grant were fixed.

In May 2006, the Human Resources and Compensation Committee (the Committee) of the Board of Directors (the Board) of the Corporation, which consists entirely of independent directors, approved the acceleration of the vesting of all unvested options to purchase the Corporations Class A Stock, par value $.01 per share (the Class A Stock), and the Corporations common stock, par value $.01 per share (the Common Stock), outstanding as of May 30, 2006 granted to employees (including executive officers) and outside directors of the Corporation (the Acceleration). Except for the Acceleration, all other terms and conditions applicable to such stock options were unchanged. Substantially all of these options had exercise prices in excess of the market value of the underlying Common Stock on May 30, 2006. The primary purpose of the Acceleration was to mitigate the future compensation expense that the Company would have otherwise recognized in its financial statements with respect to these options as a result of the adoption by the Company of Statement of Financial Accounting Standards (SFAS) No. 123R, Share Based Payment (SFAS 123R) effective as of June 1, 2006.

SCHOLASTIC CORPORATION
NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS - UNAUDITED
(Dollar amounts in millions, except per share data)

The Company adopted the fair value recognition provisions of SFAS 123R, which revises SFAS No. 123, Accounting for Stock-Based Compensation, using the modified prospective method. SFAS 123R requires the Company to recognize the cost of employee and director services received in exchange for any stock-based awards. Under SFAS 123R, the Company recognizes compensation expense on a straight-line basis over an awards requisite service period, which is generally the vesting period, based on the awards fair value at the date of grant.

The fair values of stock options granted by the Company are estimated at the date of grant using the Black-Scholes option-pricing model. The Companys determination of the fair value of share-based payment awards using this option-pricing model is affected by the price of the Common Stock as well as by assumptions regarding highly complex and subjective variables, including, but not limited to, the expected price volatility of the Common Stock over the terms of the awards, the risk-free interest rate, and actual and projected employee stock option exercise behaviors. Estimates of fair value are not intended to predict actual future events or the value that may ultimately be realized by employees or directors who receive these awards.

SFAS 123R requires forfeitures to be estimated at the time of grant and revised, if necessary, in subsequent periods if actual forfeitures differ from those estimates in order to derive the Companys best estimate of awards ultimately expected to vest. In determining the estimated forfeiture rates for stock-based awards, the Company periodically conducts an assessment of the actual number of equity awards that have been forfeited previously. When estimating expected forfeitures, the Company considers factors such as the type of award, the employee class and historical experience. The estimate of stock awards that will ultimately be forfeited requires significant judgment and, to the extent that actual results or updated estimates differ from current estimates, such amounts will be recorded as a cumulative adjustment in the period such estimates are revised. In the Companys pro forma information required under SFAS 123 for the periods prior to June 1, 2006, the Company accounted for forfeitures as they occurred.

The following table provides the estimated weighted average fair value, under the Black-Scholes option-pricing model, for options granted during the three months ended August 31, 2006 and 2005 and the significant weighted average assumptions used in their determination. The expected life represents an estimate of the period of time stock options are expected to remain outstanding based on the historical exercise behavior of the option grantees. The risk-free interest rate was based on the U.S. Treasury yield curve in effect at the time of the grant corresponding to the expected life. The volatility was estimated based on historical volatility corresponding to the expected life. The dividend yield was zero based on the fact that the Corporation has not paid any cash dividends since its initial public offering in February 1992 and has no current plans to pay any dividends.

	Three months ended August 31,	
	2006	**2005**
Dividend yield	0%	0%
Expected volatility	40.3%	49.7%
Risk free interest rate	5.1%	4.0%
Expected life (years) of stock option grant	5.6	5.0
Per share fair value of options granted	$ 12.68	$ 17.88

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SCHOLASTIC CORPORATION
NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS - UNAUDITED
(Dollar amounts in millions, except per share data)

At August 31, 2006, the Company maintained three stockholder-approved employee stock-based benefit plans with regard to the Common Stock: the Scholastic Corporation 1992 Stock Option Plan (the 1992 Plan), under which no further awards can be made; the Scholastic Corporation 1995 Stock Option Plan (the 1995 Plan), under which no further awards can be made; and the Scholastic Corporation 2001 Stock Incentive Plan (the 2001 Plan). The 2001 Plan provides for the issuance of incentive stock options, which qualify for favorable treatment under the Internal Revenue Code, and options that are not so qualified, called non-qualified options, restricted stock and other stock-based awards.

At August 31, 2006, non-qualified stock options to purchase 25,000 shares, 2,760,844 shares and 2,700,830 shares of Common Stock were outstanding under the 1992 Plan, 1995 Plan and 2001 Plan, respectively, and 750,291 shares of Common Stock were available for additional awards under the 2001 Plan. In July 2006, 33,000 options were awarded under the 2001 Plan at an exercise price of $27.58.
The Company also maintains the 1997 Outside Directors Stock Option Plan (the 1997 Directors Plan), a stockholder-approved stock option plan for outside directors. The 1997 Directors Plan, as amended, provides for the automatic grant to each non-employee director on the date of each annual stockholders meeting of non-qualified stock options to purchase 6,000 shares of Common Stock. At August 31, 2006, options to purchase 376,000 shares of Common Stock were outstanding under the 1997 Directors Plan and 144,000 shares of Common Stock were available for additional awards under the 1997 Directors Plan.

The Scholastic Corporation 2004 Class A Stock Incentive Plan (the Class A Plan) provides for the grant to Richard Robinson, the Chief Executive Officer of the Corporation as of the effective date of the Class A Plan, of options (Class A Options) to purchase shares of Class A Stock. At August 31, 2006, there were 666,000 Class A Options outstanding, and 84,000 shares of Class A Stock were available for additional awards, under the Class A Plan.

Generally, options granted under the various plans may not be exercised for a minimum of one year after the date of grant and expire approximately ten years after the date of grant. As a result of the Acceleration, all unvested stock options outstanding as of May 30, 2006 became vested and immediately exercisable.

The following table sets forth the stock option activity for the Class A Stock and Common Stock plans for the three months ended August 31, 2006:

Stock Options	**Shares (In thousands)**	**Weighted Average Exercise Price**	**Weighted Average Remaining Contractual Term (In years)**	**Aggregate Intrinsic Value (In millions)**
Outstanding at May 31, 2006	6,885	$30.24		
Granted	33	$27.58		
Exercised	(170)	$22.61		
Expired or forfeited	(219)	$30.92		
Outstanding at August 31, 2006	6,529	$30.40	5.69	$16.3
Vested and expected to vest at August 31, 2006	6,529	$30.40	5.69	$16.3
Exercisable at August 31, 2006	6,496	$30.42	5.67	$16.2

Intrinsic value is generally defined as the amount by which the market price of a companys stock exceeds the exercise price of an option to purchase the companys stock.

In addition to stock options, the Company hasissued restricted stock units (RSUs) to certain officers and key executives under the 2001 Plan. RSUs automatically convert to shares of Common Stock on a one-for-one basis as the award vests, which is typically over a four-year period. The Company measures the value of RSUs at fair value based on the number of shares granted and the price of the Common Stock at the date of grant. The Company amortizes the fair value as stock-based compensation expense over the vesting term on a straight-line basis. Upon settlement of RSUs, the total compensation expense recorded over the vesting period of the awards will equal the settlement amount, which is based on the price of the Common Stock on the settlement date.

SCHOLASTIC CORPORATION
NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS - UNAUDITED
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The Companys Management Stock Purchase Plan (MSPP) allows certain members of senior management to defer up to 100% of their annual cash bonus payment in the form of restricted stock units (the MSPP RSUs). The MSPP RSUs are purchased by the employee at a 25% discount from the lowest closing price of the Common Stock during the fiscal quarter in which such bonuses are payable and are automatically converted into shares of Common Stock on a one-for-one basis at the end of the applicable deferral period. The Company measures the value of MSPP RSUs at fair value based on the number of shares granted and the price of the Common Stock at the date of grant, giving effect to the 25% discount. The Company amortizes the fair value as stock-based compensation expense over the vesting term on a straight-line basis.

The Company also maintains an Employee Stock Purchase Plan (the ESPP), which is offered to eligible United States employees. As amended, the ESPP permits participating employees to purchase Common Stock, with after-tax payroll deductions, on a quarterly basis at a 15% discount from the closing price of the Common Stock on the last business day of each fiscal quarter. The Company measures the value of ESPP stock issuances at fair value based on the number of shares granted and the price of the Common Stock at the date of grant, giving effect to the 15% discount. Prior to June 1, 2006, no compensation expense was recognized with respect to the ESPP under APB No. 25. Upon adoption of SFAS 123R by the Company effective as of June 1, 2006, the Company began recognizing the fair value as stock-based compensation expense for the ESPP in the quarter in which the employees participated in the plan.

If SFAS 123R had been applicable to the Company during the three-month period ended August 31, 2005 and compensation cost for the Companys stock-based plans had been accounted for in accordance with SFAS 123R, the Companys net loss and basic and diluted loss per share for the three-month period ended August 31, 2005 would have been changed to the pro forma amounts in the following table:

Net loss as reported	$ (21.2)
Add: Stock-based employee compensation included in reported net loss, net of tax	0.1
Deduct: Total stock-based employee compensation expense determined under fair value-based method, net of tax	2.7
Net loss pro forma	**$ (23.8)**
Basic and diluted loss per share as reported	$ (0.52)
Basic and diluted loss per share pro forma	$ (0.58)

As a result of the adoption of SFAS 123R, the Company incurred compensation expense of $0.3 in the aggregate for the three months ended August 31, 2006, which is significantly lower than the amount that would have been recorded in that period if the Acceleration had not been implemented.

The total intrinsic value of stock options exercised during the three months ended August 31, 2006 was $1.0. As of August 31, 2006, the total pre-tax compensation cost not yet recognized by the Company with regard to outstanding unvested stock-based awards was $1.9. The weighted average period over which this compensation cost is expected to be recognized is 2.6 years.

On November 10, 2005, the FASB issued Staff Position No. 123(R)-3, “Transition Election Related to Accounting for the Tax Effects of Share-Based Payment Awards,” which provides an alternative (and simplified) method to calculate the pool of excess income tax benefits upon the adoption of SFAS 123R. Among other things, Staff Position No. 123(R)-3 provides a specific method for the presentation of excess tax benefits within the statement of cash flows when the alternative pool calculation is used. Although Staff Position No. 123(R)-3 became effective upon its issuance, companies may take up to one year from initial adoption of SFAS 123R to evaluate the available transition alternatives and make a one-time election. The Company is currently in the process of evaluating these alternative methods.

New Accounting Pronouncements

In May 2005, the FASB issued SFAS No. 154, “Accounting Changes and Error Corrections - a replacement of APB Opinion No. 20 and FASB Statement No. 3” (“SFAS 154”). Under the previous guidance, most voluntary changes in accounting principle were required to be recognized as the cumulative effect of a change in accounting principle within the net income of the period in which the change was made. SFAS 154 requires retrospective application to prior period financial statements of a voluntary change in accounting principle, unless it is impracticable to do so. SFAS 154 is effective for accounting changes and corrections of errors made in fiscal years beginning after December 15, 2005. The adoption of SFAS 154 by the Company effective as of June 1, 2006 had no material immediate effect on the Company’s consolidated financial position, results of operations or cash flows.

In July 2006, the FASB issued Interpretation No. 48, "Accounting for Uncertainty in Income Taxes" ("FIN 48"). FIN 48 clarifies the accounting for uncertainty in income taxes recognized in a company's financial statements in accordance with SFAS No. 109, "Accounting for Income Taxes." FIN 48 provides guidance on recognizing, measuring, presenting, and disclosing in the financial statements uncertain tax positions that a company has taken or expects to file in a tax return. FIN 48 will become effective for the Company's fiscal year beginning June 1, 2007. The Company is currently evaluating the impact, if any, that FIN 48 will have on its consolidated financial position, results of operations and cash flows.

In September 2006, the FASB issued SFAS No. 157, “Fair Value Measurements” (“SFAS 157). SFAS 157 defines fair value, establishes a framework for measuring fair value under generally accepted accounting principles, and expands disclosures about fair value measurements. SFAS 157 emphasizes that fair value is a market-based measurement, not an entity-specific measurement, and states that a fair value measurement should be determined based on the assumptions that market participants would use in pricing the asset or liability. SFAS 157 will become effective for the Company’s fiscal year beginning June 1, 2008. The Company is currently evaluating the impact, if any, that SFAS 157 will have on its consolidated financial position, results of operations and cash flows.

SCHOLASTIC CORPORATION
NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS - UNAUDITED
(Dollar amounts in millions, except per share data)

In September 2006, the FASB issued SFAS No. 158, Employers Accounting for Defined Benefit Pension and Other Postretirement Plansan amendment of FASB Statements No. 87, 88, 106, and 132(R) (SFAS 158). SFAS 158 requires an employer to recognize the over-funded or under-funded status of a defined benefit postretirement plan (other than a multiemployer plan) as an asset or liability in its statement of financial position and to recognize changes in that funded status in the year in which the changes occur through comprehensive income. SFAS 158 also requires the measurement of defined benefit plan assets and obligations as of the date of the employers fiscal year-end statement of financial position (with limited exceptions). Under SFAS 158, the Company will be required to recognize the funded status of its defined benefit postretirement plan and to provide the required disclosures commencing as of May 31, 2007. The Company is currently evaluating the impact, if any, that SFAS 158 will have on its consolidated financial position, results of operations and cash flows.

2. Segment Information

The Company categorizes its businesses into four operating segments: *Childrens Book Publishing and Distribution; Educational Publishing; Media, Licensing and Advertising* (which collectively represent the Companys domestic operations)*;* and *International*. This classification reflects the nature of products and services consistent with the method by which the Companys chief operating decision-maker assesses operating performance and allocates resources. Revenues and operating margin related to a segments products sold or services rendered through another segments distribution channel are reallocated to the segment originating the products or services.

Childrens Book Publishing and Distribution includes the publication and distribution of childrens books in the United States through school-based book clubs and book fairs, school-based and direct-to-home continuity programs and the trade channel.

Educational Publishing includes the production and/or publication and distribution to schools and libraries of educational technology products, curriculum materials, childrens books, classroom magazines and print and on-line reference and non-fiction products for grades pre-kindergarten to 12 in the United States.

Media, Licensing and Advertising includes the production and/or distribution of media and electronic products and programs (including childrens television programming, videos, DVDs, software, feature films, interactive programs, promotional activities and non-book merchandise); and advertising revenue, including sponsorship programs.

International includes the publication and distribution of products and services outside the United States by the Companys international operations, and its export and foreign rights businesses.

SCHOLASTIC CORPORATION
NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS - UNAUDITED
(Dollar amounts in millions, except per share data)

The following table sets forth information for the Company's segments for the periods indicated. Certain prior year amounts have been reclassified to conform with the present year presentation.

