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PUBLIC VERSION

Before the
COPYRIGHT ROYALTY BOARD
LIBRARY OF CONGRESS
Washington, D.C.

In the Matter of	)	
Mechanical and Digital Phonorecord Delivery Rate Adjustment Proceeding	)	**Docket No. 2006-3 CRB DPRA**

TESTIMONY OF LAURA GOLDBERG

1. My name is Laura Goldberg and I am the Chief Operating Officer for Napster, Inc., formerly known as *pressplay* ("Napster").[1] I submit this testimony in connection with and support of the Written Direct Statement of the Digital Music Association ("DiMA") in the above-captioned proceeding for setting rates and terms for the making and distribution of digital phonorecord deliveries ("DPDs").

2. Napster is a Delaware corporation headquartered in Los Angeles, CA with offices in New York, San Jose and San Diego, as well as overseas. In my present role with the company I am responsible for running the day-to-day business as well as setting strategy and product direction. I oversee all operational aspects of the Napster service, including product development, marketing, program management, technology, music programming, customer care, content acquisition and clearance, reporting, and key

[1] Napster bears *no relationship* to the illegal file-sharing service ("illegal Napster") that operated in the United States from 1999 until it filed for bankruptcy and sold its name to Roxio in 2002.

vendor relationships. I have been with the company (or its predecessor) since 1999. Prior to that I worked at Credit Suisse First Boston in the Principal Investments Group and then as a portfolio manager at Avenue Advisors, a distressed debt hedge fund. I have a BS degree from Carnegie Mellon University and an MBA from Harvard Business School.

3. The following testimony is based on my personal knowledge, information made available to me in the course of performing my duties at Napster, my experience of employment in the music industry, and my review of the documents exhibited to this statement. To the extent that the facts and matters set out in this statement are within my knowledge, they are true. To the extent that I have relied upon the information provided by others it is true to the best of my knowledge, information, and belief. Where I have relied on such information, I have identified its source.

I. SUMMARY

4. Consumers are fundamentally changing the way that they interact with music, as traditional methods of delivery are being rapidly replaced by newer digital technologies that offer a much greater degree of freedom, flexibility, exploration, and personalization. This trend has been fueled by the rapid growth of consumer Internet usage, particularly as a result of broadband connections that enable content to be transferred securely at much higher speeds than dial-up, and a number of powerful new technologies for compressing and sharing digital content using a personal computer ("PC").

5. The playback and enjoyment of music obtained over the Internet is not limited to the PC, but has crossed over to portable devices including MP3 players, cell phones, and other devices for the home. As a result of this digital revolution, the way people search for, purchase, listen to, and "consume" music is changing. Consumer expectations are tracking the digital revolution, as today's music collectors demand anytime, anywhere access to digital music. The CD created public expectations that songs could be easily copied and moved around to devices. Without a doubt, digital music services are compelled to keep up with increasing consumers demands for the all-encompassing music experience. The ubiquity of -- and ease of access to -- pirated music today compounds the problem for legitimate music services to appeal to listeners.

6. Napster provides a compelling consumer alternative to the illegal, "free" music file-sharing sites available on the Internet today. With a catalog of more than 3 million individual tracks representing hundreds of thousands of artists and hundreds of different record labels, from major to independent, we offer something for every musical taste and preference. But we do much more than merely offer music, Napster makes it easy for individuals to explore and expand consumption by offering a variety of different search functions, browsing possibilities, playlist creation, and other unique features. Ease of access to and discovery of more and varied music continues to drive our subscriber base. The depth and breadth of our catalog -- along with our subscribers' ability to personalize their experience -- keeps listeners coming back for more. Our fundamental value to the music business is creating a marketplace consisting of hundreds of thousands and potentially millions of customers who in the past had purchased a handful of CDs each year, but are now willing to pay $120 or more annually for access to music.

7. In all, Napster and its predecessors have invested tens of millions of dollars in its digital music business in order to create an all-encompassing digital service that brings more music to more people and builds upon the best aspects of the digital revolution. But the challenges we face are significant. We are competing in an environment in which many consumers believe our product should be free. And if they want to find unlicensed music for free, they can do so very easily. As a result, we cannot allow ourselves to be priced out of the market. Furthermore, because we are seeking to establish an entirely new way of "consuming" music and this requires a great deal of effort to educate consumers on the benefits of our business model, we face significant challenges with customer acquisition and retention. We compete against not only traditional patterns of consumption in the form of physical product (*i.e.*, CDs) but also against "digital" ownership in the form of paid subscription services, paid downloads and free downloads from illegal sites.

8. Compared to traditional music retail models and even the a la carte digital download business, we face much greater uncertainties in the form of legal disputes about copyright ownership for content distributed over the Internet -- even though *we license all our content and pay millions of dollars in royalties* to copyright owners annually. As a result, we combat significant consumer confusion with respect to content availability, which exacerbates an already challenging consumer education process inherent in the subscription business model. Consumers expect that when they access a digital music service, all the music they want to listen to is available for any use they want. However, because of the uncertainty and complexities involved with clearing rights for music, consumer expectations are frequently not met.

9. It is critical to the survival of our business that the rate set through this proceeding reflects the market dynamics and hurdles that services like ours have gone through just to get to this point -- to the point of still not making a profit in the operation of our business. A rate that is too high or the imposition of minimum fees will destroy our ability to innovate and respond to consumer demands. It should be consumers who determine if the subscription business model is the next major change to the way music is consumed, not the function of a statutory royalty rate.

II. NAPSTER'S COMPELLING DIGITAL OFERINGS EXTEND THE REACH OF THE LEGITIMATE MUSIC MARKETPLACE

10. Napster is a leading provider of subscription music services to consumers. Our digital music distribution services enable fans to explore, listen to, and purchase from one of the world's largest and most diverse online music catalogs utilizing a secure and legal platform. We acquire all of our content from copyright owners and pay millions of dollars annually in licensing fees to record labels and publishers for the public performance, reproduction, and distribution of their works.

11. Napster users have access to songs from all major labels and hundreds of independent labels, and enjoy many ways to discover, share, and acquire new music and old favorites. In this section of my testimony, I will provide background on Napster's offerings, describe the consumer experience in more detail, and explain the benefits Napster offers by making the promises of the digital marketplace a reality for our subscribers.

A. THE HISTORY OF NAPSTER AND AN INTRODUCTION TO OUR PRODUCTS

12. Napster began operations in 2001 as an audio-only, on-demand streaming and tethered download[2] subscription service (with limited options to purchase and "burn" music to CDs) known as "*pressplay*" -- a joint venture music service owned by Sony Music Entertainment Inc. and Universal Music Group. In one and a half years of operation, *pressplay* did not achieve market acceptance. There were a number of reasons for this, including the fact that *pressplay* was unable to offer consumers access to a comprehensive music catalog due to record label restrictions on what was made available from record labels through *pressplay* and the inability to clear publishing rights for a large number of songs that were made available from record labels. In May 2003, *pressplay* was sold to Roxio Inc. and was subsequently re-branded "Napster." Napster currently offers three main offerings to customers in the United States: Napster Light, which is a download store; and two "subscription" products: Napster, and Napster To Go. A video introduction to our services is attached hereto as Exhibit A.

13. ***Napster Light*** is a per-track and per-album download offering comparable to the iTunes Music Store. Napster Light allows users to listen to free 30 second samples. Users can then purchase and download from over 3 million music tracks, either as single tracks priced at 99 cents or full albums at various price points. Purchasing music through Napster Light entitles a user to transfer the music to a limited number of compatible MP3 music players or to burn it to CD.

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[2] A "tethered download" is a digital phonorecord delivery which is distributed in the form of a download that is restricted from being retained, played, burned to CD and/or transferred to a portable device on a permanent basis.

14. ***Napster*** is a subscription service that allows subscribers to download unlimited music to their PC and listen to unlimited music streams, as well as enjoy several other discovery features such as access to over 60 pre-programmed playlists, more than 60 advertisement free, interactive radio stations, and browsing through decades of Billboard charts, among others. This service is currently priced at $9.95 per month. Songs downloaded via Napster remain playable for as long as the customer maintains his/her subscription. If a subscription expires or lapses, the songs will become unplayable. Subscription downloads are secured by a technology called "digital right management" or "DRM" that prevents them from being burned to CD or transferred to any portable devices. Napster subscribers may also purchase songs as permanent downloads, under the same terms as Napster Light members with additional discounted offers for bulk purchases of "Track Packs" (download credits that can be redeemed for permanent downloads).

15. ***Napster To Go*** is a subscription service that, in addition to the functionality provided by Napster, allows users to transfer their downloaded music to authorized and compatible portable devices. Tethered downloads are otherwise subject to the same restrictions as described in the basic Napster Membership. This service is currently priced at $14.95 per month.

16. On May 1, 2006, we launched the new ***Napster.com***, the only legal, advertising-supported service that offers free, on-demand listening via streaming without monthly restrictions. The web site is part of an (as yet unproven) attempt on our part to lower customer acquisition costs by generating advertising revenues while the consumer

is learning about the subscription model. Napster.com allows members in the United States to listen to nearly every song in Napster's catalog three times without downloading any software. The site provides ***NapsterLinks***, a tool that empowers music fans to share legal music across the web. ***NapsterLinks*** create a unique URL for every song in Napster's streaming catalog that can be easily pasted into email and instant messages as well as integrated onto web sites and blogs.

17. The company also provides a product for wireless carriers through a partnership with Ericsson, a leading telecommunications supplier. ***Napster Mobile,*** through separate agreements with mobile carriers, enables consumers to download personalization content (ringtones, wallpapers) as well as purchase full-length downloads to be delivered to the user's mobile phone. Napster Mobile initially launched in September with SunCom Wireless, a leading provider of wireless phone service in the Southeast United States, went live with Cingular Wireless in early November, and will be launched on additional carrier platforms in the coming months.

18. In addition to direct purchases or subscriptions, customers can purchase Napster cards which offer prepaid permanent download credits and/or subscription service memberships, often at discounted rates, that members can use themselves or gift to others ("Napster Cards"). Napster Cards can be purchased directly from Napster.com but are predominately sold via third party retailers, such as Radio Shack, CompUSA, and Circuit City.

19. Occasionally, Napster partners with music-related or other product offerings. For example, we have entered into partner programs directly with PC and MP3

player manufacturers, whereby an offer for our paid music service and/or software comes either preloaded on the hard drive (in the case of a PC) or in the device box or device itself (in the case of MP3 players). Napster has also commissioned the manufacture of its own branded devices in order to offer Napster To Go annual memberships bundled with a free or discounted MP3 player. Customers who sign up for a three month Napster To Go membership can receive a free 512 MB player or they can upgrade to a 1 GB player for the discounted purchase price of $50.00. We also have relationships with physical retailers, such as Circuit City. These relationships range from the sale of Napster cards, as discussed above, to more extensive promotional activities, including in-store displays. In addition, our relationships with physical retailers may include permanent in-store displays, inclusion in the retailer's advertising circulars, and training of sales staff. All of these are designed to promote the sale of Napster subscription service.

20. We offer other promotional activities intended to reach out to potential subscribers as well. We have a free trial program through which anyone can sample Napster for seven days at no charge, the content for which is provided through our record label licenses without charge. Further, we participate in one-off promotions with many product manufacturers; as one example, we have teamed with Nestle for a promotion in which purchasers of a candy bar could receive a free download from our service. All of our promotional activities are intended to introduce consumers to our services and begin to convince them that they can have a complete music experience with Napster.

21. Everything about Napster's functionality is intended to make it easier for consumers to find music. Users can search using different parameters including artist, track and album; browse through numerous musical genres, as well as fifty years of Billboard Charts; see what other members are listening to with "Now Streaming," listen to, download, and transfer hundreds of pre-programmed interactive "radio" stations and playlists; obtain unique, personalized playlists based on usage behavior; and access unique Napster programming such as "live" sessions recorded in our studios. Songs can be added to the player or a user's library simply by drag-and-drop or click of a mouse. Potential subscribers and purchasers who want to explore the concept of "on demand" can either sign up for a freely available seven-day trial, or create a free account on the Napster Web service and stream each song in Napster's 3 million track catalog up to three times.

B. NAPSTER IS POISED TO FULFILL CONSUMERS' DEMANDS BY PERSONALIZING A COMPLETE DIGITAL MUSIC EXPERIENCE

22. There are many enhancements to the music listening and collecting experience that are enabled by our investments in digital distribution. By making music available on an a-la-carte basis, our service allows music fans to listen to and purchase only the music they really want. Most importantly, Napster allows music fans to explore music far beyond that which they could previously access in a record store or afford if their only option was to purchase an entire album. Digital distribution makes it easier for a customer to browse a large catalog of music in a shorter time than in the physical retail environment. The digital environment also allows customers to more robustly preview songs or albums before agreeing to purchase. Finally, with the inclusion of

recommendations, powerful search and browse tools, and other editorial content such as pre-programmed playlists, customers have more information at their finger tips when they are looking for the music they want to hear or trying to find the new music of the day or their favorites of the past than they could ever get in a physical retail environment. All of these innovations and enhancements are the result of intensive market research, extensive investment, and constant improvements in the product. Napster takes the time and invests the resources to bring to market a service that allows consumers to fully experience the digital music revolution.

23. The key to making our products attractive to consumers is our ability to allow subscribers to personalize their digital music experience as much as possible. Increased personalization of the music exploration, discovery, and consumption experience is unique to digital distribution, and it is what consumers want. Along with increased personalization, our services must be easy for subscribers to use and we must offer subscribers access to the largest collection of music possible. We spend time, energy, and money on making sure our services meet these standards.

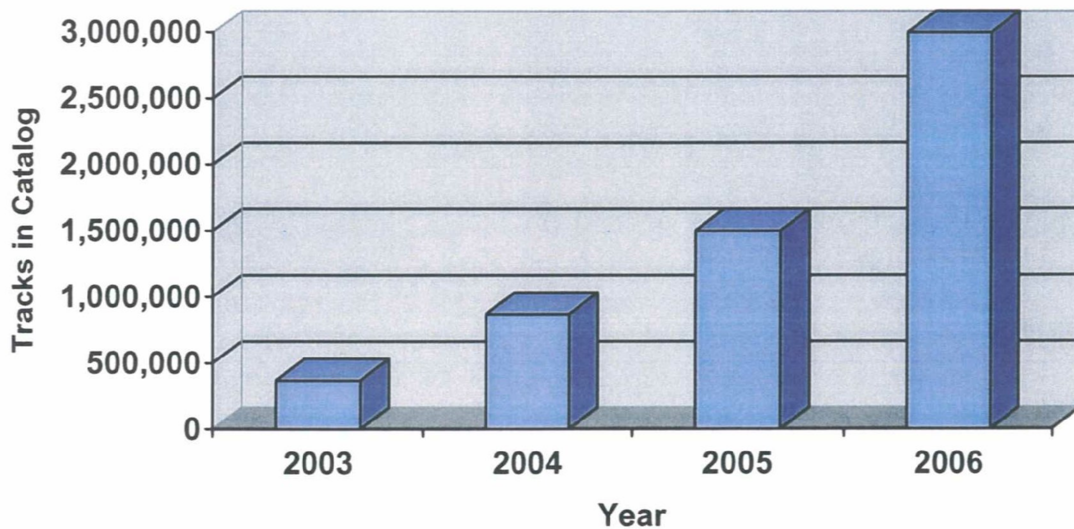
24. In the digital marketplace, consumers demand and expect full access to the largest music catalog possible. If they do not get that, they will either choose a different digital service or get their music from illegal sources. Napster offers one of the largest online music catalogs covering a wide and diverse spectrum of music genres and artists. Currently, our users have access to more than 3 million songs and more than 210,000 albums representing over 200,000 different artists. Roughly [redacted] of the tracks in our catalog have rights for all means of distribution and over [redacted] have rights for

download only. The fact that we have more tracks with download only rights than with subscription rights is a serious problem because it prevents us from offering consumers our complete catalog for all possible uses, which presents a confusing message to our consumers. Further, it exacerbates the existing issues with subscription issues with subscription as consumers are unwilling to pay a recurring fee for a service that does not provide access to all of the music that they want.

25. The chart below reflects the continued growth of our music catalog over the last four years, with the number of tracks increasing by roughly 700% since 2003.

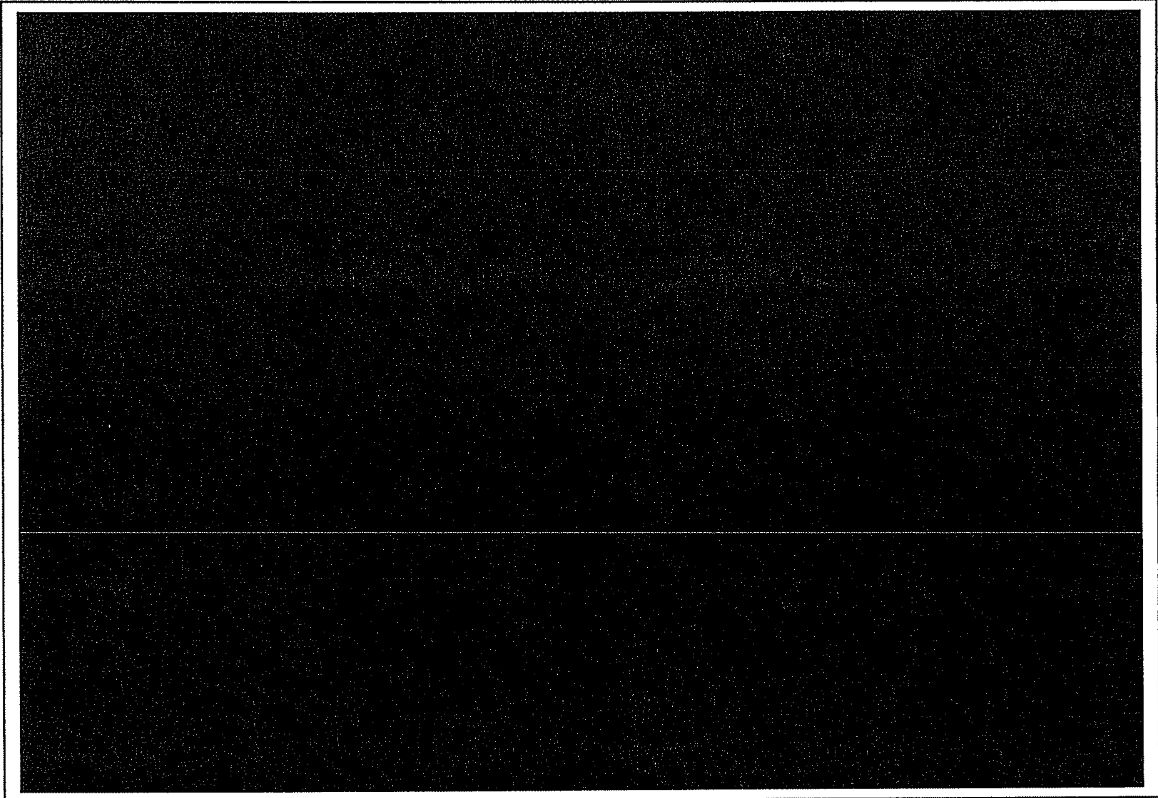
Table 1

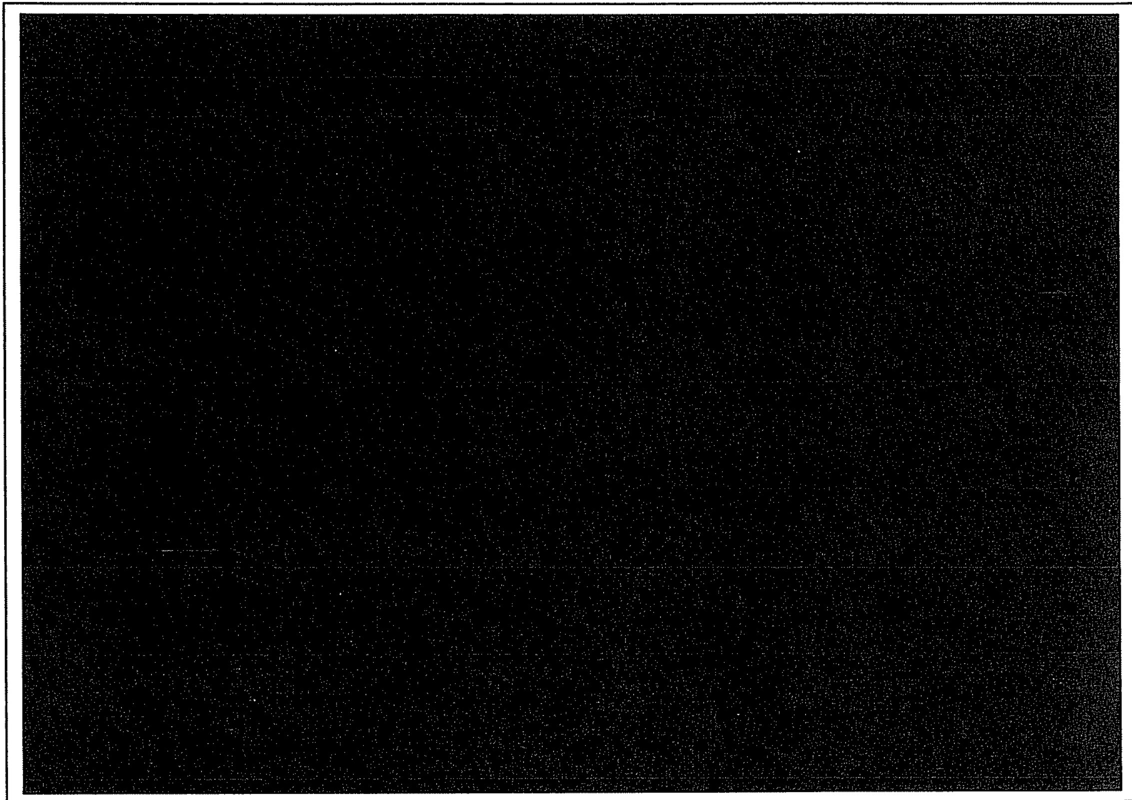
Napster Catalog Growth



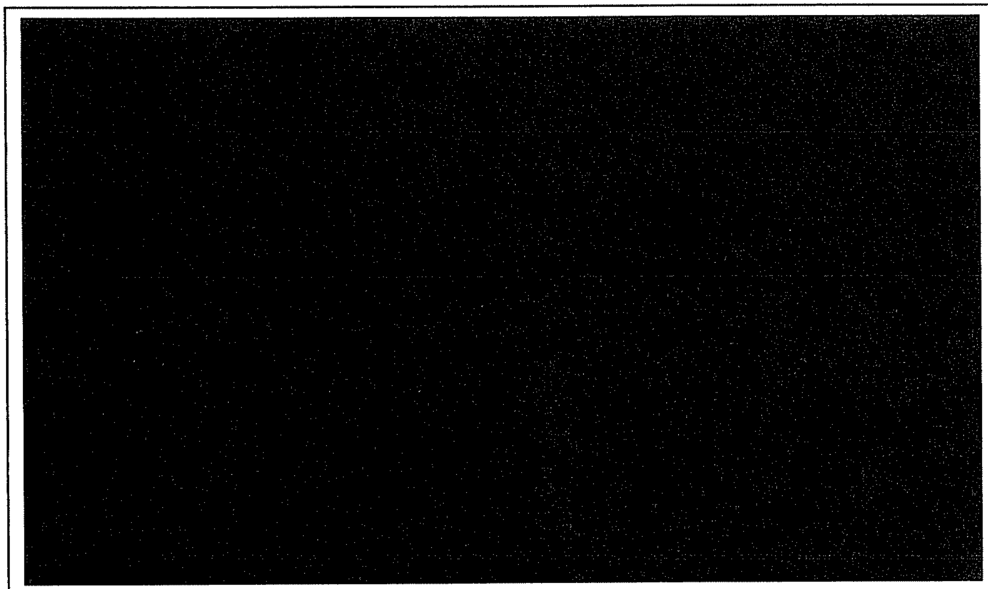
Having a sufficient catalog alone is not enough. Ease of access is incredibly important. Our service places all songs -- from the immensely popular to the more obscure -- on a virtual store shelf where users can easily find, organize, and listen to them. When our content is easy for users to access, they will increase usage and explore more of our

catalog. This exploration effect can be seen in the charts below. As these charts demonstrate, while it is obvious that the most popular tracks are played more frequently, it is towards the bottom of the chart where the full effect of our users' exploration is seen. The lower ranked tracks in our catalog still get played, which means that a wider variety of music is being accessed by our users.





