LIBERATE TECHNOLOGIES
Form 10-Q
April 14, 2004

UNITED STATES

SECURITIES AND EXCHANGE COMMISSION

WASHINGTON, D.C. 20549

FORM 10-Q

(Mark one)

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

For the quarterly period ended February 29, 2004

OR

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

For the transition period from to

Commission File Number 000-26565

LIBERATE TECHNOLOGIES

(Exact Name of Registrant as Specified in Its Charter)

Delaware	**94-3245315**
(State or Other Jurisdiction of Incorporation)	(I.R.S. Employer Identification No.)
2655 Campus Drive, Suite 250, San Mateo, California	**94403**
(Address of Principal Executive Offices)	(Zip Code)

(650) 645-4000
(Registrant s Telephone Number, Including Area Code)

2 Circle Star Way, San Carlos, California 94070

(Former Address)

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

Indicate by check mark whether the registrant is an accelerated filer (as defined in Rule 12b-2 of the Exchange Act). Yes ý No o

105,479,192 shares of the Registrant s common stock were outstanding as of March 31, 2004.

LIBERATE TECHNOLOGIES

FORM 10-Q

For The Quarterly Period Ended February 29, 2004

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Item 1. Financial Statements

LIBERATE TECHNOLOGIES

CONDENSED CONSOLIDATED BALANCE SHEETS

(In thousands)

Unaudited

	February 29, 2004	May 31, 2003
Assets		
Current assets:		
Cash and cash equivalents	$ 222,299	$ 261,689
Accounts receivable, net	3,835	3,310
Prepaid expenses and other current assets	2,273	3,069
Assets of discontinued operations		6,936
Total current assets	228,407	275,004
Property and equipment, net	4,270	6,113
Intangible assets, net		22
Deferred costs related to warrants	4,479	14,449
Restricted cash	10,876	9,249
Other assets	324	131
Total assets	$ 248,356	$ 304,968
Liabilities and Stockholders Equity		
Current liabilities:		
Accounts payable	$ 1,848	$ 1,888
Accrued liabilities	19,522	39,442
Accrued payroll and related expenses	1,380	1,562
Deferred revenues	10,415	10,619
Liabilities of discontinued operations		5,375
Total current liabilities	33,165	58,886
Long-term excess facilities charges	19,631	22,330
Other long-term liabilities	2,373	2,242
Total liabilities	55,169	83,458
Commitments and contingencies (Note 7)		
Stockholders equity:		
Common stock	1,055	1,040
Contributed and paid-in-capital	1,501,597	1,490,125

Deferred stock-based compensation		(7,589)		(194)
Accumulated other comprehensive income (loss)		(2,011)		1,804
Accumulated deficit		(1,299,865)		(1,271,265)
Total stockholders equity		193,187		221,510
Total liabilities and stockholders equity	$	248,356	$	304,968

The accompanying notes are an integral part of these unaudited condensed consolidated financial statements.

LIBERATE TECHNOLOGIES

CONDENSED CONSOLIDATED STATEMENTS OF OPERATIONS

(In thousands, except per share data)

Unaudited

	Three months ended		Nine months ended	
	February 29, 2004	February 28, 2003	February 29, 2004	February 28, 2003
Revenues:				
License and royalty	$ (54)	$ 2,077	$ (1,675)	$ 5,633
Service	1,756	3,250	6,110	14,692
Total revenues	1,702	5,327	4,435	20,325
Cost of revenues:				
License and royalty	206	257	565	1,101
Service	1,549	4,240	4,360	21,464
Total cost of revenues	1,755	4,497	4,925	22,565
Gross margin (loss)	(53)	830	(490)	(2,240)
Operating expenses:				
Research and development	5,022	5,485	12,336	21,865
Sales and marketing	703	4,258	3,136	16,087
General and administrative	3,667	5,858	12,327	14,905
Amortization of deferred costs related to warrants		841	1,831	2,788
Restructuring costs	86	4,412	1,447	6,470
Amortization and impairment of goodwill and intangible assets		479	22	1,533
Impairment of deferred costs related to warrants			4,969	
Amortization of deferred stock-based compensation		254	10	1,017
Excess facilities charges and related asset impairment		(127)	593	16,376
Total operating expenses	9,478	21,460	36,671	81,041
Loss from operations	(9,531)	(20,630)	(37,161)	(83,281)
Interest income, net	504	1,441	1,694	5,919
Other income (expense), net	1,184	(2,657)	636	(9,225)
Loss from continuing operations before income tax provision	(7,843)	(21,846)	(34,831)	(86,587)
Income tax provision (benefit)	(122)	238	(19)	1,043
Loss from continuing operations	(7,721)	(22,084)	(34,812)	(87,630)
Loss from discontinued operations		(3,999)	(3,075)	(10,088)
Gain on sale of discontinued operations	249		9,286	
Cumulative effect of a change in accounting principle				(209,289)
Net loss	$ (7,472)	$ (26,083)	$ (28,601)	$ (307,007)
Basic and diluted income (loss) per share:				