	Children's Book Publishing and Distribution	Educational Publishing	Media, Licensing and Advertising	Overhead (1)	Total Domestic	International	Consolidated
Three months ended August 31, 2006							
Revenues	$ 112.6	$ 127.4	$ 15.7	$ 0.0	$ 255.7	$ 79.2	$ 334.9
Bad debt	13.5	0.0	0.1	0.0	13.6	2.1	15.7
Depreciation and amortization	4.3	1.0	0.4	9.7	15.4	1.5	16.9
Amortization (2)	4.4	7.3	3.1	0.0	14.8	0.7	15.5
Royalty advances expensed	4.3	0.3	0.2	0.0	4.8	0.7	5.5
Operating income (loss) (3)	(67.3)	32.7	(6.1)	(19.9)	(60.6)	(5.5)	(66.1)
Segment assets	814.3	363.4	84.0	417.3	1,679.0	326.0	2,005.0
Goodwill	130.6	82.5	9.8	0.0	222.9	30.6	253.5
Expenditures for long-lived assets (4)	12.5	3.7	3.4	1.9	21.5	2.5	24.0
Long-lived assets (5)	286.8	199.8	40.5	285.2	812.3	111.8	924.1

	Children's Book Publishing and Distribution	Educational Publishing	Media, Licensing and Advertising	Overhead (1)	Total Domestic	International	Consolidated
Three months ended August 31, 2005							
Revenues	$ 275.3	$ 128.3	$ 18.1	$ 0.0	$ 421.7	$ 76.7	$ 498.4
Bad debt	9.9	0.6	0.1	0.0	10.6	2.0	12.6
Depreciation and amortization	3.2	0.8	0.4	9.6	14.0	1.6	15.6
Amortization (2)	4.1	7.9	5.9	0.0	17.9	0.5	18.4
Royalty advances expensed	3.8	0.4	0.1	0.0	4.3	0.4	4.7

Operating income (loss) (3)	(19.7)	27.5	(5.7)	(21.8)	(19.7)	(5.5)	(25.2)
Segment assets	953.1	366.4	66.7	409.5	1,795.7	315.4	2,111.1
Goodwill	130.6	82.5	9.8	0.0	222.9	31.2	254.1
Expenditures for long-lived assets (4)	21.4	7.3	6.1	5.2	40.0	2.8	42.8
Long-lived assets (5)	296.8	214.1	37.1	299.2	847.2	107.0	954.2

(1) *Overhead includes all domestic corporate amounts not allocated to reportable segments, including expenses and costs related to the management of corporate assets. Unallocated assets are principally comprised of deferred income taxes and property, plant and equipment related to the Company's headquarters in the metropolitan New York area, fulfillment and distribution facilities located in Missouri and Arkansas, and an industrial/office building complex in Connecticut.*

(2) *Includes amortization of prepublication costs and production costs.*

(3) *Operating income (loss) represents earnings (loss) before interest and income taxes.*

(4) *Includes expenditures for property, plant and equipment, investments in prepublication and production costs, royalty advances and acquisitions of, and investments in, businesses.*

(5) *Includes property, plant and equipment, prepublication costs, goodwill, other intangibles, royalty advances, production costs and long-term investments.*

SCHOLASTIC CORPORATION
NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS - UNAUDITED
(Dollar amounts in millions, except per share data)

The following table separately sets forth information for the periods indicated for the United States direct-to-home portion of the Company's continuity programs, which consist primarily of the business formerly operated by Grolier Incorporated ("Grolier") and are included in the *Children's Book Publishing and Distribution* segment, and for all other businesses included in the segment:

Three months ended
August 31,

	Direct-to-home		All Other		Total	
	2006	2005	2006	2005	2006	2005
Revenues	$ 36.3	$ 28.4	$ 76.3	$ 246.9	$ 112.6	$ 275.3
Bad debt	10.7	6.6	2.8	3.3	13.5	9.9
Depreciation and amortization	0.3	0.2	4.0	3.0	4.3	3.2
Amortization (1)	0.3	0.3	4.1	3.8	4.4	4.1
Royalty advances expensed	0.2	(0.4)	4.1	4.2	4.3	3.8
Business loss (2)	(6.5)	(6.2)	(60.8)	(13.5)	(67.3)	(19.7)
Business assets	220.9	207.1	593.4	746.0	814.3	953.1
Goodwill	92.4	92.4	38.2	38.2	130.6	130.6
Expenditures for long-lived assets (3)	1.7	1.4	10.8	20.0	12.5	21.4
Long-lived assets (4)	117.5	116.7	169.3	180.1	286.8	296.8

(1) *Includes amortization of prepublication costs.*

(2) *Business loss represents loss before interest expense and income taxes.*

(3) *Includes expenditures for property, plant and equipment, investments in prepublication costs, royalty advances and acquisitions of businesses.*

(4) *Includes property, plant and equipment, prepublication costs, goodwill, other intangibles and royalty advances.*

3. Debt

The following table summarizes debt as of the dates indicated:

	August 31, 2006	***May 31, 2006***	***August 31, 2005***
Lines of Credit	$ 42.2	$ 33.8	$ 33.7
Credit Agreement and Revolver	1.0	-	72.0
5.75% Notes due 2007, net of premium/discount	259.3	295.3	301.0
5% Notes due 2013, net of discount	173.3	173.2	173.0
Other debt	-	0.1	0.1
Total debt	**475.8**	**502.4**	**579.8**
Less lines of credit, short-term debt and current portion of long-term debt	(301.5)	(329.2)	(33.8)

Total long-term debt	$ 174.3	$ 173.2	$ 546.0

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(Dollar amounts in millions, except per share data)

The following table sets forth the maturities of the Company's debt obligations as of August 31, 2006 for the remainder of fiscal 2007 and thereafter:

Nine-month period ending May 31:	
2007	$ 301.5
Fiscal years ending May 31:	
2008	-
2009	1.0
2010	-
2011	-
Thereafter	173.3
Total debt	**$ 475.8**

Lines of Credit

Certain of Scholastic Corporation's international subsidiaries had unsecured lines of credit available in local currencies equivalent to $79.3 in the aggregate at August 31, 2006, as compared to $59.1 at August 31, 2005 and $67.9 at May 31, 2006. There were borrowings outstanding under these lines of credit equivalent to $42.2 at August 31, 2006, as compared to $33.7 at August 31, 2005 and $33.8 at May 31, 2006. These lines of credit are considered short-term in nature. The weighted average interest rates on the outstanding amounts were 6.0% and 5.5% at August 31, 2006 and 2005, respectively, and 6.0% at May 31, 2006.

Credit Agreement

Scholastic Corporation and its principal operating subsidiary, Scholastic Inc., are parties to an unsecured revolving credit agreement with certain banks (the "Credit Agreement"), which expires on March 31, 2009. The Credit Agreement provides for aggregate borrowings of up to $190.0 (with a right in certain circumstances to increase borrowings to $250.0), including the issuance of up to $10.0 in letters of credit. Interest under this facility is either at the prime rate or at a rate equal to 0.325% to 0.975% over LIBOR (as defined). There is a facility fee ranging from 0.10% to 0.30% and a utilization fee ranging from 0.05% to 0.25% if borrowings exceed 50% of the total facility. The amounts charged vary based upon the Company's credit rating. The interest rate, facility fee and utilization fee (when applicable) as of August 31, 2006 were 0.975% over LIBOR, 0.30% and 0.25%, respectively. The Credit Agreement contains certain financial covenants related to debt and interest coverage ratios (as defined) and limits dividends and other distributions. There were no borrowings outstanding under the Credit Agreement at August 31, 2006 or May 31, 2006. At August 31, 2005, $35.0 was outstanding under the Credit Agreement at a weighted average interest rate of 4.3%.

Revolver

Scholastic Corporation and Scholastic Inc. are joint and several borrowers under an unsecured revolving loan agreement with a bank (the "Revolver"). The Revolver provides for unsecured revolving credit of up to $40.0 and expires on March 31, 2009. Interest under this facility is either at the prime rate minus 1%, or at a rate equal to 0.375% to 1.025% over LIBOR (as defined). There is a facility fee ranging from 0.10% to 0.30%. The amounts charged vary based upon the Company's credit rating. The interest rate and facility fee as of August 31, 2006 were 1.025% over LIBOR and 0.30%, respectively. The Revolver contains certain financial covenants related to debt and interest coverage ratios (as defined) and limits dividends and other distributions. At August 31, 2006 and 2005, $1.0 and $37.0, respectively, were outstanding under the Revolver at a weighted average interest rate of 7.3% and 5.0%, respectively. There were no borrowings outstanding under the Revolver at May 31, 2006.

SCHOLASTIC CORPORATION
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5.75% Notes due 2007
In January 2002, Scholastic Corporation issued $300.0 of 5.75% Notes (the “5.75% Notes”). The 5.75% Notes are senior unsecured obligations that mature on January 15, 2007. Interest on the 5.75% Notes is payable semi-annually on July 15 and January 15 of each year through maturity. The Company may, at any time, redeem all or a portion of the 5.75% Notes at a redemption price (plus accrued interest to the date of the redemption) equal to the greater of (i) 100% of the principal amount, or (ii) the sum of the present values of the remaining scheduled payments of principal and interest discounted to the date of the redemption. In fiscal 2006, the Company repurchased $6.0 of the 5.75% Notes on the open market. In the quarter ended August 31, 2006, the Company repurchased $35.4 of the 5.75% Notes on the open market. After giving effect to these repurchases, the outstanding 5.75% Notes, net of premium/discount, totaled $259.3.

5% Notes due 2013
In April 2003, Scholastic Corporation issued $175.0 of 5% Notes (the “5% Notes”). The 5% Notes are senior unsecured obligations that mature on April 15, 2013. Interest on the 5% Notes is payable semi-annually on April 15 and October 15 of each year. The Company may at any time redeem all or a portion of the 5% Notes at a redemption price (plus accrued interest to the date of the redemption) equal to the greater of (i) 100% of the principal amount, or (ii) the sum of the present values of the remaining scheduled payments of principal and interest discounted to the date of the redemption.

4. Comprehensive Loss

The following table sets forth comprehensive loss for the periods indicated:

	Three months ended August 31,	
	2006	**2005**
Net loss	$ (46.9)	$ (21.2)
Other comprehensive loss - foreign currency translation adjustment	(7.0)	(6.3)
Comprehensive loss	**$ (53.9)**	**$ (27.5)**

5. Investment

In the quarter ended August 31, 2006, the Company participated in the organization of a new entity, the Children’s Network Venture LLC (“Children’s Network”), that will produce and distribute educational children’s television programming under the name “Qubo.” The Company has contributed a total of $2.4 in cash and certain rights to existing television programming to the Children’s Network. The Company’s investment, which consists of a 12.25% equity interest, is accounted for using the equity method of accounting and is included in the Other assets and deferred charges section of the Company’s consolidated balance sheets.

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SCHOLASTIC CORPORATION
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(Dollar amounts in millions, except per share data)

6. Loss Per Share

Basic loss per share is computed by dividing net loss by the weighted average Shares of Class A Stock and Common Stock outstanding during the period. Diluted loss per share is calculated to give effect to potentially dilutive options to purchase Class A and Common Stock granted pursuant to the Company's stock-based benefit plans that were outstanding during the period. The diluted loss per share was equal to the basic loss per share for each of the three month periods ended August 31, 2006 and 2005 because such options were antidilutive in those periods. The weighted average shares of Class A Stock and Common Stock outstanding for basic and diluted loss per share for the three months ended August 31, 2006 and 2005 were 42.0 and 41.0, respectively.

7. Goodwill and Other Intangibles

Goodwill and other intangible assets with indefinite lives are reviewed for impairment annually, or more frequently if impairment indicators arise.

The following table summarizes the activity in Goodwill for the periods indicated:

	Three months ended August 31, 2006	***Twelve months ended May 31, 2006***	***Three months ended August 31, 2005***
Beginning balance	$ 253.1	$ 254.2	$ 254.2
Translation adjustments	0.4	(1.1)	(0.1)
Total	**$253.5**	**$ 253.1**	**$ 254.1**

The following table summarizes Other intangibles subject to amortization at the dates indicated:

	August 31, 2006	***May 31, 2006***	***August 31, 2005***
Customer lists	$ 3.0	$ 3.0	$ 3.0
Accumulated amortization	(2.9)	(2.9)	(2.8)
Net customer lists	0.1	0.1	0.2
Other intangibles	4.0	4.0	4.0
Accumulated amortization	(2.9)	(2.8)	(2.7)
Net other intangibles	1.1	1.2	1.3
Total	**$ 1.2**	**$ 1.3**	**$ 1.5**

Amortization expense for Other intangibles totaled $0.1 for the three months ended August 31, 2006 and August 31, 2005, and $0.3 for the twelve months ended May 31, 2006. Amortization expense for these assets is currently estimated to total $0.2 for each of the fiscal years ending May 31, 2007 through 2010, and $0.1 for the fiscal year ending May 31, 2011. The weighted average amortization periods for these assets by major asset class are two years and twelve years for customer lists and other intangibles, respectively.

SCHOLASTIC CORPORATION
NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS - UNAUDITED
(Dollar amounts in millions, except per share data)

The following table summarizes Other intangibles not subject to amortization at the dates indicated:

	August 31, 2006	*May 31, 2006*	*August 31, 2005*
Net carrying value by major class:			
Titles	$ 31.0	$ 31.0	$ 31.0
Licenses	17.2	17.2	17.2
Major sets	11.4	11.4	11.4
Trademarks and Other	17.5	17.5	17.5
Total	**$ 77.1**	**$ 77.1**	**$ 77.1**

8. Pension and Other Post-Retirement Benefits

The following tables set forth components of the net periodic benefit costs under the Company's cash balance retirement plan for its United States employees meeting certain eligibility requirements (the "U.S. Pension Plan"), the defined benefit pension plan of Scholastic Ltd., an indirect subsidiary of Scholastic Corporation located in the United Kingdom (the "U.K. Pension Plan"), the defined benefit pension plan of Grolier Ltd., an indirect subsidiary of Scholastic Corporation located in Canada, and the post-retirement benefits provided by the Company to its retired United States-based employees, consisting of certain healthcare and life insurance benefits for the periods indicated:

	Pension Plans *Three months ended August 31,*		**Post-Retirement Benefits** *Three months ended August 31,*	
	2006	*2005*	*2006*	*2005*
Components of Net Periodic Benefit Cost:				
Service cost	$ 2.0	$ 2.0	$ 0.0	$ 0.1
Interest cost	2.3	2.1	0.5	0.5
Expected return on assets	(2.3)	(2.2)	-	-
Net amortization and deferrals	0.6	1.0	0.1	0.3
Net periodic benefit cost	**$ 2.6**	**$ 2.9**	**$ 0.6**	**$ 0.9**

The Company currently estimates that it will contribute $12.3 to the U.S. Pension Plan in the fiscal year ending May 31, 2007. For the three months ended August 31, 2006, the Company contributed $4.9 to the U.S. Pension Plan. The Company currently estimates that Scholastic Ltd. will contribute the equivalent of $1.1 to the U.K. Pension Plan in the fiscal year ending May 31, 2007. For the three months ended August 31, 2006, Scholastic Ltd. contributed the equivalent of $0.3 to the U.K. Pension Plan.

