LIBERATE TECHNOLOGIES
Form 10-Q
September 16, 2003

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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 28, 2003

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.)
2 Circle Star Way, San Carlos, California	**94070-6200**
(Address of principal executive office)	(Zip Code)

(650) 701-4000
(Registrant's telephone number, including area code)

Indicate by check mark whether the registrant (1) has filed all reports required to be filed by Section 13 or 15(d) of the Securities Exchange Act of 1934 during the preceding twelve 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 o No ý

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

104,006,079 shares of the Registrant's common stock were outstanding as of June 30, 2003.

LIBERATE TECHNOLOGIES

FORM 10-Q
For The Quarter Ended February 28, 2003

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Part I. Financial Information

Item 1. Financial Statements

Concurrent with the filing of this report on Form 10-Q, we are filing a report on Form 10-K/A, which amends our Annual Report on Form 10-K filed on August 8, 2002 with the Securities and Exchange Commission ("SEC") to reflect the restatement of our consolidated financial statements as of, and for the fiscal year ended May 31, 2002.

Concurrently, we are also filing amended reports on Form 10-Q/A reflecting the impact of the restatement as of, and for the quarters ended November 30, 2001 and February 28, 2002. The condensed consolidated financial statements and related notes for the fiscal quarter and nine month period ended February 28, 2002 presented in this report reflect that restatement.

Please consider this report in conjunction with our report on Form 10-K/A for the fiscal year ended May 31, 2002, our reports on Form 10-Q for the quarters ended August 31, 2002 and November 30, 2002, and our annual report on Form 10-K for the fiscal year ended May 31, 2003, which we are filing concurrently with this report. For a discussion of the reasons for our restatement, see Condensed Consolidated Financial Statements ("Financial Statements"), Note 3.

LIBERATE TECHNOLOGIES
CONDENSED CONSOLIDATED BALANCE SHEETS
(In thousands)
Unaudited

	May 31, 2002	February 28, 2003

	(As restated)	
Assets		
Current assets:		
Cash and cash equivalents	$ 111,396	$ 178,600
Short-term investments	106,228	32,570
Accounts receivable, net	12,975	6,445
Receivable from affiliate	174	174
Prepaid expenses and other current assets	6,979	5,354
Total current assets	237,752	223,143
Property and equipment, net	14,500	10,317
Long-term investments	183,409	65,838
Goodwill, net	208,764	34,630
Restricted cash	9,199	9,232
Other assets	27,317	25,330
Total assets	$ 680,941	$ 368,490
Liabilities and Stockholders' Equity		
Current liabilities:		
Accounts payable	$ 2,641	$ 1,815
Accrued liabilities	13,720	14,020
Accrued payroll and related expenses	5,073	1,949
Capital lease obligations, current portion	296	16
Deferred revenues	25,471	18,283
Total current liabilities	47,201	36,083
Capital lease obligations, net of current portion	10	
Long-term excess facilities charges	5,828	17,905
Other long-term liabilities	1,883	2,152
Total liabilities	54,922	56,140
Commitments and contingencies (Notes 8 and 13)		
Stockholders' equity:		
Common stock	1,076	1,040
Contributed and paid-in-capital	1,497,596	1,489,925
Deferred stock-based compensation	(1,163)	(278)
Accumulated other comprehensive income (loss)	518	678
Accumulated deficit	(872,008)	(1,179,015)
Total stockholders' equity	626,019	312,350
Total liabilities and stockholders' equity	$ 680,941	$ 368,490

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

LIBERATE TECHNOLOGIES
CONDENSED CONSOLIDATED STATEMENTS OF OPERATIONS
(In thousands, except per share data)
Unaudited

	Three months ended February 28, 2002 (As restated)	Three months ended February 28, 2003	Nine months ended February 28, 2002 (As restated)	Nine months ended February 28, 2003
Revenues:				
License and royalty	$ 10,747	$ 2,095	$ 28,161	$ 5,773
Service	11,190	4,027	29,207	16,109
Total revenues	21,937	6,122	57,368	21,882
Cost of revenues:				
License and royalty	657	257	1,685	1,110
Service	10,481	5,125	30,039	23,674
Total cost of revenues	11,138	5,382	31,724	24,784
Gross margin	10,799	740	25,644	(2,902)
Operating expenses:				
Research and development	11,093	7,750	34,565	27,526
Sales and marketing	6,689	4,345	19,638	16,474
General and administrative	3,087	5,945	9,528	15,117
Excess facilities charges and related asset impairment		(127)	7,479	16,376
Restructuring costs	3,075	4,994	3,075	7,052
Amortization and impairment of goodwill and intangible assets	55,210	1,298	165,631	3,445
Amortization of deferred costs related to warrants	1,407	841	10,900	2,788
Amortization of deferred stock-based compensation	205	254	1,269	1,017
Write-off of acquired in-process research and development				300
Warrant-related asset impairment			44,840	
Total operating expenses	80,766	25,300	296,925	90,095
Loss from operations	(69,967)	(24,560)	(271,281)	(92,997)
Interest income, net	3,453	1,442	13,020	5,945
Other expense, net	(768)	(2,727)	(1,560)	(9,623)
Loss before income tax provision	(67,282)	(25,845)	(259,821)	(96,675)
Income tax provision	303	238	708	1,043
Loss before cumulative effect of a change in accounting principle	(67,585)	(26,083)	(260,529)	(97,718)
Cumulative effect of a change in accounting principle				(209,289)