Continuing operations	$	(0.07)	$	(0.21)	$	(0.33)	$	(0.83)
Discontinued operations, basic	$		$	(0.04)	$	0.06	$	(0.10)
Discontinued operations, diluted	$		$		$	0.06	$	(0.10)
Cumulative effect of a change in accounting principle	$		$		$		$	(2.00)
Basic and diluted net loss per share	$	(0.07)	$	(0.25)	$	(0.27)	$	(2.93)
Shares used in computing basic and diluted net loss per share		105,204		104,006		104,573		104,667

The accompanying notes are an integral part of these unaudited condensed consolidated financial statements.

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LIBERATE TECHNOLOGIES

CONDENSED CONSOLIDATED STATEMENTS OF CASH FLOWS

(In thousands)

Unaudited

	Nine months ended	
	February 29, 2004	**February 28, 2003**
Cash flows from operating activities:		
Net loss	$ (28,601)	$ (307,007)
Adjustments to reconcile net loss to net cash used in operating activities:		
Amortization of deferred costs related to warrants	5,001	6,257
Impairment of deferred costs related to warrants	4,969	
Discontinued operations	(8,186)	(1,068)
Depreciation and amortization	2,238	5,274
Stock-based compensation expense	1,428	1,017
Asset impairment charges	41	16,442
Loss on disposal of property and equipment	16	51
Provision for doubtful accounts	16	33
Amortization and impairment of intangible assets	22	1,467
Provision for notes receivable from officers		275
Accrued interest on notes receivable from officers		(41)
Amortization of investment discount	(616)	
Write-down of equity investments		8,565
Cumulative effect of a change in accounting principle		209,289
Changes in operating assets and liabilities, net of acquisitions:		
Accounts receivable	(541)	8,184
Prepaid expenses and other current assets	796	2,307
Other assets	(186)	309
Accounts payable	(40)	(908)
Accrued liabilities	(19,922)	(1,352)
Accrued payroll and related expenses	(182)	(3,345)
Deferred revenues	(204)	(11,526)
Other long-term liabilities	(2,568)	(1,434)
Net cash used in operating activities	(46,519)	(67,211)
Cash flows from investing activities:		
Purchase of investments	(266,384)	
Proceeds from sale of discontinued operations	7,075	
Proceeds from notes receivable from officers		1,384
Increase in restricted cash	(1,627)	(33)
Purchases of property and equipment, net	(385)	(1,745)
Proceed from sale of property and equipment	74	
Proceeds from maturity of investments	267,000	184,441
Cash used in acquisitions, net of cash received		(38,085)

Purchase of equity investments				(1,777)
Net cash provided by investing activities		5,753		144,185
Cash flows from financing activities:				
Principal payments on capital lease obligations		(6)		(290)
Repurchase of common stock				(9,957)
Proceeds from issuance of common stock		2,526		413
Net cash provided by (used in) financing activities		2,520		(9,834)
Effect of exchange rate changes		(1,144)		64
Net increase (decrease) in cash and cash equivalents		(39,390)		67,204
Cash and cash equivalents, beginning of period		261,689		111,396
Cash and cash equivalents, end of period	$	222,299	$	178,600

The accompanying notes are an integral part of these unaudited condensed consolidated financial statements.

NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS

Unaudited

Note 1. Description of Business

Liberate Technologies (Liberate, we, us, or our) and its wholly owned subsidiaries, is a provider of software and services for digital cable systems. Our software enables cable operators to run multiple applications and services including interactive programming guide, high definition television, video on demand, personal video recorders and games on multiple platforms.

Note 2. Significant Accounting Policies

Basis of Presentation

Our unaudited condensed consolidated financial statements (Financial Statements) include the accounts of Liberate and our subsidiaries. All intercompany accounts and transactions have been eliminated in consolidation. These interim financial statements are unaudited and reflect all adjustments that we believe are necessary to provide a fair statement of the financial position and the results of operations for the interim periods in accordance with the rules of the Securities and Exchange Commission (SEC). However, these condensed consolidated statements omit certain information and footnote disclosures necessary to conform to generally accepted accounting principles. These statements should be read in conjunction with the audited consolidated financial statements and notes included in our annual report on Form 10-K for the fiscal year ended May 31, 2003. The results of operations for the interim periods reported do not necessarily indicate the results expected for the full fiscal year or for any future period.

In this report, we sometimes use the words fiscal or FY followed by a year to refer to our fiscal years, which end on May 31 of the specified year. We also sometimes use Q1, Q2, Q3, and Q4 to refer to our fiscal quarters, which end on August 31, November 30, the last day of Februar and May 31 of each fiscal year.