SCHOLASTIC CORPORATION

Item 2. Management□s Discussion and Analysis of Financial Condition and Results of Operations (□MD&A□)

Overview and Outlook

The Company□s first quarter is generally its smallest revenue period as most schools are not in session, resulting in a seasonal loss. The net loss in the quarter ended August 31, 2006 was $46.9 million, compared to a $21.2 million net loss in the quarter ended August 31, 2005. The net loss in the prior fiscal year quarter was unusually low due to the benefit of approximately $185 million of revenues related to the release of *Harry Potter and the Half-Blood Prince*, the sixth book in the planned seven book series, in July 2005.

In the quarter ended August, 31, 2006, Scholastic made solid initial progress toward achieving its goals for fiscal 2007. Key factors in the quarter included growth in operating profit from the *Educational Publishing* segment, primarily as a result of a 9% increase in educational technology revenues, as well as growth in non-*Harry Potter* trade revenues, which increased primarily due to sales of new releases, including the eighth title in the *Captain Underpants* series. In addition, the Company is on track to meet its previously announced cost savings targets.

Results of Operations - Consolidated

Revenues for the quarter ended August 31, 2006 decreased $163.5 million, or 32.8%, to $334.9 million, compared to $498.4 million in the prior fiscal year quarter. This decrease related primarily to $162.7 million in lower revenues from the *Children□s Book Publishing and Distribution* segment as compared to the prior fiscal year quarter, which reflected the July 2005 release of *Harry Potter and the Half-Blood Prince*. Revenues increased $2.5 million, or 3.3%, in the *International* segment and declined by $2.4 million, or 13.3%, in the *Media, Licensing and Advertising* segment.

Cost of goods sold decreased to $171.8 million in the quarter ended August 31, 2006, or 51.3% of revenues, compared to $293.0 million, or 58.8% of revenues, in the quarter ended August 31, 2005, primarily due to higher costs related to the *Harry Potter* release in the prior fiscal year quarter.

Selling, general and administrative expenses for the quarter ended August 31, 2006 decreased $5.8 million to $196.6 million, compared to $202.4 million in the prior fiscal year quarter, which included approximately $11 million of costs related to the *Harry Potter* release in that period. This benefit was partially offset by a $3.1 million increase in promotional expenses primarily in the Company□s continuity businesses and a $1.9 million increase in severance costs related to the Company□s cost savings initiatives.

Bad debt expense totaled $15.7 million for the quarter ended August 31, 2006, compared to $12.6 million in the prior fiscal year quarter, primarily due to higher bad debt in the Company□s continuity businesses.

The resulting operating loss for the quarter ended August 31, 2006 was $66.1 million, compared to an operating loss of $25.2 million in the prior fiscal year quarter, primarily due to a $47.6 million operating loss in the *Children□s Book Publishing and Distribution* segment, partially offset by a $5.2 million increase in operating income in the *Educational Publishing* segment.

The effective income tax rate for the quarter ended August 31, 2006 decreased to 36.2% compared to 37.1% in the prior fiscal year quarter, primarily due to higher anticipated tax-exempt interest income. The tax rate for the quarter ended August 31, 2006 approximated the effective income tax rate for the fiscal year ended May 31, 2006.

Net loss was $46.9 million, or $1.12 per diluted share, for the quarter ended August 31, 2006, compared to a net loss of $21.2 million, or $0.52 per diluted share, in the prior fiscal year quarter.

SCHOLASTIC CORPORATION
Item 2. MD&A

Results of Operations - Segments

Children's Book Publishing and Distribution

($ amounts in millions)	***Three months ended August 31,***	
	2006	**2005**
Revenue	$ 112.6	$ 275.3
Operating loss	(67.3)	(19.7)
Operating margin	*	*

* not meaningful

Revenues in the *Children's Book Publishing and Distribution* segment for the quarter ended August 31, 2006 decreased by $162.7 million to $112.6 million, compared to $275.3 million in the prior fiscal year quarter. This decrease was substantially due to lower *Harry Potter* revenues in the current fiscal year quarter, which decreased by approximately $180 million due to the release of *Harry Potter and the Half-Blood Prince* in the prior fiscal year quarter, partially offset by a $9.6 million increase in non-*Harry Potter* trade revenues and a $6.8 million increase in revenues from the Company's continuity businesses. School-based book clubs and book fairs have minimal activity in the Company's first fiscal quarter, as most schools are not in session.

Segment operating loss for the quarter ended August 31, 2006 was $67.3 million, compared to $19.7 million in the prior fiscal year quarter, primarily due to the lower operating results for the Company's trade business.

The following highlights the results of the direct-to-home portion of the Company's continuity programs, which is included in the *Children's Book Publishing and Distribution* segment.

Direct-to-home continuity *($ amounts in millions)*	***Three months ended August 31,***	
	2006	**2005**
Revenue	$ 36.3	$ 28.4
Operating loss	(6.5)	(6.2)
Operating margin	*	*

* not meaningful

Revenues from the direct-to-home continuity business for the quarter ended August 31, 2006 increased to $36.3 million, compared to $28.4 million in the prior fiscal year quarter. This increase was primarily attributable to new customers acquired through new product offerings and web-based sales initiatives. The business operating loss was $6.5 million in the current fiscal year quarter, compared to a $6.2 million operating loss in the prior fiscal year quarter. The higher operating loss was due to a $4.1 million increase in bad debt expense, as well as a $3.1 million increase in promotional expense, associated with the Company's effort to acquire new customers as part of its strategy to increase revenues in this business.

SCHOLASTIC CORPORATION
Item 2. MD&A

Excluding the direct-to-home portion of the continuity business, segment revenues for the quarter ended August 31, 2006 decreased by $170.6 million to $76.3 million, compared to $246.9 million in the prior fiscal year quarter, and segment operating loss in the quarter ended August 31, 2006 increased to $60.8 million, compared to $13.5 million in the prior fiscal year quarter.

Educational Publishing

($ amounts in millions)	***Three months ended August 31,***	
	2006	**2005**
Revenue	$ 127.4	$ 128.3
Operating income	32.7	27.5
Operating margin	**25.7%**	**21.4%**

Revenues in the *Educational Publishing* segment for the quarter ended August 31, 2006 decreased slightly to $127.4 million, compared to $128.3 million in the prior fiscal year quarter. Higher revenues from sales of educational technology products, led by the Company's *READ 180*® reading intervention program, which increased by $5.4 million, were offset by lower revenues from paperback collections and library publishing, which decreased by $3.5 million and $2.5 million, respectively.

Segment operating profit for the quarter ended August 31, 2006 improved by $5.2 million, or 18.9%, to $32.7 million, compared to $27.5 million in the prior fiscal year quarter. This improvement was primarily due to the revenue growth from sales of educational technology products, which have higher gross margins.

Media, Licensing and Advertising

($ amounts in millions)	***Three months ended August 31,***	
	2006	**2005**
Revenue	$ 15.7	$ 18.1
Operating loss		

We recognize revenue in accordance with the Statement of Position 97-2, "Software Revenue Recognition" ("SOP 97-2"). Under SOP 97-2, we recognize revenues from software license fees when the licensed product is delivered, collection is probable, the fee for each element of the transaction is fixed and determinable, persuasive evidence of an arrangement exists, and vendor-specific objective evidence exists to allocate the total fee to all delivered and undelivered elements of the arrangement. Revenue may be deferred in cases where the license arrangement calls for the future delivery of products or services and we do not have vendor-specific objective evidence to allocate a portion of the total fee to the undelivered element. In such cases, revenue is recognized when the undelivered elements are delivered or vendor-specific objective evidence of the undelivered elements becomes available. However, if such undelivered elements consist of services that are essential to the functionality of the software, we recognize license and service revenues using contract accounting. If license arrangements include the rights to unspecified future products, revenue is recognized over the contractual or estimated economic term of the arrangement. Royalty revenues are typically recognized when reported to us, which occurs after shipment or activation of the related products. Prepaid royalties are deferred and recognized when reported or as they expire.

Service Revenues. Service revenues consist of consulting, maintenance, and other services. Service revenues also include reimbursable expenses billed to customers in accordance with EITF No. 01-14, "Income Statement Characterization of Reimbursements Received for 'Out-of-Pocket' Expenses Incurred" ("EITF 01-14"). EITF 01-14 generally requires that a company recognize as revenue travel expense and other reimbursable expenses billed to customers. With the adoption of EITF 01-14, we typically recognize as service revenues reimbursable expenses billed to customers when an agreement to bill the customer for reimbursable expenses exists, the expenses have been incurred and billed, and collection is probable.

We generally recognize consulting and other service revenues, including non-recurring engineering and training, as services are performed. Where consulting services are performed under a fixed-price arrangement, we generally recognize revenues on a percentage-of-completion basis. Maintenance services include both updates and technical support. Maintenance revenues are recognized ratably over the term of the maintenance agreement, and generally range between 15% and 25% of the cumulative license fees and activation royalties incurred under the contract, depending upon the level of support being provided. Where software license agreements include a combination of consulting, maintenance, and other services, these separate elements are unbundled from the arrangement based on each element's vendor-specific objective evidence of fair value.

Our current revenue recognition practices are in accordance with generally accepted accounting principles. However, revenue recognition guidelines continue to evolve as accounting standards, business, and market conditions change. To the extent that these guidelines continue to change, we may need to update our revenue recognition practices.

Valuation of Warrants

In fiscal 1999, we entered into agreements whereby we agreed to issue warrants to certain network operators who satisfy certain milestones within specific time frames. The value of these warrants is estimated using the Black-Scholes pricing model as of the earlier of the grant date or the date that it is likely that the warrants will be earned. Under the requirements of EITF No. 96-18, we will continue to

revalue the warrants if appropriate. The value of the warrants was recorded primarily as a non-current asset on the accompanying consolidated balance sheets and is being amortized over the estimated economic life of the arrangements with the network operators. Through the remainder of fiscal 2002, we will continue to evaluate warrants for impairment in accordance with Statement of Financial Accounting Standards ("SFAS") No. 121, "Accounting for the Impairment of Long-lived Assets and for Long-lived Assets to Be Disposed Of" ("SFAS 121"). We will adopt SFAS No. 144 "Accounting for the Impairment of Long-Lived Assets" for our fiscal year beginning June 1, 2002.

Management judgment is required in assessing the useful life of our warrant assets and the need for impairment. To make this assessment, management must forecast future revenue streams. These forecasts are used to determine whether the warrant balances should be impaired. To the extent that our projections of revenue streams should change, we may be required to further impair those warrants.

Restructuring Costs

We have recorded significant restructuring costs in connection with the consolidation of our research and development activities into our development centers in San Carlos, California, and London, Ontario, Canada. See Note 8 of Notes to Condensed Consolidated Financial Statements. Restructuring costs include severance costs, facilities costs, and other costs related to the restructuring.

Severance costs include those expenses related to severance pay and related employee benefit obligations, including the acceleration of certain stock option grants in connection with terminated employees. Facilities costs include obligations under non-cancelable leases for facilities we will no longer occupy, as well as the cost associated with unrecoverable leasehold improvements. Other costs related to restructuring include the write-down of the assembled workforce intangible asset and amounts expected to be paid in connection with terminated contracts.

We record restructuring costs in accordance with EITF No. 94-03 "Liability Recognition of Certain Employee Termination Benefits and Other Costs Incurred in a Restructuring," and SEC Staff Accounting Bulletin No. 100 "Restructuring and Impairment Charges." In some cases, these costs were based on estimates made in the best judgment of management. To the extent that actual events differ from what we expected, we may be required to record changes to these amounts.

Assessment of Equity Investments

We have experienced significant volatility in our equity investments in private companies. These investments are originally recorded on the balance sheet at cost. We analyze equity investments for impairment on a quarterly and annual basis and recognize an impairment charge when the estimated fair value falls below the book value and is judged to be other-than-temporary. We consider various factors in determining whether we should recognize an impairment charge, including an entity's cash available for operations, performance to budget, general business condition, ability to obtain additional working capital, and business plan. Negative changes in these factors could result in a material impairment of our equity investments. Significant management judgment is required to determine whether these equity investments should be impaired.

Assessment of Purchased Intangibles, Including Goodwill

Management periodically reviews purchased intangibles, including goodwill, for impairment in accordance with SFAS 121. For these assets, we initiate a review whenever events or changes in circumstances indicate that the carrying amount of a long-lived asset may not be recoverable. Recoverability of an asset is measured by comparison of its carrying amount to the expected future undiscounted cash flows (without interest charges) that the asset is expected to generate. Any impairment to be recognized is measured by the amount by which the carrying amount of the asset

exceeds its fair market value. Significant management judgment is required in the forecasting of future operating results that are used in the preparation of projected cash flows. Changes in conditions could require material write-downs of net intangible assets, goodwill, or both.

Under SFAS No. 142, "Goodwill and Other Intangibles," ("SFAS 142") goodwill will no longer be subject to amortization over its estimated useful life. Prospectively, goodwill will be subject to at least an annual assessment for impairment, applying a fair-value-based test. Additionally, an acquired intangible asset should be separately recognized if its benefit comes through contractual or other legal rights, or if it can be sold, transferred, licensed, rented, or exchanged, regardless of the acquirer's intent to do so. Upon our planned adoption of SFAS 142 on June 1, 2002, we will cease to amortize goodwill.

Excess Facilities and Asset Impairment

Management periodically reviews facilities and related long-lived assets for impairment in accordance with SFAS 121. We initiate a review of our facilities and related assets whenever events or changes in circumstances indicate that the carrying amount of these long-lived assets may not be recoverable. We record excess facilities and asset impairment charges when the future cash flows are not sufficient to cover the carrying amounts of those assets.

Significant management judgment is required in order to estimate the magnitude of the excess facilities and asset impairment charges. These estimates are based on many factors, including current real estate market rates and conditions, anticipated occupancy rates, and forecasted future sublease income. If current market conditions for the commercial real estate market remain the same or worsen, we may be required to record additional charges.

Allowance for Doubtful Accounts

Management periodically evaluates the adequacy of our allowance for doubtful accounts. In order to do this, we evaluate our accounts receivable at the end of each accounting period for amounts that we believe are subject to collection risk. This evaluation is performed based on review of the age of the outstanding receivables, the customer financial statements and available credit information, and any historical collection experience with the customer. Significant management judgment is required in determining the adequacy of the allowance for doubtful accounts. Changes in market or customer conditions could affect this evaluation.

Accounting for Income Taxes

We are required to estimate our income tax liability in each of the jurisdictions in which we operate. This process requires us to estimate our actual current tax exposures together with assessing the temporary differences resulting from different treatment of items for tax and accounting purposes. These differences result in deferred tax assets and liabilities. Management must then assess the likelihood that our deferred tax assets will be recovered from future taxable income. To the extent that we determine that recovery is not likely, we must establish a valuation allowance. At this time, management has determined that a full valuation allowance is appropriate.