	Three months ended February 28,		Nine months ended February 28,	
Net loss	$ (67,585)	$ (26,083)	$ (260,529)	$ (307,007)
Basic and diluted loss per share before cumulative effect of a change in accounting principle	$ (0.63)	$ (0.25)	$ (2.46)	$ (0.93)
Basic and diluted net loss per share	$ (0.63)	$ (0.25)	$ (2.46)	$ (2.93)
Shares used in computing basic and diluted net loss per share	106,539	104,006	105,777	104,667

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

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LIBERATE TECHNOLOGIES
CONDENSED CONSOLIDATED STATEMENTS OF CASH FLOWS
(In thousands)
Unaudited

	Nine months ended February 28,	
	2002 (As restated)	**2003**
Cash flows from operating activities:		
Net loss	$ (260,529)	$ (307,007)
Adjustments to reconcile net loss to net cash used in operating activities:		
Cumulative effect of a change in accounting principle		209,289
Write-down of equity investments		8,565
Amortization of deferred costs related to warrants	13,787	6,257
Depreciation and amortization	5,561	5,911
Amortization of intangible assets	1,538	3,378
Asset impairment charges	45,343	1,479
Non-cash stock-based compensation expense	1,269	1,017
Write-off of acquired in-process research and development		300
Amortization of goodwill and assembled workforce	164,093	
Non-cash restructuring costs	1,409	
Loss (gain) on disposal of property and equipment	1,066	(5)
Provision for (recovery of) doubtful accounts	62	(279)
Changes in operating assets and liabilities, net of acquisitions:		
Accounts receivable	(2,674)	7,702
Prepaid expenses and other current assets	2,027	2,965
Other assets	(332)	1,592
Accounts payable	1,546	(1,504)
Accrued liabilities	4,060	(5,392)
Accrued payroll and related expenses	1,049	(3,124)
Deferred revenues	(23,489)	(8,694)

	Nine months ended February 28,	
Other long-term liabilities	4,230	12,346
Net cash used in operating activities	(39,984)	(65,204)
Cash flows from investing activities:		
Proceeds from maturity of investments	350,284	184,441
Purchases of investments	(281,175)	
Cash used in acquisitions, net of cash received		(38,085)
Purchases of property and equipment	(3,635)	(2,464)
Purchase of equity investments	(1,070)	(1,777)
Increase in restricted cash	(400)	(33)
Net cash provided by investing activities	64,004	142,082
Cash flows from financing activities:		
Repurchase of common stock		(9,957)
Principal payments on capital lease obligations	(518)	(290)
Proceeds from issuance of common stock	6,706	413
Net cash provided by (used in) financing activities	6,188	(9,834)
Effect of exchange rate changes on cash	179	160
Net increase in cash and cash equivalents	30,387	67,204
Cash and cash equivalents, beginning of period	126,989	111,396
Cash and cash equivalents, end of period	$ 157,376	$ 178,600

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

LIBERATE TECHNOLOGIES
NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS
Unaudited

Note 1. Description of Business

Liberate is a leading provider of digital infrastructure software and services for cable networks. Our software supports a wide variety of services, including interactive and enhanced TV, on-demand video, service management, and provisioning of voice and high-speed data communications.

Note 2. Significant Accounting Policies

Basis of Presentation

Our unaudited condensed consolidated 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 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/A for our 2002 fiscal year and our Form 10-K for our 2003 fiscal year, filed concurrently with this report. The results of operations for the interim periods reported below 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 February, and May 31 of each year.

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. We report net income per share based on 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 the effect of converting outstanding stock options and warrants would be anti-dilutive. Accordingly, we did not include 19,043,385 potential shares in the calculations for the periods ended February 28, 2002 or 18,432,579 potential shares in the calculations for the periods ended February 28, 2003.

Stock-Based Compensation

In December 2002, the Financial Accounting Standards Board ("FASB") issued Statements of Financial Accounting Standards ("SFAS") No. 148, "Accounting for Stock-Based Compensation Transition and Disclosure-an amendment of FASB Statement No. 123." Under SFAS 148, we are required to disclose the impact on net income and earnings per share assuming the adoption of SFAS 123. This disclosure requirement is effective for both quarterly reports filed on Form 10-Q and annual reports filed on Form 10-K for fiscal years ended after December 31, 2002.