Based on my experience in the music business, I believe this type of exposure for lesser-known artists is unmatched by the physical retail world. Furthermore, the chart below demonstrates that by year's end, ███ of our catalog has been played.



Again, it is my experience that this comprehensive usage is not matched by the physical retail world. Additional information regarding the usage of our catalog for FY 2005-2007 can be found in the chart attached hereto as Exhibit B.

26. We add yet another layer of personalization to the digital music experience by allowing users to create and maintain their own personal playlists. The playlist features offer users an element of manipulation and sharing to their music collecting experience that is missing from a physical music collection. In addition to creating their own playlists, we offer several different versions of pre-programmed playlists for our consumers in a variety of themes. Playlists are designed for users who want to sample a few songs, burn a CD, or transfer to a portable device; and "radio" stations offer a pure lean-back experience -- hours of listening with the ability to skip or fast forward as desired.

27. For a purely individualized experience, users can access a personalized "Playlist of the Day," which we create by analyzing users' listening habits and music libraries and presenting recommendations. Napster also automatically creates a playlist of the last 200 songs played, and the Napster home page displays the last three radio stations selected, so users can easily access music that they have played recently.

28. Napster has invested significant resources to add unique features and functionality to make it easier for users to find, listen to, and buy music. Each of our services is designed to be as user-friendly, reliable, and safe to use as possible. The protection that our services give users from harmful computer viruses and spyware is very important to them. Users of illegal services do not receive this valuable protection.

Our services also offer users access to content that can only be found on Napster, such as Napster Live, tributes to music legends, and unique artist biographies. We have created a truly unique music experience.

C. NAPSTER'S SERVICES BENEFIT ALL CONTENT CREATORS BY MAKING A WIDE VARIETY OF MUSIC MORE ACCESSIBLE TO CONSUMERS

29. Napster has built the largest music catalog possible, created special personalization features such as customized playlists, included unique editorial content, and made our service as easy to use as possible. As a result, our subscribers benefit by having an all-encompassing digital music experience at their finger tips. But content creators also benefit from the unique aspects of our service because it increases the exposure of their music to a broader audience. Our services encourage the music discovery process through special features and functionality, and when our subscribers explore our catalog they are exposed to music that they may not have previously considered for their collection.

30. Because Napster offers so many different ways to easily search and browse through millions of songs, and we encourage exploration through features such as customized recommendations based on user preferences, our consumers listen to a wider and deeper selection of music than they would if they only purchased their music or listened to the radio. Being a digital online music service allows Napster to make a vastly larger catalog of music accessible to consumers than a physical retailer could at any given location, and because it is all available on a track by track basis, superior to online CD retailers as well. For example, a Napster user can easily search and browse

our catalog by genre, artist, song title, album title, new releases, current and historical record charts, and even by what current Napster users are listening to at that particular moment. Our search and browse function even allows users to review the music collection of other users. We lower the cost and therefore the risk of music discovery and exploration for consumers encouraging them to listen to music they might not have otherwise heard.

31. After listening to or purchasing recordings from a particular artist, a user may decide to explore some of the recommendations offered. These recommendations can be music from the same artist, similar artists, or from a completely different music genre. Even if the user does not download or purchase music from any of the recommended artists, he or she may continue jumping to additional material by following the customized recommendation system. In just a matter of minutes a user can follow a trail deep into the catalog and be exposed to many different artists' and types of music. Building upon users' willingness to explore our catalog, our service has the effect of exposing artists to a different demographic of listener, with nothing required from the artist other than making their music available.

32. Napster introduces its consumers to a greater range of music and artists through a variety of functional and promotional tools. For example, we have artists come to our studio to create exclusive sets of recordings for our online audience via our "Napster Live" program. In order to make Napster Live as unique and special for our users as possible, we constructed our own recording studio in our offices for the performances. After the Napster Live performance, we make the content exclusively

available on our website (for periods of time that vary depending on label amenability) and promote its availability.

33. Napster Live is a great way for participating content creators to increase exposure and offer consumers different versions of songs already known to the public, introduce the public to previously unknown songs, or indulge their artistic desires to perform "cover" versions of other artists' songs. Over the past three years, Napster has spent just over one hundred million dollars on marketing and special promotions.

34. Our deep catalog, unique personalization features, and ease-of-use does not just benefit content creators affiliated with the largest record labels. We have made a concerted effort to design our music store to benefit content creators affiliated with smaller independent labels, including offering very detailed genre subdivisions, featuring independent content in our programming, and offering a separate browse category just for independent content. Approximately [REDACTED] of the tracks in our catalog come from non-major record labels. Attached hereto as Exhibit C is a list of all of the different independent record labels whose content we make available in our catalog. One of the major benefits of online retail and subscription specifically is that we have an unlimited "shelf space" on which to offer a wide variety of music content to our users. Utilizing categorization, we can easily make available a breadth of music to consumers far in excess of music that is available in the physical retail environment. This is of particular interest to independent labels who, by virtue of more limited releases, less market power and less money to spend on promotion and cooperative advertising, often end up not well represented in the physical retail environment.

35. Content creators also benefit from our services making music more accessible to consumers because we help transform consumers from sporadic CD purchasers to intense listeners and collectors willing to spend $120-180 or more annually on music. We have seen in our usage data that a track's availability for "subscription" delivery, whether by stream or conditional download, does not cannibalize purchases of that track. In fact, it may well promote sale of the track by permanent download.

III. THE MARKETPLACE IS COMPLEX, DYNAMIC, AND HIGHLY COMPETITIVE

36. Reports of declining music sales and the death of the CD are widespread. There is no doubt this phenomenon can be attributed to the pervasive availability of free, pirated music online. Not only does this affect our ability to price and compete in the marketplace, it has affected consumer behavior and expectations about the ubiquitous availability of music and made it more important for us to make our service available across all platforms, technologies, and devices. In other words, piracy drives prices down and makes ubiquity a competitive necessity. As a result, we need to keep investing and innovating to add value in the marketplace. These efforts cost music copyright owners nothing and benefit them tremendously as we strive to create a legitimate market for creative works.

37. Despite being perceived as market leaders, Napster has been operating at a loss since inception. After almost five years of operation, we have accumulated fewer than five hundred thousand subscribers in the United States. We face significant challenges acquiring and retaining customers and proving the viability of the subscription

music model. Overcoming these challenges has required substantial investments to date and will require additional investments into the foreseeable future.

A. MUSIC PIRACY IS A FORMIDABLE COMPETITIVE REALITY

38. Some estimates conclude there are nearly one billion infringing music files available on the Internet. Regardless of the actual number, the effect of completely ubiquitous free music is profound: everyone knows someone who has downloaded music for free, copied it from a friend, or burned it to share. The fact is, this behavior is so ingrained that most people don't consider it wrong to do these things - or, not wrong enough to stop. While the legitimate digital music industry has taken significant steps to combat piracy, pirated music is still very much available and still very much a part of consumer behavior.

39. We have sought to change consumer attitudes in part by joining forces with several of the nation's largest universities to offer Napster on campus at a significant discount. Because we know that the college-aged demographic has the highest usage of illegal music services, we felt it was important to focus anti-piracy efforts on that demographic. Students at partnering schools have full access to our unlimited subscription features and online music community, including the chance to share playlists and view other students' music collections in a safe and legal environment, at a dramatic discount from the standard monthly fee. Though Napster does not profit substantially from this program, we believe that is important to give this critical demographic the opportunity to experience the benefits of a legitimate service.

40. University partnering programs are not going to defeat Internet piracy, however. The number of pirated files available to online continues to increase with no end in sight, despite highly publicized legal actions by copyright owners. Experience has shown that the way to combat piracy and establish a legitimate market for music online cannot depend on lawsuits. It depends on investments and innovation, creating a new business model, and meeting and exceeding consumer expectations. As we attempt to find that right balance, we face additional obstacles.

B. WE MUST INNOVATE AND INVEST TO MEET AND EXCEED CONSUMER EXPECTATIONS OF PORTABILITY

41. The digital music revolution has brought so many benefits to the music collecting and listening experience, but it has also brought with it dynamics that still confuse many consumers. Gone are the days when consumers went to a corner record store, bought a CD, record album, or cassette, and returned home to listen to their purchase. Back then, when consumers purchased a record or cassette, there was little worry that it would play on their device at home. There is *no such guarantee* in the digital environment. While more options to obtain and listen to music have been placed before consumers through advances in technology, those options play out in a landscape of competing file formats and business models where songs are offered for sale or download to digital music players that may or may not actually play them. As a result, we must constantly innovate and invest to make our service accessible where consumers demand it to be. This requires overcoming technological and business barriers, and it is not inexpensive.

C. WE NEED TO SUCCESSFULLY DEMONSTRATE THE VALUE OF THE SUBSCRIPTION BUSINESS MODEL

42. Access to multiple platforms is not the only additional barrier we face. Among the most significant impediments to the growth of our business is that many consumers do not intuitively appreciate the value of our subscription services and remain apprehensive to try them. This may be because subscribing to music is an unfamiliar experience or difficult to describe to people who have not experienced it. Or it may be because there are technological hurdles. It may also be in part because of the interoperability issues described above. I believe that non-Napster users are willing to consider purchasing their digital music through us, but they need more information about our service before they are willing to subscribe. This requires an extensive, ongoing investment in marketing and consumer education.

43. Historically, most people have relied upon owning copies of the music they want to listen to (an "ownership" model of consumption). Although the medium in which the copy of that music was embodied may have changed -- from acetate lacquers to vinyl to cassette to CD -- the basic concept has not. Consumers traditionally have acquired, assembled, selected, and enjoyed their music of choice by purchasing a physical copy of the same -- and primarily in an album format consisting of ten to fifteen songs that have been recorded and selected to be sold together.

44. But the subscription experience is fundamentally different for the customer in that it allows them to experience a far broader selection of individual tracks, and sample widely from a far greater variety of musical genres. Users of subscription services have little if any trepidation when it comes to downloading a song or album

because they are not paying for that particular download per se. In the event that a subscriber downloads a song or album and later after listening to the entire song or album decides that it is not to their liking, they do not have to regret the fact that they just purchased something they will not listen to again. Because of this "guilt-free" downloading ability, users of subscription services are able to sample and be exposed to a wider variety of music and are more likely to use the service more often because they simply pay one fee for unlimited usage. And unlike the mere purchase of a song or album, which offers artists and songwriters compensation solely at the point of sale, creators are benefited in a subscription environment by a longer-term source of revenue as payment is based upon usage.

45. Consumers do not yet fully understand the additional flexibility offered from a subscription service. To some degree, both digital downloading and on-demand subscription services afford consumers who use them a similar experience -- the opportunity to listen to the music of their choice at the time and place of their choosing. The purchaser of a permanent download may retrieve and play any selection in his or her library that has been previously purchased and/or stored on the user's hard drive. A Napster subscriber, as long as their Napster subscription remains current, can select any song from the Napster library and either listen to the selected recording on demand, from any PC, or add it to their own library of music to enjoy listening to at a later time. In this respect, a subscription service allows users to take a step towards purchasing but without requiring a full commitment.

D. WE FACE STIFF COMPETITION FROM OTHER SERVICES AND BUSINESS MODELS ACROSS A RANGE OF ENTERTAINMENT MARKETS

46. In addition to free music from P2P sites, limitations with the portability of our service, and the difficulties in marketing a new form of music consumption to consumers, we face a range of competitors fiercely seeking to grab market share with their own business models and approaches. In the still unproven subscription service sector, there are several companies competing for market share, including well-known consumer brands such as AOL, Yahoo!, RealNetworks, and MTV. Microsoft has recently launched and is heavily marketing its own alternative service and portable device called Zune. While the combined marketing activities may help to raise consumer awareness, they may also continue to confuse, rather than enlighten, consumers and not have a significant impact on the adoption of these services.

47. At the same time, Apple Computer's iTunes Music Store is a substantial competitor even though it does not presently offer a subscription service. The reasons for this are two-fold. Not only is the iPod a dominant market presence, but it relies on marketing and selling a traditional "ownership" model of consuming music. Apple customers download permanent copies of music to their devices and pay as they go. This is the message conveyed to the public in Apple's marketing campaigns. It is inconsistent with our message about the benefits of the subscription service model. As a result, our message may be drowned out or cause confusion in consumer minds.

48. There are other well-financed competitors in the digital space, from traditional retailers such as Wal-Mart to online retailers such as Amazon.com. Satellite

radio companies Sirius and XM are spending millions of dollars marketing their own brand of subscription services and making them available not only in cars but in homes and on portable devices as well. We also compete with Internet-based radio services, both non-interactive add-supported offerings and interactive offerings. Even mobile phone companies are entering the market through services such as Verizon V-cast and Sprint Music Store. Consumers will ultimately choose based on overall value and the appeal of the service. Napster's offerings must be competitive with all of these well-financed companies in order to succeed in the market.

E. AS A RESULT OF COMPETITIVE PRESSURES, CUSTOMER ACQUISITION AND RETENTION ARE STILL DIFFICULT CHALLENGES FOR US

49. The difficulties of competing in the marketplace as described above are most readily apparent when considering the challenge we face in acquiring and retaining customers. Although we spend a considerable amount marketing our services and developing features and attributes to increase customer retention, we still have difficulty retaining customers.

50. We believe that customer churn is in large part a function of inadequate customer understanding and education regarding digital music generally and the subscription model in particular, the continued existence of illegal/pirate services through which consumers can get every song ever recorded or performed for free, and the inability of consumers to understand that our service will not work with every digital device. Converting illegal file-swappers into legal buyers is a long-term challenge, which is in part due to the fact that our catalog of nearly 3 million tracks is significantly smaller than the number of tracks available through illegal means. In part to address that, not

only do we constantly upgrade our paid service to add consumer-friendly features, we are attempting to drive more potential subscribers to Napster.com so they may experience "on demand listening" and encourage them to upgrade to a paid subscription (and/or to purchase tracks for permanent use). In addition, we hope that increased traffic to the website will generate advertising revenue and reduce our customer acquisition costs.

51. There are things that we can proactively do to try and reduce our customer churn, all of which involve significant investment on our part. First, we can continue to be innovative with our service. Enhancing features and functionality, in addition to constantly adding new content, will keep the offering fresh in consumers' minds. The costs of continually revising our technology and updating our platform are substantial. Last year, we spent over 11 million dollars on research and development alone. Second, we can continue our efforts to educate subscribers at the moment they sign-up for our service. Today, all of our new subscribers are presented with a detailed service overview at the time they sign-up for membership. We continually reach out to our customers to inform them of the benefits of the service and encourage them to explore more music -- we spent over 50 million dollars last year on marketing and sales. In addition, we continue to promote portable subscription use by providing bundled offers and inexpensive portable devices in order to encourage adoption of our Napster To Go service. Finally, we continue to improve our customer service to ensure that questions are answered in a timely fashion and our customers have the best experience possible with Napster.

IV. SUBSTANTIAL INVESTMENTS AND CONTINUED COMMITMENT TO THE DIGITAL MUSIC REVOLUTION HAVE BEEN AND WILL CONTINUE TO BE REQUIRED TO OPEN NEW MARKETS AND NEW MEDIA TO DIGITAL MUSIC

52. Napster today stands on the shoulders of previous substantial investments in the business made by prior investors beginning in 1998 and continuing forward. There has been no return on these investments to date as the market continues to evolve and become increasingly more competitive. Staying in business over the next five years will require additional investments and continued operating losses. Any rates set in this proceeding must take into consideration not only the substantial losses incurred to date but the fragility of the business generally and the risks we face.

A. NAPSTER REPRESENTS A NEARLY HALF BILLION DOLLAR INVESTMENT IN SUBSCRIPTION DIGITAL MUSIC SERVICE

53. Napster and its predecessor entities have invested significant capital to build Napster, refine the infrastructure on which our current offerings are based, get the service up and running, open new markets, and develop new media. In May 2001, Vivendi Universal Net Tech purchased mp3.com, much of which was used to power *pressplay*, the backbone of the current Napster service. From 2000 through early 2003, Sony Music and Universal Music Group invested approximately $130 million on the *pressplay* service, which was acquired by Roxio (together with the VU Net Tech infrastructure) for an aggregate of $35 million dollars. Roxio paid an additional $5 million to acquire the Napster brand out of bankruptcy. Millions have been invested, even before considering the additional tens of millions incurred over the past three and a half years to continue to build and improve the service.

B. NAPSTER HAS YET TO BE PROFITABLE DUE PRIMARILY TO EXTREMELY HIGH LICENSING AND MARKETING COSTS

54. Looking back at the investments made to date is only part of the picture. There is a misconception that offering music for purchase in digital format lowers distribution costs. This is simply not the case. In fact, the costs associated with distributing music in the digital environment outpace those in the physical world. Making over 3 million songs available to the public for listening and purchasing is an expensive undertaking. The technology infrastructure costs alone are staggering, so much so that only three companies in the digital music space own their own infrastructure. In addition, the offering of subscription services where the customer has no contractual obligation to maintain their subscription brings with it substantial administrative costs. Copies of Napster's latest annual and quarterly public filings are attached hereto as Exhibit D.

55. As our public filings indicate, a tremendous percentage of our revenues are paid out in royalties for content from copyright owners. For permanent downloads, we pay upwards of seventy percent of revenues to record labels and publishers. For subscription services, we pay slightly less to the labels and publishers (to the extent those obligations have been defined) for the assorted rights, to the extent that our publishing obligations are definable at this point. A copy of our current agreement with the Harry Fox Agency for our subscription offerings is attached hereto as Exhibit E. In addition, we pay license fees for the public performance rights embodied in our music to ASCAP, BMI, and SESAC (the performing rights organizations, or "PROs"). In all, this

represents tens of millions of dollars annually in licensing fees, a large percentage of our revenues.

56. Importantly, because our subscription service streams music as well as offers tethered downloads, I believe that we pay, or are asked to pay, more to the PROs than we should. The PROs, who represent the same copyright owners (publishers) who receive payment under the Section 115 license at issue in this proceeding, have taken the public position that all of our activities (including downloads) implicate the public performance right that they administer for the publishers. Therefore, because we require a public performance license for our streaming activities and thus have no choice but to engage with the PROs in order to provide our service to consumers, we are quite possibly charged higher rates for streaming activities based on this implicit perspective. The result is that the publishers are likely double-dipping and assessing more than they should -- charging us multiple administrative fees for doing so -- and in the end raising our costs and the price we must charge consumers for our service.

57. Although we believe in paying content owners for their works, these costs are far and away above what is warranted in the marketplace (and certainly, the demand for double-payment is nothing short of abuse of leverage). If these costs are not rationalized soon, they will make it impossible to sustain a business. This proceeding should recognize this reality. If legitimate music services are to compete with "free" online music, the investments needed to develop the business cannot be freighted with excessive content costs.

58. In addition to content costs, marketing not surprisingly represents our most substantial expense. These include costs incurred in advertising our services online, in print, on radio, and on television. We need to aggressively market our service if we are going to achieve widespread adoption in the market. At the same time, there are many competing services available in the market, which requires us to spend substantial resources to distinguish ourselves from our competitors. Particularly at this nascent stage of the market, when the number of early adopters is limited, we must compete aggressively to win this crucial audience. Further, as previously mentioned, we devote a significant amount of our marketing resources trying to educate consumers generally about the benefits of digital music, as well as trumpeting the benefits of our subscription service.

C. OUR OTHER COSTS REMAIN SUBSTANTIAL AND SHOW NO SIGN OF GOING DOWN IN THE NEXT FIVE YEARS AS WE COMPETE TO STAY RELEVANT IN THE DYNAMIC MARKETPLACE

59. As described above, marketplace realities dictate that we continue to devote substantial resources to upgrading our software and customer interface in order to maintain competitive relevance. Our services would lose consumer appeal if we did not continuously upgrade and modify our systems. In addition, we need to expand our service to new platforms such as the mobile phone in order to meet customer demands and preferences as well as to new developments in the marketplace. As digital distribution is a new concept that is changing the music industry and related technology continues to advance rapidly, we have found ourselves having to develop and adjust at an incredible pace to keep up with our competitors and with consumer expectations.

60. In addition to these expenses, we incur order processing and subscription management costs, including subscription billing, adding and maintaining billing options (such as PayPal) and customer service costs. This is another example of an area in which Napster incurs significantly higher costs in comparison to permanent download services or offline retailers. Napster needs sophisticated billing systems to check every month that the subscriber's registered credit card is valid, that the authorization to deduct fees continues, and that problems due to consumers changing credit cards and/or credit cards expiring are addressed. This makes the billing and customer services process much more complex and time-consuming than it is for our competitors, increasing overall costs to the company. The intricacies of subscription billing also make it considerably more difficult to run price promotions or to increase price points, as any such price changes are technically more complex to implement and have to be positively brought to the attention of all subscribers, which may have the negative effect of encouraging them to cancel their subscription.

61. We also include information technology costs for hardware and software, licensing costs for any such technology, systems development and technical costs, development and maintenance of the client software and website, encoding, storage, accounting, database management, and reporting. And we also spend resources on integrating and upgrading DRM software, including integration with third party devices and quality assurance, as well as bandwidth and hosting. Again, DRM software is significantly more complicated in the subscription environment than for one-off download purchases.

62. Because Napster is committed to reducing the number and appeal of illegal music services, we incur substantial costs in our efforts to fight piracy. These costs include investment in the development and operation of a comprehensive DRM structure to ensure that songs are secure and cannot be freely shared on the internet as well as educating the consumer on the benefits of paid, legal subscription versus the illegal alternatives. These efforts to change consumer behavior are absolutely critical to the survival of the legitimate digital music industry and we have not shied away from the task of convincing music fans that legal digital music services are the only way to fully and legally enjoy music online.

63. While we believe that we offer the best possible digital music experience to our customers, we realize that continued innovation and development is crucial to our success. We realize that we must continue to invest heavily in the development of new technologies as well as learn to take advantage of other industry advances. As more and more consumers are expressing their desire to obtain anytime, anywhere mobile multimedia content, our company must be in a position to respond and be competitive. As a result, we do not see our costs for technology and development going down over time.

64. Of course we cannot develop and operate the services that we do without incurring significant administrative expenses. Last year, our general and administrative expenses were roughly 20 million dollars. A significant portion of those expenses are related to copyright royalty accounting, which is unnecessarily cumbersome. Napster is responsible for paying mechanical royalties for its tethered downloads for the vast

majority of our catalog. Even though the major labels handle publishing royalties for their permanent download deals, and have the relevant information to do so for tethered downloads as well, they will not do it for us, nor will they (or the publishing community) provide us with the information that we require to be able to license or administer payments efficiently.

65. As a result, we need to secure the resources to identify copyright owners and comply with royalty administration costs ourselves. Every single track in our catalog of 3 million songs may have one or more writers, which in turn means one or more publishers. The information is not necessarily included with the tracks we license from the labels; even when it is, that information is rarely complete -- one but not all writers, a writer but not the publisher, and so on. We need to obtain contact information for these entities. We also need to determine how <u>much</u> of each song each writer/publisher controls. This is a significant burden, and one that will increase as our catalog increases.