Recent Accounting Pronouncements

In October 2001, the FASB issued Statement of Financial Accounting Standards ("SFAS") No. 144, "Accounting for the Impairment of Long-lived Assets" ("SFAS 144"). SFAS 144 supersedes the accounting and reporting provisions of SFAS No. 121, "Accounting for the Impairment of Long-lived Assets and for Long-lived Assets to Be Disposed Of" ("SFAS 121"), and APB Opinion No. 30, "Reporting the Results of Operations-Reporting the Effects of Disposal of a Segment of a Business, and Extraordinary, Unusual and Infrequently Occurring Events and Transactions." Liberate will adopt SFAS 144 for the fiscal year beginning June 1, 2002. Liberate currently evaluates long-lived assets for impairment in accordance with SFAS 121 and, as a result, does not expect that the adoption of SFAS 144 will have a material impact on its financial position, results of operations, or cash flows.

Effects of Recent Accounting Pronouncements

Effective June 1, 2001, Liberate adopted SFAS No. 133, "Accounting for Derivative Instruments and Hedging Activities" ("SFAS 133"), which establishes accounting and reporting standards for derivative financial instruments and hedging activities related to those instruments, as well as other hedging activities. The adoption of SFAS 133 did not materially impact Liberate's financial position, results of operations, or cash flows.

Reclassifications

Effective December 1, 2001, we adopted EITF 01-09 "Accounting for Consideration Given by a Vendor to a Customer or Reseller of the Vendor's Products." EITF 01-09 generally requires that consideration, including the amortization of warrants issued to a customer, should be classified in a vendor's financial statements not as an expense, but as an offset to revenues up to the amount of cumulative revenues recognized or to be recognized from that customer. In accordance with the transition guidance in EITF 01-09, adoption required the reclassification of financial statement presentations for prior periods presented for comparative purposes. Adopting EITF 01-09 did not affect our basic and diluted net loss per share, financial position, results of operations, or cash flows. The reclassification did affect the presentation of certain revenue and expense items contained within our financial statements by reducing revenues and expenses by corresponding amounts.

In January 2002, the Financial Accounting Standards Board issued EITF 01-14, "Income Statement Characterization of Reimbursements Received for 'Out-of-Pocket' Expenses Incurred," which generally requires that a company recognize as revenue travel expenses and other reimbursable expenses billed to customers. We adopted EITF 01-14 on December 1, 2001, and in accordance with the transition guidance, for comparative purposes, we reclassified our financial statement presentations for prior periods. Adopting EITF 01-14 did not affect our basic and diluted net loss per share, financial position, results of operations, or cash flows. The reclassification did affect the presentation of certain revenue and expense items contained within our financial statements.

Total revenues for the periods reported, including the effects of EITF 01-09 and 01-14, were as follows (in thousands):

	Three months ended February 28,		Nine months ended February 28,	
	2001	2002	2001	2002
		(As restated)		(As restated)
License and royalty revenues before the adoption of EITF 01-09	$ 8,608	$ 11,686(1)	$ 18,910	$ 31,048(3)
Impact of EITF 01-09	(939)	(939)	(12,148)	(2,887)
License and royalty revenues	$ 7,669	$ 10,747(1)	$ 6,762	$ 28,161(3)
Service revenues before the adoption of EITF 01-14	$ 5,831	$ 10,742(2)	$ 16,661	$ 28,280(4)
Impact of EITF 01-14	468	448	1,018	927
Service revenues	$ 6,299	$ 11,190(2)	$ 17,679	$ 29,207(4)
Total revenues	$ 13,968	$ 21,937	$ 24,441	$ 57,368

(1) We have increased the amount originally presented in our quarterly report on Form 10-Q filed on April 12, 2002 by $72,000 to reflect the restatement of our financial statements. See Note 2.

(2) We have reduced the amounts originally presented in our quarterly report on Form 10-Q filed on April 12, 2002 by $1.8 million to reflect the restatement of our financial statements. See Note 2.

(3) We have reduced the amounts originally presented in our quarterly report on Form 10-Q filed on April 12, 2002 by $664,000 to reflect the

restatement of our financial statements. See Note 2.

(4) We have reduced the amounts originally presented in our quarterly report on Form 10-Q filed on April 12, 2002 by $3.3 million to reflect the restatement of our financial statements. See Note 2.

Cost of service revenues for the periods reported, including the effects of EITF 01-14 were as follows (in thousands):

	Three months ended February 28,		Nine months ended February 28,	
	2001	2002	2001	2002
		(As restated)		(As restated)
Cost of service revenues before the adoption of EITF 01-14	$ 7,703	$ 10,033(1)	$ 19,136	$ 29,112(2)
Impact of EITF 01-14	468	448	1,018	927
Cost of service revenues	$ 8,171	$ 10,481(1)	$ 20,154	$ 30,039(2)

(1) We have increased the amounts originally presented in our quarterly report on Form 10-Q filed on April 12, 2002 by $126,000 to reflect the restatement of our financial statements. See Note 2.

(2) We have increased the amounts originally presented in our quarterly report on Form 10-Q filed on April 12, 2002 by $194,000 to reflect the restatement of our financial statements. See Note 2.

Amortization of warrants (included in operating expenses) for the periods reported including the effects of EITF 01-09 were as follows (in thousands):

Three months ended February 28,		Nine months ended February 28,	
2001	2002	2001	2002

	Three months ended February 28,		Nine months ended February 28,	
		(As restated)		(As restated)
Amortization of warrants before the adoption of EITF 01-09	$ 5,721	$ 2,346	$ 17,488	$ 13,787
Impact of EITF 01-09	(939)	(939)	(12,148)	(2,887)
Amortization of warrants	$ 4,782	$ 1,407	$ 5,340	$ 10,900

In February 2002, Liberate reclassified to operating expenses an asset impairment charge of $503,000 related to leasehold improvements that had been permanently impaired. This amount was previously included in "Other expense, net" for the first three months of fiscal 2002 and is now included in "Excess facilities charges and related asset impairment." This reclassification did not affect fiscal 2001 amounts.

Results of Operations

Revenues

We generate revenues by licensing our client and server products, applications, and tools, largely to network operators (primarily providers of television services) and, in some cases, to consumer device manufacturers (primarily set-top box manufacturers). In addition, we generate revenues from consulting, maintenance, and other services provided in connection with those licenses. As discussed above in Impact of Recent Accounting Pronouncements, adoption of EITF 01-09 and 01-14 has affected our presentation of license and royalty revenues as well as total revenues for the past and present periods reported herein. See "Risk Factors The reduction in our revenues from our adoption of EITF 01-09 could result in a decline of our stock price" and Note 1 of Notes to Condensed Consolidated Financial Statements. Total revenues for the periods reported were as follows (in thousands):

	Three months ended February 28,		Nine months ended February 28,	
	2001	2002	2001	2002
		(As restated)		(As restated)
Total revenues	$ 13,968	$ 21,937	$ 24,441	$ 57,368

	Three months ended February 28,		Nine months ended February 28,	
Percentage increase, year over year		57%		135%

International revenues as a percentage of total revenues were as follows:

	Three months ended February 28,		Nine months ended February 28,	
	2001	2002	2001	2002
		(As restated)		(As restated)
International revenues	76%	67%	65%	66%
Domestic revenues	24%	33%	35%	34%
Total revenues	100%	100%	100%	100%

As of February 28, 2002, deferred revenues were $30.7 million, reflecting a decrease of approximately $9.4 million for Q3 fiscal 2002 and $23.5 million for the first nine months of fiscal 2002. These decreases primarily resulted from customers using our current products and services, the renegotiation of certain contract terms with several of our large North American network operators, and licenses and services related to legacy products.

During Q3 fiscal 2002, we renegotiated certain contract terms with several large North American network operators in order to encourage more timely deployments and predictable revenue streams. These renegotiated agreements provide that network operators may use their existing prepaid royalty, license, or service balances over the next three to five quarters. A portion of the unused balances will expire at the end of each quarter. In connection with these renegotiations, some of the network operators also provided marketing commitments and we provided temporary deployment discounts, acceleration of pre-existing warrants, or both. Expiration of licenses and services rights and these customers' ongoing use of licenses and services reduced our deferred revenue balance by $4.0 million in Q3 fiscal 2002. Our deferred revenues also decreased during the three months ended February 28, 2002 as a result of our recognition of revenues related to legacy products.

License and Royalty. License and royalty revenues consist principally of fees earned from the licensing of our software and royalty fees earned upon the shipment or activation of products that incorporate our software, offset by the consideration (including equity instruments) given to a customer, up to the amount of cumulative revenue recognized or to be recognized. We typically

recognize revenues from software license fees when the licensed product is delivered, collection is probable, the fee for each element of the transaction is fixed and determinable, persuasive evidence of an arrangement exists, and there is vendor-specific objective evidence supporting the allocation of the total fee to all delivered and undelivered elements of the arrangement. In addition to license fees, network operators typically pay server royalty fees on a per-subscriber basis. We typically recognize revenue on these server royalty fees when a network operator reports to us that a user of a consumer device has activated the operator's service. We also license our client software to either network operators or consumer device manufacturers, who typically pay us royalties on a per-unit basis. We typically recognize client software revenue when a network operator reports to us that one of its subscribers has activated the operator's service or when a consumer device manufacturer reports to us that it has shipped a device. License and royalty revenues for the periods reported were as follows (in thousands):

	Three months ended February 28,		**Nine months ended February 28,**	
	2001	**2002**	**2001**	**2002**
		(As restated)		**(As restated)**
License and royalty revenues	$ 7,669	$ 10,747	$ 6,762	$ 28,161
Percentage of total revenues	55%	49%	28%	49%
Increase, year over year		$ 3,078		$ 21,399
Percentage increase, year over year		40%		316%

The increase in license and royalty revenues for Q3 fiscal 2002 was primarily due to the termination and renegotiation of certain customers' rights to use one-time prepayments for unused products partially related to legacy products. Upfront license fees also contributed to the increase in revenues for the three months ended February 28, 2002. The increase for Q3 fiscal 2002 was partially offset by the net decreased deployments of our customers' subscribers.

The increase in license and royalty revenues for the first nine months of fiscal 2002 was directly attributable to the decrease in the amounts of warrant amortization expense offset for that period. For the first nine months of fiscal 2002, warrant amortization offsets were $2.9 million compared to $12.1 million for the comparable period in fiscal 2001. See Note 1 of Notes to Condensed Consolidated Financial Statements. Additionally, this increase was due to the termination and renegotiation of certain customers' rights to use one-time prepayments for unused products partially related to legacy products. Upfront license fees also contributed to the increase in revenues for the nine months ended February 28, 2002.

Service. Service revenues consist of revenues related to consulting, maintenance, training, and reimbursable expenses. We generally recognize consulting and other service revenues, including non-recurring engineering, and training revenues as services are performed. Reimbursable expenses billed to customers are typically recognized as revenue when an agreement to bill the customer for reimbursable expenses exists, the expenses have been incurred and billed, and collection is probable. Where consulting services are performed under a fixed-price arrangement, revenues are generally recognized on a percentage-of-completion basis. Maintenance services include both updates and technical support. Maintenance revenues are typically recognized ratably over the term of the maintenance agreement, and generally range between 15% and 25% of the cumulative license fees and activation royalties incurred under the contract, depending upon the level of support being provided. Where software license agreements include a combination of consulting, maintenance, or other services, these separate elements are unbundled from the arrangement based on each element's vendor-specific

objective evidence of fair value. Service revenues for the periods reported were as follows (in thousands):

	Three months ended February 28,		**Nine months ended February 28,**	
	2001	**2002**	**2001**	**2002**
		(As restated)		**(As restated)**
Service revenues	$ 6,299	$ 11,190	$ 17,679	$ 29,207
Percentage of total revenues	45%	51%	72%	51%

	Three months ended February 28,		Nine months ended February 28,	
Increase, year over year		$ 4,891		$ 11,528
Percentage increase, year over year		78%		65%

The increase in absolute dollars for Q3 fiscal 2002 and the first nine months of fiscal 2002 was primarily due to continued growth in our customer base, which resulted in an increased need for the integration, implementation, and support services that we provide. Additionally, our maintenance revenues have increased from certain of our customers due to increased deployment levels. These customers are now paying maintenance fees based on cumulative license fees and activation royalties incurred rather than lower annual minimum payments. Additionally, the renegotiation of certain service contracts with customers allowed us to recognize revenues for services that we had previously performed and for which we had not previously been reimbursed.

Cost of Revenues

Total cost of revenues for the periods reported were as follows (in thousands):

	Three months ended February 28,		Nine months ended February 28,	
	2001	2002	2001	2002
		(As restated)		(As restated)
Cost of revenues	$ 8,670	$ 11,138	$ 21,914	$ 31,724
Percentage of total revenues	62%	51%	90%	55%

License and Royalty. Cost of license and royalty revenues consists primarily of costs incurred for licenses and support of third-party technologies that are incorporated in our products. Cost of license and royalty revenues for the periods reported were as follows (in thousands):

Three months ended February 28,		Nine months ended February 28,	
2001	2002	2001	2002

	Three months ended February 28,		Nine months ended February 28,	
		(As restated)		(As restated)
Cost of license and royalty revenues	$ 499	$ 657	$ 1,760	$ 1,685
Percentage of license and royalty revenues	7%	6%	26%	6%

Cost of license and royalty revenues as a percentage of license and royalty revenues remained relatively flat for Q3 fiscal 2002 compared to the same period in fiscal 2001. Cost of license and royalty revenues as a percentage of license and royalty revenues was higher for the first nine months of fiscal 2001 compared to the same period in fiscal 2002 due to lower license and royalty revenues in fiscal 2001.

Service. Cost of service revenues consists primarily of salary and other related costs for employees and external contractors. Cost of service revenues for the periods reported were as follows (in thousands):

	Three months ended February 28,		Nine months ended February 28,	
	2001	2002	2001	2002
		(As restated)		(As restated)
Cost of service revenues	$ 8,171	$ 10,481	$ 20,154	$ 30,039
Percentage of service revenues	130%	94%	114%	103%

Cost of service revenues decreased as a percentage of service revenues for Q3 fiscal 2002 and for the first nine months of fiscal 2002 compared to the same periods in fiscal 2001, primarily due to the increase in service revenues. Also contributing to the lower percentage cost of service revenues for Q3 fiscal 2002 and for the first nine months of fiscal 2002 was the increase in maintenance revenues, which generally have lower costs.