Recent Accounting Pronouncements

In August 2001, the FASB issued SFAS No. 143, "Accounting for Asset Retirement Obligations." SFAS 143 establishes financial accounting and reporting obligations associated with the retirement of

tangible long-lived assets and the associated asset retirement costs. SFAS 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. This statement will be effective in fiscal 2004. Although we have not yet assessed the impact of adopting SFAS 143, we do not expect that the adoption will 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. The provisions of EITF 00-21 will apply to revenue arrangements entered into in fiscal periods beginning after June 15, 2003. We are currently evaluating the effect that the adoption of EITF 00-21 will have on our results of operations and financial condition.

In December 2002, the FASB issued SFAS No. 148, "Accounting for Stock-Based Compensation-Transition and Disclosure, an amendment of FASB Statement No. 123." Under SFAS 148, we are required to disclose the impact on net income and earnings per share assuming the adoption of SFAS 123. This disclosure requirement is effective for both quarterly reports filed on Form 10-Q and annual reports filed on Form 10-K for fiscal years ended after December 31, 2002.

In May 2003, the FASB issued SFAS No. 150, "Accounting for Certain Financial Instruments with Characteristics of both Liabilities and Equity." SFAS 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). SFAS 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. We believe that the adoption of SFAS 150 will not have a material effect on our financial position, results of operations, or cash flows.

Effects of Recent Accounting Pronouncements

In April 2001, the FASB issued EITF No. 01-03, "Accounting in a Purchase Business Combination for Deferred Revenue of an Acquiree." EITF 01-03 provides guidance regarding the recognition of deferred revenue as a liability with respect to business combinations. In March 2002, the FASB reached consensus that an acquiring entity should recognize a liability related to a revenue arrangement of an acquired entity only if it has assumed a legal obligation to provide goods, services, or other consideration to a customer. The amount assigned to this liability should be based on its fair value at the date of the acquisition. We adopted the guidelines set forth in EITF 01-03 to record deferred revenues we received in connection with the Sigma Systems Group (Canada) acquisition in August 2002. See Note 4.

In April 2002, the FASB issued SFAS No. 145, "Rescission of FASB Statements No. 4, 44, and 64, Amendment of FASB Statement No. 13, and Technical Corrections." SFAS 145 rescinds SFAS No. 4 "Reporting Gains and Losses from Extinguishment of Debt," and an amendment of that Statement, SFAS No. 64, "Extinguishments of Debt Made to Satisfy Sinking-Fund Requirements." SFAS 145 also rescinds SFAS No. 44, "Accounting for Intangible Assets of Motor Carriers." SFAS 145 amends SFAS No. 13, "Accounting for Leases," to eliminate an inconsistency between the required accounting for sale-leaseback transactions and the required accounting for certain lease modifications that have economic effects that are similar to sale-leaseback transactions. SFAS 145 also amends other existing authoritative pronouncements to make various technical corrections, clarify meanings, or describe their applicability under changed conditions. We adopted SFAS 145 for our fiscal year beginning June 1,

2002, and do not expect that the adoption will materially affect our financial position, results of operations, or cash flows.

In June 2002, we adopted SFAS No. 144, "Accounting for the Impairment or Disposal of Long-Lived Assets," which superseded SFAS No. 121, "Accounting for the Impairment of Long-Lived Assets and for Long-Lived Assets to be Disposed Of." Under SFAS 144, we periodically review long-lived assets for impairment whenever events or changes in circumstances indicate that the carrying amount of these assets may not be recoverable. We measure recoverability of these assets by comparing their carrying amount to the future undiscounted cash flows that they are expected to generate. Impairment reflects the amount by which the carrying value of the assets exceeds their fair market value. The adoption of SFAS 144 did not materially affect our financial position, results of operations, or cash flows.

In June 2002, the FASB issued SFAS No. 146, "Accounting for Exit or Disposal Activities." SFAS 146 addresses significant issues regarding the recognition, measurement, and reporting of costs that are associated with exit and disposal activities, including restructuring activities that are currently accounted for under EITF No. 94-03, "Liability Recognition for Certain Employee Termination Benefits and Other Costs to Exit an Activity (including Certain Costs Incurred in a Restructuring)." SFAS 146 also establishes accounting standards for costs related to termination of a contract that is not a capital lease and certain involuntary termination benefits for employees. Under SFAS 146, severance packages for employees in transition are earned and expensed as the exit transition is completed. Our restructurings tend to include transitional employees whose costs were accrued immediately under EITF 94-03. SFAS 146 covers exit or disposal activities that are initiated after December 31, 2002. The adoption of SFAS 146 did not materially affect the dollar impact of our restructuring charges on our condensed consolidated financial statements, but did affect the timing of when those restructuring charges were recognized, generally causing them to be recognized in a later quarter.