V. A REASONABLE ROYALTY MUST MINIMIZE THE SUBSTANTIAL POTENTIAL FOR DISRUPTION IN THIS STILL-EVOLVING MARKETPLACE

66. In order to remain competitive, Napster needs to work hard to market the service and keep it compelling to consumers. This means we need to keep our costs as low as possible and maintain the ability to adapt in the marketplace and not get stuck in business models that are not competitive in the marketplace. There are tremendous uncertainties going forward. The Board should set a rate that recognizes the contributions we make to creators of musical works and the risks we face in continuing to create a market for those works.

67. There are a number of risks outside our control that require our active engagement and investment to address. For example, our business is dependent upon modern communications systems and increased adoption of new consumer electronic devices. Continued penetration of wire-line and wireless broadband is required as well in order for us to increase our exposure to the market and offer a complete product. Our platform and distribution depend on a broadband presence, but we need to constantly invest and innovate to remain relevant to new distribution platforms.

68. In addition, we must stay current with respect to network security, employing encryption and authentication technologies that prevent attacks on our system from hackers.

69. As technology in the digital market place changes, so too will the way consumers listen to music. This is not a mature industry and the market will continue to evolve. We will need to continue to invest to stay relevant on all of the relevant platforms and devices so we are not shut out of a significant business opportunity and consumers can access us as they do other services they choose. Consumers demand that a digital music service bring with it the ability to operate seamlessly on the widest range of platforms and devices.

70. When a rate is set, Napster will face substantial costs in administering the compulsory license and making payments to copyright owners. Each track in our catalog may have one or more writers, which means one or more publishers. As stated above, we do not receive complete writer and publisher data, nor the percentage of ownership of each track, from our licensors. In the course of negotiating copyright reform legislation,

the Harry Fox Agency estimated that it would take them more than two years and ten million dollars to assemble this information and build out their database to house it and they administer licenses for 70% of the publishers in the United States. Thus, when the compulsory rate is set, Napster will have to first identify and locate publishers, send them compulsory notices, and then be prepared to report and pay within ten days after the end of each month. This is simply not feasible given the lack of information available today.

71. On October 6, 2006, Napster entered into an agreement settling copyright royalty litigation in the United Kingdom. The settlement and license are attached here to as Exhibit F. As a result, Napster (as well as the other digital music services) will pay [redacted] fees to the owners of copyright in musical compositions for a blanket license to the rights that include the equivalent of the United States rights of public performance, reproduction, and distribution. Certain important issues remain to be litigated.

72. We believe the settlement represents a fair compromise to settle litigation in that jurisdiction. It does not, however, provide a directly applicable analogy to the United States because of the nature of the rights conveyed (*i.e.*, both performance and mechanical rights were conclusively licensed), differences in the respective markets, and the specific negotiation path taken. At most, it is a ceiling on what a reasonable royalty would be because it provides a so-called "blanket license" for all necessary publishing rights and it incorporates both the rights to publicly perform and communicate the catalog to the public as well as to reproduce and distribute the catalog. Such a blanket license eliminates many of Napster's publishing issues in the United States, as discussed above --

including the legal uncertainty inherent in the publishing licensing climate, negotiation with several different publishing representatives and administration of various licenses, and the substantial expenses associate with administering those licenses.

73. There are also unique attributes to pricing and consumer adoption of digital services in the United Kingdom. In the UK, customers appear more accustomed to paying for subscription services such as Napster. And the market is in any case less significant to Napster than the United States, where the overwhelming majority of Napster's investments have been made and subscribers are located, so that the threat of significant continued litigation costs was weighed against a very different outcome impact.

74. The royalty in this proceeding should be set in a manner that takes into account the nascent stage of the market, its continued evolution, and the realities I have described above. A percentage of revenue rate would allow both copyright owner and user to share in the risks and rewards of the business. The revenue base should be defined as DiMA proposes to assess solely those activities related to the use of the license: the purchase of the permanent download or the plays made by subscribers of tethered downloads offered by the service.

75. A percentage not inconsistent with the rate set for physical recordings in 1981 seems a reasonable ceiling for setting rates for this newer industry. On a spectrum of consumer use of digital music ranging from DMCA compliant radio to permanent ownership, tethered downloads should command a slightly lower percentage rate than permanent downloads because consumers acquire "less" than permanent ownership

rights. This is in fact acknowledged by the record labels, who typically charge less for licensing sound recordings for subscription use. Further, there is less acceptance of the business model, as evidenced by the costs of customer acquisition and the investments required to reduce churn. Moreover, as discussed above, I believe we probably pay more than we should for public performance rights to the same copyright owners for streaming activities that consumers pay for in their subscriptions, so a lower assessment in this context also makes sense.

76. Importantly, the Board should not set a per-copy, or per-user minimum fee at this time. Although the United Kingdom settlement includes [redacted] this was in the nature of the overall compromise made to avoid protracted litigation in that market. A minimum fee would cripple our ability to vary prices and remain competitive. A penny rate for use or plays of tethered downloads would likely require Napster to impose content usage limitations on consumers that are antithetical to the way music fans demand to consume digital music (as well as provide yet another roadblock against distinguishing our legitimate service from the pirate sites), creating the wrong incentive structure and in fact leading to less subscription uptake and higher churn. These burdens and the associated reduction in total output of creative works would be inconsistent with the statutory ratesetting objectives applicable in this proceeding. We know these sorts of limitations do not work because they were in effect when *pressplay* launched and were central to the failure of that initial business. If consumers who are already facing the challenge of learning not to "own" music are further restricted in how much they can "play" they quickly lose interest in the service.

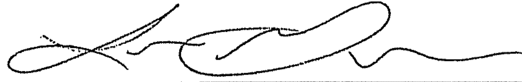
77. Napster has yet to turn a profit. Increased royalty rates necessarily increase our costs and create upward pressure on prices. The price at which we offer our services is so critical to our existence that if royalty rates were to be set too high so that we could no longer charge our customers a competitive price for our services, it would likely mean the end of our business. There is no question that very small increases in our price would drive away substantial numbers of our customers and be unsustainable. Consumers have a price breaking point above which they are unwilling to pay for digital music services. Pricing Napster out of the market would be penny wise and pound foolish, as there is no chance it would have an impact on pirated music.

VI. CONCLUSION

78. For the foregoing reasons, I support DiMA's proposed rate of 4.1% of applicable revenue for permanent downloads and 4% of applicable revenue for limited downloads, as well as the terms for the license. DiMA's proposed rate will provide content creators and users with a fair return. In addition, DiMA's proposed rates will not cause disruption to the still-evolving digital music market and will help spur growth and development of the business to the benefit of copyright owners, users and consumers.

WDC 393826v.1

I declare under penalty of perjury that the foregoing is true and correct to the best of my knowledge, information and belief:



Laura Goldberg

3/30/07

Date

A

B

This exhibit contains restricted information that is subject to a confidentiality agreement and has been redacted from the publicly filed version

C

This exhibit contains restricted information that is subject to a confidentiality agreement and has been redacted from the publicly filed version

D

10-Q 1 d10q.htm QUARTERLY REPORT ON FORM 10-Q

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

FORM 10-Q

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

For the quarterly period ended September 30, 2006

OR

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

Commission File Number: 000-32373

Napster, Inc.
(Exact name of Registrant as specified in its charter)

Delaware (State or other jurisdiction of incorporation or organization)	77-0551214 (IRS Employer Identification No.)

9044 Melrose Avenue
Los Angeles, California 90069
(Address of principal executive offices, including zip code)

Registrant's telephone number, including area code: (310) 281-5000

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

Indicate by check mark whether the Registrant 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 ☐ 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 ☒

As of November 1, 2006, there were approximately 44,900,000 shares of the Registrant's Common Stock outstanding, par value $0.001.

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NAPSTER, INC.
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Cautionary Note regarding Forward-Looking Statements

In addition to historical information, this Quarterly Report on Form 10-Q (this "Quarterly Report") contains forward-looking statements within the meaning of Section 27A of the Securities Act of 1933, as amended, and Section 21E of the Securities Exchange Act of 1934, as amended. Forward-looking statements are those that predict or describe future events or trends and that do not relate solely to historical matters. You can generally identify forward-looking statements as statements containing the words "believe," "expect," "will," "anticipate," "intend," "estimate," "project," "plan," "may," "predict," "assume" or other similar expressions, although not all forward-looking statements contain these identifying words. All statements in this Quarterly Report regarding our future strategy, future operations, projected financial position, estimated future revenues, projected costs, future prospects, and results that might be obtained by pursuing management's current plans and objectives are forward-looking statements. You should not place undue reliance on our forward-looking statements because the matters they describe are subject to known and unknown risks, uncertainties and other unpredictable factors, many of which are beyond our control. Our forward-looking statements are based on the information currently available to us and speak only as of the date on which this Quarterly Report was filed with the Securities and Exchange Commission ("SEC"). We expressly disclaim any obligation to issue any updates or revisions to our forward-looking statements, even if subsequent events cause our expectations to change regarding the matters discussed in those statements. Over time, our actual results, performance or achievements will likely differ from the anticipated results, performance or achievements that are expressed or implied by our forward-looking statements, and such difference might be significant and materially adverse to our stockholders. Many important factors that could cause such a difference are described in this Quarterly Report under the caption "Risk Factors" and elsewhere in this Quarterly Report which you should review carefully. Please consider our forward-looking statements in light of those risks as you read this Quarterly Report.

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PART I - FINANCIAL INFORMATION

ITEM 1. FINANCIAL STATEMENTS

NAPSTER, INC.

CONDENSED CONSOLIDATED BALANCE SHEETS
(in thousands, except per share data)
(unaudited)

	As of September 30, 2006	As of March 31, 2006
ASSETS		
Current assets:		
Cash and cash equivalents	$ 31,064	$ 46,812
Short-term investments	59,254	49,812
Foreign currency conversion in transit	—	7,545
Accounts receivable, net of allowance for doubtful accounts of $8 at September 30, 2006 and $7 at March 31, 2006	1,283	1,042
Prepaid expenses and other current assets	4,464	6,182
Total current assets	96,065	111,393
Property and equipment, net	5,768	7,012
Goodwill	34,658	34,658
Investment in unconsolidated entity	1,461	2,203
Other assets	226	275
Total assets	$ 138,178	$ 155,541
LIABILITIES AND STOCKHOLDERS' EQUITY		
Current liabilities:		
Accounts payable	$ 5,226	$ 3,279
Income taxes payable	4,244	4,139
Accrued liabilities	17,017	16,745
Deferred revenues	9,510	12,824
Total current liabilities	35,997	36,987
Long-term liabilities		
Deferred income taxes	3,085	2,622
Other long-term liabilities	120	159
Total liabilities	39,202	39,768
Commitments and contingencies (Note 8)		
Stockholders' equity:		
Common stock, $0.001 par value; Authorized: 100,000 shares; Issued and Outstanding: 44,929 shares at September 30, 2006 and 43,826 shares at March 31, 2006	45	44
Additional paid-in capital	259,181	260,198
Deferred stock-based compensation	—	(2,934)
Accumulated deficit	(160,188)	(141,368)
Accumulated other comprehensive loss	(62)	(167)
Total stockholders' equity	98,976	115,773
Total liabilities and stockholders' equity	$ 138,178	$ 155,541

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

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NAPSTER, INC.

CONDENSED CONSOLIDATED STATEMENTS OF OPERATIONS
(in thousands, except per share data)
(unaudited)

	Three Months Ended September 30,		Six Months Ended September 30,	
	2006	2005	2006	2005
Net revenues	$25,460	$ 23,379	$ 53,576	$ 44,380
Cost of revenues (1)	18,526	18,287	37,648	32,692
Gross margin	6,934	5,092	15,928	11,688
Operating expenses:				
Research and development (1)	2,297	3,216	5,234	6,411
Sales and marketing (1)	8,526	10,391	18,997	26,663
General and administrative (1)	5,712	4,791	11,700	10,987
Amortization of intangible assets	—	474	—	948
Total operating expenses	16,535	18,872	35,931	45,009
Loss from operations	(9,601)	(13,780)	(20,003)	(33,321)
Other income, net	1,227	451	2,408	331
Loss before income tax provision	(8,374)	(13,329)	(17,595)	(32,990)
Income tax provision	(290)	(283)	(557)	(548)
Loss from unconsolidated entity	(338)	—	(668)	—
Net loss	$ (9,002)	$(13,612)	$(18,820)	$(33,538)
Basic and diluted net loss per share	$ (0.21)	$ (0.32)	$ (0.44)	$ (0.78)
Weighted average shares used in computing net loss per share:				
Basic and diluted	43,197	42,977	43,147	42,969

(1) Amounts reported include stock-based compensation expense as follows:

Cost of revenues	$ 6	$ 3	$ 16	$ 4
Research and development	181	72	368	95
Sales and marketing	115	29	258	38
General and administrative	677	190	1,311	286

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

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NAPSTER, INC.

CONDENSED CONSOLIDATED STATEMENT OF CHANGES IN STOCKHOLDERS' EQUITY
(in thousands)
(unaudited)

	Common Stock		Additional Paid-in Capital	Deferred Stock-based Compensation	Accumulated Deficit	Accumulated Other Comprehensive Loss	Total Stockholders' Equity
	Shares Outstanding	Amount					
Balance at March 31, 2006	43,826	$ 44	$260,198	$ (2,934)	$ (141,368)	$ (167)	$ 115,773
Net loss	—	—	—	—	(18,820)	—	(18,820)
Foreign currency translation adjustment	—	—	—	—	—	36	36
Unrealized gain on short- term investments	—	—	—	—	—	69	69
Total comprehensive loss							(18,715)
Reversal of deferred stock- based compensation upon adoption of SFAS No. 123(R)	—	—	(2,934)	2,934	—	—	—
Issuance of common stock under employee stock plans, net of cancellations and share repurchases	1,103	1	(36)	—	—	—	(35)
Stock-based compensation expense	—	—	1,953	—	—	—	1,953
Balance at September 30, 2006	44,929	$ 45	$259,181	$ —	$ (160,188)	$ (62)	$ 98,976

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

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NAPSTER, INC.

CONDENSED CONSOLIDATED STATEMENTS OF CASH FLOWS
(in thousands)
(unaudited)

	Six Months Ended September 30, 2006	Six Months Ended September 30, 2005
Cash flows from operating activities:		
Net loss	$ (18,820)	$ (33,538)
Adjustments to reconcile net loss to net cash used in operating activities:		
Depreciation and amortization	1,766	2,634
Amortization of prepaid marketing expenses	—	1,727
Stock-based compensation charges	1,953	423
Change in fair market value of investment hedge	—	684
Non-cash loss from remeasurement of cash balance	—	510
Deferred tax expense	463	464
Loss from unconsolidated entity	668	—
Change in operating assets and liabilities:		
Accounts receivable	(237)	(16)
Prepaid expenses and other current and long term assets	(400)	(496)
Accounts payable	1,918	(1,324)
Income taxes payable	98	(454)
Accrued liabilities	265	2,153
Deferred revenues	(3,408)	(22)
Other long-term liabilities	(34)	(3)
Net cash used in operating activities	(15,768)	(27,258)
Cash flows from investing activities:		
Purchases of property and equipment	(521)	(1,572)
Proceeds from sale of Consumer Software Division	2,200	—
Purchases of short-term investments	(45,533)	(62,749)
Proceeds from maturities and sale of short-term investments	36,159	39,934
Foreign currency conversion in transit	7,545	—
Other	68	—
Net cash used in investing activities	(82)	(24,387)
Cash flows from financing activities:		
Principal payment of capital lease obligation	(31)	(51)
Repayment of line of credit	—	(15,000)
Issuance of common stock under employee stock plans	167	108
Repurchase of common stock	(202)	—
Net cash used in financing activities	(66)	(14,943)
Effect of exchange rates on cash	168	(779)
Change in cash and cash equivalents	(15,748)	(67,367)
Cash and cash equivalents at beginning of period	46,812	135,416
Cash and cash equivalents at end of period	$ 31,064	$ 68,049

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

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NAPSTER, INC.

CONDENSED CONSOLIDATED STATEMENTS OF CASH FLOWS—(Continued)
(in thousands)
(unaudited)

	Six Months Ended September 30,	
	2006	2005
Non-cash disclosure of investing and financing activities:		
Unrealized gains (losses) on short term investments, net	$ 69	$ 140
Deferred stock-based compensation related to issuance of common stock options and restricted awards to employees, net of terminations	$ —	$ 3,885
Asset purchased under capital lease	$ —	$ 22

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

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NAPSTER, INC.

NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS
(unaudited)

NOTE 1—BASIS OF PRESENTATION

Basis of Presentation

The unaudited condensed consolidated financial statements have been prepared by Napster, Inc., a Delaware corporation ("Napster" or the "Company"), pursuant to the rules and regulations of the Securities and Exchange Commission ("SEC"). The condensed consolidated balance sheet as of March 31, 2006, was derived from audited financial statements but does not include all disclosures required by accounting principles generally accepted in the United States. Certain information and footnote disclosures normally included in consolidated financial statements prepared in accordance with generally accepted accounting principles in the United States have been condensed or omitted pursuant to such rules and regulations. However, Napster believes that the disclosures are adequate to make the information presented not misleading. These condensed consolidated financial statements should be read in conjunction with the consolidated financial statements and the notes included in Napster's Annual Report on Form 10-K for the year ended March 31, 2006.

The condensed consolidated financial statements reflect all adjustments, which include only normal, recurring adjustments, that are, in the opinion of management, necessary to state fairly the results for the periods presented. The results for such periods are not necessarily indicative of the results to be expected for the full year.

The preparation of condensed consolidated financial statements in conformity with generally accepted accounting principles in the United States requires management to make estimates and assumptions that affect the reported amounts of assets and liabilities and disclosure of contingent assets and liabilities at the date of the condensed consolidated financial statements and the reported amounts of revenues and expenses during the reporting periods. Actual results could differ from those estimates.

Our fiscal year end is March 31, and our fiscal quarters end on June 30, September 30 and December 31. Unless otherwise stated, all dates refer to our fiscal year and fiscal periods.

Advertising Costs

Advertising costs are expensed as incurred through direct spending and were approximately $6.0 million and $12.9 million for the three and six months ended September 30, 2006, respectively, and $7.3 million and $20.0 million for the three and six months ended September 30, 2005, respectively.

Revenue Recognition

We recognize revenues in accordance with Staff Accounting Bulletin ("SAB") No. 104, "Revenue Recognition in Financial Statements", Emerging Issues Task Force ("EITF") 00-21, "Revenue Arrangements with Multiple Deliverables", and EITF 99-19, "Reporting Revenue Gross as a Principal versus Net as an Agent". In general, we recognize revenue, net of sales related taxes, when there is persuasive evidence of an arrangement, the fee is fixed or determinable, the product or services have been delivered and collectability of the resulting receivable is reasonably assured.

Revenues from prepaid cards and promotions are deferred and then recognized as (i) tracks are downloaded by the end users, (ii) if redeemed for a subscription, over the subscription period or (iii) when Napster has no further obligation to provide services or refund the associated prepayments ("breakage"). As of September 30, 2006, we have not had sufficient historical experience to estimate prepaid card breakage rates, so we recognize prepaid card breakage when our obligation to honor the redemption of the prepaid cards or promotions has legally expired. During the first quarter of fiscal 2007, based on the resolution of certain legal restrictions associated with previously sold prepaid cards, we recognized $1.9 million of prepaid card breakage related to cards that were subject to expiration based on their term prior to 2007 but had other legal restrictions that precluded our recognition of revenue.

During May 2006 we launched a free music service on which we sell advertising. Advertising revenues are recognized when an advertisement appears in web pages viewed by users. Advertising revenues were immaterial for the six months ended September 30, 2006.

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NOTE 2—CASH, CASH EQUIVALENTS AND INVESTMENTS

Cash and Cash Equivalents

Napster's cash and cash equivalents at fair value consist of the following (in thousands):

	September 30, 2006	March 31, 2006
Cash	$ 17,735	$ 6,359
Cash equivalents:		
Commercial paper	9,804	22,773
Certificates of deposit	302	1,106
Money market securities	3,223	16,574
Total cash equivalents	13,329	40,453
Total cash and cash equivalents	$ 31,064	$46,812

Short-Term Investments

Napster's short-term investments at fair value consist of the following (in thousands):

	September 30, 2006	March 31, 2006
Commercial paper	$ 19,533	$ 5,041
Asset backed securities	5,762	—
Certificates of deposit	2,987	3,979
Corporate securities	25,652	25,399
Municipal securities	2,003	9,815
U.S. agencies securities	3,317	5,578
	$ 59,254	$49,812

Napster's investments in marketable securities and short-term investments are all considered available for sale. The fair values of these investments approximate carrying value. Realized and unrealized gains and losses on investments are determined on the specific identification method.

Approximately $58.5 million and $47.0 million of the short-term investments mature in less than one year as of September 30, 2006 and March 31, 2006, respectively. The remaining short-term investments generally have effective maturity dates between one and two years. Because the short-term investments represent the investment of cash available to fund current operations, the entire balance has been classified as short-term in the condensed consolidated balance sheet.

Realized gains and losses, amortization and accretion on cash equivalents and short-term investments, net, totaled $395,000 and $815,000 for the three and six months ended September 30, 2006, respectively, and $104,000 and $173 ,000 for the three months and six months ended September 30, 2005, respectively. Gross realized losses on short-term investments for the three and six months ended September 30, 2006 and 2005 were not significant. Additionally, gross unrealized gains on cash equivalents and short-term investments were $7,000 and $4,000 as of September 30, 2006 and March 31, 2006, respectively, and gross unrealized losses were $49,000 and $114,000 as of September 30, 2006 and March 31, 2006, respectively. Napster has determined that the gross unrealized losses on its available-for-sale securities as of September 30, 2006 are temporary in nature.

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NOTE 3—BALANCE SHEET DETAIL

Deferred revenues (in thousands)

	September 30, 2006	March 31, 2006
Unearned subscription revenue	$ 4,251	$ 4,592
Unredeemed pre-paid card and promotional content	3,816	6,929
Unearned hardware and license revenue	1,007	1,012
Other	436	291
	$ 9,510	$12,824

During the first quarter of fiscal 2007, based on the resolution of certain legal restrictions associated with previously sold prepaid cards, we recognized $1.9 million of revenue related to cards that were subject to expiration based on their term prior to 2007 but had other legal restrictions that precluded our recognition of revenue.

NOTE 4—SHORT-TERM DEBT

At September 30, 2006, Napster had available a $17.0 million revolving line of credit with Silicon Valley Bank and was in compliance with all financial covenants relating to this line of credit. There was no balance outstanding under this line of credit at September 30, 2006. Napster terminated this line of credit during October 2006.

NOTE 5—STOCKHOLDERS' EQUITY

Stock-based Compensation

Effective April 1, 2006, Napster adopted the provisions of Statement of Financial Accounting Standards ("SFAS") No. 123 (revised 2004), "Share-Based Payment" ("SFAS No. 123(R)"). SFAS No. 123(R) requires the measurement and recognition of compensation expense for all stock-based awards issued to employees and directors based on estimated fair values. SFAS No. 123(R) supersedes Napster's previous accounting under Accounting Principles Board Opinion No. 25, "Accounting for Stock Issued to Employees" ("APB No. 25"), for periods beginning April 1, 2006. In March 2005, the SEC issued SAB No. 107 ("SAB 107") relating to SFAS No. 123(R). Napster has applied the provisions of SAB 107 in its adoption of SFAS No. 123(R).