Operating Expenses

Research and Development. Research and development expenses consist primarily of salary, costs for employee-related expenses, and external contractors, as well as costs related to outsourced development projects necessary to support product development. Research and development expenses for the periods reported were as follows (in thousands):

	Three months ended February 28,		Nine months ended February 28,	
	2001	2002 (As restated)	2001	2002 (As restated)
Research and development	$ 14,758	$ 11,093	$ 38,268	$ 34,565
Percentage of total revenues	106%	51%	157%	60%
Decrease, year over year		$ (3,665)		$ (3,703)
Percentage decrease, year over year		(25)%		(10)%

The decrease in research and development expense in absolute dollars for Q3 fiscal 2002 and for the first nine months of fiscal 2002 compared to the same periods in fiscal 2001 reflected decreases in employee-related expenses, including salaries, and increased use of vacation during the holiday period, combined with reduced spending for external contractors and travel. For the first nine months of fiscal 2002, these decreases of $1.3 million in employee-related expenses and $3.1 million in outside contractor costs were partially offset by an increase of $708,000 in depreciation expense.

Sales and Marketing. Sales and marketing expenses consist primarily of salaries and other employee-related costs for sales and marketing personnel, sales commissions, travel, public relations, marketing materials, tradeshows, and facilities for regional offices. Sales and marketing expenses for the periods reported were as follows (in thousands):

Three months ended February 28,	Nine months ended February 28,

	2001	2002 (As restated)	2001	2002 (As restated)
Sales and marketing	$ 5,816	$ 6,689	$ 16,557	$ 19,638
Percentage of total revenues	42%	30%	68%	34%
Increase, year over year		$ 873		$ 3,081
Percentage increase, year over year		15%		19%

The increase in absolute dollars for Q3 fiscal 2002 compared to Q3 fiscal 2001 was attributable to higher commissions reflecting higher revenue levels, combined with the increased use of external contractors by our marketing organization. The increase in absolute dollars for the first nine months of fiscal 2002 compared to the same period in fiscal 2001 was attributable to a $785,000 increase in salaries and employee benefits and a $1.6 million increase in sales commissions and bonuses due to higher revenue levels. Outside contractor costs increased by $355,000, while depreciation expense increased $443,000. These increases were partially offset by a $485,000 decrease in travel and entertainment costs.

General and Administrative. General and administrative expenses consist primarily of salaries and other employee-related costs for corporate development, finance, human resources, and legal

employees; outside legal and other professional fees; as well as non-income-based taxes. General and administrative expenses for the periods reported were as follows (in thousands):

	Three months ended February 28,		Nine months ended February 28,	
	2001	2002 (As restated)	2001	2002 (As restated)
	$ 2,932	$ 3,087	$ 8,151	$ 9,528

	Three months ended February 28,		Nine months ended February 28,	
General and administrative				
Percentage of total revenues	21%	14%	33%	17%
Increase, year over year		$ 155		$ 1,377
Percentage increase, year over year		5%		17%

General and administrative expenses remained relatively flat in absolute dollars from Q3 fiscal 2001 to Q3 fiscal 2002. The increase in absolute dollars for the first nine months of fiscal 2002 compared to the same period in fiscal 2001 was primarily due to a $1.0 million increase in employee-related expenses, reflecting increased headcount. In addition, during the first nine months of fiscal 2002, we recorded non-income based taxes of $555,000 related to our Horsham, Pennsylvania operations. These increases were partially offset by decreases in professional fees of $594,000 during the first nine months of fiscal 2002.

Amortization of Purchased Intangibles. Purchased intangibles, including goodwill, represent the purchase price of companies that we have acquired in excess of identified tangible assets and are amortized over three years. Since our inception, we have recorded purchased intangibles, including goodwill, related to three acquisitions:

August 1997, we acquired Navio. We issued 17,441,322 shares of Series B and Series C convertible preferred stock and stock options to acquire 6,315,780 shares of Series C convertible preferred stock in exchange for all of Navio's outstanding common stock, preferred stock, and options to purchase shares of Navio common stock. The acquisition was accounted for as a purchase. The fair market value of the equity securities issued in the acquisition was $77.1 million. We recorded $18.3 million of purchased intangibles related to this acquisition. These purchased intangibles were fully amortized as of Q1 fiscal 2001.

In March 2000, we acquired the VirtualModem assets of SourceSuite in exchange for 1,772,000 shares of our common stock. The acquisition was accounted for as a purchase. The fair market value of the equity securities issued in the acquisition was $190.5 million. We recorded $192.0 million of purchased intangibles related to this acquisition.

In June 2000, we acquired MoreCom. In connection with the acquisition, we issued 7,310,830 shares of common stock in exchange for all of the outstanding stock of MoreCom and assumed all of MoreCom's stock options. The acquisition was accounted for as a purchase. The fair market value of the equity securities issued in the acquisition was $459.0 million. We recorded $470.9 million of purchased intangibles related to this acquisition.

Amortization of purchased intangibles for the periods reported, was as follows (in thousands):

	Three months ended February 28,		**Nine months ended February 28,**	
	2001	**2002**	**2001**	**2002**
		(As restated)		**(As restated)**
Amortization of purchased intangibles	$ 55,289	$ 55,210	$ 160,838	$ 165,631

Warrant-Related Asset Impairment. In Q2 fiscal 2002, we recorded warrant-related asset impairment expense of $44.8 million. This impairment charge reduced the carrying value of certain warrant-related assets to a level equal to the expected future revenues from the holders of those warrants during the amortization period of those warrants. We did not record warrant-related asset impairment expense for Q3 fiscal 2002, Q3 fiscal 2001, or for the first nine months of fiscal 2001.

Amortization of Warrants. As of February 28, 2002, several network operators had earned warrants to purchase up to 2,396,660 shares of our common stock. See Note 7 of Notes to Condensed Consolidated Financial Statements. The fair market value of those warrants at the time they were earned, based on the Black-Scholes pricing model, was $117.5 million. The portion of warrant-related amortization expense included in operating expenses for the periods reported was as follows (in thousands):

	Three months ended February 28,		Nine months ended February 28,	
	2001	2002	2001	2002
		(As restated)		(As restated)
Amortization of warrants	$ 4,782	$ 1,407	$ 5,340	$ 10,900

The amount of warrant-related amortization expense included in operating expenses for Q3 fiscal 2002 compared to Q3 fiscal 2001 decreased as a direct result of the write-down of warrants for impairment in Q2 fiscal 2002, which lowered the carrying value to be amortized over future periods. See Warrant-Related Asset Impairment above. As a result of the lower carrying value of those warrants, warrant-related amortization expense decreased by $3.6 million for Q3 fiscal 2002.

The increase in warrant-related amortization expense for the first nine months of fiscal 2002 was primarily attributable to decreased amounts reclassified as an offset to revenues in accordance with EITF 01-09. For the first nine months of fiscal 2002, only $2.8 million of warrant-related amortization expense was reclassified as an offset to revenues and $10.9 million was classified as warrant-related amortization expense. Additionally, total warrant-related amortization expense for the first nine months of fiscal 2002 was reduced by $3.6 million attributable to the write-down of warrants for impairment in Q2 fiscal 2002 as described above. For the first nine months of fiscal 2001, $12.1 million of warrant-related amortization expense was reclassified as an offset to revenues and only $5.3 million was classified as warrant-related amortization expense.

Restructuring Costs. Restructuring costs include severance costs, facilities costs, and other costs related to the restructuring. Severance costs include those expenses related to severance pay and related employee benefit obligations, including the acceleration of certain stock option grants in connection with terminated employees. Facilities costs include obligations under non-cancelable leases for facilities we will no longer occupy, as well as the cost associated with unrecoverable leasehold improvements. Other costs related to the restructuring include the write-down of the assembled workforce intangible asset and amounts expected to be paid in connection with terminated contracts. See Note 8 of Notes to Condensed Consolidated Financial Statements.

We recorded $3.1 million of restructuring costs for Q3 fiscal 2002 and for the first nine months of fiscal 2002, which was comprised of $2.5 million of accrued restructuring costs and $616,000 of expenses related to the impairment of fixed assets. We did not record restructuring costs for Q3 fiscal 2001 or for the first nine months of fiscal 2001. Restructuring costs for Q3 fiscal 2002 and for the first nine months of fiscal 2002 were comprised of the following components (in thousands):

	Total
Salaries and employee-related expenses	$ 978
Disposal of fixed assets	616
Impairment of long-lived assets	500
Lease commitments	438
Acceleration of certain stock option grants	281
Other items	262
Total restructuring costs	$ 3,075

Excess Facilities Charges and Related Asset Impairment. We have existing commitments to lease office space at our headquarters in San Carlos, California in excess of our needs for the foreseeable future and do not anticipate that we will be able to sublease a substantial portion of our excess office space in the near future. Excess facilities charges and related asset impairment are recorded when the future cash flows are not sufficient to cover the carrying amounts of those assets. We did not record an excess facilities charges and related asset impairment for Q3 fiscal 2002. For the first nine months of fiscal 2002, we recorded excess facilities charge and related asset impairment of $7.5 million. Of that amount, $7.0 million related to a change in estimated future income from previously sublet excess facilities and represented the remaining lease commitment on the excess facilities, net of expected sublease income. Additionally, $503,000 related to the impairment of certain long-lived assets, consisting of leasehold improvements, that we estimated would not generate future cash flows sufficient to cover their carrying amounts. We did not record an excess facilities charge and related asset impairment for Q3 fiscal 2001 or for the first nine months of fiscal 2001.

Amortization of Deferred Stock Compensation. Deferred stock compensation represents the difference between the estimated fair value of our common stock for accounting purposes and the option exercise price of such options at the grant date. Deferred stock compensation for stock options granted to employees and others is amortized on a straight-line basis over the vesting period of such options. Amortization of deferred stock compensation expense for the periods reported was as follows (in thousands):

	Three months ended February 28,	Nine months ended February 28,

	2001	2002 (As restated)	2001	2002 (As restated)
Amortization of deferred stock compensation	$ 464	$ 205	$ 1,439	$ 1,269

The decreases for Q3 fiscal 2002 and for the first nine months of fiscal 2002 were attributable to employee terminations, and to a lesser extent, to options that have fully vested. Additionally, in Q3 fiscal 2002 we reversed $207,000 in stock-based compensation expense recorded in the second quarter of fiscal 2002 because of a decline in our stock price.

Acquired In-Process Research and Development. Acquired in-process research and development expense consists of the value of research projects and products that were in process on the date of certain acquisitions that, in the opinion of management, had not reached technological feasibility and had no alternative future use. For the first nine months of fiscal 2001, acquired in-process research and development expense related to our acquisition of MoreCom was $22.4 million. We did not record acquired in-process research and development expense for Q3 fiscal 2002, Q3 fiscal 2001, or for the first nine months of fiscal 2002.

Interest Income

Interest income consists of interest earned on our cash and cash equivalents and short-term and long-term investments, and is netted against interest expense related to capital leases. Interest income for the periods reported was as follows (in thousands):

	Three months ended February 28,		Nine months ended February 28,	
	2001	2002 (As restated)	2001	2002 (As restated)
Interest income	$ 7,898	$ 3,453	$ 23,846	$ 13,020

These decreases were primarily due to lower cash balances, declining market interest rates, and the maturation of some of our longer-term investments previously invested at higher yields.

Other Income (Expense), Net

Net other expense consists of losses on disposals of fixed assets, foreign currency exchange gains and losses, and other non-operating income and expenses. Other income (expense), net for the periods reported was as follows (in thousands):

	Three months ended February 28,		Nine months ended February 28,	
	2001	2002	2001	2002
		(As restated)		(As restated)
Other income (expense), net	$ 454	$ (768)	$ (115)	$ (1,560)

For Q3 fiscal 2002 and the first nine months of fiscal 2002, the other expense was recorded for losses on disposals of fixed assets, which included a reserve for fixed assets that were lost or otherwise not accounted for, and foreign currency exchange fluctuations.

Income Tax Provision

Income tax provision consists of foreign withholding tax expense and foreign and state income taxes. Income tax provision for the periods reported was as follows (in thousands):

	Three months ended February 28,		Nine months ended February 28,	
	2001	2002	2001	2002
		(As restated)		(As restated)
Income tax provision	$	$ 303	$ 204	$ 708

These increases consisted primarily of foreign withholding and income taxes.

Liquidity and Capital Resources

As of February 28, 2002, cash, cash equivalents, short-term investments, and long-term investments were $412.3 million. Our principal source of liquidity was cash and cash equivalents of $157.4 million.

For the first nine months of fiscal 2001, net cash used in operating activities was $47.1 million. This amount was primarily comprised of a net loss of $227.0 million (which included $206.5 million of non-cash adjustments to reconcile net cash to net cash used in operations), $11.5 million of deferred revenues, $8.8 million of accounts receivable, $5.2 million of accrued liabilities, and $2.3 million of prepaid expenses and other current assets.

For the first nine months of fiscal 2002, net cash used in operating activities was $40.0 million. This amount was primarily comprised of a net loss of $260.5 million (which included $234.1 million of non-cash adjustments to reconcile net cash to net cash used in operations), $23.5 million of deferred revenues, and $2.7 million of accounts receivable. These amounts were offset by $4.2 million of other long-term liabilities, $4.1 million of accrued liabilities, and $2.0 million of prepaid expenses and other current assets.

For the first nine months of fiscal 2001, net cash used in investing activities of $42.7 million included $345.2 million used to purchase investments, $7.4 million used to purchase property and equipment, and $7.0 million used to issue a note receivable, offset by $318.4 million of proceeds received from the maturities of investments.

For the first nine months of fiscal 2002, net cash provided by investing activities of $64.1 million included $350.3 million of proceeds received from the maturities of investments, offset by $281.2 million used to purchase investments, $3.6 million used to purchase property and equipment, and $1.1 million used to purchase equity investments.

For the first nine months of fiscal 2001, net cash provided by financing activities of $105.2 million included $100.0 million of proceeds from our private placement in July 2000. Additionally, we received $5.7 million from issuances of common stock to employees, directors, and external consultants through our stock option plan, and to employees in connection with purchases through our employee stock purchase plan. These amounts were offset by payments made for capital lease obligations.

For the first nine months of fiscal 2002, net cash provided by financing activities of $6.1 million included $6.7 million of proceeds from the issuance of common stock to employees, directors, and external consultants through our stock option plan, and to employees in connection with purchases through our employee stock purchase plan. This amount was offset by payments made for capital lease obligations.

As of February 28, 2002, our outstanding short- and long-term obligations were $8.2 million, and consisted primarily of an excess facilities charge, deferred rent expense and capital lease commitments. We did not have any material commitments for capital expenditures.

A summary of our contractual obligations, some of which are discussed in more detail below, is as follows (in thousands):

		Payments due by period			
	Total	Less than one year	1-3 years	4-5 years	After 5 years
Operating leases	$ 56,376	$ 6,920	$ 13,794	$ 13,853	$ 21,809
Venture fund obligations(1)	2,026	2,026			
Unconditional purchase obligations(2)	2,825	2,825			
Other short-term obligations(3)	3,160	3,160			
Capital lease obligations	490	471	19		
Other long-term obligations					
Total contractual obligations	$ 64,877	$ 15,402	$ 13,813	$ 13,853	$ 21,809

(1) The venture fund commitments are primarily comprised of our obligations to TWTV and China Broadband (H.K.) discussed below.