Liquidity

On April 14, 2004, Liberate issued a press release and filed a report on Form 8-K disclosing its financial results for the quarter ended February 29, 2004 and announcing that it is considering filing under Chapter 11 of the U.S. Bankruptcy Code to resolve certain liabilities and exposures.

Given Liberate s current cash position coupled with the workforce and expense reductions implemented last year, Liberate expects to have sufficient cash and cash equivalents and short-term investments to meet its ongoing obligations and operate its business in normal course for the next twelve months. At the date of the filing of this Form 10-Q, Liberate has not made a final decision on whether to pursue a Chapter 11 reorganization.

As discussed above, our interim financial statements are unaudited and reflect all adjustments that we believe are necessary to provide a fair statement of the financial position and the results of operations for the interim periods in accordance with the rules of the Securities and Exchange Commission (SEC). We have not made any changes in our basis of accounting or recorded any adjustments to Liberate s consolidated financial statements as a result of the possible Chapter 11 filing.

Computation of Basic and Diluted Net Loss Per Share

We compute basic net loss per share using the weighted average number of shares of common stock outstanding during the periods presented. Our policy is to report net income (loss) per share based on the number of fully diluted shares, which includes the weighted average number of shares of common stock, stock options, and warrants outstanding. As we have recorded a net loss for all periods presented, net loss per share on a diluted basis is equivalent to basic net loss per share because converting outstanding stock options and warrants would be anti-dilutive. Accordingly, we did not include 18,432,579 potential shares in the calculations for the periods ended February 28, 2003, or 13,410,414 potential shares in the calculations for the periods ended February 29, 2004.

Stock-Based Compensation

We have elected to continue to follow the intrinsic value method of accounting prescribed by Accounting Principles Board (APB) Opinion No. 25, Accounting for Stock Issued to Employees, to account for employee stock options. Under APB 25, we do not recognize compensation expense unless the exercise price of the employee stock option is less than market price of the underlying stock at the date of grant. We have recorded stock-based compensation expense in the periods presented because of the amortization of deferred stock-based compensation related to stock options granted prior to our initial public offering and more recently, to the grant of restricted stock units. Following our initial public offering we granted stock options at fair market value on the date of grant. See Note 8 for further information.

The following information regarding net loss and loss per share was prepared in accordance with Statement of Financial Accounting Standards (FAS) No. 123 and has been determined as if we had accounted for our employee stock options, shares issued under our 1999 Employee Stock Purchase Plan (ESPP), and restricted stock units (RSUs) under the fair value method prescribed by FAS 123. The resulting effect on net loss and loss per share pursuant to FAS 123 is not likely to be representative of the effects on net loss and loss per share pursuant to FAS 123 in future periods, because future periods will include the effects of additional grants and periods of vesting. During Q3 FY04, we did not issue any shares under the ESPP or any stock options. During Q3 FY04, we granted 2,186,500 RSUs to employees under the Liberate 1999 Equity Incentive Plan. See Note 8 for further information. For the periods presented, the fair value of shares issued under the ESPP, stock options, and RSUs was estimated at the date of grant utilizing a Black-Scholes valuation model with the following weighted-average assumptions:

	Options (1)			
	Three months ended		Nine months ended	
	February 29, 2004	February 28, 2003	February 29, 2004	February 28, 2003
Risk-free interest rate		2.04%		2.71%
Average expected life of options granted (in years)		2.98		2.64
Dividend yield		0%		0%
Volatility of common stock		106%		106%
Weighted average fair value of options granted		$ 0.77		$ 1.51

(1) For purposes of disclosure pursuant to FAS 123 as amended by FAS 148, Accounting for Stock-Based Compensation Transition and Disclosure, we amortize the estimated fair value of an option over the option s vesting period.

	ESPP Shares (2)			
	Three months ended		Nine months ended	
	February 29, 2004	February 28, 2003	February 29, 2004	February 28, 2003
Risk-free interest rate				2.08%
Average expected life of ESPP shares issued (in years)				0.51
Dividend yield				0%
Volatility of common stock				94%
Weighted average fair value of ESPP shares issued				$ 2.47

(2) The 1999 Employee Stock Purchase Plan is currently suspended.

	Restricted Stock Units			
	Three months ended		Nine months ended	
	February 29, 2004	February 28, 2003	February 29, 2004	February 28, 2003
Risk-free interest rate	2.43%		2.41%	
Average expected life of RSUs issued (in years)	3.0		2.98	
Dividend yield	0		0%	
Volatility of common stock	47%		47%	
Weighted average fair value of RSUs issued	$ 3.72		$ 3.70	

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The following table illustrates the effect on reported net loss and loss per share had we applied the fair value recognition provisions of FAS 123 to stock-based compensation (in thousands, except per share data):