Napster adopted SFAS No. 123(R) using the modified prospective method, which requires the application of the accounting standard as of April 1, 2006, the first day of the Company's fiscal year. Napster's condensed consolidated financial statements as of and for the three and six-months ended September 30, 2006 reflect the impact of SFAS No. 123(R). In accordance with the modified-prospective transition method, Napster's condensed consolidated financial statements for prior periods have not been restated to reflect, and do not include, the impact of adopting SFAS No. 123(R). Effective April 1, 2006, stock-based compensation expense includes compensation expense for (1) all stock-based compensation awards granted prior to but not vested as of April 1, 2006, based on the grant date fair value estimated in accordance with the original provisions of SFAS No. 123, "Accounting for Stock-Based Compensation" ("SFAS No. 123"), and (2) all stock-based compensation awards granted after April 1, 2006 based on the grant-date fair value estimated in accordance with the provisions of SFAS No. 123(R).

Under SFAS No. 123(R), compensation expense for all share-based compensation awards is recognized on a straight-line basis over the period the employee performs the related services, generally the vesting period of four years, net of estimated forfeitures. The application of the estimated forfeiture rate under SFAS No. 123(R) to unvested restricted stock awards as of April 1, 2006 was not material. Napster has estimated forfeitures based on historical experience and will revise the rates, if necessary, in subsequent periods if actual forfeitures differ from initial estimates.

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Stock-based compensation expense of $979,000 and $1,953,000 for the three and six months ended September 30, 2006, respectively, includes approximately $565,000 ($0.01 per share) and $1,205,000 ($0.03 per share), respectively, related to stock options and shares purchased under the Employee Stock Purchase Plan ("ESPP"), which would not have been expensed under the intrinsic value method of APB No. 25.

Under SFAS No. 123(R), Napster has selected the Black-Scholes option-pricing model to determine the estimated fair value at the date of grant for stock options, which is consistent with the method Napster used for pro forma disclosures under SFAS No. 123. The fair value of stock options granted and shares purchased under ESPP for the six months ended September 30, 2006 was $72,000 and $74,000, respectively. There were no stock options granted in the three months ended September 30, 2006. The fair value of restricted stock awards is measured at the market price of the unrestricted stock on the grant date.

Prior to the adoption of SFAS No. 123(R), Napster presented deferred compensation as a separate component of stockholders' equity. In accordance with the provisions of SFAS No. 123(R), on April 1, 2006, Napster reclassified the balance of deferred compensation expense to additional paid-in capital on its condensed consolidated balance sheet.

The adoption of SFAS No. 123(R) also requires additional accounting related to income taxes. Due to the full valuation allowance provided on its net deferred tax assets, Napster has not recorded any tax benefit attributable to stock-based compensation expense.

The following table illustrates the effect on net loss and net loss per share for the three and six months ended September 30, 2005, if Napster had applied the fair value recognition provisions of SFAS No. 123 to stock-based employee compensation using the Black-Scholes model (in thousands, except per share amounts):

	Three Months Ended September 30, 2005	Six Months Ended September 30, 2005
Net loss, as reported	$ (13,612)	$ (33,538)
Add:		
Stock-based employee compensation expense included in reported net loss	284	413
Deduct:		
Stock-based employee compensation expense determined under fair value method for all awards	(1,193)	(2,430)
Pro forma net loss	$ (14,521)	$ (35,555)
Net loss per share:		
Basic and diluted—as reported	$ (0.32)	$ (0.78)
Basic and diluted—pro forma	$ (0.34)	$ (0.83)
Weighted average shares used in computing net income and pro forma net income per share:		
Basic and diluted shares	42,977	42,969

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Stock Plans

The following table summarizes the activity relating to restricted stock awards and stock option grants for the six months ended September 30, 2006:

	Restricted Stock		Stock Options	
	Unvested Shares	Weighted Average Fair Value	Shares	Weighted Average Exercise Price
Outstanding at March 31, 2006	784,810	$ 4.17	4,321,637	$ 7.52
Awarded/granted	1,233,625	$ 3.95	26,700	$ 4.05
Vested	(181,588)	$ 4.22	—	—
Exercised	—	—	(22,032)	$ 4.13
Forfeited	(120,828)	$ 4.05	(59,811)	$ 4.33
Expired	—	—	(200,403)	$ 6.57
Outstanding at September 30, 2006	1,716,019		4,066,091	

As of September 30, 2006, there was $4.7 million, $2.7 million and $163,000 of total unrecognized compensation expense related to unvested restricted stock awards, stock options and ESPP purchases, respectively, which is expected to be recognized over the weighted-average periods of 1.96, 0.93 and 0.94 years, respectively.

The following table summarizes information about stock options outstanding as of September 30, 2006:

	Options Outstanding			Options Exercisable		
Range of Exercise Prices	Number Outstanding	Weighted Average Remaining Contractual Life (in years)	Weighted Average Exercise Price	Number Exercisable	Weighted Average Remaining Contractual Life (in years)	Weighted Average Exercise Price
$3.48–$4.05	504,779	5.84	$ 3.87	466,704		$ 3.86
$4.13	1,079,125	7.85	$ 4.13	541,750		$ 4.13
$4.23–$7.22	262,812	7.29	$ 4.91	169,184		$ 4.95
$7.47	651,000	6.93	$ 7.47	489,125		$ 7.47
$7.92–$8.37	92,125	8.27	$ 8.12	37,469		$ 8.13
$8.50	654,500	4.55	$ 8.50	654,500		$ 8.50
$8.84–$16.55	821,750	5.24	$ 14.68	789,111		$ 14.90
	4,066,091	6.37	$ 7.61	3,147,843	6.02	$ 8.31

The aggregate intrinsic value of options outstanding and exercisable as of September 30, 2006 was $354,000 and $266,000, respectively.

As of September 30, 2006, Napster has reserved shares of common stock for future issuance as follows:

Stock option and award plans	11,098,985
ESPP	426,828
	11,525,813

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NOTE 6—EARNINGS PER SHARE

Basic net loss per share is computed using the weighted-average number of common shares outstanding during the period. Diluted net loss per share is computed using the weighted-average number of common and dilutive common equivalent shares outstanding during the period. Potentially dilutive common equivalent shares consist of restricted stock awards that are subject to repurchase and common stock issuable upon exercise of stock options, computed using the treasury stock method.

Common equivalent shares excluded from the calculation because their effect would have been anti-dilutive totaled 5.8 million and 5.9 million as of September 30, 2006 and 2005, respectively.

NOTE 7—GEOGRAPHIC INFORMATION

Net Revenue

The following table presents net revenues by country based on the location of customers (in thousands):

	Three Months Ended September 30,		Six Months Ended September 30,	
	2006	2005	2006	2005
United States	$20,608	$20,615	$44,848	$39,090
United Kingdom	2,932	2,764	5,901	5,290
Germany	1,920	—	2,827	—
	$25,460	$23,379	$53,576	$44,380

Cash and Investments

The following table presents cash, cash equivalents, foreign currency conversion in transit and short-term investments held in entities organized in the following legal jurisdictions (in thousands):

	September 30, 2006	March 31, 2006
United States	$ 78,698	$ 93,948
United Kingdom	1,024	1,837
Denmark	7,614	7,545
Luxembourg	2,949	839
Germany	33	—
	$ 90,318	$104,169

Napster does not anticipate that it will incur any material U.S. income or foreign withholding taxes when cash is repatriated from these entities to the United States.

Long-Lived Assets

The following table presents long-lived assets, excluding goodwill and investment in unconsolidated entity, by country based on the location of the assets (in thousands):

	September 30, 2006	March 31, 2006
United States	$ 5,906	$ 7,201
Other	88	86
	$ 5,994	$ 7,287

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NOTE 8—COMMITMENTS AND CONTINGENCIES

Litigation

Napster and Napster, LLC's predecessor, Pressplay, have been notified by a number of companies that the Pressplay and Napster digital music services may infringe patents owned by those companies. Napster is investigating the nature of these claims and the extent to which royalties may be owed by Napster and Pressplay to these entities. The ultimate resolution of these claims cannot be determined at this time.

On October 8, 2004, SightSound Technologies, Inc. ("SightSound") filed a lawsuit against Napster and Napster, LLC in U.S. District Court for the Western District of Pennsylvania, Case No. 04-1549, alleging infringement of certain of its patents by the Napster service. SightSound is demanding monetary damages and injunctive relief. Napster was served with the complaint in the lawsuit on November 5, 2004. Napster has answered the complaint and filed an application with the United States Patent and Trademark Office for reexamination of the patents. The court proceedings have been administratively closed pending the outcome of Napster's reexamination application. The patents are currently being reexamined by the Patent Office which recently rejected all of the claims of each of the patents. In or around November 2005, SightSound sold the patents in question to a subsidiary of General Electric for an undisclosed amount. Management believes that it is not currently possible to estimate the impact, if any, that the ultimate resolution of these matters will have on Napster's business, results of operations, financial position or cash flows.

On August 5, 2005, Ho Keung Tse filed suit against Apple Computer, Inc., Napster, MusicMatch, Inc., Sony Connect, Inc., Yahoo, Inc. and RealNetworks, Inc. in U.S. District Court for the District of Maryland alleging infringement of U.S. Patent No. 6665797 by the defendants' respective music distribution services. The lawsuit was recently transferred to U.S. District Court for the Northern District of California. Mr. Tse is demanding monetary damages and injunctive relief. The defendants have formed a joint defense group, have moved for change of venue, and intend to defend themselves vigorously. Management believes that it is not currently possible to estimate the impact, if any, that the ultimate resolution of these matters will have on Napster's business, results of operations, financial position or cash flows.

Napster is a party to other litigation matters and claims from time to time in the ordinary course of its operations, including copyright infringement litigation for which it is entitled to indemnification by content providers. While the results of such litigation and claims cannot be predicted with certainty, Napster believes that the final outcome of such matters will not have a material adverse impact on its business, financial position, cash flows or results of operations.

Indemnification

In December 2004, Napster completed the sale of substantially all of the assets and liabilities of its consumer software division to Sonic Solutions, a California corporation ("Sonic"). Napster agreed to indemnify Sonic for unpaid tax liabilities with respect to any tax year ended on or before December 17, 2004 (or for any other tax year to the extent allocable to the portion of such period beginning before and ending on December 17, 2004), to the extent such tax liabilities neither are reflected in the closing working capital calculation pursuant to the sale agreement nor create a realized reduction in Sonic's tax liabilities. Napster also agreed to indemnify Sonic for damages that relate to certain other tax-related matters, as described in the sale agreement. No limitation is set forth on the period of time by which a claim must be made pursuant to the foregoing indemnities nor is there a specified limitation on the maximum amount of potential future payments.

Obligations to content and distribution providers

Napster has certain royalty commitments associated with the licensing of the music content. Future payments under these content agreements are due to partners based upon net revenues and online music distribution volumes.

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NOTE 9—RECENT ACCOUNTING PRONOUNCEMENTS

In July 2006, the Financial Accounting Standards Board ("FASB") issued FASB Interpretation 48, "Accounting for Uncertainty in Income Taxes—an interpretation of FASB Statement No. 109" ("FIN 48"), which prescribes a recognition threshold and measurement process for recording in the financial statements uncertain tax positions taken or expected to be taken in a tax return. Additionally, FIN 48 provides guidance on the recognition, classification, accounting in interim periods and disclosure requirements for uncertain tax positions. The accounting provisions of FIN 48 will be effective for the Company beginning April 1, 2007. The Company is in the process of determining the effect, if any, that the adoption of FIN 48 will have on its financial statements.

In September 2006, the Financial Accounting Standards Board ("FASB") issued FASB Statement No. 157, "Fair Value Measurements" ("FAS 157"), which addresses how companies should measure fair value when they are required to use a fair value measure for recognition or disclosure purposes under generally accepted accounting principles ("GAAP"). The accounting provisions of FAS 157 will be effective for the Company beginning April 1, 2008. The Company is in the process of determining the effect, if any, that the adoption of FAS 157 will have on its financial statements.

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ITEM 2. MANAGEMENT'S DISCUSSION AND ANALYSIS OF FINANCIAL CONDITION AND RESULTS OF OPERATIONS

The following discussion should be read in conjunction with the financial statements and notes thereto included elsewhere in this Quarterly Report. The following discussion contains forward-looking statements that involve risks and uncertainties. Our actual results could differ materially from the results contemplated by these forward-looking statements due to certain factors, including those discussed below, in "Risk Factors" and elsewhere in this Quarterly Report.

Management's Discussion and Analysis of Financial Condition and Results of Operations is organized as follows:

- *Executive Summary*—a high level discussion of the business including a discussion of our strategy, opportunities, challenges and risks.
- *Critical Accounting Policies and Estimates*—a discussion of accounting policies that require critical judgments and estimates.
- *Results of Operations*—an analysis of our consolidated results of operations for the periods presented in our financial statements.
- *Liquidity and Capital Resources*—an analysis of cash flows, sources and uses of cash, and contractual obligations.
- *Recent Accounting Pronouncements*—information on recent accounting pronouncements.

Executive Summary

Napster, one of the most recognized global brands in digital music, offers consumers unlimited legal access to one of the world's largest and most diverse online music catalogues utilizing a secure and flexible digital rights management platform. Napster's online and portable music subscription services – Napster and Napster-To-Go ("NTG") – have over 500,000 subscribers and provide consumers with access to over 3.75 million unique CD-quality tracks worldwide via the PC and over 60 portable music players.

Because of its powerful brand awareness and superior user experience, Napster has established itself as a market leader in premium music subscription, not only in the US, but also globally, including the United Kingdom and Germany. Furthering its global presence, Napster recently launched its paid music service in Japan, leveraging Napster's joint venture with Tower Records Japan ("TRJ") and their relationship with NTT DoCoMo, a strategic investor in TRJ. These relationships position Napster to be a leader in yet another of the world's largest music markets.

In addition, Napster operates an a-la-carte download music store, called Napster Light, where customers can purchase individual tracks or albums. Napster has over 9.0 million registered members and through the successful launch of Napster.com, the Company's new advertising supported website that offers a free music experience, Napster has substantially increased the user traffic to Napster.com to over 4 million unique visitors per month. By offering visitors to Napster the ability to discover, share and listen to music for free on Napster.com, Napster is helping users to understand the value proposition of the subscription model, while creating a very compelling new web-based media property on which to build a substantial advertising platform.

Napster paid music services are also available over-the-air as "Napster Mobile". This recently launched service is available to SunCom Wireless and Cingular Wireless customers through our partnership with Ericsson, and to NTT DoCoMo Wireless customers through our joint venture with TRJ.

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The market for digital music is rapidly growing and we expect our digital music distribution business to continue to grow as the industry expands. This market is highly competitive and we expect competition to continue to increase in the future as the market expands. We believe that our brand, robust infrastructure, innovation and superior user experience position us ahead of many of our competitors.

Our overall strategy is to drive consumers to Napster.com as a means to generate ad revenue and reduce our subscriber acquisition cost, continue to innovate by investing in new services and technologies, extend leadership in the distribution of digital music through partnerships with wireless carriers, broaden access of Napster premium services through other well-known consumer electronics companies, and continue to pursue and execute strategic partnerships. The Company has established key strategic partnerships with leading wireless companies such as Ericsson, NTT DoCoMo and Cingular Wireless; leading consumer electronics device manufacturers such as Toshiba and Samsung; leading retailers such as Circuit City and Radio Shack; and the leading satellite radio company—XM Satellite Radio.

On September 18, 2006, we announced that in response to recent third party interest in establishing strategic partnerships or potentially acquiring the company, we have retained UBS Securities LLC to assist the Board and management in the evaluation of strategic alternatives. Although this evaluation could potentially lead to a new strategic partnership or the sale of the company, our primary focus in the meantime remains on growing Napster.

We sell online music services to end users worldwide through our website, affiliate network, and universities that have site licenses, as well as prepaid cards through retail partners. We have historically derived our primary revenues from online subscriptions and permanent music downloads. Beginning in the first quarter of fiscal 2007, we also began deriving revenue from advertising. In addition, Napster periodically licenses merchandising rights and resells hardware that our end users may utilize to store and replay their digital music content. Subscription and permanent download fees are generally paid by end user customers in advance either via credit card, online payment systems or redemption of pre-paid cards, gift certificates or promotional codes. Advertising and licensing revenue is generally paid on industry standard net terms. Hardware sales are typically paid in advance by credit card.

Since the acquisition of Pressplay on May 19, 2003, our digital music distribution business has operated at a loss and with negative cash flow. We expect to continue to operate at a loss and with negative cash flow near term as we spend on marketing to increase subscriber growth.

Critical Accounting Policies and Estimates

Management's Discussion and Analysis of Financial Condition and Results of Operations is based upon our condensed consolidated financial statements, which have been prepared in accordance with generally accepted accounting principles in the United States. The preparation of these financial statements requires management to make estimates and assumptions that affect the reported amounts of assets, liabilities, revenue and expenses, and related disclosure of contingent assets and liabilities. Management bases its estimates on historical experience and on various other assumptions that it believes to be reasonable under the circumstances. The results of these estimates form the basis for making judgments about the carrying values of assets and liabilities that are not readily apparent from other sources. Actual results may differ from our estimates.

An accounting policy is deemed to be critical if it requires an accounting estimate to be made based on assumptions about matters that are highly uncertain at the time the estimate is made, and if different estimates that reasonably could have been used or changes in the accounting estimate that are reasonably likely to occur could materially change the financial statements. Except as indicated below, there have been no significant changes during the six months ended September 30, 2006 to the items that we disclosed as our critical accounting policies and estimates in Management's Discussion and Analysis of Financial Condition and Results of Operations in our Annual Report on Form 10-K for the fiscal year ended March 31, 2006.

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Revenue Recognition

We recognize revenues in accordance with Staff Accounting Bulletin No. 104, "Revenue Recognition in Financial Statements", Emerging Issues Task Force ("EITF") 00-21, "Revenue Arrangements with Multiple Deliverables" and EITF 99-19, "Reporting Revenue Gross as a Principal versus Net as an Agent". In general, we recognize revenue, net of sales related taxes, when there is persuasive evidence of an arrangement, the fee is fixed or determinable, the product or services have been delivered and collectability of the resulting receivable is reasonably assured.

Revenues from pre-paid cards and promotions are deferred and then recognized as (i) tracks are downloaded by the end users, (ii) if redeemed for a subscription, over the subscription period or (iii) when Napster has no further obligation to provide services or refund the associated prepayments ("breakage"). As of September 30, 2006, we have not had sufficient historical experience to estimate breakage rates, so we recognize breakage when our obligation to honor the redemption of prepaid cards or promotions has legally expired. In future periods, management will continue to evaluate our actual breakage experience and determine when we have sufficient history to commence revenue recognition using breakage estimates.

Management exercises significant judgment in determining the fair value of multiple elements within revenue arrangements or separately identified goods or services, and in assessing when prepaid cards, promotions or royalties no longer involve a future obligation to provide services or refund the associated prepayments. These estimates represent our best estimates, but changes in circumstances relating to the products and services sold in these arrangements may result in one-time expense or revenue charges.

Stock-based compensation

Effective April 1, 2006, Napster adopted the provisions of Statement of Financial Accounting Standards ("SFAS") No. 123 (revised 2004) "Share-Based Payment" ("SFAS No. 123(R)"), using the modified-prospective transition method. SFAS No. 123(R) requires that the fair value of all share-based payment awards made to employees and directors for services must be expensed over the period in which the services are provided.

Under SFAS No. 123(R), compensation expense for all share-based compensation awards is recognized on a straight-line basis over the period the employee performs the related services, generally the vesting period of four years, net of estimated forfeitures. Napster has estimated forfeitures based on historical experience and will revise the rates, if necessary, in subsequent periods if actual forfeitures differ from initial estimates.

Management uses historical data to estimate forfeiture rates on stock-based awards in recording stock-based compensation expense. To the extent actual results or updated estimates differ from our prior estimates, such amounts, if significant, will be recorded as a cumulative adjustment in the period that any such estimates are revised. If actual results differ significantly from what we previously estimated, our stock-based compensation expense and our results of operations could be materially impacted.

Results of Operations

Our fiscal year ends on March 31, and our fiscal quarters end on June 30, September 30 and December 31. Unless otherwise stated, all dates refer to our fiscal year and fiscal periods.

The financial information presented in this Quarterly Report is not necessarily indicative of our financial position, results of operations or cash flows in the future.

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Net Revenues

The following table sets forth, for the periods indicated, the summary of our revenues (in thousands, except percentages):

	Three Months Ended September 30,		As a Percentage of Net Revenues Three Months Ended September 30,		Six Months Ended September 30,		As a Percentage of Net Revenues Six Months Ended September 30,	
	2006	2005	2006	2005	2006	2005	2006	2005
Online music revenues:								
Service	$25,359	$21,036	100%	90%	$53,406	$41,787	100%	94%
Product and license	101	2,343	—%	10%	170	2,593	—%	6%
Total online music revenues	$25,460	$23,379	100%	100%	$53,576	$44,380	100%	100%

Service Revenues

Service revenues increased for the three and six months ended September 30, 2006 as compared to the corresponding periods of fiscal 2006 due primarily to growth in the online music market, consumer adoption of our products and international expansion. The Napster paid music service was launched in Germany during December 2005.

From the launch of Napster's paid music service in the United States in October 2003 until the launch of our free, advertising supported, music service in May 2006, our subscriber base increased each quarter, excluding the cyclical impact of university subscribers. Following the launch of the free music service, paid subscribers (excluding university subscribers) dropped to 487,000 at September 30, 2006, while churn reached an all-time low. This decrease in paid subscribers is attributed in part to prospective new customers trying the free music service before subscribing to our premium music services. The improvement in churn followed our increased focus on acquisition and retention over the last year. We expect paid subscribers to increase in the second half of fiscal 2007.

Service revenues for the six months ended September 30, 2006 include a one-time benefit of $1.9 million in prepaid card breakage related to the resolution of certain legal restrictions associated with previously sold prepaid cards. There was no corresponding one-time benefit to service revenues during the six months ended September 20, 2005.

In the long term, we anticipate that service revenues will continue to increase as a result of marketing activities and initiatives designed to continue subscriber growth, expand internationally and maintain low customer churn. In the near term, we expect service revenues to increase due to seasonality and as prospective customers who have been trying the free music services subscribe to our paid music services. Additionally, we expect to record a one-time benefit from prepaid card breakage in the third quarter of fiscal 2007 when we have sufficient history to estimate breakage rates and begin recognizing prepaid card revenue net of estimated breakage.

Product and License Revenues

Product and license revenues for the three and six months ended September 30, 2006 decreased as compared to the corresponding periods of fiscal 2006 primarily due to the timing of hardware promotional programs. We recognized $2.1 million of product revenue from a promotion in the second quarter of fiscal 2006. We expect that product and license revenues will fluctuate depending on the product promotions and licenses that we enter into each quarter.

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Geographic Revenues

The following table sets forth, for the periods indicated, the summary of our net revenues per geographic region (in thousands, except percentages):

	Three Months Ended September 30,		As a Percentage of Net Revenues Three Months Ended September 30,		Six Months Ended September 30,		As a Percentage of Net Revenues Six Months Ended September 30,	
	2006	2005	2006	2005	2006	2005	2006	2005
Revenues:								
North America	$20,608	$20,615	81%	88%	$44,848	$39,090	84%	88%
Europe	4,852	2,764	19%	12%	8,728	5,290	16%	12%
Net revenues	$25,460	$23,379	100%	100%	$53,576	$44,380	100%	100%

Revenues in North America remained stable for the three months ended September 30, 2006 as compared to the corresponding period of fiscal 2006, due primarily to a $2.2 million increase in service revenue during the second quarter of fiscal 2007, which was offset by a $2.2 million decrease in product revenue. The revenue increase in North America for the six months ended September 30, 2006 as compared to the corresponding period of fiscal 2006 is primarily due to the one-time benefit of $1.9 million in prepaid card breakage and subscriber growth year over year.