(2) The unconditional purchase obligations are primarily comprised of commitments due to Motorola and MediaOne discussed below.

(3) The other short-term obligations are comprised of amounts due as a result of our restructuring as well as payments due under employment agreements.

In January 2001, we extended loans in exchange for promissory notes from Coleman Sisson, our President and Chief Operating Officer, and David Limp, our Executive Vice President and Chief Strategy Officer. In April 2001, we extended a loan in exchange for a promissory note from Donald Fitzpatrick, our Executive Vice President, Sales and Service. Each loan is for $500,000, carries an interest rate of

5.9% compounded annually, and is due and payable two years from issuance. As of February 28, 2002, we recorded $96,000 of interest receivable related to these promissory notes. In January 2001, we also entered into employee retention agreements with Mr. Sisson, Mr. Fitzpatrick, and Mr. Limp. Each retention agreement provides approximately $818,000 to the employee over the following two years of continued service. As of February 28, 2002, $183,000 had been paid to each of these executives under these agreements.

Under a development agreement entered into with Motorola in April 1999 and amended in August 2001, we are committed to pay $8.9 million over three years in development fees for certain services to be performed by Motorola. These fees are being paid out over a three-year period. During the first nine months of fiscal 2001 and 2002, we paid $1.9 million and $2.5 million to Motorola, respectively. In March 2002, the final payment of $1.7 million was paid under this agreement.

Through the Liberate Corporate Venture Fund, we have invested $16.3 million in our portfolio of companies. As of February 28, 2002, our net equity investments were valued at $11.0 million and included a write-down of $5.3 million of equity investments that we determined had been permanently impaired in Q4 fiscal 2001.

In June 2001, through the Liberate Corporate Venture Fund, we committed to invest $2.0 million in China Broadband (H.K.) for reinvestment in China New Broadband Video and Communication, a Chinese joint venture that makes interactive television software. We made the first investment of $750,000 during the first nine months of fiscal 2002.

In January 2002, through the Liberate Corporate Venture Fund, we and other existing shareholders and management of Two Way TV ("TWTV") entered into a credit facility agreement to loan TWTV up to £4 million, of which we committed to loan up to £753,723 (approximately $1.1 million at the time of the commitment). See Note 6 of Notes to Condensed Consolidated Financial Statements. In February 2002, TWTV drew down £226,116 (approximately $324,000) from us under this loan facility and issued warrants to us to purchase 113,058,000 shares of TWTV common stock. These warrants were immediately exercised. The exercise price of £113,058 (approximately $160,000) was deducted from the outstanding owed by TWTV under the loan facility. We recorded the value of the shares of TWTV common stock and the remaining loan receivable as an addition to equity investments.

In March 2002, TWTV completed the second draw-down from us of £207,273 (approximately $296,000) and issued warrants to Liberate to purchase an additional 103,636,500 shares of TWTV common stock. See Note 9 of Notes to Condensed Consolidated Financial Statements. These warrants were immediately exercised and the exercise price of £103,637 (approximately $148,000) was deducted from the outstanding debt owed by TWTV under the loan facility. We recorded the value of the shares of TWTV common stock and the remaining loan receivable as an addition to equity investments.

In April 2002, TWTV initiated the third draw-down from us of £160,166 (approximately $230,000) and will issue warrants to Liberate to purchase an additional 80,083,000 shares of TWTV common stock.

In March 2002, we agreed to repurchase from MediaOne of Colorado and MediaOne of Michigan (each, a wholly owned subsidiary of AT&T Broadband and collectively, "MediaOne") certain unvested warrants that we had previously issued to MediaOne. See Note 9 of Notes to Condensed Consolidated

Financial Statements. If MediaOne closes the transaction, we will pay $1.1 million for these 400,000 warrants.

Related Party Transactions

As described above in "Results of Operations-Revenues," during Q3 fiscal 2002, we renegotiated certain contract terms with several of our large North American network operators, including Cox Communications ("Cox"), in order to encourage more timely deployments and predictable revenue streams. An executive officer of Cox, Christopher J. Bowick holds a rotating seat on Liberate's Board of Directors. The rotating seat is filled by a representative of one of several network operators with whom we have entered into a Voting Agreement dated May 12, 1999, as amended.

As described in the proxy statement for our annual meeting held October 30, 2001, in the section titled "Certain Relationships and Related Transactions," we have certain agreements with Oracle (our former parent) and its affiliates.

Risk Factors

Any of the following risks could seriously harm our business, financial condition, and results of operations, causing the trading price of our common stock to decline.

Demand for information-oriented consumer devices and interactive television may not develop as we anticipate.

Because the market for interactive television and information-oriented consumer devices (such as set-top boxes) is newly emerging, the potential size of the market opportunity and the timing of its development are uncertain. As a result, our profit potential is unknown.

Sales of our technology and services depend upon the commercialization and broad acceptance by consumers and businesses of interactive television and information-oriented devices, primarily cable and satellite set-top boxes as well as networks of game consoles, smart phones, and personal digital assistants. This will depend in turn on many factors, including the development of content and applications of interest to significant numbers of consumers, and the emergence of industry standards that facilitate the distribution of such content.

If the market for interactive television consumer devices, and set-top boxes in particular, does not develop or develops more slowly or in a different direction than we anticipate, our revenues will not grow as quickly as expected, if at all. For example, a consumer device manufacturer or its customers could choose to use only applications and content developed to operate directly with a particular consumer device, thereby eliminating the need for our software platform. A number of industry analysts have predicted that North American cable operators will focus on rolling out to their subscribers various forms of video-on-demand services, which could operate directly with a set-top box. Moreover, although we have focused on developing software that operates with set-top boxes, consumers may in the future receive interactive television through multi-purpose home entertainment devices or advanced game consoles, using software platforms other than ours.

Deployment and availability of interactive television and consumer device networks may be limited by high costs or limited availability of system components.

Interactive television networks and other consumer-device networks are complex systems, requiring the successful interaction of many elements in order to be technologically and financially attractive to deploy. Many network operators seek to deploy a complete interactive television system, including features such as video-on-demand and guide services, rich content, and robust infrastructure support. Several vendors are typically involved in providing the content and applications that comprise a complete interactive television system. For us to be successful, our products must operate with the other elements of a complete system. For example, we will need to attract third-party developers to create content and applications for our platform and we may not be successful in doing so.

In different regions of the world, certain elements of interactive television systems may be controlled by a single company or a few large companies. For example, in the United States one of the largest potential markets for interactive television the manufacture of set-top boxes and ownership of cable networks are relatively concentrated. Development of the interactive television market may be slowed if these companies delay or do not participate in the deployment of interactive television, charge excessive fees, or use proprietary technologies rather than industry standards that permit interconnection and a uniform environment for developing applications and content.

Moreover, some companies have obtained patent protection on technology relating to important parts of a complete interactive television system. If patent licenses were required to assemble a complete interactive television system and could not be obtained on reasonable terms, the development

of the interactive television industry could be slowed and revenues available to other participants in the market could be reduced.

Our success depends on a limited number of network operators introducing and promoting products and services incorporating our technology.

Our success depends on large network operators introducing and promoting products and services based on our technology. There are, however, only a limited number of large network operators worldwide. Mergers or other business combinations among these network operators would reduce this number, possibly disrupting our business relationships, and adversely affecting demand for our products and services. Some of our largest European customers may consider restructuring as they face pressure to reduce their debt, while their share prices are at historically low levels.

Currently, only a subset of these network operators are deploying products and services incorporating our technology and services for consumer devices. In addition, none of our network operator customers is contractually obligated to introduce or promote products and services incorporating our technology, nor to achieve any specific introduction schedule. Accordingly, even if a network operator initiates a customer trial of products incorporating our technology, that operator is under no obligation to continue its relationship with us or to launch a full-scale deployment of these products. Further, our agreements with network operators are generally not exclusive, so network operators with whom we have agreements may enter into similar license agreements with one or more of our competitors.

Because the large-scale deployment of products and services incorporating our technology is complex, time-consuming, and expensive, network operators are cautious about proceeding with such deployments. While we believe that products and services based on our technology will have significant value to network operators (in the form of opportunities to generate additional revenues per subscriber from interactive applications, such as video-on-demand, and the loss of fewer subscribers to competing services), there is only limited data available to demonstrate to network operators that they will receive attractive returns on their investments. Moreover, the customization process for new customers requires a lengthy and significant commitment of resources by our customers and us. The commitment of resources required by our customers may slow deployment, which could, in turn, delay market acceptance of these products and services. Also, many of our customers rely on debt-based financing and subscriber revenues to fund their deployments, so economic conditions that reduce either of these sources of financing may slow or stop deployment, or make it more difficult to collect receivables. Some of our largest European customers face pressure to reduce their debt, while their share prices are at historically low levels. Unless network operators introduce and promote products and services incorporating our technology in a successful and timely manner, our software platform will not achieve widespread acceptance, consumer device manufacturers will not use our software in their products, and our revenues will not grow as quickly as expected, if at all.

Our success depends on consumer device manufacturers introducing and promoting products that incorporate or operate with our technology.

We do not typically manufacture hardware components that incorporate our technology. Rather, we license software technology to consumer device manufacturers and work with them to ensure that our products operate together. Accordingly, our success will depend, in part, upon our ability to convince a number of consumer device manufacturers to manufacture products that incorporate or operate with our technology and upon the successful introduction and commercial acceptance of these products.

While we have entered into a number of agreements with consumer device manufacturers, none of these manufacturers is contractually obligated to introduce or promote consumer devices incorporating

our technology, nor are any of them contractually required to achieve any specific production schedule. Moreover, our agreements with consumer device manufacturers are generally not exclusive, so consumer device manufacturers with whom we have agreements may enter into similar license agreements with one or more of our competitors. Our failure to convince consumer device manufacturers to incorporate our software platform into their products or modify their products to operate with our software, or the failure of these products to achieve broad acceptance with retailers and consumers, will result in our revenues not growing as quickly as expected, if at all.

A continued downturn in macroeconomic conditions could reduce sales of our products and services or result in collection difficulties.

Economic growth in the United States and internationally has slowed significantly in the past several quarters and the prospects for near-term economic growth worldwide are uncertain. The economic slowdown and uncertainty may harm our business by reducing our customers' spending and the rate at which they accept our technology and services or by making it more difficult for us to collect our receivables. Additionally, some of our European customers are facing large debt burdens and cash constraints, while their share prices are at historically lower levels. In the future, we may experience substantial fluctuations from period to period as a consequence of general economic conditions affecting the timing of orders from major customers and other factors affecting the capital spending or financial condition of our customers. There can be no assurance that these factors will not harm our business, financial condition, or operating results.

Our limited operating history makes evaluation of our business difficult.

We were incorporated in April 1996 and began shipping our initial products to customers in the last quarter of fiscal 1997. Our limited operating history makes evaluation of our business and prospects difficult. In addition, any evaluation of our business and prospects must be made in light of the risks and unexpected expenses and difficulties frequently encountered by companies in an early stage of development in a new market. For us, these risks include:

- Uncertainty of broad acceptance by retailers and consumers of network services such as interactive television and of information-oriented consumer devices, primarily cable and satellite set-top boxes, as well as game consoles, smart phones, and personal digital assistants;

- The limited number of large network operators, such as providers of television services, who have deployed products and services incorporating our technology;

- The limited number of consumer device manufacturers, such as set-top box manufacturers, who have incorporated our technology into their products;

- Delays in deployment of high-speed networks and of interactive and enhanced services and applications by our network operator customers; and

Our unproven long-term business model, which depends on generating the majority of our revenues from license and royalty fees paid by network operators and consumer device manufacturers.

Many of these risks are described in more detail elsewhere in this "Risk Factors" section. Our business could be seriously harmed by adverse developments in any of these areas.

We disclose pro forma financial information.

We prepare and release quarterly unaudited financial statements prepared in accordance with generally accepted accounting principles ("GAAP"). We also disclose and discuss certain pro forma financial information in the related earnings release and investor conference call. This pro forma

financial information excludes special charges, including warrant-related amortization expense that is offset to revenues in accordance with EITF 01-09; the amortization of purchased intangibles, warrants, and deferred stock compensation; warrant-related asset impairment expense; restructuring costs; and an excess facilities and asset impairment charge. We believe the disclosure of the pro forma financial information helps investors more meaningfully evaluate the results of our ongoing operations. However, we urge investors to carefully review the GAAP financial information included as part of our Quarterly Reports on Form 10-Q, our Annual Reports on Form 10-K, and our quarterly earnings releases, compare GAAP financial information with the pro forma financial results disclosed in our quarterly earnings releases and investor calls, and read the associated reconciliation.

If we do not meet our announced pro forma revenue or profitability goals, our stock price could decline.

Each quarter, we announce our target range of pro forma revenue for the next quarter. We have also announced that we expect to achieve profitability on a pro forma basis in the first half of fiscal 2003. Our pro forma results exclude special charges that include items such as the effects of certain warrant-related amortization expense that is offset to revenues in accordance with EITF 01-09; amortization expense for purchased intangibles, warrants, and deferred stock compensation; warrant-related asset impairment expense; restructuring costs; and an excess facilities and asset impairment charge. If we do not achieve our pro forma revenue target in a quarter or do not achieve pro forma profitability on the timeline we have announced, our stock price could decline. See "Risk Factors The reduction in our revenues from our adoption of EITF 01-09 could result in a decline of our stock price" and Note 1 of Notes to Condensed Consolidated Financial Statements.

Although historically our revenues have increased every fiscal year, we may not be able to sustain our historical revenue growth rates. Our ability to achieve our pro forma revenue and profitability goals will depend in large part upon increased license and royalty revenues from deployments in North America, which are largely beyond our control. Pro forma profitability will also depend upon our ability to increase our higher-margin license and royalty revenues as a percentage of total revenues and to improve our services margins. From the beginning of fiscal 1997 until the present, our customers have primarily been in the design and implementation phases with our products, and we have derived over half of our revenues from services and not from license and royalty fees. Some of our current and historical revenues consist of one-time revenues derived from the termination of certain customers' unused rights to use prepayments for products and services. In the future, we will need to substantially increase our sources of sustainable revenue to maintain our historical rates of pro forma revenue growth and to meet our pro forma revenues and profitability goals. See "Risk Factors Our success depends on a limited number of network operators introducing and promoting products and services incorporating our technology," "Risk Factors Our success depends on consumer device manufacturers introducing and promoting products that incorporate or operate with our technology," and "Risk Factors A continued downturn in macroeconomic conditions could reduce sales of our products and services or result in collection difficulties."

To meet our pro forma profitability goal, we will have to increase revenues while keeping expenses flat or slightly higher than current levels. Since our inception, we have not had a profitable quarter, on a pro forma basis or otherwise, and may never achieve or sustain profitability. For the first nine months of fiscal 2001 and 2002, we incurred a net loss of $227.0 million and $260.5 million, respectively. We could continue to incur significant losses and negative cash flows in the near future, which would adversely affect our stock price, business, and financial condition.