	Three months ended		Nine months ended	
	February 29, 2004	February 28, 2003	February 29, 2004	February 28, 2003
Net loss, as reported	$ (7,472)	$ (26,083)	$ (28,601)	$ (307,007)
Adjustments:				
Stock-based employee compensation expense included in reported loss, net of related tax effects		254	10	1,017
Restricted stock unit compensation expense included in reported loss, net of related tax effects	1,296		1,310	
Total stock-based employee compensation expense determined under fair value method for all awards granted since July 1, 1995, net of related tax effects	(2,664)	1,336	(3,588)	(6,825)
Pro forma net loss	$ (8,840)	$ (24,493)	$ (30,869)	$ (312,815)
Basic and diluted net loss per share, as reported	$ (0.07)	$ (0.25)	$ (0.27)	$ (2.93)
Basic and diluted net loss per share, pro forma	$ (0.08)	$ (0.24)	$ (0.30)	$ (2.99)

Recent Accounting Pronouncements

In August 2001, the Financial Accounting Standards Board (FASB) issued FAS No. 143, Accounting for Asset Retirement Obligations. FAS 143 establishes financial accounting and reporting obligations associated with the retirement of tangible long-lived assets and the associated asset retirement costs. FAS 143 requires that the fair value of a liability for an asset retirement obligation be recognized in the period in which it is incurred if a reasonable estimate of fair value can be made. The associated asset retirement costs are capitalized as part of the carrying amount of the long-lived asset. The liability is accreted to its present value each period while the cost is depreciated over its useful life. We adopted FAS 143 for our quarter ended November 30, 2003, and adoption did not materially affect our financial position, results of operations, or cash flows.

In November 2002, the Emerging Issues Task Force (EITF) reached a consensus on EITF No. 00-21, Revenue Arrangements with Multiple Deliverables. EITF 00-21 provides guidance on how to account for arrangements that involve the delivery or performance of multiple products, services, and/or rights to use assets. We adopted EITF No. 00-21 for our quarter ended November 30, 2003, and adoption did not have a significant impact on our financial statements.

In January 2003, the FASB issued Interpretation No. (FIN) 46, Consolidation of Variable Interest Entities. This interpretation of Accounting Research Bulletin No. 51, Consolidated Financial Statements, addresses consolidation by business enterprises of certain variable interest entities where there is a controlling financial interest in a variable interest entity or where the variable interest entity does not have sufficient equity at risk to finance its activities without additional subordinated financial support from other parties. We do not expect that the adoption of FIN 46 will have a significant impact on our financial statements.

In May 2003, the FASB issued FAS No. 150, Accounting for Certain Financial Instruments with Characteristics of both Liabilities and Equity. FAS 150 establishes standards for how an issuer classifies and measures certain financial instruments with characteristics of both liabilities and equity. It requires that an issuer classify a financial instrument that is within its scope as a liability (or an asset in some circumstances). FAS 150

is effective for financial instruments entered into or modified after May 31, 2003, and otherwise is effective at the beginning of the first interim period beginning after June 15, 2003 for public companies. The adoption of FAS 150 did not have a material effect on our financial position, results of operations, or cash flows.

Cumulative Effect of a Change in Accounting Principle

On June 1, 2002, we adopted FAS No. 141, Business Combinations and FAS No. 142, Goodwill and Other Intangible Assets. FAS 141 requires us to account for all business combinations initiated after June 30, 2001 using the purchase method of accounting. Under FAS 142, we no longer amortize the remaining balances of goodwill. Rather, we tested goodwill for impairment immediately upon the date of adoption and will continue to test goodwill for impairment at least once a year. Under FAS 141 and FAS 142, the value of an assembled workforce is no longer considered an identifiable intangible asset with a definite useful life, and accordingly, we reclassified the net assembled workforce balance of $526,000 to goodwill as of June 1, 2002.

Based on the criteria of FAS 142, we determined that we had one reporting segment at the time we adopted FAS 142. Our testing and analysis process included obtaining an independent appraisal of the fair value of Liberate based on two valuation approaches. The first valuation approach determined our market capitalization based on our fair value on the date of adoption using our average stock price over a range of days in May and June 2002. This average stock price was increased by a control premium based on premiums paid for control of comparable companies. The second valuation used a discounted cash flows approach.

This analysis resulted in an allocation of fair values to identifiable tangible and intangible assets and an implied valuation of goodwill of zero as of June 1, 2002. Comparing this goodwill fair value to the carrying value resulted in a goodwill impairment of $209.3 million, with no income tax effect, at June 1, 2002. We recorded the impairment as the cumulative effect of a change in accounting principle on our condensed consolidated statement of operations for Q1 FY03. Future impairments, if any, will be recorded as operating expenses.