The increase in revenue in Europe for both the three and six months ended September 30, 2006 as compared to the corresponding periods of fiscal 2006 is generally related to the launch of the paid music service in Germany in December 2005.

We anticipate that the proportion of revenue outside of the United States will fluctuate as a result of continued marketing activities and initiatives focused on world-wide customer growth and international expansion.

Gross Margin

The following table sets forth, for the periods indicated, our gross margins (in thousands, except percentages):

	Three Months Ended September 30,		As a Percentage of Related Revenues Three Months Ended September 30,		Six Months Ended September 30,		As a Percentage of Related Revenues Six Months Ended September 30,	
	2006	2005	2006	2005	2006	2005	2006	2005
Gross Margin								
Service	$ 7,047	$ 5,696	28%	27%	$16,087	$12,160	30%	29%
Product and license	(113)	(604)	(112%)	(26%)	(159)	(472)	(94%)	(18%)
Total gross margin	$ 6,934	$ 5,092	27%	22%	$15,928	$11,688	30%	26%

Service gross margin is the profit from revenues after deducting the cost of royalties to content providers and publishers, technical support, bandwidth and hosting costs, depreciation and amortization of infrastructure and certain identifiable intangible assets related to the delivery of the services, and any other direct costs of providing the services. Product and license gross margin is the profit from revenues after deducting the cost of product sold, order fulfillment services, product shipping costs and any other direct expenses to deliver the product or licenses.

Service gross margin as a percentage of net revenue improved slightly during the three and six months ended September 30, 2006 as compared to the corresponding periods of fiscal 2006. The increase for the three months ended September 30, 2006 is primarily attributable to the change in mix of revenue towards higher margin services. The increase in the six months ended September 30, 2006 is also due to $1.9 million of prepaid card breakage, which was recognized in the first quarter of fiscal 2007 and has no cost of revenues.

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Excluding one-time breakage revenues, service gross margin for the three and six months ended September 30, 2006 decreased 2 percentage points from the same periods of fiscal 2006. This change is primarily due to increased encoding costs and additional ongoing expenditures for service infrastructure, offset in part by a change in revenue mix from download revenues to subscription revenues, which have a higher gross margin.

Product and license gross margin decreased for the three and six months ended September 30, 2006 as compared to the corresponding periods of fiscal 2006 due primarily to the timing of promotional hardware programs.

Service headcount dedicated to maintaining content and providing customer care was 12 and 9 at September 30, 2006 and 2005, respectively.

In the third quarter, gross margins are expected to improve because we plan to record a one-time benefit from prepaid card breakage. Longer term gross margins, excluding one-time items such as breakage and low margin hardware promotions, may improve as our revenue mix changes.

Operating Expenses

We classify operating expenses as research and development, sales and marketing and general and administrative. Each category includes related expenses for salaries, employee benefits, incentive compensation, stock-based compensation, travel, telephone, communications, facility costs and professional fees. Our sales and marketing expenses include additional expenditures specific to the marketing group, such as public relations, advertising, trade shows, marketing collateral materials and subscriber acquisition costs, as well as expenditures specific to the sales group, such as commissions and referral fees paid to marketing partners. In addition, we include certain amortization of identifiable intangible assets as operating expenses.

The following table sets forth, for the periods indicated, our operating expenses (in thousands, except percentages):

	Three Months Ended September 30,		As a Percentage of Net Revenues Three Months Ended September 30,		Six Months Ended September 30,		As a Percentage of Net Revenues Six Months Ended September 30,	
	2006	2005	2006	2005	2006	2005	2006	2005
Research and development	$ 2,297	$ 3,216	9%	14%	$ 5,234	$ 6,411	10%	14%
Sales and marketing	8,526	10,391	33%	44%	18,997	26,663	35%	60%
General and administrative	5,712	4,791	22%	21%	11,700	10,987	22%	25%
Amortization of intangible assets	—	474	—	2%	—	948	—	2%
	$16,535	$18,872	64%	81%	$35,931	$45,009	67%	101%

Research and Development

Research and development expenses consist primarily of salary, benefits (including stock-based compensation) and contractors' fees for our development and other costs associated with the minor enhancements of existing products, development of new services or development of new features for existing services.

Research and development expenses decreased for the three and six months ended September 30, 2006 as compared to the corresponding periods of fiscal 2006 primarily due to lower headcount costs and lower depreciation. During the second quarter of fiscal 2007 we deployed resources on projects for which we were reimbursed by Napster Japan. The $356,000 reimbursement was reflected as a reduction in R&D headcount costs during the second quarter of fiscal 2007.

Research and development headcount was 64 and 74 as of September 30, 2006 and 2005, respectively.

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We anticipate that research and development expenses in the third quarter of fiscal 2007 will be comparable to the first quarter of fiscal 2007, because the development projects funded by Napster Japan have been completed. Longer term, we expect research and development expenses to remain steady or increase slightly as we focus on the continued investment in new products and functionality.

Sales and Marketing

Sales and marketing expenses consist primarily of salary and benefits (including stock-based compensation) for sales and marketing personnel, referral fees paid to marketing partners, other subscriber acquisition costs, as well as costs associated with advertising and promotions.

Sales and marketing expenses decreased for the three and six months ended September 30, 2006 as compared to the corresponding periods of fiscal 2006 due primarily to the reduction in U.S. marketing programs as part of our goal to continuously bring down our cash burn.

Sales and marketing headcount increased to 36 at September 30, 2006 from 35 at September 30, 2005. Headcount increased because we added sales personnel for the advertising supported free music service.

We expect sales and marketing expenses for the remainder of fiscal 2007 to increase as we launch holiday marketing programs. In the long-term, we will continue our focus on reducing acquisition cost per subscriber.

General and Administrative

General and administrative expenses consist primarily of salary and benefits (including stock-based compensation) for executive and administrative personnel, professional services, administrative outsources and other general corporate activities.

General and administrative expenses increased for the three months ended September 30, 2006 as compared to the corresponding period of fiscal 2006 primarily due to approximately $500,000 of stock based compensation, and approximately $400,000 in professional and administrative outsource fees.

The increase in the six months ended September 30, 2006 as compared to the corresponding period of fiscal 2006 is due primarily to higher professional and administrative outsource fees. Headcount costs are flat and comprised of increased stock based compensation offset by lower bonuses.

General and administrative headcount, including all corporate general and administrative employees, was 42 at both September 30, 2006 and 2005.

We expect general and administrative expenses to increase in the near term as we evaluate strategic alternatives, and to generally increase in the long term as revenue, and the company overall, grows.

Amortization of Intangible Assets

Amortization of intangible assets consists of amortization expense related to the intangible assets recorded in connection with our acquisition of Napster's name in December 2002 and Napster, LLC, formerly known as Pressplay, in May 2003. There was no amortization of intangible assets in the first half of fiscal 2007 because identifiable intangible assets were fully amortized as of March 31, 2006. Unless we acquire new intangible assets, we do not expect future amortization expense.

Loss from Unconsolidated Entity

The loss from unconsolidated entity represents our 31.5% portion of the loss incurred by Napster Japan during the periods presented. Napster Japan was formed during October 2005, and this loss represents our share of the company's start-up expenses. We expect our share of the losses from Napster Japan to increase near term following the launch of the Napster service in Japan in October 2006.

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Other Income, Net

Other income, net, consists primarily of interest income on our cash equivalents and short-term investments, realized gains (losses) on short-term investments, interest expense, change in the fair value of the hedge and other miscellaneous income.

Other income, net increased $770,000 in the three months ended September 30, 2006 as compared to the corresponding period of fiscal 2006 primarily due to the elimination of the hedge on our shares of Sonic Solutions stock. The hedge discount was $342,000 during the second quarter of fiscal 2006 and zero during fiscal 2007. Investment income in the three months ended September 30, 2006 also increased $292,000.

Other income, net increased $2.1 million to $2.4 million in the first half of fiscal 2007 as compared to $331,000 in the corresponding period of fiscal 2006 primarily due to a $573,000 reduction in foreign currency losses and the elimination of the hedge on our shares of Sonic Solutions stock. The hedge discount was $684,000 during the first half of fiscal 2006 and zero during the first half of fiscal 2007. These changes were accompanied by a $642,000 increase in investment income and $147,000 increase in interest income attributed to higher interest rates in the first half of fiscal 2007.

We expect other income, net to decrease in the future as investments are used to fund operations. We also expect other income, net to fluctuate due to foreign currency fluctuations.

Income Tax Provision

We have recorded a valuation allowance to reduce deferred tax assets to the amount we believe is more likely than not to be realized. In the event that deferred tax assets would be realizable in the future in excess of the net recorded amount, an adjustment to the valuation allowance on deferred tax assets would increase income in the period such determination was made.

During January 2005, following the divestiture of Consumer Software Division ("CSD"), which utilized substantially all of our tax operating losses, Napster made a tax election to step up the basis in Pressplay goodwill for tax purposes. As a result, the Pressplay goodwill is deductible for tax purposes, which creates a tax timing difference that is presented as a deferred tax liability and deferred tax expense. As realization of this taxable temporary difference is not assured, a net tax expense related to this item is recorded.

The tax provisions for the first half of fiscal 2007 and 2006 represent primarily foreign taxes and the timing difference related to the Pressplay goodwill. In the near term, we expect to continue to incur operating losses from operations.

We are subject to various tax rates in the jurisdictions in which we do business. Our tax provision does not take into account any future benefit from loss carryforwards, which may be realized if we again achieve profitability and begin generating taxable income.

Liquidity and Capital Resources

At September 30, 2006, Napster had $90.3 million in cash, cash equivalents and short-term investments. These amounts consist principally of commercial paper, corporate securities, U.S. government securities, municipal securities, asset backed securities, certificates of deposit and money market securities. This balance represents a $13.9 million decrease as compared to cash, cash equivalents, short-term investments and foreign currency in-transit at March 31, 2006. Our primary ongoing source of cash is receipts from revenues. The primary uses of cash are payroll (salaries and related benefits), general operating expenses (marketing, travel and office rent), payments to content providers, payments for products held for resale, and purchases of property and equipment, including software development costs. Our working capital was $60.1 million at September 30, 2006 compared to $74.4 million at March 31, 2006.

Line of Credit

As of September 30, 2006, we had $17.0 million available for borrowing under our line of credit, which was terminated during October 2006. At September 30, 2006, we were in compliance with all covenants under the line of credit and had no outstanding borrowings under this line.

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Financial Position

We believe that the liquidity provided by existing cash, cash equivalents and short-term investments will provide sufficient capital to meet our requirements for at least the next 12 months. Napster operates and will continue to operate in the near term at a loss and with net negative cash flow as we spend on marketing to increase subscriber growth.

We do not currently hold any debt. Accordingly, we have not been exposed to near-term adverse changes in interest rates or other market prices. We may, however, experience such adverse changes if we incur debt or hold other derivative financial instruments in the future.

Cash Flows

Operating Activities

Net cash used in operating activities was $15.8 million in the first half of fiscal 2007 as compared to $27.3 million in the corresponding period of fiscal 2006, due primarily to a $14.7 million decrease in our operating loss in the first half of fiscal 2007.

Investing Activities

Compared to the corresponding period of fiscal 2006, net cash used by investing activities decreased $24.3 million in the first half of fiscal 2007. The significant decrease in cash used by investing activities was primarily due to the investment of remaining cash proceeds from the sale of CSD to Sonic during the first quarter of fiscal 2006 and the utilization of investments for operating cash as the year progressed.

We expect to use investments in the future as we use short-term investments to fund operating cash flows.

Financing Activities

Net cash used in financing activities decreased to $66,000 in the first half of fiscal 2007 as compared to $15.0 million in the corresponding period of fiscal 2006. This change is primarily due to the repayment of our $15.0 million line of credit in May 2005 and the fact that we have not borrowed funds under the line of credit since then.

Off-Balance Sheet Arrangements

As of September 30, 2006, we did not have any off-balance-sheet arrangements, as defined in Item 303(a)(4)(ii) of SEC Regulation S-K.

Recent Accounting Pronouncements

For recent accounting pronouncements, see Note 9 – Recent Accounting Pronouncements to the condensed consolidated financial statements appearing in Item 1, Part I to this Quarterly Report, which are incorporated by reference into this Item 2, Part I.

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ITEM 3. QUANTITATIVE AND QUALITATIVE DISCLOSURES ABOUT MARKET RISK

Interest Rate Risk

The primary objective of our investment activities is to preserve principal while at the same time maximizing the income we receive from our investments without significantly increasing risk. We maintain our cash, cash equivalents and short-term investments with high quality financial institutions and, as part of our cash management process, we perform periodic evaluations of the relative credit standing of these financial institutions. Amounts deposited with these institutions may exceed federal depository insurance limits. In addition, the portfolio of investments conforms to our policy regarding concentration of investments, maximum maturity and quality of investment.

Some of the securities in which we have invested may be subject to market risk. This means that a change in prevailing interest rates may cause the principal amount of the investment to fluctuate. For example, if we hold a security that was issued with a fixed interest rate at the then-prevailing rate and the prevailing interest rate later rises, the principal amount of our investment will probably decline in value. To reduce this risk, we maintain our portfolio of cash equivalents and short-term investments in a variety of securities, including commercial paper, corporate bonds, U.S. agencies securities, asset-backed securities and money market funds. In general, money market funds are not subject to interest rate risk because the interest paid on these funds fluctuates with the prevailing interest rate. All of our short-term investments mature in less than two years.

The following table presents the amounts of our short-term investments that are subject to market risk by range of remaining expected maturity and weighted-average interest rates as of September 30, 2006. Our cash equivalents are invested in commercial paper, money market funds and certificates of deposit, which are not included in the table because those funds are not subject to interest rate risk due to their short maturities (in thousands, except interest rates).

	Less than One Year	More than One Year	Total	Estimated Fair Value
Short-term investments	$58,450	$ 804	$59,254	$59,254
Weighted-average interest rate	4.24%	5.12%		

Financial instruments that potentially subject us to significant concentrations of credit risk consist principally of trade accounts receivable and accounts payable.

Exchange Rate Risk

We market our Napster service in the United States, Canada, the United Kingdom and Germany, resulting in sales denominated in U.S. dollars, Canadian dollars, United Kingdom pounds and Euro. Additionally we have agreements with our Japanese Joint Venture that are denominated in Japanese yen. As such, our financial results could be affected by factors such as changes in foreign currency exchange rates or weak economic conditions in foreign markets.

Transactions denominated in currencies other than the functional currency of the legal entity are remeasured to the functional currency of the legal entity at the period-end exchange rates. Any associated currency re-measurement gains and losses are recognized in current operations.

For our foreign subsidiaries whose functional currency is the local currency, we translate assets and liabilities to U.S. dollars using period-end exchange rates and translate revenues and expenses using average exchange rates during the period. Exchange gains and losses arising from translation of foreign entity financial statements are included as a component of other comprehensive income (loss).

Cash and cash equivalents are predominantly denominated in U.S. dollars. As of September 30, 2006, we held $3.1 million of cash and cash equivalents in United Kingdom pounds, $1.9 million in Euro and $693,000 in other foreign currencies.

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ITEM 4. CONTROLS AND PROCEDURES

Evaluation of Disclosure Controls and Procedures

Our management has evaluated, with the participation of our Chief Executive Officer and our Chief Financial Officer, the effectiveness of our disclosure controls and procedures (as defined in Rule 13a-15(e) and Rule 15d-15(e) under the Securities Exchange Act of 1934, as amended (the "Exchange Act")) as of the end of the period covered by this Quarterly Report on Form 10-Q. Based on this evaluation, our Chief Executive Officer and our Chief Financial Officer have concluded that our disclosure controls and procedures were effective to ensure that information we are required to disclose in reports that we file or submit under the Exchange Act (i) is recorded, processed, summarized and reported within the time periods specified in Securities and Exchange Commission rules and forms, and (ii) is accumulated and communicated to our management, including our Chief Executive Officer and our Chief Financial Officer, as appropriate, to allow for timely decisions regarding required disclosure. Our disclosure controls and procedures are designed to provide reasonable assurance that such information is accumulated and communicated to our management. Our disclosure controls and procedures include components of our internal control over financial reporting.

Changes in Internal Control Over Financial Reporting

During the quarter ended September 30, 2006, there were no changes in our internal control over financial reporting that have materially affected, or are reasonably likely to materially affect, our internal control over financial reporting.

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PART II—OTHER INFORMATION

ITEM 1. LEGAL PROCEEDINGS

For legal proceedings, see Note 8 – Commitments And Contingencies to the condensed consolidated financial statements appearing in Item 1, Part I to this Quarterly Report, which are incorporated by reference into this Item 1, Part II.

ITEM 1A. RISK FACTORS

Investing in our common stock involves a high degree of risk. You should carefully consider the risks described below and the other information in this Quarterly Report. If any of the following risks occur, our business could be materially harmed, and our financial condition and results of operations could be materially and adversely affected. As a result, the price of our common stock could decline, and you could lose all or part of your investment.

Our digital music distribution business has a limited operating history and a history of losses and may not be successful.

On May 19, 2003, we acquired substantially all of the ownership interests of Napster, LLC (f/k/a Pressplay). We used the Pressplay-branded service as a technology platform to roll-out our online music services division in October 2003. The business models, technologies and market for digital music services are new and unproven. Prior to our acquisition of Napster, LLC, consumer adoption and usage of the Pressplay-branded service had not been significant. You should consider our business and prospects in light of the risks, expenses and difficulties encountered by companies in their early stage of development.

Our digital music distribution business has experienced significant net losses since its inception and, given the significant operating and capital expenditures associated with our business plan, we expect to incur net losses for at least the next twelve months and will likely continue to experience net losses thereafter. No assurance can be made that our paid Napster service or the free music service will ever contribute net income to our statement of operations. During the period beginning April 1, 2003, just prior to our acquisition of Pressplay in May 2003, through September 30, 2006, we incurred approximately $174.5 million of after tax losses from continuing operations.

The success of our paid Napster service depends upon our ability to add new subscribers and reduce churn.

We cannot assure you that we will be able to attract new subscribers to the paid Napster service or that existing subscribers will continue to subscribe. Existing subscribers may cancel their subscriptions to the paid Napster service for many reasons, including a perception that they do not use the services enough to justify the expense or that the service does not provide enough value, or availability of content relative to our competition. In addition, users of our free music service may decide not to upgrade to our paid music service. The early stages of subscription services such as ours are characterized by higher than normal churn rates and customer acquisition cost. If we are unable to reduce these two factors we may be unable to achieve a profitable business model. In addition, there is significant seasonality in our subscriber numbers due to our university program and softness in customer acquisition during the summer months when consumers spend less time online. Students who subscribe to the paid Napster service generally only do so during the school year when the school is paying for their subscriptions and most of the students do not maintain such subscriptions during the summer in between school terms. If we do not continue to increase the total number of subscribers each quarter, our operating results will be adversely impacted.

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If advertising revenues were to fail to grow as expected, our results of operations and business would be harmed.

Revenues from advertising are important to the future success of our business. Advertising revenues are based on the number of page views by visitors to the Napster.com Web site. If our free music service fails to attract and retain visitors, our revenues will not grow as expected. Most advertisers currently spend only a small portion of their advertising budgets on Internet advertising. There are also significant lead times associated with securing these advertising dollars. Furthermore, expenditures by advertisers tend to be cyclical, reflecting overall economic conditions and budgeting and buying patterns. If we fail to persuade potential advertisers to spend a portion of their budget on advertising with us, or if advertising spending declines due to general economic conditions or the failure of the Internet to be an effective advertising medium, our business and advertising revenues could be adversely affected. In addition, sales of advertisements occur under short-term contracts, which are difficult to forecast accurately. Advertisers generally have the right to cancel an advertising campaign on short notice without penalty. Accordingly, the cancellation or deferral of advertising agreements could have a material adverse effect on our financial results.

We experience fluctuations in our quarterly operating results, which may cause our stock price to decline.

Our quarterly operating results may fluctuate from quarter to quarter. We cannot reliably predict future revenue and margin trends and such trends may cause us to adjust our operations. Other factors that could affect our quarterly operating results include:

- timing of service introductions;
- seasonal fluctuations in sales of our prepaid cards, university subscriptions, and bundled hardware promotions, as well as other products and services;
- potential declines in selling prices of music as a result of competitive pressures;
- changes in the mix of our revenues and our users represented by our various services;
- fluctuations in traffic levels on our Web sites, which can be significant as a result of business, financial and other news events;
- fluctuating and unpredictable demand for advertising on our Web sites as well as on the Web in general;
- reductions in rates paid for Web advertising resulting from softening demand, competition, or other factors;
- adverse changes in the level of economic activity in the United States or other major economies in which we do business, or in industries, such as the music industry, on which we are particularly dependent;
- foreign currency exchange rate fluctuations;
- expenses related to, and the financial impact of, possible acquisitions of other businesses; and
- expenses incurred in connection with the development of our digital music distribution services.

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We rely on the value of the Napster brand, and our revenues could suffer if we are not able to maintain its high level of recognition in the digital music sector.

We believe that maintaining and expanding the Napster brand is an important aspect of our efforts to attract and expand our user and advertiser base. We rely on a broad branding program to ensure that our position in the digital music sector continues to be strongly associated with the Napster name. Promotion and enhancement of the Napster brand will depend in part on our ability to provide consistently high-quality products and services. If we are not able to successfully maintain or enhance consumer awareness of the Napster brand or, even if we are successful in our branding efforts, if we are unable to maintain or enhance customer awareness of the Napster brand in a cost effective manner, our business, operating results and financial condition would be harmed.

We face significant competition from traditional retail music distributors, from emerging paid online music services delivered electronically such as ours, and from "free" peer-to-peer services.

Our paid Napster service faces significant competition from traditional retail music distributors, as well as online retailers such as Amazon.com. These retailers may include regional and national mall-based music chains, international chains, deep-discount retailers, mass merchandisers, consumer electronics outlets, mail order, record clubs, independent operators and online physical retail music distributors, some of which have greater financial and other resources than we do. To the extent that consumers choose to purchase media in non-electronic formats, it may reduce our sales, reduce our gross margins, increase our operating expenses and decrease our profit margins in specific markets.

Our digital music distribution services' competitors currently include Apple Computer's iTunes Music Store, AOL Music Now, RealNetworks, Inc., the provider of the Rhapsody service, MTV's Urge, Sony Connect, Walmart.com, FYE, Microsoft's MSN Music service and online music services powered by MusicNet such as Yahoo! Music Unlimited, MTV's Urge, Virgin, V-cast and Sprint. Other potential competitors such as Best Buy and Amazon.com have announced their intention to provide competing music distribution services. Internationally we currently compete with OD2, Puretracks, 3 Music Store and Vodafone's music offerings, as well as with a number of the other competitors described above.

Our digital music distribution business also faces significant competition from "free" peer-to-peer services, such as KaZaA, Morpheus, Grokster and a variety of similar services that allow computer users to connect with each other and to copy many types of program files, including music and other media, from one another's hard drives, all without securing licenses from content providers. While the U.S. Supreme Court has found that Grokster may violate copyright laws, the court did not establish that such services are necessarily liable for copyright infringement, opting instead for a fact-based analysis of the services' efforts to promote copyright infringement. Additionally, enforcement efforts against those in violation have not effectively shut down these services, and there can be no assurance that these services will ever be shut down. The ongoing presence of these "free" services substantially impairs the marketability of legitimate services, regardless of the ultimate resolution of their legal status.