Our quarterly revenues and operating results could be volatile and difficult to forecast, and if our quarterly operating results are below the expectations of analysts, the market price of our common stock may decline.

Our quarterly operating results are likely to vary from quarter to quarter. In the short term, we expect our quarterly revenues to depend significantly on a small number of relatively large orders for our products and services. As a result, our quarterly operating results may fluctuate if we are unable to complete one or more substantial sales on the schedule we anticipated. In some cases, we recognize revenues from services on a percentage-of-completion basis. Our ability to recognize these revenues may be delayed if we are unable to meet service milestones on a timely basis. In the longer term, we expect to recognize an increasing percentage of revenues based on our receipt of royalty reports. Delays in network operators' deployment schedules or our receipt of royalty reports could adversely affect our revenues for any given quarter. Because our expenses are relatively fixed in the near term, any shortfall from anticipated revenues could result in greater short-term losses.

We have found it difficult to forecast the timing and amount of specific sales because our sales process is complex and our sales cycle is long. The purchase of our products and services involves a significant commitment of capital and other resources by a customer. In many cases, our customers' decision to use our products and services requires them to change their established business practices and conduct their business in new ways. As a result, we may need to educate our potential customers on the use and benefits of our products and services. In addition, our customers generally must consider a wide range of other issues before committing to purchase and incorporate our technology into their offerings. As a result of these and other factors, including the approval at a number of levels of management within a customer's organization, our sales cycle averages from six to twelve months and may sometimes be significantly longer.

We base our quarterly revenue projections, in part, upon our expectation that specific sales will occur in a particular quarter. In the past, our sales have occurred in quarters other than those anticipated by us. If our expectations, and thus our revenue projections, are not accurate for a particular quarter, our actual operating results for that quarter could fall below the expectations of financial analysts and investors, resulting in a potential decline in our stock price.

Although we have limited historical financial data, in the past we have experienced seasonal decreases in our rate of revenue growth in our quarter ending August 31. These seasonal trends may continue to affect our quarter-to-quarter revenues.

We have relied and expect to continue to rely on a limited number of customers for a significant portion of our revenues.

We currently derive, and expect to continue to derive, a significant portion of our revenues from a limited number of customers. For the first nine months of fiscal 2001, Telewest, NTL, and AOL each accounted for more than 10% of total revenues, for a total of 77% of total revenues. For the first nine months of fiscal 2002, Telewest and NTL each accounted for more than 10% of total revenues, for a total of 37% of total revenues.

We expect that we will continue to depend upon a limited number of customers for a significant portion of our revenues in future periods, although the specific customers may vary from period to period. As a result, if we fail to successfully sell our products and services to one or more customers in any particular period, or a large customer purchases fewer of our products or services, defers or cancels orders, fails to meet its payment obligations, or terminates its relationship with us, our revenues could decline significantly.

Several of our largest customers have significant debt burdens and may need to recapitalize or restructure their operations in the near future. While these customers continue to deploy our products

and use our services, and pay us on a regular basis, there can be no assurance that corporate changes will not create risk to future business or payments.

We may not be successful in making strategic investments.

In fiscal 2001, we established the Liberate Corporate Venture Fund to make strategic investments in other companies. In most instances, we make investments in return for equity securities of private companies, for which there is no public market. These companies may be expected to incur substantial losses and may never become profitable, publicly traded companies. If no active trading market develops for these securities, or these securities are not attractive to other investors, we may never realize any return on these investments. During fiscal 2001, we wrote down these investments by $5.3 million, as their fair market value had been permanently impaired. If these companies are not successful, we could incur additional future charges related to write-downs or write-offs of these types of assets. Losses or charges resulting from these and other investments could harm our basic net loss.

Failure to manage our growth could harm our ability to reach profitability, deliver products in a timely manner, fulfill existing customer commitments, and attract and retain new customers.

Our rapid growth has placed, and is expected to continue to place, a significant strain on our managerial, operational, and financial resources, especially as more network operators and consumer device manufacturers incorporate our software into their products and services. This potential for rapid growth is particularly significant in light of the large customer bases of network operators and consumer device manufacturers and the frequent need to tailor our products and services to our customers' unique needs. To the extent we add several customers simultaneously or add customers whose product needs require extensive customization, we may need to significantly expand our operations. Moreover, we may expand our domestic and international operations by, among other things, expanding the number of employees in consulting and engineering services, and sales and marketing.

Our future success will depend, in part, upon the ability of our senior management to manage growth efficiently and effectively. This will require us to implement additional management information systems; to further develop our operating, administrative, financial, and accounting systems and controls; to hire additional personnel; to develop additional levels of management; to locate additional office space internationally; and to maintain close coordination among our research and development, sales and marketing, services and support, and administrative organizations. Failure to meet any of these requirements in a cost-effective manner could harm our ability to reach profitability, deliver products in a timely manner, fulfill existing customer commitments, and attract and retain new customers.

The loss of any of our key personnel would harm our competitiveness.

We believe that our success will depend on the continued employment of our senior management team and key technical personnel. If members of our senior management team or key technical personnel are unable or unwilling to continue in their present positions, they could be difficult to replace, which could harm our ability to manage day-to-day operations, develop and deliver new technologies, attract and retain customers, attract and retain other employees, and generate revenues.

International revenues account for a significant portion of our revenues; accordingly, if we are unable to expand or hedge our international operations in a timely manner, our financial results will be harmed.

International revenues consist of sales to customers outside of the United States and are assigned to specific countries based on the origin of the sales contract. International and domestic revenues as a percentage of total revenues for the periods reported were as follows:

	Three months ended February 28,		Nine months ended February 28,	
	2001	2002 (As restated)	2001	2002 (As restated)
International revenues	76%	67%	65%	66%
Domestic revenues	24%	33%	35%	34%

	Three months ended February 28,		Nine months ended February 28,	
Total revenues	100%	100%	100%	100%

European revenues are primarily comprised of U.K.-based revenues and North American revenues are primarily comprised of U.S.-based revenues, as follows (in thousands):

	Three months ended February 28,		Nine months ended February 28,	
	2001	2002	2001	2002
		(As restated)		(As restated)
U.K.-based revenues	$ 7,368	$ 7,710	$ 15,991	$ 21,994
U.S.-based revenues	$ 3,297	$ 7,332	$ 8,575	$ 19,491

We expect to derive a significant portion of our revenues for the foreseeable future from sources outside the United States, especially as we increase our international sales and marketing activities. Accordingly, our success will depend, in part, upon international economic, political, legal, and regulatory conditions and our ability to manage international sales and marketing operations. To successfully expand international sales, we must establish additional foreign operations, hire additional personnel, and increase our foreign direct and indirect sales forces. This expansion will require significant management attention and resources, which could divert attention from other aspects of our business. Failing to expand our international operations in a timely manner would limit the growth of our international revenues. See Note 3 of Notes to Condensed Consolidated Financial Statements.

To date, the majority of our revenues and costs have been denominated in U.S. dollars and so the effect of changes in foreign currency exchange rates on revenues and operating expenses has not been material. However, expanded international operations are likely to result in increased foreign currency receivables and payables. Although we may from time to time undertake foreign exchange hedging transactions to cover a portion of our foreign currency transaction exposure, we do not currently do so. Accordingly, any fluctuation in the value of foreign currency could seriously harm our international revenues and results of operations.

Competition from bigger, better capitalized competitors could result in price reductions, reduced gross margins, and loss of market share.

We face intense competition in licensing software for networks and consumer devices. Our principal competitors in the client software market include Microsoft, OpenTV, Canal + Technologies, and PowerTV (a wholly-owned subsidiary of Scientific Atlanta). Our primary competitor in the server market is Microsoft. Additionally, certain interactive television applications developers, such as Gemstar-TV Guide, NDS Group (a non-wholly owned subsidiary of News Corporation), and Wink Communications, may expand into the interactive television platform market where we compete. We expect additional competition from other established and emerging companies in the television, computing, software, and telecommunications sectors and from stronger competitors created by the current consolidation in our industry. Increased competition could result in price reductions, fewer customer orders, reduced gross margins, longer sales cycles, reduced revenues, and loss of market share.

Several of our existing and potential competitors have one or more of the following advantages: longer operating histories, larger customer bases, greater name recognition, more patents relating to important technologies, and significantly greater financial, technical, sales and marketing, and other resources. This may place us at a disadvantage in responding to their pricing strategies, technological advances, advertising campaigns, strategic partnerships, and other initiatives. Our competitors may be able to respond more quickly to new or emerging technologies and changes in customer or governmental requirements, or to devote greater resources to the development, marketing, promotion, and sale of their technologies than we can. In addition, many of our competitors have well-established relationships with our current and potential customers. Some of our competitors, particularly Microsoft, have made and may continue to make large strategic investments in our current and potential customers. Such investments may allow our competitors to strengthen existing relationships or quickly establish new relationships with our current or potential customers.

Our products may contain errors or be unable to support and manage a potentially unlimited number of users.

Software development is an inherently complex and subjective process, which frequently results in products that contain errors as well as defective or non-competitive features or functions. Moreover, our technology is integrated into the products and services of our network operator customers. Accordingly, a defect, error, or performance problem with our technology could cause our customers' cable and satellite television or other telecommunications systems to fail for a period of time. Any such failure could cause severe customer service and public relations problems for our customers and could result in delayed or lost revenue due to adverse customer reaction, negative publicity, and damage claims.

Despite frequent testing of our software's scalability in a laboratory environment and in customer deployments, the ability of our software platform to support and manage a potentially unlimited number of users is uncertain. If our software platform does not efficiently scale while maintaining a high level of performance, demand for our products and services and our ability to sell additional products to our existing customers will be significantly reduced.

Our success depends on our ability to keep pace with the latest changes in technology and industry and governmental standards, and any delays or failure in developing and introducing new software products in a cost-effective way could result in a loss of market share, render our technology obsolete, or make it difficult for us to reach our pro forma profitability goal.

The market for consumer device and network operations software is characterized by evolving industry and governmental standards, rapid technological change, and frequent new product

introductions and enhancements. Accordingly, our success will depend in large part upon our ability to adhere to and adapt our products to evolving communications protocols and standards. Therefore, we will need to develop and introduce new products that meet changing customer requirements and emerging industry and governmental standards on a timely and cost-effective basis. We have encountered, in the past, and may encounter in the future, delays in completing the development and introduction of new software products. The different products that we have developed for different markets may be costly for us to maintain and improve if we permit the product lines to branch farther apart from each other. Any delays or failure in developing or introducing new products that meet consumer requirements, technological requirements, or industry or governmental standards could result in a loss of customers and render our products and services obsolete or non-competitive. If we fail to develop new products in a cost-effective way, our expenses may be higher than we have forecasted and we may be unable to reach or pro forma profitability goal.

As we exhaust sales opportunities in our existing markets, we may be unable to identify and take advantage of new business opportunities.

Our unproven, long-term business model depends on generating the majority of our revenues from license and royalty fees paid by network operators and consumer device manufacturers. If we are unable to identify and take advantage of new business opportunities, we may not be able to maintain our historical rates of revenue growth.

We hope to increase our potential revenues by expanding our sales efforts to reach customers we have not traditionally targeted. So far, we have primarily targeted sales to large network operators and manufacturers of set-top boxes. However, worldwide, there are only a limited number of large network operators and, in the United States, only a few manufacturers of set-top boxes. In the future, we hope to expand our sales efforts to reach a wider variety of customers, including producers, vendors, and aggregators of content; service providers; and manufacturers of other types of consumer devices, such as game consoles, smart phones, and personal digital assistants. We may not succeed in customizing our software to meet the unique needs of those devices. We do not have experience making these kinds of sales and may not be successful. We may choose to expand our indirect distribution to reach these new customers, but may be unable to attract indirect channel partners able to effectively market and sell our products and services. Gaining direct sales experience and expanding our indirect distribution would require significant company resources and management attention, which could harm our business if our efforts do not generate significant revenues.

We also hope to increase our potential revenues by creating more extensions to our software platform. However, we may not be successful in developing or selling those extensions, and may incur significant development costs not offset by new revenues. See also "Risk Factors Our success depends on our ability to keep pace with the latest changes in technology and industry and governmental standards, and any delays or failure in developing and introducing new software products in a cost-effective way could result in a loss of market share, render our technology obsolete, or make it difficult for us to reach our pro forma profitability goal."

We have been named in securities class-action litigation and may be named in additional litigation.

Beginning May 16, 2001, a number of class-action lawsuits seeking monetary damages were filed in the Southern District of New York against several of the firms that underwrote Liberate's initial public offering, naming Liberate and certain of its officers and directors as co-defendants. The plaintiffs subsequently added allegations regarding our secondary offering, and named additional officers and directors as co-defendants. The plaintiffs allege that the underwriters received excessive and improper commissions that were not disclosed in our prospectuses. These cases have now been consolidated with several hundred other cases against underwriters and other issuers. We have retained Wilson Sonsini Goodrich & Rosati as our lead counsel, and have tendered notice to our insurance carriers and underwriters pursuant to the terms of the insurance policies and underwriting agreements. We will be seeking to have the claims against the individual defendants dismissed, and, while litigation is by its nature uncertain, we do not believe that we face any material exposure arising from these cases.

More generally, securities class-action litigation has often been brought against a company following periods of volatility in the market price of its securities. This risk is especially acute for us because technology companies have experienced greater-than-average stock price volatility in recent years and, as a result, have been subject to, on average, a greater number of securities class action claims than companies in other industries. Due to the volatility of our stock price, we may in the future be the target of this kind of litigation. Securities litigation could result in substantial costs and divert management's attention and resources.

We may have to cease or delay product shipments if we are unable to obtain key technology from third parties.

We rely on technology licensed from third parties, including applications that are integrated with internally developed software and used in our products. Most notably, we license certain technologies from BitStream, Macromedia, RealNetworks, RSA, and Sun Microsystems. These third-party technology licenses may not continue to be available to us on commercially reasonable terms, or at all, and we may not be able to obtain licenses for other existing or future technologies that we desire to integrate into our products. If we cannot maintain existing third-party technology licenses or enter into licenses for other existing or future technologies needed for our products, we may be required to cease or delay product shipments while we seek to develop or license alternative technologies.

We have been sued for patent infringement by one of our competitors and may be subject to other third-party intellectual property infringement claims that could be costly and time-consuming to defend. We do not have insurance to protect against these claims.

On February 7, 2002, OpenTV filed a lawsuit against Liberate in the United States District Court for Northern California, alleging that Liberate is infringing two of OpenTV's patents and seeking monetary damages and injunctive relief. Liberate has retained Dergosits & Noah as its legal counsel, and on March 21, 2002 filed an answer denying OpenTV's allegations and instituting counter-claims that OpenTV infringes four of Liberate's patents for interactive networking software. Liberate will seek to have OpenTV's patents invalidated, request a finding that Liberate's technology does not infringe OpenTV's patents, and seek monetary damages and injunctive relief against OpenTV.