As required by FAS 142, a reconciliation of previously reported net loss and net loss per share to the amounts adjusted to exclude the impairment of goodwill and assembled workforce is as follows (in thousands, except per share data):

		Nine months ended February 28, 2003
Net loss, as reported	$	(307,007)
Add back:		
Cumulative effect of a change in accounting principle		209,289
Loss before cumulative effect of a change in accounting principle, as adjusted	$	(97,718)
Basic and diluted net loss per share, as reported	$	(2.93)
Add back:		
Cumulative effect of a change in accounting principle		2.00
Loss per share before cumulative effect of a change in accounting principle, as adjusted	$	(0.93)
Shares used in computing per share amounts		104,667

Reclassifications

Certain reclassifications, primarily resulting from discontinued operations, have been made to previously reported amounts in order to conform to the current period presentations. See Note 4 for further information.

Note 3. Acquisition

In August 2002, we acquired the outstanding capital stock of Sigma Systems Group (Canada) for $60.4 million in cash, before deducting $22.3 million of cash received in connection with the acquisition. We also assumed Sigma Systems unvested employee options with a fair value of $1.9 million, agreed to satisfy certain obligations of Sigma Systems to its employees in the aggregate amount of $3.0 million, and incurred acquisition costs of approximately $1.3 million. The total consideration and acquisition costs were $66.6 million and we accounted for the acquisition as a purchase.

Sigma Systems developed and marketed operational support systems (OSS) software that let network operators create, deploy, monitor, and maintain digital subscriber services.

We allocated the total purchase price consideration of $66.6 million as follows (in thousands):

Cash	$	22,314
Receivables and other current assets		2,232
Property, plant, and equipment		672
Liabilities assumed		(3,586)
Deferred compensation		184
In-process research and development		300
Intangible assets		9,830

Goodwill		34,630
Total consideration	$	66,576

We immediately wrote off $300,000 of acquired in-process research and development that had not reached technological feasibility and had no alternative future use. The value of Sigma Systems in-process research and development was determined by using the income approach, which measures the present worth and anticipated future benefit of the intangible asset.

We also used the income approach to determine the value of Sigma Systems existing products and technology, customer lists and order backlog, and trademarks. Based on these valuations, we initially recorded

$9.8 million of intangible assets. We began amortizing this amount on a straight-line basis over an estimated useful life of three years. Intangible assets consisted of $9.2 million of existing technology and $630,000 of customer lists and order backlog and trademarks. We also initially recorded $34.6 million of goodwill, which represented the purchase price in excess of the identified net tangible and intangible assets. In accordance with FAS 142, we did not amortize goodwill, but periodically reviewed it for impairment. In accordance with the annual test for impairment under FAS 142, in Q4 FY03 we wrote off $31.5 million of goodwill related to our acquisition of Sigma Systems. See Note 5, Goodwill and Intangible Assets.

At the time of the acquisition, Liberate entered into an escrow agreement with Sigma Systems and deposited $9.0 million into an escrow account to secure certain obligations of Sigma Systems and its major shareholders. On November 19, 2003, Liberate and the representative of such former Sigma Systems major shareholders entered into a settlement agreement and limited release of claims, pursuant to which Liberate received approximately $3.5 million in cash from the escrow account. The return of escrow funds was accounted for as part of the gain on sale of discontinued operations. See Note 4, Discontinued Operations.

Note 4. Discontinued Operations

In August 2002, we acquired the outstanding capital stock of Sigma Systems. In accordance with FAS 142, we determined that Sigma Systems had two reporting units, OSS and Bill-Care. In May 2003, we sold Bill-Care to a company owned by certain former shareholders of Sigma Systems for consideration of $1.0 million in cash. In September 2003, we announced that we were actively exploring the sale of the OSS division and in November 2003, we completed the sale of the OSS division and its assets to Sigma Software Solutions Inc. and affiliated entities. The purchase price included approximately $3.6 million in cash and the assumption of approximately $7.4 million of lease obligations and other liabilities. In connection with the sale, we received approximately $7.1 million in cash representing the total proceeds from the OSS business sale and return of escrow funds and recognized a gain of $9.0 million. See Note 3.

Computation of gain on sale follows:

		Nine months ended February 29, 2004
Proceeds	$	7,075
Expenses of sale		(715)
Net liabilities sold		2,926
Gain on sale of discontinued operations	$	9,286

Pursuant to the provisions of FAS 144, amounts in the financial statements and related notes have been reclassified to reflect the discontinued operations of both Bill-Care and OSS. Operating results for the discontinued operations are reported, net of tax, under Loss from discontinued operations on the condensed consolidated statements of operations. Related assets and liabilities are disclosed in the balance sheet as Assets of discontinued operations or Liabilities of discontinued operations.

The following table reflects the impact of discontinued operations on certain statement of operations data (in thousands, except per share information).