Our advertising-supported music website competes, directly and indirectly, for advertisers, viewers, members, and content providers with publishers and distributors of traditional off-line media, such as television, radio and print, including those targeted to music, many of which have established or may establish websites, such as MTV. We also face intense competition from general purpose consumer online services such as Yahoo, MSN and Google, each of which provides access to music-related content and services and from websites targeted to music related content, such as Yahoo and myspace.com.

Many of our competitors have significantly more resources than we do, and some of our competitors may be able to leverage their experience in providing digital music distribution services or similar services to their customers in other businesses. We or our competitors may be able to secure limited exclusive rights to content from time to time. If our competitors secure significant exclusive content, it could harm the ability of our online music services to compete effectively in the marketplace.

In particular, some of these competitors offer other goods and services and may be willing and able to offer music services at a lower price than we can in order to promote the sale of these goods and services. If we lower our prices, our gross margins and operating results will be adversely affected. If we do not lower our prices, we may be unable to compete with discount services. This could harm the ability of our online music services to

compete effectively in the marketplace.

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Digital music distribution services in general are new and rapidly evolving and may not prove to be a profitable or even viable business model.

Digital music distribution services are a relatively new business model for delivering digital media over the Internet. It is too early to predict whether consumers will accept, in significant numbers, digital music services and accordingly whether the services will be financially viable. If digital music distribution services do not prove to be popular with consumers, or if these services cannot sustain any such popularity, our business and prospects would be harmed.

We rely on content provided by third parties, which may not be available to us on commercially reasonable terms or at all.

We rely on third-party content providers, including music publishers and music labels, to offer online music content that can be delivered to users of our digital music distribution services. Rights to provide this content to our customers, particularly publishing rights, are difficult to obtain and require significant time and expense. In order to provide a compelling service, we must be able to continue to license a wide variety of music content to our customers with attractive usage rights such as CD recording, output to MP3 players, portable subscription rights and other rights. In addition, if we do not have sufficient breadth and depth of the titles necessary to satisfy increased demand arising from growth in our subscriber base, our subscriber satisfaction will be affected adversely.

Under copyright law we are required to pay licensing fees for compositions embodied in digital sound recordings and for the sound recordings themselves that we deliver in our Napster service. Copyright law generally does not specify the rate and terms of the licenses, which are determined by voluntary negotiations among the parties or, for certain compulsory publishing licenses where voluntary negotiations are unsuccessful, by a copyright royalty board ("CRB"), an administrative judicial proceeding supervised by the United States Copyright Office. Past copyright proceedings have resulted in proposed rates for statutory webcasting that were significantly in excess of rates requested by webcasters. Currently, there is a CRB proceeding for mechanical licenses in a subscription context. We cannot predict the outcome of any negotiations or CRB proceedings. We may also elect to attempt to directly license compositions for our services, either alone or in concert with other affected companies. Such licenses may only apply to music performed in the United States. The availability of licenses for compositions used in certain international versions of the services is unclear. Therefore, our ability to negotiate appropriate licenses is uncertain.

Voluntarily negotiated rates for mechanical licenses with respect to streaming and conditional digital downloads with the Harry Fox Agency and National Music Publishers Association have not been agreed to, and we are currently operating under a standstill agreement until such rates are negotiated. No final agreement has been reached with performing rights societies such as ASCAP or BMI regarding whether digital downloads constitute public performances of copyrighted works that would trigger payment of public performance royalties. In addition to certain other negotiations, European Union and Canadian tribunals are currently in process, which will set rates for subscription music services and services that deliver digital downloads of music, and the outcome of these negotiations and proceedings will also likely affect our business in ways that we cannot predict. Napster accrues for the cost of these fees, based on contracted or statutory rates, when established, or management's best estimates based on facts and circumstances regarding the specific music services and agreements in similar geographies or with similar agencies. If the final agreed rates differ significantly from management's estimate, the actual amount paid and expensed could differ materially from the recorded amounts.

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Our success depends on our digital music distribution service's interoperability with our customer's music playback hardware.

In order for the paid Napster service to be successful, we must design our service to interoperate effectively with a variety of hardware products, including home stereos, car stereos, portable MP3 players, cell phones, PCs and other mobile devices. We depend on significant cooperation with manufacturers of these products and with software manufacturers that create the operating systems for such hardware devices to achieve our design objectives and to offer a service that is attractive to our customers. Currently, there are a limited number of devices that offer the portable subscription functionality that is required to support our Napster To Go service and certain current manufacturers may not be able to profitably continue to offer existing devices. Our software is not compatible with the iPod music player, the current equipment market leader. If we cannot successfully design our service to interoperate with the music playback devices that our customers own, or if music-enabled devices fail to grow significantly over time, our business will be harmed.

We may not successfully develop new products and services.

The success of our digital music distribution services will depend on our ability to develop leading-edge media and digital distribution products and services. Our business and operating results will be harmed if we fail to develop products and services that achieve widespread market acceptance or that fail to generate significant revenues or gross profits to offset our development and operating costs. We may not timely and successfully identify, develop and market new product and service opportunities.

We may not be able to add new content such as video, spoken word or other content as quickly or as efficiently as our competitors or at all. If we introduce new products and services, they may not attain broad market acceptance or contribute meaningfully to our revenues or profitability. Competitive or technological developments may require us to make substantial, unanticipated investments in new products and technologies, and we may not have sufficient resources to make these investments.

Because the markets for our products and services are changing rapidly, we must develop new offerings quickly. Delays and cost overruns could affect our ability to respond to technological changes, evolving industry standards, competitive developments or customer requirements. Our products also may contain undetected errors that could cause increased development costs, loss of revenues, adverse publicity, reduced market acceptance of our products or services or lawsuits by customers.

We must maintain and add to our strategic marketing relationships in order to be successful.

We depend on a number of strategic relationships with third parties to co-market our services. We have entered into co-marketing agreements with infrastructure providers, retailers and other companies to broaden the distribution of our brand and our services. There is no guarantee that we will be able to renew existing agreements or enter into new agreements on acceptable terms, or at all. If we cannot maintain existing strategic relationships or enter into new relationships, our ability to market our services will be harmed.

In addition, because of the rapidly evolving nature of digital music distribution and our short history of operations, we often enter into strategic agreements where the financial impact on our business and operations is uncertain. We cannot guarantee that any of these agreements will result in the desired benefits to our business or result in significant additional revenue.

Our network is subject to security and stability risks that could harm our business and reputation and expose us to litigation or liability.

Online commerce and communications depend on the ability to transmit confidential information and licensed intellectual property securely over private and public networks. Any compromise of our ability to transmit such information and data securely or reliably, and any costs associated with preventing or eliminating such problems, could harm our business. Online transmissions are subject to a number of security and stability risks, including:

- our own or licensed encryption and authentication technology, and access and security procedures, may be compromised, breached or otherwise be insufficient to ensure the security of customer information or our music content;

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- we could experience unauthorized access, computer viruses, system interference or destruction, "denial of service" attacks and other disruptive problems, whether intentional or accidental, that may inhibit or prevent access to our web sites or use of our products and services;
- someone could circumvent our security measures and misappropriate our, our partners' or our customers' intellectual property or interrupt operations, or jeopardize our licensing arrangements, which are contingent on our sustaining appropriate security protections;
- our computer systems could fail and lead to service interruptions;
- we may be unable to scale our infrastructure with increases in customer demand; or
- our network of facilities may be affected by a natural disaster, terrorist attack or other catastrophic events.

The occurrence of any of these or similar events could damage our business, hurt our ability to distribute products and services and collect revenue, threaten the proprietary or confidential nature of our technology, harm our reputation and expose us to litigation or liability. We may be required to expend significant capital or other resources to protect against the threat of security breaches, hacker attacks or system malfunctions or to alleviate problems caused by such breaches, attacks or failures.

We depend on key personnel who may not continue to work for us.

Our success substantially depends on the continued employment of certain executive officers and key employees, including, in particular, Christopher Gorog, our Chief Executive Officer. The loss of the services of these key officers and employees could harm our business. If any of these individuals were to leave our company, we could face substantial difficulty in hiring qualified successors and could experience a loss in productivity while any such successor obtains the necessary training and experience.

If we fail to manage expansion effectively, we may not be able to successfully manage our business, which could cause us to fail to meet our customer demand or to attract new customers, which would adversely affect our revenue.

Our ability to successfully offer our products and services and implement our business plan in a rapidly evolving market requires an effective planning and management process. We plan to continue to increase the scope of our digital music distribution operations domestically and internationally. In addition, we plan to continue to hire a significant number of employees in the next twelve months for the development of new products and services. This anticipated growth in future operations will place a significant strain on our management resources.

In the future, we plan to continue to develop and improve our financial and managerial controls, reporting systems and procedures. In addition, we plan to continue to expand, train and manage our work force worldwide.

We may be unable to adequately protect our proprietary rights.

Our inability to protect our proprietary rights, and the costs of failing to do so, could harm our business. Our success and ability to compete partly depend on the superiority, uniqueness or value of our technology, including both internally developed technology and technology licensed from third parties. To protect our proprietary rights, we rely on a combination of patent, trademark, copyright and trade secret laws, confidentiality agreements with our employees and third parties, and protective contractual provisions. These efforts to protect our intellectual property rights may not be effective in preventing misappropriation of our technology. These efforts also may not prevent the development and design by others of products or technologies similar to, competitive with or superior to those we develop. Any of these results could reduce the value of our intellectual property. We may be forced to litigate to enforce or defend our intellectual property rights and to protect our trade secrets. Any such litigation could be very costly and could distract our management from focusing on operating our business.

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A significant portion of the revenues from our paid Napster service is derived from international revenues. Economic, political, regulatory and other risks associated with international revenues and operations could have an adverse effect on our revenues.

Because we operate worldwide, our business is subject to risks associated with doing business internationally. International net revenues did not account for a significant percentage of our net revenues prior to the sale of our consumer software division; however, revenues from international operations have represented a significant portion of our total net revenues from our digital music distribution business. We anticipate that revenues from international operations will continue to represent a substantial portion of our total net revenues as we expand our Napster service abroad and enter into additional joint venture arrangements, if any, with international partners. Accordingly, our future revenues could decrease based on a variety of factors, including:

- disputes with joint venture partners;
- mismanagement or fraud by joint venture partners;
- changes in foreign currency exchange rates;
- seasonal fluctuations in sales of our prepaid cards as well as other products and services;
- changes in a specific country's or region's political or economic condition, particularly in emerging markets;
- unexpected changes in foreign laws and regulatory requirements;
- difficulty of effective enforcement of contractual provisions in local jurisdictions;
- trade protection measures and import or export licensing requirements;
- potentially adverse tax consequences including changes to the VAT collection scheme;
- difficulty in managing widespread sales operations; and
- less effective protection of intellectual property.

To grow our business, we must be able to hire and retain sufficient qualified technical, sales, marketing and administrative personnel.

Our future success depends in part on our ability to attract and retain engineering, sales, marketing, finance and customer support personnel. If we fail to retain and hire a sufficient number of these employees, we will not be able to maintain and expand our business. We cannot assure you that we will be able to hire and retain a sufficient number of qualified personnel to meet our business objectives.

We may be subject to intellectual property infringement claims, which are costly to defend and could limit our ability to use certain technologies in the future.

Many parties are actively developing streaming media and digital distribution-related technologies, e-commerce and other Web-related technologies, as well as a variety of online business methods and models. We believe that these parties will continue to take steps to protect these technologies, including, but not limited to, seeking patent protection. As a result, disputes regarding the ownership of these technologies and rights associated with streaming media, digital distribution and online businesses are likely to arise in the future and may be very costly. In addition to existing patents and intellectual property rights, we anticipate that additional third-party patents related to our products and services will be issued in the future. If a blocking patent has been issued or is issued in the future, we would need to either obtain a license or design around the patent. We may not be able to obtain such a license on acceptable terms, if at all, or design around the patent, which could harm our business.

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Companies in the technology and content-related industries have frequently resorted to litigation regarding intellectual property rights. We may be forced to litigate to determine the validity and scope of other parties' proprietary rights. Any such litigation could be very costly and could distract our management from focusing on operating our business. In addition, we believe these industries are experiencing an increased level of litigation to determine the applicability of current laws to, and the impact of new technologies on, the use and distribution of content over the Internet and through new devices, especially in the music industry. As we develop products and services that provide or enable the provision of content, in such ways, our litigation risk may increase. The existence and/or outcome of such litigation could harm our business.

From time to time we receive claims and inquiries from third parties alleging that our internally developed technology, or technology we license from third parties, may infringe the other third parties' proprietary rights, especially patents. Third parties have also asserted and most likely will continue to assert claims against us alleging infringement of copyrights, trademark rights, or other proprietary rights, or alleging unfair competition or violations of privacy rights. We could be required to spend significant amounts of time and money to defend ourselves against such claims. If any of these claims were to prevail, we could be forced to pay damages, comply with injunctions, or stop distributing our products and services while we re-engineer them or seek licenses to necessary technology, which might not be available on reasonable terms, or at all. We could also be subject to claims for indemnification resulting from infringement claims made against our customers and strategic partners, which could increase our defense costs and potential damages. Any of these events could require us to change our business practices and could harm our business.

A decline in current levels of consumer spending could reduce our sales.

Our business is directly affected by the level of consumer spending. One of the primary factors that affect consumer spending is the general state of the local economies in which we operate. Lower levels of consumer spending in regions in which we have significant operations could have a negative impact on our business, financial condition or results of operations.

We depend on software from third parties to deliver and to track and measure the delivery of advertisements and it could be difficult to replace these services.

It is important to our future success that we are able to effectively deliver our advertisers' advertisements and it is important to our advertisers that we accurately measure the delivery of such advertisements on our websites. We depend on third-party software to provide these measurement and delivery services. If these third parties are unable to provide these services in the future, we would be required to perform them ourselves or obtain them from other providers. This could cause us to incur additional costs or cause interruptions in our business during the time we are replacing these services. Companies may not advertise on our websites or may pay less for advertising if they do not perceive our measurements or measurements made by third parties to be reliable.

We may need additional capital, and we cannot be sure that additional financing will be available.

Although we currently anticipate that our available funds and expected cash flows from operations will be sufficient to meet our cash needs for at least the next twelve months, we may require additional financing. Our ability to obtain financing will depend, among other things, on our development efforts, business plans, operating performance and condition of the capital markets at the time we seek financing. We expect to experience operating losses from the digital music distribution business in at least the short-term. We cannot assure you that additional financing will be available to us on favorable terms when required, or at all. If we raise additional funds through the issuance of equity, equity-linked or debt securities, those securities may have rights, preferences or privileges senior to the rights of our common stock, and our stockholders may experience dilution.

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There is no guarantee that we will enter into any strategic transaction with any third party.

In September 2006, we engaged UBS Securities LLC to assist us in evaluating potential strategic alternatives. We cannot guarantee that any strategic alternative, including any possible acquisition or merger of Napster, will be available to us on favorable terms, or at all.

We are subject to risks associated with governmental regulation and legal uncertainties.

Few existing laws or regulations specifically apply to the Internet, other than laws and regulations generally applicable to businesses. Certain United States export controls and import controls of other countries, including controls on the use of encryption technologies, may apply to our products. Many laws and regulations, however, are pending and may be adopted in the United States, individual states, and local jurisdictions and other countries with respect to the Internet. These laws may relate to many areas that impact our business, including content issues (such as obscenity, indecency and defamation), copyright and other intellectual property rights, digital rights management, encryption, caching of content by server products, personal privacy, taxation, e-mail, sweepstakes, promotions, prepaid card expiration, escheatment, network and information security and the convergence of traditional communication services with Internet communications, including the future availability of broadband transmission capability and wireless networks. These types of regulations are likely to differ between countries and other political and geographic divisions. Other countries and political organizations are likely to impose or favor more and/or different regulations than that which has been proposed in the United States, thus furthering the complexity of regulation. In addition, state and local governments may impose regulations in addition to, inconsistent with, or stricter than federal regulations. The adoption of such laws or regulations, and uncertainties associated with their validity, interpretation, applicability and enforcement, may affect the available distribution channels for and costs associated with our products and services and may affect the growth of the Internet. Such laws or regulations may harm our business. Our products and services may also become subject to investigation and regulation of foreign data protection and e-commerce authorities, including those in the European Union. Such activities could result in additional product and distribution costs for us in order to comply with such regulations.

We do not know for certain how existing laws governing issues such as property ownership, copyright and other intellectual property issues, digital rights management, taxation, security, illegal or obscene content, retransmission of media, personal privacy and data protection apply to the Internet. The vast majority of such laws were adopted before the advent of the Internet and related technologies and do not address the unique issues associated with the Internet and related technologies. Most of the laws that relate to the Internet have not yet been interpreted. In addition to potential legislation from local, state and federal governments, labor guild agreements and other laws and regulations that impose fees, royalties or unanticipated payments regarding the distribution of media over the Internet may directly or indirectly affect our business. While we and our customers may be directly affected by such agreements, we are not a party to such agreements and have little ability to influence the degree such agreements favor or disfavor Internet distribution or our business models. Changes to or the interpretation of these laws and the entry into such industry agreements could:

- limit the growth of the Internet;
- create uncertainty in the marketplace that could reduce demand for our products and services;
- increase our cost of doing business;
- expose us to increased litigation risk, substantial defense costs and significant liabilities associated with content available on our web sites or distributed or accessed through our products or services, with our provision of products and services and with the features or performance of our products and web sites;
- lead to increased product development costs or otherwise harm our business; or
- decrease the rate of growth of our user base and limit our ability to effectively communicate with and market to our user base.

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The Child Online Protection Act and the Child Online Privacy Protection Act impose civil and criminal penalties on persons distributing material harmful to minors (e.g., obscene material) over the Internet to persons under the age of 17, or collecting personal information from children under the age of 13. We do not knowingly distribute harmful materials to minors or collect personal information from children under the age of 13. The manner in which these Acts may be interpreted and enforced cannot be fully determined, and future legislation similar to these Acts could subject us to potential liability if we were deemed to be non-compliant with such rules and regulations, which in turn could harm our business.

There are a large number of legislative proposals before the United States Congress and various state legislatures regarding intellectual property, digital rights management, copy protection requirements, privacy, email marketing and security issues related to our business. Furthermore, as part of our regular business activities now, and in the past, we engage in the issuance of gift cards redeemable for our services. It is possible that money received by us for the sale of gift cards could be subject to state and federal escheat, or unclaimed property, laws in the future. If this were the case, our business could be adversely impacted. It is not possible to predict whether or when such legislation may be adopted, and certain proposals, if adopted, could materially and adversely affect our business through a decrease in user registration and revenue, and influence how and whether we can communicate with our customers.

We may be subject to market risk and legal liability in connection with the data collection capabilities of our products and services.

Many of our products are interactive Internet applications which by their very nature require communication between a client and server to operate. To provide better consumer experiences and to operate effectively, our products send information to servers. Many of the services we provide also require that a user provide certain information to us. We post an extensive privacy policy concerning the collection, use and disclosure of user data involved in interactions between our client and server products. Any failure by us to comply with our posted privacy policy and existing or new legislation regarding privacy issues could impact the market for our products and services, subject us to litigation and harm our business.

If, in the future, we conclude that our internal control over financial reporting is not adequate, or if our auditors conclude that our evaluation of internal controls over financial reporting is not adequate, investors could lose confidence in the reliability of our financial statements, which could result in a decrease in the value of our common stock.

As directed by Section 404 of the Sarbanes-Oxley Act of 2002, the Securities and Exchange Commission ("SEC") adopted rules requiring public companies to include a report of management on the company's internal control over financial reporting in their annual reports on Form 10-K. This report is required to contain an assessment by management of the effectiveness of such company's internal control over financial reporting. In addition, the independent registered public accounting firm auditing a public company's financial statements must attest to and report on management's assessment of the effectiveness of the company's internal control over financial reporting. There is a risk that in the future we may identify internal control deficiencies that suggest that our controls are no longer effective. This could result in an adverse reaction in the financial markets due to a loss of confidence in the reliability of our financial statements, which could cause the market price of our common stock to decline and make it more difficult for us to finance its operations.

The effectiveness of our disclosure and internal controls may be limited.

Our disclosure controls and procedures and internal control over financial reporting may not prevent all errors and misrepresentations. In the event that there are errors or misrepresentations in our historical financial statements or the SEC disagrees with our accounting, we may need to restate our financial statements. For example, in November 2004 we restated our financial statements in order to correct the valuation of a previously issued warrant and to adjust the purchase accounting of our former subsidiary, MGI Software, and in May 2005 we restated our financial statements to reallocate the tax benefit of certain operating losses from our discontinued operations to our continuing operations. Any system of internal controls can only provide reasonable assurance that all control objectives are met. Some of the potential risks involved could include, but are not limited to, management judgments, simple errors or mistakes, willful misconduct regarding controls or misinterpretation. There is no guarantee that existing controls will prevent or detect all material issues or be effective in future

conditions, which could materially and adversely impact our financial results in the future.

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We hold cash in foreign subsidiaries, which we may repatriate to the United States, and which may result in income taxes that could negatively impact our results of operations and financial position.

We are in the process of completing a corporate restructuring to close the overseas operations of certain dormant subsidiaries of our former consumer software division. We may repatriate our cash from these foreign subsidiaries to the United States. We may incur additional income taxes from the repatriation, which could negatively affect our results of operations and financial position.

Provisions in our agreements, charter documents, stockholder rights plan and Delaware law may delay or prevent acquisition of us, which could decrease the value of our stock.

Our certificate of incorporation and bylaws and Delaware law contain provisions that could make it more difficult for a third party to acquire us without the consent of our board of directors. These provisions include a classified board of directors and limitations on actions by our stockholders by written consent. In addition, our board of directors has the right to issue preferred stock without stockholder approval, which could be used to dilute the stock ownership of a potential hostile acquirer. Delaware law also imposes some restrictions on mergers and other business combinations between us and any holder of 15% or more of our outstanding common stock. In addition, we have adopted a stockholder rights plan that makes it more difficult for a third party to acquire us without the approval of our board of directors. Although we believe these provisions provide for an opportunity to receive a higher bid by requiring potential acquirers to negotiate with our board of directors, these provisions apply even if the offer may be considered beneficial by some stockholders.

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ITEM 2. UNREGISTERED SALES OF EQUITY SECURITIES AND USE OF PROCEEDS

None.

ITEM 3. DEFAULTS UPON SENIOR SECURITIES

None.

ITEM 4. SUBMISSION OF MATTERS TO A VOTE OF SECURITY HOLDERS

The most recent annual meeting of stockholders was held on September 21, 2006. Proposals I and II were approved. The results were as follows:

Proposal I

The following directors were elected at the meeting to serve a three-year term as directors:

	For	Authority Withheld
Joseph C. Kaczorowski	35,450,206	2,632,795
Brian C. Mulligan	35,806,332	2,276,669

The following directors' terms of office continued after the annual meeting of stockholders: Vernon E. Altman, Wm. Christopher Gorog, Richard J. Boyko, Philip J. Holthouse and Robert Rodin.

Proposal II

Ratification of the appointment of PricewaterhouseCoopers LLP as Napster's independent registered public accounting firm for the fiscal year ending March 31, 2007:

For	Against	Abstain	Broker Non-Vote
36,986,890	1,078,046	18,065	—

The proposals above are described in detail in Napster's definitive proxy statement dated August 1, 2006 for the annual meeting of stockholders held on September 21, 2006.

ITEM 5. OTHER INFORMATION

None.

ITEM 6. EXHIBITS

Exhibits

The exhibits listed on the Exhibit Index (following the Signatures section of this report) are included, or incorporated by reference, in this Quarterly Report.

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SIGNATURES

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

NAPSTER, INC.