Cumulative Effect of a Change in Accounting Principle

On June 1, 2002, we adopted SFAS No. 141, "Business Combinations" and SFAS No. 142, "Goodwill and Other Intangible Assets." SFAS 141 requires us to account for all business combinations initiated after June 30, 2001 using the purchase method of accounting. Under SFAS 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 SFAS 141 and SFAS 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 balance of $526,000 to goodwill as of June 1, 2002. See Note 5.

SFAS 142 requires a different valuation methodology than SFAS 121 and is more likely to result in impairment because SFAS 142 uses discounted rather than undiscounted cash flows. Based on the criteria of SFAS 142, we determined that we had one reporting segment at the time we adopted SFAS 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 implied goodwill valuation 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. We will record any future impairments as operating expenses.

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

	Three months ended February 28,		Nine months ended February 28,	
	2002 (As restated)	**2003**	**2002 (As restated)**	**2003**
Net loss, as reported	$ (67,585)	$ (26,083)	$ (260,529)	$ (307,007)
Add back:				
Amortization of goodwill and assembled workforce, net of tax	54,697		164,093	
Cumulative effect of a change in accounting principle				209,289
Loss before cumulative effect of a change in accounting principle, as adjusted	$ (12,888)	$ (26,083)	$ (96,436)	$ (97,718)
Basic and diluted net loss per share, as reported	$ (0.63)	$ (0.25)	$ (2.46)	$ (2.93)
Add back:				
Amortization of goodwill and assembled workforce, net of tax	0.51		1.55	
Cumulative effect of a change in accounting principle				2.00
Loss per share before cumulative effect of a change in accounting principle, as adjusted	$ (0.12)	$ (0.25)	$ (0.91)	$ (0.93)
Shares used in computing per share amounts	106,539	104,006	105,777	104,667

Note 3. Restatement of Financial Statements for the Fiscal Year Ended May 31, 2002 and Revision of Financial Information for the Quarter Ended August 31, 2002

On October 15, 2002, we announced that we would restate our financial results for our fourth quarter and fiscal year ended May 31, 2002 and delay the filing of our quarterly report on Form 10-Q for the quarter ended August 31, 2002. Our audit committee, which is composed of independent outside directors, retained independent counsel to review our revenue reported during our fiscal year ended May 31, 2002. While our audit committee's investigation was pending, we were not able to file our quarterly reports on Form 10-Q, and as a result, our stock was delisted from the Nasdaq National Market in January 2003 and currently trades through the Pink Sheets system.

Our audit committee and its independent advisors concluded that our historical financial statements had overstated our revenue by $2.2 million in Q2 FY02; $1.8 million in Q3 FY02; and $5.9 million in Q4 FY02. The total revenue overstatement for fiscal 2002 was $9.9 million, so that our revenue for that year should have been reported as $70.5 million. Expenses for FY02 were understated by $216,000, reflecting increases of approximately $646,000 related to cost of service revenues, offset by a decrease in research and development expense of $229,000 and a decrease in income tax provisions of $201,000. Our reported net loss for fiscal 2002 was understated by $10.1 million, and should have been reported as $335.1 million.

In addition, our audit committee and its independent advisors concluded that our preliminary earnings report for Q1 FY03 issued on September 26, 2002 had overstated our revenue by $901,000

and that revenue for that quarter should have been reported as $9.4 million rather than $10.3 million. Expenses for that quarter were overstated by $1.2 million. As a result, our reported net loss for that quarter should have been $249.3 million rather than $249.6 million.

Of the $9.9 million of revenue overstatements for fiscal 2002 and the $901,000 of revenue overstatements for Q1 FY03, as noted above, we are deferring approximately $6.8 million to Q2 FY03 and subsequent quarters.

As part of the adjustments necessary to correct the overstatement of our revenues, we have adjusted other items on our balance sheets such as accounts receivable, deferred revenues, prepaid expenses, other assets, and accrued liabilities, as well as items on our statements of operations such as cost of service revenues, research and development, bad debt expense, and income tax provision. For further details on the restatement, please read our report on Form 10-K/A for the year ended May 31, 2002, filed concurrently with the SEC.

Note 4. Sigma Systems Acquisition

In August 2002, we acquired the outstanding capital stock of Sigma Systems, a privately-held corporation based in Toronto, 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 lets network operators create, deploy, monitor, and maintain digital subscriber services. Through this acquisition, we sought to expand our product offerings. In September 2002, Sigma Systems changed its legal name to Liberate Technologies (Toronto) Ltd. We have included the results of operations of Sigma Systems in our consolidated financial statements since August 8, 2002.

We have 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 compen		