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	Three months ended		Nine months ended	
	February 29, 2004	February 28, 2003	February 29, 2004	February 28, 2003
Total revenues	$	$ 795	$ 2,552	$ 1,557
Cost of revenues		886	1,275	2,219
Gross margin (loss)		(91)	1,277	(662)
Operating expenses		2,439	4,357	6,260
Write-off of acquired in-process research and development				300
Amortization of purchased intangibles		819	287	1,911
Amortization of deferred stock compensation			46	
Restructuring costs		582	23	582
Operating loss from discontinued operations		(3,931)	(3,436)	(9,715)
Interest and other income (expense)		(68)	361	(373)
Loss from discontinued operations	$	$ (3,999)	$ (3,075)	$ (10,088)

Note 5. Goodwill and Intangible Assets

Under the provisions of FAS 142, we test goodwill for impairment at least once a year. Additionally, FAS 142 defines assembled workforce intangible assets as part of goodwill. Effective June 1, 2002, with the adoption of FAS 142, we transferred the remaining net book value of assembled workforce intangible assets of $526,000 to goodwill and tested the resulting balance of goodwill for impairment. Based on the results of this testing, we determined that $209.3 million of goodwill was impaired. In Q1 FY03, we acquired Sigma Systems and recorded $34.6 million in goodwill. Sigma Systems net goodwill of $31.5 million was deemed impaired as a result of the annual FAS 142 test performed in Q4 FY03. The remaining Sigma Systems goodwill has been classified as Assets of Discontinued Operations on our condensed consolidated balance sheets. Goodwill activity through February 29, 2004 was as follows (in thousands):

	Net book value
Balance at May 31, 2002	$ 208,763
Assembled workforce reclassification	526
Impairment upon adoption of FAS 142 (1)	(209,289)
Sigma Systems acquisition	34,630
Transfer of Sigma System assets to discontinued operations (2)	(34,210)
Balance at August 31, 2002	420
Q2 FY03 activity	
Balance at November 30, 2002	420
Q3 FY03 activity	
Balance at February 28, 2003	420
Goodwill associated with sale of Bill-Care	(420)
Balance at May 31, 2003	
Fiscal 2004 activity	
Balance at February 29, 2004	$

(1) Recorded as Cumulative effect of a change in accounting principle.

(2) Subsequently, in FY03, $31.5 million of goodwill was impaired under the FAS 142 test.

Intangible Assets

We amortize intangible assets on a straight-line basis over their estimated useful lives, which are normally three years. In June 2002, with the adoption of FAS 144, we determined that the fair value of the

Virtual Modem trademarks that we had acquired in fiscal 2000 was zero. This permanent impairment resulted in a write-down of the carrying value from $66,000 to zero. In August 2002, in connection with the acquisition of Sigma Systems, we acquired intangible assets with a value of $9.8 million. In Q4 FY03, we recorded impairment of $5.6 million of intangible assets related to Sigma Systems under FAS 144. All Sigma Systems goodwill and intangible assets and associated amortization and impairment have been presented as discontinued operations in our condensed consolidated financial statements contained herein. See Note 4, Discontinued Operations. As of February 29, 2004 and May 31, 2003, intangible assets were as follows (in thousands):

	Net book value	
	February 29, 2004	**May 31, 2003**
Existing products and technology	$	$ 8
Customer lists and order backlog		14
Total	$	$ 22

Amortization expense related to intangible assets was zero in Q3 FY04, $479,000 in Q3 FY03, $22,000 in the nine months ended February 29, 2004 and $1.5 million in the nine months ended February 28, 2003. As of February 29, 2004, our intangible assets had been fully amortized.

In Q2 FY04, we recorded warrant-related asset impairment expense of $5.0 million as a result of our realignment of strategy to focus on the U.S. cable market and the related impairment of warrants issued to non-U.S. customers. 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.

Note 6. Excess Facilities Charges and Related Asset Impairment

We have existing commitments to lease office space at our former 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 represent the remaining lease commitment on those vacant facilities, net of expected sublease income. Each quarter we evaluate our existing needs, the current and estimated future value of our subleases, and other future commitments to determine whether we should record excess facilities charges or record adjustments to such charges. Additionally, each quarter we evaluate our leasehold improvements for impairment and if necessary, we reduce the carrying value using estimates of future cash flows to a level equal to the expected future value at that time. These impairment amounts are included in excess facilities charges and related asset impairment on our condensed consolidated statements of operations.

We recorded excess facilities charges and related asset impairment expense of zero in Q3 FY04 and $593,000 in the nine months ended February 29, 2004. In Q3 FY03, we recorded a reversal of excess facilities charges and related asset impairment of $127,000, and in the nine months ended February 28, 2003, we recorded $15.1 million of excess facilities charges and $1.5 million of related asset impairment charges.