(Registrant)

Date: November 8, 2006

By: /s/ WM. CHRISTOPHER GOROG
Wm. Christopher Gorog
Chief Executive Officer
(Principal Executive Officer)

By: /s/ NAND GANGWANI
Nand Gangwani
Vice President and
Chief Financial Officer
(Principal Financial and Accounting Officer)

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INDEX TO EXHIBITS

Exhibit Number	Description of Exhibit
2.1	Purchase Agreement among the Registrant, UMG Duet Holdings, Inc., a Delaware corporation, and SMEI Duet Holdings, Inc., a Delaware corporation, dated May 19, 2003 (1)
2.2	Amended and Restated Asset Purchase Agreement between the Company and Sonic Solutions, dated December 17, 2004 (2)
3.1	Amended and Restated Certificate of Incorporation of the Registrant (3)
3.2	Amended and Restated Bylaws of the Registrant (4)
3.3	Certificate of Designation of Rights, Preferences and Privileges of Series A Participating Preferred Stock of Roxio, Inc. (5)
4.1	Form of Common Stock certificate of the Registrant (2)
4.2	Preferred Stock Rights Agreement, dated as of May 18, 2001, between Registrant and Mellon Investor Services, LLC, including the Certificate of Designation, the form of Rights Certificate and the Summary of Rights attached thereto as Exhibits A, B, and C, respectively (5)
4.3	Form of Purchase Agreement dated as of June 18, 2003 by and between the Registrant and certain Purchasers set forth on the signature page thereto (6)
4.4	Amended and Restated LLC Operating Agreement of Napster, LLC dated May 19, 2003 by and between Registrant, UMG Duet Holdings, Inc. and SMEI Duet Holdings, Inc. (4)
4.5	Form of Purchase Agreement dated as of January 13, 2004 by and between Napster and certain Purchasers set forth on the signature page thereto (7)
4.6	Registration Rights Agreement dated June 17, 2004 between the Registrant and Best Buy Enterprise Services Inc. (8)
4.7	Common Stock Purchase Agreement between Registrant and Best Buy Enterprise Services Inc. dated June 17, 2004 (8)
4.8	Form of Purchase Agreement dated as of January 20, 2005 by and between Registrant and certain Investors (9)
31.1	Certification of Chief Executive Officer required pursuant to Section 302 of the Sarbanes-Oxley Act of 2002
31.2	Certification of Chief Financial Officer required pursuant to Section 302 of the Sarbanes-Oxley Act of 2002
32.1	Certification pursuant to 18 U.S.C. Section 1350, as adopted pursuant to Section 906 of the Sarbanes-Oxley Act of 2002

(1) Incorporated by reference to the Registrant's Current Report on Form 8-K as filed with the Securities and Exchange Commission on May 19, 2003.
(2) Incorporated by reference to the Registrant's Current Report on Form 8-K as filed with the Securities and Exchange Commission on December 23, 2004.
(3) Incorporated by reference to the Registrant's Form 10 Registration Statement (No. 000-32373) as filed with the Securities and Exchange Commission on May 15, 2001.
(4) Incorporated by reference to the Registrant's Annual Report on Form 10-K as filed with the Securities and Exchange Commission on June 30, 2003.
(5) Incorporated by reference to the Registrant's Registration Statement on Form 8-A as filed with the Securities and Exchange Commission on June 5, 2001.
(6) Incorporated by reference to the Registrant's Current Report on Form 8-K as filed with the Securities and Exchange Commission on June 20, 2003.
(7) Incorporated by reference to the Registrant's Current Report on Form 8-K as filed with the Securities and Exchange Commission on January 13, 2004.
(8) Incorporated by reference to the Registrant's Registration Statement on Form S-3 (No. 333-117520) as filed with the Securities and Exchange Commission on July 20, 2004.
(9) Incorporated by reference to the Registrant's Current Report on Form 8-K as filed with the Securities and Exchange Commission on January 21, 2005.

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

FORM 10-K

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

For the fiscal year ended
March 31, 2006

or

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

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

Delaware (State or other jurisdiction of incorporation)	000-32373 (Commission File No.)	77-0551214 (I.R.S. Employer Identification Number)

9044 Melrose Ave.
Los Angeles, CA 90069
(Address of principal executive offices)

Registrant's telephone number, including area code: (310) 281-5000

N/A
(Former name or former address, if changed since last report.)

Securities registered pursuant to Section 12(b) of the Act: None

Securities registered pursuant to Section 12(g) of the Act:

Common Stock, $0.001 par value per share

Series A Participating Preferred Stock, $0.001 par value per share

Indicate by check mark if the registrant is a well-known seasoned issuer, as defined in Rule 405 of the Securities Act. Yes ☐ No ☒

Indicate by check mark if the registrant is not required to file reports pursuant to Section 13 or Section 15(d) of the Act. Yes ☐ No ☒

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

Indicate by check mark if disclosure of delinquent filers pursuant to Item 405 of Regulation S-K is not contained herein, and will not be contained, to the best of registrant's knowledge, in definitive proxy or information statements incorporated by reference in Part III of this Form 10-K or any amendment to this Form 10-K. ☒

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 ☐ 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 ☒

As of June 1, 2006, the aggregate market value of voting and non-voting common equity held by non-affiliates of the registrant was approximately $144 million. For this computation, Napster has excluded the market value of all common stock beneficially owned by all executive officers and directors of Napster as a group. As of June 1, 2006, the number of outstanding shares of common stock of the registrant was approximately 44,915,547.

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INTRODUCTION AND NOTE ON FORWARD LOOKING STATEMENTS

We are a Delaware corporation, and our principal executive offices are located at 9044 Melrose Avenue, Los Angeles, California 90069.

You should not rely on forward-looking statements in this annual report. This annual report contains forward-looking statements that involve risks and uncertainties. We use words such as "anticipates," "plans," "expects," "future," "intends," "may," "will," "should," "estimates," "predicts," "potential," "continue" and similar expressions to identify such forward-looking statements. This annual report also contains forward-looking statements attributed to certain third parties relating to their estimates regarding the growth of certain markets. Forward-looking statements are subject to known and unknown risks, uncertainties and other facts that may cause our actual results to be materially different from those expressed or implied by such forward-looking statements. These risks, uncertainties and other factors include, among others, those identified under "Risk Factors" and elsewhere in this annual report.

Although we believe that the expectations reflected in the forward-looking statements are reasonable, we cannot guarantee future results, levels of activity, performance or achievements. Moreover, neither we nor any other person assumes responsibility for the accuracy and completeness of these statements, and we assume no obligation to update any such statements.

The name "Napster", our tagline, Napster.com, Napster Light, Napster To Go, NapsterLinks, Narchive and Napster Mobile are trademarks of Napster, Inc. or its subsidiaries in the United States and/or other countries. Other trademarks and tradenames appearing in this annual report are the property of their respective holders.

DOCUMENTS INCORPORATED BY REFERENCE

Portions of our definitive proxy statement for the 2006 annual meeting of stockholders, to be held on September 21, 2006, have been incorporated by reference into Part III of this annual report.

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PART I

ITEM 1. BUSINESS

Napster, among the most recognized brands in digital music, is a leading provider of online music for the consumer market. Our digital music distribution services enable fans to sample, listen to and purchase from one of the world's largest and most diverse online music catalogues utilizing a secure and legal platform. Napster users have access to songs from all major labels and hundreds of independent labels, and have many ways to discover, share and acquire new music and old favorites.

On May 1, 2006 we launched the new Napster.com, the only legal, advertising-supported service that offers free, on-demand listening without monthly restrictions. This free music site allows members in the United States to listen to nearly every song in Napster's more than 2 million song subscription catalog five times each for free anywhere on the web without downloading any software. Napster.com members outside the United States enjoy free access to 30 second clips of these tracks.

For those consumers who want access to unlimited music, including the ability to download music with high quality sound, enjoy their music in an advertising-free environment and access many features including radio, Billboard charts and many community features, we continue to offer Napster and Napster to Go subscriptions for use on the PC or portable devices. The paid Napster service is also currently available in Canada, the United Kingdom and Germany. We expect to launch our paid service in Japan through our joint venture with Tower Records in fiscal 2007.

Napster is headquartered in Los Angeles with sales offices in London and Frankfurt.

Until December 17, 2004, Napster was known as "Roxio, Inc.", and we operated our business in two divisions, the consumer software division ("CSD") and the online music distribution division, also known as the Napster division.

On December 17, 2004, we completed the sale of substantially all of the assets and liabilities of CSD to Sonic Solutions, a California corporation ("Sonic"), including all of the capital stock of certain international subsidiaries. Sonic paid us a total of $74.7 million in cash and 653,837 shares of Sonic common stock, valued at approximately $13.6 million as of the closing date. We are using the proceeds for general working capital purposes and to operate and expand our Napster business.

Since the sale of CSD, we have focused exclusively on our online music distribution business under the Napster brand and, since January 3, 2005, have been traded on the Nasdaq Stock Market under the symbol "NAPS".

Napster was incorporated in Delaware in August 2000. We maintain executive offices and principal facilities at 9044 Melrose Avenue, Los Angeles, California 90069. Our telephone number is 310-281-5000.

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Industry Background

Consumers are fundamentally changing the way that they interact with content, as traditional methods of delivery are being rapidly replaced by newer digital technologies that offer a much greater degree of freedom and flexibility. This trend has been fueled by the rapid growth of Internet usage by consumers, particularly as a result of broadband connections that enable content to be transferred securely at much higher speeds, and a number of powerful new technologies for compressing and sharing digital content using a personal computer. The playback and enjoyment of content obtained over the Internet is not limited to the PC. Content can be "burned" to CDs easily and affordably, or transferred to a growing number of portable consumer devices, including MP3 players, cell phones, and digital media devices for the living room. The increasing adoption of portable digital players further increases the demand for content as consumers look to "fill up" their players with music, personal photos and videos. Consumers are embracing technologies and services that allow them to conveniently obtain, manage and move digital content in an easy and affordable manner.

The growth of consumer Internet connectivity, particularly broadband, has increased consumer access to digital media.

Broadband Internet connections enable consumers to transfer data more quickly than on traditional dial-up connections. Data transfer speed becomes increasingly important as the size of the information being transferred grows. JupiterResearch forecasted swift broadband adoption over the next few years, reaching nearly 80 percent of United States online households by 2010, in its report entitled "U.S. Broadband Forecast, 2005 to 2010". We believe that this trend, along with other new technologies, will improve consumers' access to digital media. As digital media to consumers' PCs via the Internet increases, we believe that consumers will continue to seek products and services that help them quickly and easily find and access content, manage their own collection of digital assets, and help them move their personal collection from their PCs to other media such as CDs, DVDs and digital entertainment devices, including portable MP3 players and cell phones.

Portable MP3 players have proliferated and their use has increased.

Many users are playing back digital music, spoken word and video content via consumer electronics devices such as portable MP3 players. The market for portable MP3 players is rapidly expanding. According to Jupiter Research's "Portable Media Players" report dated August 2005, in the United States the portable MP3 player market is expected to grow from a 15.2 million installed base in 2004 to a projected base of 51.4 million players in 2006. Since fall 2004, a number of device manufacturers, including most of the major mobile phone manufacturers, have incorporated, or announced that they plan to incorporate, Microsoft's Windows Media Digital Rights Management 10 technology ("WMDRM10") into portable MP3 players and mobile phones. WMDRM10 technology allows users to extend their online music subscriptions to their portable MP3 players and mobile phones, providing them greater flexibility in the use of their music collections.

The use of these devices has created demand for services that can provide permanent or limited access to content to "fill" these devices.

The growth in broadband penetration and portable electronic device usage (for example MP3 players and cell phones) is driving growth in the online music industry.

Consumer demand for downloadable digital content, such as compressed audio files, has given rise to independent music web sites and subscription services. IDC estimates that United States purchases of downloadable digital music, including subscriptions, will exceed $1.5 billion by 2009.

Online advertising has increased in recent years and is expected to continue to grow.

With increased adoption of the Internet, many companies have correspondingly increased their advertising dollars to the online medium as another means of reaching their target markets. This trend is expected to continue as online advertising spending becomes a greater percentage of total advertising expenditures. According to Parks Associates, the United States online advertising market is expected to grow from 5% of the total advertising market in 2004 to 10% in 2010.

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Our Solution and Products

On May 1, 2006 we launched the new Napster.com, the only legal, advertising supported service that offers free, on-demand listening without monthly restrictions. Our free music service in the United States allows members to listen to nearly every song in Napster's more than 2 million song subscription catalog five times each for free anywhere on the web without downloading any software. In addition, Napster.com now also provides the following consumer features/products:

- ***NapsterLinks*** is a tool that empowers music fans to share legal music across the web by easily adding links to free Napster music to anything they create on web sites, blogs and instant messages; and
- ***Narchive*** is an interactive home for comprehensive music information that actively documents the ever-expanding history of music through contributions from music authorities, as well as from music fans.

Our paid music subscription services, Napster and Napster To Go, provide consumers in the United States with unlimited, high fidelity, access to over 2,000,000 tracks for monthly fees of $9.95 and $14.95, respectively. Napster subscribers enjoy unlimited access to CD-quality music on up to three computers and have access to over 50 interactive radio stations, extensive community features, message boards, historical Billboard chart information and enhanced programming. Napster To Go subscribers can transfer an unlimited amount of music from Napster to their choice of over 65 compatible MP3 players for the entire term of their subscription without having to purchase individual tracks and albums a la carte. In addition, all Napster subscribers enjoy community features, such as the ability to send song links to friends, and our subscribers can browse other subscribers' published collections. We also offer Napster and Napster To Go in Canada, Germany and the United Kingdom at fees that are based on the local currency and vary accordingly. The feature sets and track availability in these countries vary slightly from the United States.

In addition to our Napster and Napster To Go offerings, we provide a separate download music store, called Napster Light, where customers who are not subscribers (including users of Napster.com) can purchase individual tracks for $0.99 each or albums starting at $6.95. These tracks can be "burned" to a CD or transferred to an MP3 player. Napster's United States catalogue of available music exceeds two million tracks, and all content is licensed from major music companies, including EMI Recorded Music, Sony BMG, Universal Music Group and Warner Music Group, as well as numerous independent labels, on a non-exclusive basis.

We also have announced agreements with Ericsson, a leading telecommunications supplier, and SunCom Wireless, a leading provider of wireless phone service in the Southeast United States, under which we expect to make Napster Mobile available during fiscal 2007.

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Our Strategy

Our objective is to become the leading global provider of consumer digital music services. We intend to pursue the following key strategic initiatives to accomplish our objective:

Drive Traffic to Napster.com as a means to Generate Ad Revenue and Reduce our Subscriber Customer Acquisition Cost

We have embarked on a fully integrated marketing program and communication strategy in the United States with the goal of driving consumers to Napster.com. By bringing consumers to the website with the offer of free music, we anticipate that unique monthly visitors, and the corresponding page views generated through exploration of the free website and playing free music, will increase. This increased traffic is expected to generate advertising revenues. Additionally, after consumers are exposed to full length music, rather than 30 second clips, and reach their five song maximum, we expect that many will choose to subscribe to the paid Napster service and/or purchase the music track. New paying customers who originate through Napster.com will cost us substantially less to obtain than customers we have acquired in the past. We also expect to bring consumers to Napster.com through the creation of NapsterLinks on third party web sites, blogs and social networking sites. These links can be created by any consumer and enable the recipient to click and listen to the named track. The proliferation of these links throughout the Web is expected to increase consumer awareness of Napster.com and increase visitors on the free music web site.

Continue to Innovate by Investing in New Services and Technologies

We plan to continue to innovate by investing in product development to improve our services, expand the breadth of our service offerings, and maintain compatibility with popular technology standards. A significant focus of our future development efforts will continue to be on free music and portable subscriptions. We plan to provide free music listeners increased functionality and to enable paid subscribers to enjoy their subscriptions on an increased number of and variety of devices including cell phones, a fast growing segment of the portable device market. In addition, we intend to market our core service offerings along with related products and services that support our offerings, add to the richness of the consumer experience and provide additional revenue.

Continue to Pursue and Execute Strategic Partnerships

We intend to enter into additional strategic partnerships with the goal of delivering the best experience for consumers. Strategic partnerships allow us to enhance, expand upon and complement our product offerings and increase our distribution by joining with companies that have significantly greater resources and specific expertise than we do. To date, we have entered into strategic partnerships with technology companies (Ericsson, Microsoft, Intel), hardware companies (iRiver, Dell, Samsung, Gateway, Toshiba), retailers (Tower Records Japan, Best Buy, Radio Shack, Dixons Group, The Link, PC World, Currys), and others.

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Sales, Marketing and Support

In the United States, we have embarked on an integrated marketing program and communication strategy with the goal of increasing the number of visitors who come to Napster.com. This marketing program focuses online, where we can most cost effectively reach the age 18-34 target audience, as well as the strategic use of print, leveraging and building upon our leading university/college programs and establishing a strong Napster presence at relevant music events.

In the United Kingdom and Germany, we continue to market our paid Napster service directly to consumers through an integrated offline and online marketing program, consistent with the existing strong awareness and perception of the Napster brand. The marketing message is focused on our subscription service, which differentiates our offering from many of our competitors. Offline marketing channels include television and print advertising. Our online marketing program includes advertising placements on a number of web sites (including affiliate partners) and search engines. We have not launched or begun marketing an advertising supported free music service in Europe.

We enter into partner programs directly with PC and MP3 player manufacturers, whereby our paid Napster music service and/or software comes either preloaded on the hard drive (in the case of PCs) or in the device box (in the case of MP3 players). We also have relationships with a number of direct-to-consumer retailers, such as Best Buy in the United States and Dixon's in the United Kingdom. The nature of these relationships range from the sale of Napster retail products, such as prepaid download cards, to more extensive promotions, including inclusion in the retail chain's own advertising efforts, special promotions and in-store displays These relationships include a number of components, such as store placement via permanent displays, inclusion in the retail chain's own advertising efforts (such as Sunday circulars), salespeople training, and sales of Napster retail products such as prepaid download cards, subscription CDs and free trial offers.

Our advertising and promotional efforts will continue to focus on building the Napster brand and aggressively supporting our new product launches, such as Napster.com.

Product Development

With the acquisition of Napster, LLC (formerly known as Pressplay) in May 2003, we acquired considerable in-house engineering skill in the areas of digital media delivery, content management, and digital rights management. Along with skilled additional engineering resources, we now have (i) a distribution system tailored to manage digital media files and the associated metadata and associated usage rights; (ii) a scalable e-commerce and media delivery infrastructure, which can support a range of business models for the delivery of digital music including a la carte and subscription services; and (iii) a digital rights management platform, which provides security for the digital media assets, as well as the ability to tailor usage rights and offerings to end consumers. The digital rights management capability has recently been extended to support portable subscriptions—the ability to download an unlimited amount of content to a set number of portable devices, and to continue to allow users access to that content as long as they continue to pay their subscription fee.

Research and development expenses for our Napster business totaled $13.1 million in the year ended March 31, 2006 ("fiscal 2006") and $12.1 million in the year ended March 31, 2005 ("fiscal 2005").

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Customers

Our online music services are offered directly to end users by us through our website, affiliate network and universities that have procured site licenses. We also sell prepaid cards through our retail partners and bundle our services with OEM partners, such as iRiver, Dell, Creative Labs and Samsung. We have licensed certain merchandising rights to select third parties and expect to continue to do so in the future.

Competition

The markets we are targeting are highly competitive, and we expect competition to increase in the future. Increased competition may result in price reductions and loss of market share, which could reduce our future revenues and otherwise harm our business. Primary competitors for online music services include Apple Computer's iTunes Music Store, RealNetworks, Inc.'s Rhapsody, Yahoo! Unlimited, MTV's Urge, Sony Connect, and AOL Music Now. Other competitors include online and offline retailers such as Amazon.com and WalMart, satellite radio providers such as XM and Sirius, and mobile operators such as Verizon's V-cast service and Sprint's Music Store. Finally, our online music distribution services also compete against "free" peer-to-peer services, as well as traditional retail music distributors.

We believe that the principal competitive factors affecting the market for our services include programming, features, price and performance, quality of customer support, compatibility with popular hardware devices and brand. We believe that we compete more favorably than many of our current competitors with respect to some or all of these factors. However, we may not be able to maintain our competitive position against current and potential competitors, especially those with significantly greater resources. For example, many of our competitors in the online music distribution industry have significantly more resources than we do, including exclusive access to music content, and some of these competitors may be able to leverage their experience in providing online music distribution services or similar services to their customers in other businesses. Some of these competitors have offered and will likely continue to offer services at a lower price than we do.

Intellectual Property

Our success and ability to compete depend substantially upon our intellectual property. As of June 1, 2006, we have 25 pending United States and foreign patent applications. These applications cover online music distribution functionality and peer-to-peer technology. We currently have seven United States and foreign patents issued, with terms ending in 2017 through 2026.

Employees

As of March 31, 2006, Napster had 145 employees, of which 12 provide support to the online music service (maintaining content and providing customer care), 32 were in sales and marketing, 63 were in engineering and product development and 38 were in finance, administration and operations.

Our future performance depends, in significant part, upon our ability to attract new personnel and retain existing personnel in key areas including engineering, technical support and sales. None of our employees is represented by a collective bargaining agreement. We have not experienced any work stoppages, and we consider our relations with our employees to be good.

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Investor Information

We are subject to the informational requirements of the Securities Exchange Act of 1934 (the "Exchange Act"). Therefore, we file periodic reports, proxy statements and other information with the Securities and Exchange Commission (the "SEC"). Such reports, proxy statements and other information may be obtained by visiting the Public Reference Room of the SEC at 100 F Street N.E., Washington, D.C. 20549 or by calling the SEC at 1-800-SEC-0330. In addition, the SEC maintains an Internet site (http://www.sec.gov) that contains reports, proxy and information statements and other information regarding issuers that file electronically. We also maintain a Web site at www.napster.com. Investors can obtain copies of our SEC filings from this site free of charge, as well as from the SEC Web site. The information on our website shall not be deemed incorporated by reference in or otherwise a part of this report.

ITEM 1A. RISK FACTORS

Investing in our common stock involves a high degree of risk. You should carefully consider the risks described below and the other information in this annual report. If any of the following risks occur, our business could be materially harmed, and our financial condition and results of operations could be materially and adversely affected. As a result, the price of our common stock could decline, and you could lose all or part of your investment.

Our digital music distribution business has a limited operating history and a history of losses and may not be successful.

On May 19, 2003, we acquired substantially all of the ownership interests of Napster, LLC (f/k/a Pressplay). We used the Pressplay-branded service as a technology platform to roll-out our online music services division in October 2003. The business models, technologies and market for digital music services are new and unproven. Prior to our acquisition of Napster, LLC, consumer adoption and usage of the Pressplay-branded service had not been significant. On December 17, 2004, we completed the sale of our consumer software division to Sonic Solutions and have subsequently focused our business exclusively on paid digital music distribution and our recently launched advertising-supported music website, under the Napster brand. You should consider our business and prospects in light of the risks, expenses and difficulties encountered by companies in their early stage of development.

Our digital music distribution business has experienced significant net losses since its inception and, given the significant operating and capital expenditures associated with our business plan, we expect to incur net losses for at least the next twelve months and will likely continue to experience net losses thereafter. No assurance can be made that our paid Napster service or the free music service will ever contribute net income to our statement of operations. During the period beginning April 1, 2003, just prior to our acquisition of Pressplay in May 2003, through March 31, 2006, we incurred approximately $155.7 million of after tax losses from continuing operations.

The success of our paid Napster service depends upon our ability to add new subscribers and reduce churn.