We expect that, like other software product developers, we will increasingly be subject to infringement claims as the number of products and competitors developing consumer device software grows, software patents become more common, and the functionality of products in different industry segments overlaps. From time to time, we hire or retain employees or external consultants who have worked for independent software vendors or other companies developing products similar to ours. These prior employers may claim that our products are based on their products and that we have misappropriated their intellectual property.

Several other companies involved in the interactive television market have large patent portfolios that they have aggressively sought to enforce. While we do not believe we currently infringe such patents, and believe that we have valuable patents that we are seeking to enforce in the context of litigation, claims of infringement are always possible, and success in litigation or other successful resolution of claims is by no means assured.

We currently do not have liability insurance to protect against the risk that our own technology or licensed third-party technology infringes the intellectual property of others. Claims relating to our intellectual property, regardless of their merit, may seriously harm our ability to develop and market our products and manage our day-to-day operations because they are time-consuming and costly to

defend, and may divert management's attention and resources, cause product shipment delays, require us to redesign our products, or require us to enter into royalty or licensing agreements.

Our limited ability to protect our intellectual property and proprietary rights may harm our competitiveness.

Our ability to compete and continue to provide technological innovation depends substantially upon internally developed technology. We rely primarily on a combination of patents, trademark laws, copyright laws, trade secrets, confidentiality procedures, and contractual provisions to protect our proprietary technology. While we have a number of patent applications pending, patents may not issue from these or any future applications. In addition, our existing and future patents may not survive a legal challenge to their validity or provide significant protection for us.

The steps we have taken to protect our proprietary rights may not be adequate to prevent misappropriation of our proprietary information. Further, we may not be able to detect unauthorized use of, or take appropriate steps to enforce, our intellectual property rights. Our competitors may also independently develop similar technology. In addition, the laws of many countries do not protect our proprietary rights to as great an extent as do the laws of the United States. Any failure by us to meaningfully protect our intellectual property could result in competitors offering products that incorporate our most technologically advanced features, which could seriously reduce demand for our products and services.

Oracle holds a substantial portion of our stock and could cause our stock price to decline with large sales of our stock.

As of February 28, 2002, Oracle beneficially owned 33,399,843 shares, or 31% of our outstanding common stock, based on 106,740,849 shares outstanding. These shares are held by two co-trustees for the benefit of Delphi Asset Management, a wholly owned subsidiary of Oracle, subject to the terms of a trust agreement that is intended to be irrevocable and will be effective for as long as any shares of our stock are held by Delphi Asset Management (or by the co-trustees for its benefit). The trust agreement specifies that these shares will be voted in proportion to all other voted shares of Liberate. Under a standstill agreement, Delphi Asset Management has agreed not to acquire any more shares of our common stock; not to sell, transfer, or encumber the shares of our common stock beneficially owned by it, except in certain limited ways; and not to seek to control or influence the management or business of Liberate. If Oracle were to sell large amounts of its holdings, our stock price could decline and we could find it difficult to raise capital through the sale of additional equity securities.

In order to remain competitive in our market, we may need to make acquisitions that could be difficult to integrate, disrupt our business, and dilute stockholder value.

We may acquire other businesses in the future in order to remain competitive or to acquire new technologies. As a result of future acquisitions, we may need to integrate product lines, technologies, personnel, customers, widely dispersed operations, and distinct corporate cultures. These integration efforts may not succeed or may distract our management from operating our existing business. Our failure to successfully manage future acquisitions could seriously harm our operating results. In addition, our stockholders would be diluted if we were to finance acquisitions by incurring convertible debt or issuing equity securities.

The reduction in our revenues from our adoption of EITF 01-09 could result in a decline of our stock price.

Recently issued accounting standards have affected how we account for the warrants we have issued to network operators. Effective December 1, 2001, we adopted EITF 01-09, which generally

require that consideration, including warrants, issued to a customer should be classified in a vendor's financial statements not as an expense, but as an offset to revenues up to the amount of cumulative revenue recognized or to be recognized from that customer. In accordance with the transition guidance in EITF 01-09, adoption required the reclassification of financial statements for prior periods presented for comparative purposes. See Note 1 of Notes to Condensed Consolidated Financial Statements.

While these accounting changes do not affect our basic and diluted net loss per share, the reclassification does reduce our revenue. To the extent that analysts or investors value us on the basis of our revenues, our stock price could decline. See "Risk Factors We may incur net losses or increased net losses if we are required to record a significant accounting expense related to the issuance or impairment of warrants."

We may incur net losses or increased net losses if we are required to record a significant accounting expense related to the issuance or impairment of warrants.

In fiscal 1999, Liberate entered into agreements to issue several network operators warrants to purchase up to 4,599,992 shares of Liberate common stock. Those warrants can be earned and exercised if the network operators satisfy certain milestones within specific time frames. The fair market value of the warrants is estimated using the Black-Scholes pricing model as of the earlier of the grant date or the date that it becomes probable that they will be earned. Pursuant to the requirements of EITF No. 96-18, "Accounting for Equity Instruments That Are Issued to Other Than Employees for Acquiring, or in Conjunction with Selling, Goods or Services," Liberate will revalue the warrants if appropriate. Additionally, the value of the warrants is subject to classification as an offset to revenues up to the amount of cumulative revenue recognized or to be recognized, in accordance with EITF 01-09. See Note 1 and Note 7 of Notes to Condensed Consolidated Financial Statements.

We have in the past accelerated and made other modifications to these warrants to motivate the network operators to deploy our software and we may do so again. If the remaining warrants are earned, accelerated, modified, or impaired, we may be required to record additional significant non-cash expenses or offsets to revenues. As a result, we could incur net losses or increased net losses for a given period and this could seriously harm our operating results and result in a decline of our stock price.

We may incur net losses or increased net losses if we are required to record additional significant accounting charges related to excess facilities that we are unable to sublease.

We have existing commitments to lease office space at our headquarters in San Carlos, California in excess of our needs for the foreseeable future. The commercial real estate market in the San Francisco Bay Area has developed such a large excess inventory of office space that we now believe we will be unable to sublease a substantial portion of our excess office space in the near future. Accordingly, in the first nine months of fiscal 2002, we recorded an excess facilities and asset impairment charge of $7.5 million. Of this charge, $7.0 million represented the remaining lease commitments for vacant facilities, net of expected sublease income, and $503,000 related to the impairment of related assets. If current market conditions for the commercial real estate market remain the same or worsen, we may be required to record additional charges.

New or changed government regulation could significantly reduce demand for our products and services.

We are subject not only to regulations applicable to businesses generally, but also to laws and regulations directly applicable to the Internet, cable and satellite television networks, and other telecommunications content and services. Although there are currently few such laws and regulations, state, federal, and foreign governments may adopt laws and regulations that adversely affect us or our

markets in any of the following areas: user privacy, copyrights, consumer protection, taxation of e-commerce, the online distribution of content, standards for transmission of interactive and enhanced television, and the characteristics and quality of online products and services. In particular, government laws or regulations restricting or burdening the exchange of personally identifiable information could delay the implementation of interactive services or create liability for us or other manufacturers of software that facilitates information exchange. Also, if we have to re-design our products to comply with new or changed government laws or regulations, we could face additional expense and delay in delivering our products to our customers. See "Risk Factors Our success depends on our ability to keep pace with the latest changes in technology and industry and governmental standards, and any delays or failure in developing and introducing new software products in a cost-effective way could result in a loss of market share, render our technology obsolete, or make it difficult for us to reach our pro forma profitability goal."

Moreover, the market for television, and particularly cable and satellite television, is extensively regulated by a large number of national, state, and local government agencies. New or altered laws or regulations regarding interactive television that change its competitive landscape, limit its market, or affect its pricing could seriously harm our business prospects.

We expect our operations to continue to produce negative cash flow in the near term; consequently, if we should need additional capital and could not raise it, we may not be able to fund our continued operations.

Since our inception, cash used in our operations has substantially exceeded cash received from our operations and we expect this trend to continue for the near future. We believe that our existing cash balances will be sufficient to meet our working capital and capital expenditure needs for at least the next twelve months. At some point in the future, we may need to raise additional funds and we cannot be certain that we will be able to obtain additional financing on favorable terms, or at all. If we need additional capital and cannot raise it on acceptable terms, we may not be able to develop our products and services, acquire complementary technologies or businesses, open new offices, hire and retain employees, or respond to competitive pressures or new business requirements.

Provisions of our corporate documents and Delaware law could deter takeovers and prevent stockholders from receiving a premium for their shares.

Certain provisions of our certificate of incorporation and bylaws may discourage, delay, or prevent a change in control of our company that a stockholder may consider favorable. These include provisions that:

- Authorize the issuance of "blank check" preferred stock to increase the number of outstanding shares and thwart a takeover attempt;

- Require super-majority voting to make certain amendments to our certificate of incorporation and bylaws;

- Limit who may call special meetings of stockholders;

- Prohibit stockholder action by written consent, which requires all actions to be taken at a meeting of the stockholders; and

- Establish advance notice requirements for nominations of candidates for election to the Board of Directors or for proposing matters that can be acted upon by stockholders at stockholder meetings.

In addition, Section 203 of the Delaware General Corporation Law and provisions in our stock incentive plans may discourage, delay, or prevent a change in control of our company.

Item 3. Quantitative and Qualitative Disclosures about Market Risk

Interest Rate Risk

As of February 28, 2002, our investment portfolio included $321.8 million of U.S. government obligations, commercial paper, and other corporate securities, all of which may increase or decrease in value if interest rates change prior to maturity. We do not use derivative financial instruments in our investment portfolio. We place our investments only with quality issuers who have earned high credit ratings, and by policy, limit the amount of credit exposure to any one issuer. We are averse to principal loss and seek to preserve our invested funds by limiting the default risk, market risk, and reinvestment risk. We currently maintain sufficient cash and cash equivalent balances so that we can typically hold our investments to maturity. An immediate 10% change in interest rates would be immaterial to our financial condition or results of operations.

Foreign Currency/Exchange Rate Risk

We transact business in various foreign currencies and, accordingly, are subject to adverse movements in foreign currency exchange rates. To date, the effect of changes in foreign currency exchange rates on revenues and operating expenses has not been material, as the majority of our revenues and operating expenses are denominated in U.S. dollars. Operating expenses incurred by our foreign subsidiaries are denominated primarily in local currencies. We do not currently use financial instruments to hedge foreign revenues or operating expenses.

Part II. Other Information

Item 1. Legal Proceedings

Beginning May 16, 2001, a number of class-action lawsuits seeking monetary damages were filed in the Southern District of New York against several of the firms that underwrote Liberate's initial public offering, naming Liberate and certain of its officers and directors as co-defendants. The plaintiffs subsequently added allegations regarding Liberate's secondary offering, and named additional officers and directors as co-defendants. The plaintiffs allege that the underwriters received excessive and improper commissions that were not disclosed in Liberate's prospectuses. These cases have now been consolidated with several hundred other cases against underwriters and other issuers. Liberate has retained Wilson Sonsini Goodrich & Rosati as its lead counsel, and has tendered notice to its insurance carriers and underwriters pursuant to the terms of its insurance policies and underwriting agreements. Liberate will be seeking to have the claims dismissed, and, while litigation is by its nature uncertain, Liberate does not believe that it faces any material exposure arising from these cases.

On February 7, 2002, OpenTV filed a lawsuit against Liberate in the United States District Court for Northern California, alleging that Liberate is infringing two of OpenTV's patents and seeking monetary damages and injunctive relief. Liberate has retained Dergosits & Noah as its legal counsel, and on March 21, 2002 filed an answer denying OpenTV's allegations and instituting counter-claims that OpenTV infringes four of Liberate's patents for interactive networking software. Liberate will seek to have OpenTV's patents invalidated, request a finding that Liberate's technology does not infringe OpenTV's patents, and seek monetary damages and injunctive relief against OpenTV. While litigation is by its nature uncertain, Liberate does not believe that it faces any material exposure arising from this case.

Item 2. Changes in Securities and Use of Proceeds

(d) Use of Proceeds

On July 27, 1999, the Securities and Exchange Commission declared effective our Registration Statement on Form S-1 (File No. 333-78781) for our IPO. In the IPO, we sold an aggregate of 13,402,100 shares of our common stock (including 902,100 shares in connection with the exercise of the underwriters' overallotment), at $8.00 per share (all share numbers and the share price are split-adjusted). The IPO generated gross proceeds of $107.2 million for us. Our net proceeds were $97.8 million, after deducting $9.4 million in underwriters' discounts and other related costs of the IPO.

On February 17, 2000 (following our stock split), we commenced a secondary stock offering pursuant to a Registration Statement on Form S-1 (File No. 333-95139). In the secondary offering, we sold 2,890,000 shares of our common stock at $108.00 per share, for gross proceeds of $312.1 million. Net proceeds from this transaction, after underwriters' discounts and other related costs of $14.9 million, were $297.2 million.

For our IPO, Credit Suisse First Boston and Hambrecht & Quist served as managing underwriters. For our secondary offering, Credit Suisse First Boston served as the managing underwriter. For both offerings, we directly paid the underwriters (none of whom was affiliated with us, our directors, or our officers) for their underwriting expenses.

Our IPO concluded on August 2, 1999 and our secondary offering concluded on February 24, 2000. In each case, all securities registered were sold.

Item 3. Defaults Upon Senior Securities

None.

Item 4. Submission Of Matters to a Vote of Securities Holders

None.

Item 5. Other Information

The following executive officers and directors have adopted sales plans under Rule 10b5-1 of the Securities Exchange Act of 1934, as amended, for trading in shares of Liberate's common stock:

David J. Roux
Mitchell E. Kertzman
Donald M. Fitzpatrick
John Kent Walker, Jr.

Each individual's plan is separate and sales under the plans will not be coordinated.

Item 6. Exhibits and Reports on Form 8-K

(a) Exhibits

Exhibit No.	**Exhibit**
10.54	Amendment to Employee Retention Agreement between Liberate and David A. Limp, dated February 20, 2002 (incorporated by reference to similarly numbered exhibit to Form 10-Q filed by registrant on April 12, 2002).
31.1	Certification of David Lockwood pursuant to Rule 13a-14(a)/15d-14(a).
31.2	Certification of Gregory S. Wood pursuant to Rule 13a-14(a)/15d-14(a).
32.1	Section 1350 Certification.

(b) Reports on Form 8-K

None.

Signatures

Pursuant to the requirements of the Securities Exchange Act of 1934, the registrant has duly caused this report to be signed on its behalf by the undersigned, thereunto duly authorized.

		Liberate Technologies
Date: September 16, 2003	By:	/s/ DAVID LOCKWOOD
		David Lockwood Chief Executive Officer
Date: September 16, 2003		/s/ GREGORY S. WOOD
		Gregory S. Wood Executive Vice President and Chief Financial Officer

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