Note 7. Commitments and Contingencies

Indemnification Obligations

In November 2002, the FASB issued FIN 45 Guarantor s Accounting and Disclosure Requirements for Guarantees, Including Indirect Guarantees of Indebtedness of Others. FIN 45 requires that a guarantor recognize, at the inception of a guarantee, a liability for the fair value of the obligation undertaken in issuing the guarantee or indemnification. FIN 45 also requires additional disclosure by a guarantor in its interim and annual financial statements about its obligations under certain guarantees and indemnifications. The initial recognition and measurement provisions of FIN 45 are applicable for guarantees issued or modified after December 31, 2002. The disclosure requirements of FIN 45 are effective for financial statements of interim or annual periods ending after December 15, 2002. We adopted the recognition and measurement provisions of FIN 45 for guarantees issued or modified after December 31, 2002. The adoption of this standard did not have a material impact on our consolidated results of operations or financial position.

Our software license agreements typically provide for indemnification of customers for intellectual property infringement claims. To date, no such claims have been filed against us. We also warrant to customers that software products operate substantially in accordance with specifications. Historically, we have incurred minimal costs related to product warranties, and accordingly, we have not accrued warranty costs for the periods presented. In addition, we are obligated to indemnify our officers and directors under the terms of indemnity agreements entered into with them, as well as pursuant to our certificate of incorporation, bylaws, and applicable Delaware law. We are unable to quantify the charge that could result from officer and director indemnification.

Legal Matters

Underwriting Litigation. Beginning on May 16, 2001, a number of class-action lawsuits seeking monetary damages were filed in the United States District Court for the Southern District of New York against several of the firms that underwrote our initial public offering, naming Liberate and certain of our officers and directors as co-defendants. The suits, which have since been consolidated with hundreds of similar suits filed against underwriters and issuers, allege that the underwriters received excessive and improper commissions that were not disclosed in our prospectus and that the underwriters artificially increased the price of our stock. The plaintiffs subsequently added allegations regarding our secondary offering, and named additional officers and directors as co-defendants. While we deny allegations of wrongdoing, we have agreed to enter into a global settlement of these claims, and expect our insurers to cover amounts in excess of our deductible. The settlement is being negotiated among plaintiffs, insurers and co-defendants. A suit making similar allegations based on the same facts was filed in California state court, and Liberate and its related parties have been dismissed as defendants in that suit.

OpenTV Patent Litigation. 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. We have filed an answer denying OpenTV s allegations. Our counter-claim alleges that OpenTV infringes one of our patents for information retrieval systems. We are seeking to have OpenTV s patents invalidated, requesting a finding that our technology does not infringe OpenTV s patents, and seeking monetary damages and injunctive relief against OpenTV. The court has issued a claim construction ruling hearing and trial has recently been rescheduled for early 2005. While we intend to vigorously defend this lawsuit and are confident in our technology and intellectual property, because litigation is by its nature uncertain, we are unable to predict the outcome of this litigation and whether we may face any material exposure for damages or the need to alter our software arising from this case.

Restatement Class-Action Litigation. Beginning on October 17, 2002, five securities class-action lawsuits were filed in the United States District Court for the Northern District of California against us and certain officers and directors (collectively, the Class Action Defendants), which were subsequently consolidated into a single action (the Class Action). The Class Action is based on our announcements in October and November 2002 that we would restate our financial results for fiscal 2002 and that we were investigating other periods. The Class Action generally alleges, among other things, that members of the purported class were damaged when they acquired our securities because, as a result of accounting irregularities, our previously issued financial statements were materially false and misleading, and caused the price of our securities to be inflated artificially. The Class Action further alleges that, as a result of this conduct, the Class Action Defendants violated Section 10(b) and 20(a) of the Securities Exchange Act of 1934, and SEC Rule 10b-5, promulgated thereunder. The Class Action seeks unspecified monetary damages and other relief from all Class Action Defendants.

Restatement Derivative Litigation. In addition, on or about October 29, 2002, a shareholder derivative action was filed in the California Superior Court for the County of San Mateo, naming Liberate as a nominal party and naming certain of our officers and directors as defendants (collectively, the Derivative Defendants). A second shareholder derivative action was filed on or about November 6, 2002. On February 26, 2003, these actions were consolidated into a single action (the Derivative Action). The Derivative Action is based on substantially the same facts and circumstances as the Class Action and generally alleges that the Derivative Defendants failed to adequately oversee our financial reporting, and thus are liable for breach of their fiduciary duties, abuse of control, gross mismanagement, and waste of corporate assets. The Derivative Action also alleges that the Derivative Defendants are liable for unjust enrichment and that certain current or former officers and directors are liable for violations of California Code Section 25402 and breach of fiduciary duty for insider selling and misappropriation of information. The Derivative Action seeks unspecified monetary damages and other relief.

SEC Investigation. When we announced that we would restate our financial statements, we contacted the SEC and provided them with additional information regarding our findings. In February 2003, we learned that the SEC had initiated a formal, non-public investigation into the events and circumstances that led to the restatement of our financial statements. We have been cooperating with the SEC and will continue to do so.

The cost of participating and defending against these actions is substantial and will require the continued diversion of management s attention and corporate resources.

We cannot predict or determine the outcome or resolution of the Class Action, the Derivative Action, or the SEC investigation, or estimate the amounts of, or potential range of, loss with respect to these proceedings. In addition, the timing of the final resolution of these proceedings is uncertain. The possible resolutions of these proceedings could include judgments against us or settlements that could require substantial payments by us, which could have a material adverse impact on our financial position, results of operations, and cash flows.

On August 29, 2003, Liberate purchased a $100 million supplemental loss mitigation insurance policy from a AAA/A++ rated insurance carrier to cover damages that may arise from pending securities and derivative litigation related to Liberate s restatement. This policy is in addition to Liberate s existing policies that provide up to $15 million of coverage. Liberate paid a $17.9 million premium for the loss mitigation policy, with a rebate of up to $4.4 million if an eventual settlement or judgment is less than specified amounts. Liberate has certain deductibles under its insurance arrangements for which it is solely responsible.

Litigation-Related Indemnification Obligations. We have agreed to indemnify our directors and officers to the fullest extent permitted by Delaware law. As a consequence, we are advancing expenses (including reasonable attorneys fees) incurred by directors and officers in connection with the Class Action, the Derivative Action, and the SEC investigation, although these payments are subject to reimbursement if such expenses are ultimately found to be non-indemnifiable. Additionally, we may ultimately be obligated to pay indemnifiable judgments, penalties, fines, and amounts paid in settlement in connection with these proceedings.

We have notified our various insurance carriers of the Class Action, the Derivative Action, and the SEC investigation. Our insurance carriers, however, may refuse to cover all or portions of our defense costs, any settlement, any judgment rendered against us, or amounts we are required to pay to any indemnified person in connection with the Class Action, the Derivative Action, the SEC investigation, or any other matter.

Note 8. Offerings of Common Stock

Common Stock

In Q3 FY04, we issued 301,304 shares of common stock to employees upon the exercise of stock options and 197,077 shares of common stock upon the vesting and settlement of restricted stock units. In the nine months ended February 29, 2004, we issued 1,165,062 shares of common stock to employees upon the exercise of stock options and 201,243 shares of common stock upon the vesting and settlement of stock units and 103,000 shares under a stock award to an executive officer whose employment subsequently terminated. In Q3 FY03, we issued no shares of stock to employees upon the exercise of stock options, and in the nine months ended February 28, 2003, we issued 182,672 shares of stock to employees upon the exercise of stock options. In addition we issued 204,068 shares under our ESPP during the nine months ended February 28, 2003.

Stock Repurchase

In July 2002, we repurchased 3,963,780 shares of our common stock beneficially owned by Cisco for an aggregate purchase price of $10.0 million. The purchase price per share of $2.5117 was our average stock price for the ten consecutive trading days prior to July 18, 2002, less a 2% discount. Following the repurchase, the shares were retired and are now authorized and unissued.

Warrant Agreements

In fiscal 1999, we agreed to issue warrants to purchase up to 4,599,992 shares of our common stock to certain network operators who satisfied specific milestones within specific time frames. We estimated the fair market value of the warrants using the Black-Scholes pricing model as of the earlier of the date the warrants were earned or the date that it became likely that they would be earned. Pursuant to the requirements of EITF 96-18, Accounting for Equity Instruments That Are Issued to Other Than Employees for Acquiring, or in Conjunction with Selling, Goods or Services, we revalue the warrants as appropriate.

As of February 29, 2004, warrants to purchase 1,803,332 shares had expired unexercised, we had repurchased unvested warrants to acquire 400,000 shares, and network operators had earned warrants to purchase 2,396,660 shares. Of this last amount, warrants to purchase 552,774 shares had previously been exercised, warrants to purchase 163,890 shares had been retired in connection with those exercises, and warrants to purchase 380,000 had expired unexercised. In fiscal 2004, unearned warrants to purchase 650,000 shares expired. As of February 29, 2004, there were earned and outstanding warrants to purchase 1,299,996 shares with exercise prices of $4.80 and $6.90 per share and a weighted average exercise price of $6.47 per share. The outstanding warrants expire between July 29, 2004 and May 31, 2005.

In August 2002, we paid $1.1 million to MediaOne of Colorado and MediaOne of Michigan, each a wholly owned subsidiary of AT&T Broadband, to buy back unvested warrants to purchase 400,000 shares.

Warrant activity through February 29, 2004 was as follows:

	Warrant activity				
	Available	**Earned**	**Repurchased**	**Expired**	**To Be Earned**
Balance May 31, 2000	4,599,992	(2,336,660)			2,263,332
Fiscal 2001 activity				(50,000)	(50,000)
Balance May 31, 2001	4,599,992	(2,336,660)		(50,000)	2,213,332
Fiscal 2002 activity		(60,000)		(170,000)	(230,000)

Balance May 31, 2002	4,599,992	(2,396,660)		(220,000)	1,983,332
Fiscal 2003 activity					