We cannot assure you that we will be able to attract new subscribers to the paid Napster service or that existing subscribers will continue to subscribe. Existing subscribers may cancel their subscriptions to the paid Napster service for many reasons, including a perception that they do not use the services enough to justify the expense or that the service does not provide enough value, or availability of content relative to our competition. The early stages of subscription services such as ours are characterized by higher than normal churn rates and customer acquisition cost. If we are unable to reduce these two factors we may be unable to achieve a profitable business model. In addition, there is significant seasonality in our subscriber numbers due to our university program and softness in customer acquisition during the summer months when consumers spend less time online. Students who subscribe to the paid Napster service generally only do so during the school year when the school is paying for their subscriptions and most of the students do not maintain such subscriptions during the summer in between school terms. If we do not continue to increase the total number of subscribers each quarter, our operating results will be adversely impacted.

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Our future success will depend on advertising revenues to grow our business and obtain profitability, and if advertising revenues were to fail to grow as expected, our results of operations and business would be harmed.

Revenues from advertising are important to the future success of our business. Advertising revenues are based on the number of page views by visitors to the Napster.com Web site. If our free music service, including Narchive, fails to attract and retain visitors, our revenues will not grow as expected. Most advertisers currently spend only a small portion of their advertising budgets on Internet advertising. There are also significant lead times associated with securing these advertising dollars. Furthermore, expenditures by advertisers tend to be cyclical, reflecting overall economic conditions and budgeting and buying patterns. If we fail to persuade potential advertisers to spend a portion of their budget on advertising with us, or if advertising spending declines due to general economic conditions or the failure of the Internet to be an effective advertising medium, our business and revenues could be adversely affected. In addition, sales of advertisements occur under short-term contracts, which are difficult to forecast accurately. Advertisers generally have the right to cancel an advertising campaign on short notice without penalty. Accordingly, the cancellation or deferral of advertising agreements could have a material adverse effect on our financial results.

We experience fluctuations in our quarterly operating results, which may cause our stock price to decline.

Our quarterly operating results may fluctuate from quarter to quarter. We cannot reliably predict future revenue and margin trends and such trends may cause us to adjust our operations. Other factors that could affect our quarterly operating results include:

- timing of service introductions;
- seasonal fluctuations in sales of our prepaid cards, university subscriptions, and bundled hardware promotions, as well as other products and services;
- potential declines in selling prices of music as a result of competitive pressures;
- changes in the mix of our revenues represented by our various services;
- fluctuations in traffic levels on our Web sites, which can be significant as a result of business, financial and other news events;
- fluctuating and unpredictable demand for advertising on our Web sites as well as on the Web in general;
- reductions in rates paid for Web advertising resulting from softening demand, competition, or other factors;
- adverse changes in the level of economic activity in the United States or other major economies in which we do business, or in industries, such as the music industry, on which we are particularly dependent;
- foreign currency exchange rate fluctuations;
- expenses related to, and the financial impact of, possible acquisitions of other businesses; and
- expenses incurred in connection with the development of our digital music distribution services.

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We rely on the value of the Napster brand, and our revenues could suffer if we are not able to maintain its high level of recognition in the digital music sector.

We believe that maintaining and expanding the Napster brand is an important aspect of our efforts to attract and expand our user and advertiser base. We have embarked on a broad branding program to ensure that our position in the digital music sector continues to be strongly associated with the Napster name. Promotion and enhancement of the Napster brand will depend in part on our ability to provide consistently high-quality products and services. If we are not able to successfully maintain or enhance consumer awareness of the Napster brand or, even if we are successful in our branding efforts, if we are unable to maintain or enhance customer awareness of the Napster brand in a cost effective manner, our business, operating results and financial condition would be harmed.

We face significant competition from traditional retail music distributors, from emerging paid online music services delivered electronically such as ours, and from "free" peer-to-peer services.

Our paid Napster service faces significant competition from traditional retail music distributors, as well as online retailers such as Amazon.com. These retailers may include regional and national mall-based music chains, international chains, deep-discount retailers, mass merchandisers, consumer electronics outlets, mail order, record clubs, independent operators and online physical retail music distributors, some of which have greater financial and other resources than we do. To the extent that consumers choose to purchase media in non-electronic formats, it may reduce our sales, reduce our gross margins, increase our operating expenses and decrease our profit margins in specific markets.

Our digital music distribution services competitors currently include Apple Computer's iTunes Music Store, AOL Music Now, RealNetworks, Inc., the provider of the Rhapsody service, MTV's Urge, Sony Connect, Walmart.com, FYE, Microsoft's MSN Music service and online music services powered by MusicNet such as Yahoo! Music Unlimited, MTV's Urge, Virgin, V-cast and Sprint. Other potential competitors such as Amazon.com have announced their intention to provide competing music distribution services. Internationally we currently compete with OD2, Puretracks, Music Store and Vodafone's music offerings, as well as with a number of the other competitors described above.

Our digital music distribution business also faces significant competition from "free" peer-to-peer services, such as KaZaA, Morpheus, Grokster and a variety of similar services that allow computer users to connect with each other and to copy many types of program files, including music and other media, from one another's hard drives, all without securing licenses from content providers. While the U.S. Supreme Court has recently found that Grokster may violate copyright laws, the court did not establish that such services are necessarily liable for copyright infringement, opting instead for a fact-based analysis of the services' efforts to promote copyright infringement. Additionally, enforcement efforts against those in violation have not effectively shut down these services, and there can be no assurance that these services will ever be shut down. The ongoing presence of these "free" services substantially impairs the marketability of legitimate services, regardless of the ultimate resolution of their legal status.

Our advertising-supported music website competes, directly and indirectly, for advertisers, viewers, members, and content providers with publishers and distributors of traditional off-line media, such as television, radio and print, including those targeted to music, many of which have established or may establish websites, such as MTV. We also face intense competition from general purpose consumer online services such as Yahoo, MSN and Google, each of which provides access to music-related content and services and from websites targeted to music related content, such as Yahoo and myspace.com. Finally, we compete directly for content and for users of our advertising-supported website from community-generated information websites that include music-related content, such as Wikipedia.

Many of our competitors have significantly more resources than we do, and some of our competitors may be able to leverage their experience in providing digital music distribution services or similar services to their customers in other businesses. We or our competitors may be able to secure limited exclusive rights to content from time to time. If our competitors secure significant exclusive content, it could harm the ability of our online music services to compete effectively in the marketplace.

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In particular, some of these competitors offer other goods and services and may be willing and able to offer music services at a lower price than we can in order to promote the sale of these goods and services. If we lower our prices, our gross margins and operating results will be adversely affected. If we do not lower our prices, we may be unable to compete with discount services. This could harm the ability of our online music services to compete effectively in the marketplace.

Digital music distribution services in general are new and rapidly evolving and may not prove to be a profitable or even viable business model.

Digital music distribution services are a relatively new business model for delivering digital media over the Internet. It is too early to predict whether consumers will accept, in significant numbers, digital music services and accordingly whether the services will be financially viable. If digital music distribution services do not prove to be popular with consumers, or if these services cannot sustain any such popularity, our business and prospects would be harmed.

We rely on content provided by third parties, which may not be available to us on commercially reasonable terms or at all.

We rely on third-party content providers, including music publishers and music labels, to offer online music content that can be delivered to users of our digital music distribution services. Rights to provide this content to our customers, particularly publishing rights, are difficult to obtain and require significant time and expense. In order to provide a compelling service, we must be able to continue to license a wide variety of music content to our customers with attractive usage rights such as CD recording, output to MP3 players, portable subscription rights and other rights. In addition, if we do not have sufficient breadth and depth of the titles necessary to satisfy increased demand arising from growth in our subscriber base, our subscriber satisfaction will be affected adversely.

Under copyright law we are required to pay licensing fees for compositions embodied in digital sound recordings and for the sound recordings themselves that we deliver in our Napster service. Copyright law generally does not specify the rate and terms of the licenses, which are determined by voluntary negotiations among the parties or, for certain compulsory publishing licenses where voluntary negotiations are unsuccessful, by a copyright royalty board ("CRB"), an administrative judicial proceeding supervised by the United States Copyright Office. Past copyright proceedings have resulted in proposed rates for statutory webcasting that were significantly in excess of rates requested by webcasters. We cannot predict the outcome of any negotiations or CRB proceedings. We may also elect to attempt to directly license compositions for our services, either alone or in concert with other affected companies. Such licenses may only apply to music performed in the United States. The availability of licenses for compositions used in certain international versions of the services is unclear. Therefore, our ability to negotiate appropriate licenses is uncertain.

Voluntarily negotiated rates for mechanical licenses with respect to streaming and conditional digital downloads with the Harry Fox Agency and National Music Publishers Association have not been agreed to, and we are currently operating under a standstill agreement until such rates are negotiated. No final agreement has been reached with performing rights societies such as ASCAP or BMI regarding whether digital downloads constitute public performances of copyrighted works that would trigger payment of public performance royalties. In addition to certain other negotiations, European Union and Canadian tribunals are in process, which will set rates for subscription music services and services that deliver digital downloads of music, and the outcome of these negotiations and proceedings will also likely affect our business in ways that we cannot predict. Napster accrues for the cost of these fees, based on contracted or statutory rates, when established, or management's best estimates based on facts and circumstances regarding the specific music services and agreements in similar geographies or with similar agencies. If the final agreed rates differ significantly from management's estimate, the actual amount paid and expensed could differ materially from the recorded amounts.

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Our success depends on our digital music distribution service's interoperability with our customer's music playback hardware.

In order for the paid Napster service to be successful, we must design our service to interoperate effectively with a variety of hardware products, including home stereos, car stereos, portable MP3 players, cell phones, PCs and other mobile devices. We depend on significant cooperation with manufacturers of these products and with software manufacturers that create the operating systems for such hardware devices to achieve our design objectives and to offer a service that is attractive to our customers. Currently, there are a limited number of devices that offer the portable subscription functionality that is required to support our Napster To Go service. Our software is not compatible with the iPod music player, the current equipment market leader. If we cannot successfully design our service to interoperate with the music playback devices that our customers own, our business will be harmed.

We may not successfully develop new products and services.

The success of our digital music distribution services will depend on our ability to develop leading-edge media and digital distribution products and services. Our business and operating results will be harmed if we fail to develop products and services that achieve widespread market acceptance or that fail to generate significant revenues or gross profits to offset our development and operating costs. We may not timely and successfully identify, develop and market new product and service opportunities.

We may not be able to add new content such as video, spoken word or other content as quickly or as efficiently as our competitors or at all. If we introduce new products and services, they may not attain broad market acceptance or contribute meaningfully to our revenues or profitability. Competitive or technological developments may require us to make substantial, unanticipated investments in new products and technologies, and we may not have sufficient resources to make these investments.

Because the markets for our products and services are changing rapidly, we must develop new offerings quickly. Delays and cost overruns could affect our ability to respond to technological changes, evolving industry standards, competitive developments or customer requirements. Our products also may contain undetected errors that could cause increased development costs, loss of revenues, adverse publicity, reduced market acceptance of our products or services or lawsuits by customers.

We must maintain and add to our strategic marketing relationships in order to be successful.

We depend on a number of strategic relationships with third parties to co-market our services. We have entered into co-marketing agreements with infrastructure providers, retailers and other companies to broaden the distribution of our brand and our services. There is no guarantee that we will be able to renew existing agreements or enter into new agreements on acceptable terms, or at all. If we cannot maintain existing strategic relationships or enter into new relationships, our ability to market our services will be harmed.

In addition, because of the rapidly evolving nature of digital music distribution and our short history of operations, we often enter into strategic agreements where the financial impact on our business and operations is uncertain. We cannot guarantee that any of these agreements will result in the desired benefits to our business or result in significant additional revenue.

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Our network is subject to security and stability risks that could harm our business and reputation and expose us to litigation or liability.

Online commerce and communications depend on the ability to transmit confidential information and licensed intellectual property securely over private and public networks. Any compromise of our ability to transmit such information and data securely or reliably, and any costs associated with preventing or eliminating such problems, could harm our business. Online transmissions are subject to a number of security and stability risks, including:

- our own or licensed encryption and authentication technology, and access and security procedures, may be compromised, breached or otherwise be insufficient to ensure the security of customer information or our music content;
- we could experience unauthorized access, computer viruses, system interference or destruction, "denial of service" attacks and other disruptive problems, whether intentional or accidental, that may inhibit or prevent access to our web sites or use of our products and services;
- someone could circumvent our security measures and misappropriate our, our partners' or our customers' intellectual property or interrupt operations, or jeopardize our licensing arrangements, which are contingent on our sustaining appropriate security protections;
- our computer systems could fail and lead to service interruptions;
- we may be unable to scale our infrastructure with increases in customer demand; or
- our network of facilities may be affected by a natural disaster, terrorist attack or other catastrophic events.

The occurrence of any of these or similar events could damage our business, hurt our ability to distribute products and services and collect revenue, threaten the proprietary or confidential nature of our technology, harm our reputation and expose us to litigation or liability. We may be required to expend significant capital or other resources to protect against the threat of security breaches, hacker attacks or system malfunctions or to alleviate problems caused by such breaches, attacks or failures.

We depend on key personnel who may not continue to work for us.

Our success substantially depends on the continued employment of certain executive officers and key employees, including, in particular, Christopher Gorog, our Chief Executive Officer. The loss of the services of these key officers and employees could harm our business. If any of these individuals were to leave our company, we could face substantial difficulty in hiring qualified successors and could experience a loss in productivity while any such successor obtains the necessary training and experience.

If we fail to manage expansion effectively, we may not be able to successfully manage our business, which could cause us to fail to meet our customer demand or to attract new customers, which would adversely affect our revenue.

Our ability to successfully offer our products and services and implement our business plan in a rapidly evolving market requires an effective planning and management process. We plan to continue to increase the scope of our digital music distribution operations domestically and internationally. In addition, we plan to continue to hire a significant number of employees in the next twelve months for the development of new products and services. This anticipated growth in future operations will place a significant strain on our management resources.

In the future, we plan to continue to develop and improve our financial and managerial controls, reporting systems and procedures. In addition, we plan to continue to expand, train and manage our work force worldwide.

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A significant portion of the revenues from our paid Napster service is derived from international revenues. Economic, political, regulatory and other risks associated with international revenues and operations could have an adverse effect on our revenues.

Because we operate worldwide, our business is subject to risks associated with doing business internationally. International net revenues did not account for a significant percentage of our net revenues prior to the sale of our consumer software division; however, revenues from international operations have represented a significant portion of our total net revenues from our digital music distribution business. We anticipate that revenues from international operations will continue to represent a substantial portion of our total net revenues as we expand our Napster service abroad and enter into joint venture arrangements with international partners such as Tower Records Japan, Inc. Accordingly, our future revenues could decrease based on a variety of factors, including:

- disputes with joint venture partners;
- mismanagement or fraud by joint venture partners;
- changes in foreign currency exchange rates;
- seasonal fluctuations in sales of our prepaid cards as well as other products and services;
- changes in a specific country's or region's political or economic condition, particularly in emerging markets;
- unexpected changes in foreign laws and regulatory requirements;
- difficulty of effective enforcement of contractual provisions in local jurisdictions;
- trade protection measures and import or export licensing requirements;
- potentially adverse tax consequences including changes to the VAT collection scheme;
- difficulty in managing widespread sales operations; and
- less effective protection of intellectual property.

To grow our business, we must be able to hire and retain sufficient qualified technical, sales, marketing and administrative personnel.

Our future success depends in part on our ability to attract and retain engineering, sales, marketing, finance and customer support personnel. If we fail to retain and hire a sufficient number of these employees, we will not be able to maintain and expand our business. We cannot assure you that we will be able to hire and retain a sufficient number of qualified personnel to meet our business objectives.

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We may be unable to adequately protect our proprietary rights.

Our inability to protect our proprietary rights, and the costs of failing to do so, could harm our business. Our success and ability to compete partly depend on the superiority, uniqueness or value of our technology, including both internally developed technology and technology licensed from third parties. To protect our proprietary rights, we rely on a combination of patent, trademark, copyright and trade secret laws, confidentiality agreements with our employees and third parties, and protective contractual provisions. These efforts to protect our intellectual property rights may not be effective in preventing misappropriation of our technology. These efforts also may not prevent the development and design by others of products or technologies similar to, competitive with or superior to those we develop. Any of these results could reduce the value of our intellectual property. We may be forced to litigate to enforce or defend our intellectual property rights and to protect our trade secrets. Any such litigation could be very costly and could distract our management from focusing on operating our business.

We may be subject to intellectual property infringement claims, such as those claimed by SightSound Technologies, which are costly to defend and could limit our ability to use certain technologies in the future.

Many parties are actively developing streaming media and digital distribution-related technologies, e-commerce and other Web-related technologies, as well as a variety of online business methods and models. We believe that these parties will continue to take steps to protect these technologies, including, but not limited to, seeking patent protection. As a result, disputes regarding the ownership of these technologies and rights associated with streaming media, digital distribution and online businesses are likely to arise in the future and may be very costly. In addition to existing patents and intellectual property rights, we anticipate that additional third-party patents related to our products and services will be issued in the future. If a blocking patent has been issued or is issued in the future, we would need to either obtain a license or design around the patent. We may not be able to obtain such a license on acceptable terms, if at all, or design around the patent, which could harm our business.

Companies in the technology and content-related industries have frequently resorted to litigation regarding intellectual property rights. We may be forced to litigate to determine the validity and scope of other parties' proprietary rights. Any such litigation could be very costly and could distract our management from focusing on operating our business. In addition, we believe these industries are experiencing an increased level of litigation to determine the applicability of current laws to, and the impact of new technologies on, the use and distribution of content over the Internet and through new devices, especially in the music industry. As we develop products and services that provide or enable the provision of content, in such ways, our litigation risk may increase. The existence and/or outcome of such litigation could harm our business.

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From time to time we receive claims and inquiries from third parties alleging that our internally developed technology, or technology we license from third parties, may infringe the other third parties' proprietary rights, especially patents. Third parties have also asserted and most likely will continue to assert claims against us alleging infringement of copyrights, trademark rights, or other proprietary rights, or alleging unfair competition or violations of privacy rights. We could be required to spend significant amounts of time and money to defend ourselves against such claims. If any of these claims were to prevail, we could be forced to pay damages, comply with injunctions, or stop distributing our products and services while we re-engineer them or seek licenses to necessary technology, which might not be available on reasonable terms, or at all. We could also be subject to claims for indemnification resulting from infringement claims made against our customers and strategic partners, which could increase our defense costs and potential damages. Any of these events could require us to change our business practices and could harm our business.

We may be subject to legal liability for online services.

Our free music service allows individuals and businesses to post content, advertise products and services, conduct business and engage in various online activities on an international basis. The law relating to the liability of providers of these online services for activities of their users is currently unsettled both within the United States and internationally. Claims have been threatened and have been brought against similar website owners for defamation, negligence, copyright or trademark infringement, unlawful activity, tort, including personal injury, fraud, or other theories based on the nature and content of information that such websites provide links to or that may be posted online or generated by users. We may be subject to similar actions in domestic or other international jurisdictions in the future. Although we generally will obtain representations as to the origin and ownership of content licensed from third parties and generally will obtain indemnification from these third parties to cover a breach of any such representation, we may not receive representations or indemnification that are sufficient to cover all liability relating to the third-party content. Our defense of any such actions could be costly and involve significant time and attention of our management and other resources.

A decline in current levels of consumer spending could reduce our sales.

Our business is directly affected by the level of consumer spending. One of the primary factors that affect consumer spending is the general state of the local economies in which we operate. Lower levels of consumer spending in regions in which we have significant operations could have a negative impact on our business, financial condition or results of operations.

We depend on software from third parties to deliver and to track and measure the delivery of advertisements and it could be difficult to replace these services.

It is important to our future success that we are able to effectively deliver our advertisers' advertisements and it is important to our advertisers that we accurately measure the delivery of such advertisements on our websites. We depend on third-party software to provide these measurement and delivery services. If these third parties are unable to provide these services in the future, we would be required to perform them ourselves or obtain them from other providers. This could cause us to incur additional costs or cause interruptions in our business during the time we are replacing these services. Companies may not advertise on our websites or may pay less for advertising if they do not perceive our measurements or measurements made by third parties to be reliable.

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We may need additional capital, and we cannot be sure that additional financing will be available.

Although we currently anticipate that our available funds and expected cash flows from operations will be sufficient to meet our cash needs for at least the next twelve months, we may require additional financing. Our ability to obtain financing will depend, among other things, on our development efforts, business plans, operating performance and condition of the capital markets at the time we seek financing. We expect to experience operating losses from the digital music distribution business in at least the short-term. We cannot assure you that additional financing will be available to us on favorable terms when required, or at all. If we raise additional funds through the issuance of equity, equity-linked or debt securities, those securities may have rights, preferences or privileges senior to the rights of our common stock, and our stockholders may experience dilution.

Changes in stock option accounting rules may adversely impact our reported operating results prepared in accordance with generally accepted accounting principles, our stock price and our competitiveness in the employee marketplace.

Technology companies like ours have a history of using broad-based employee stock option programs to hire, provide incentives to and retain our workforce in a competitive marketplace. We have elected to apply Accounting Principles Board ("APB") Opinion No. 25, "Accounting for Stock Issued to Employees" ("APB No. 25"), to account for stock options. Accordingly we generally have not recognized any expense with respect to employee stock options as long as such options are granted at exercise prices equal to the fair value of our common stock on the date of grant.

On December 16, 2004, the Financial Accounting Standards Board ("FASB") adopted Statement of Financial Accounting Standards ("SFAS") No. 123(R), "Share-Based Payment" ("SFAS No. 123(R)"), which revises the previously effective SFAS No. 123, "Accounting for Stock-Based Compensation", and supersedes APB No. 25. This statement addresses the accounting for share-based payment transactions in which an enterprise receives employee services in exchange for either equity instruments of the enterprise or liabilities that are based on the fair value of the enterprise's equity instruments or that may be settled by the issuance of such equity instruments. The statement eliminates the ability to account for share-based compensation transactions using APB No. 25 and generally requires that such transactions be accounted for using a fair-value-based method and recognized as expenses in our consolidated statements of operations. The effective date of the standard for public companies is for the first annual reporting periods beginning after June 15, 2005. We will adopt SFAS No. 123(R) effective April 1, 2006 and expect it to have an adverse impact on our consolidated statements of operations and net income (loss) per share.

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We are subject to risks associated with governmental regulation and legal uncertainties.

Few existing laws or regulations specifically apply to the Internet, other than laws and regulations generally applicable to businesses. Certain United States export controls and import controls of other countries, including controls on the use of encryption technologies, may apply to our products. Many laws and regulations, however, are pending and may be adopted in the United States, individual states, and local jurisdictions and other countries with respect to the Internet. These laws may relate to many areas that impact our business, including content issues (such as obscenity, indecency and defamation), copyright and other intellectual property rights, digital rights management, encryption, caching of content by server products, personal privacy, taxation, e-mail, sweepstakes, promotions, prepaid card expiration, escheatment, network and information security and the convergence of traditional communication services with Internet communications, including the future availability of broadband transmission capability and wireless networks. These types of regulations are likely to differ between countries and other political and geographic divisions. Other countries and political organizations are likely to impose or favor more and/or different regulations than that which has been proposed in the United States, thus furthering the complexity of regulation. In addition, state and local governments may impose regulations in addition to, inconsistent with, or stricter than federal regulations. The adoption of such laws or regulations, and uncertainties associated with their validity, interpretation, applicability and enforcement, may affect the available distribution channels for and costs associated with our products and services and may affect the growth of the Internet. Such laws or regulations may harm our business. Our products and services may also become subject to investigation and regulation of foreign data protection and e-commerce authorities, including those in the European Union. Such activities could result in additional product and distribution costs for us in order to comply with such regulations.

We do not know for certain how existing laws governing issues such as property ownership, copyright and other intellectual property issues, digital rights management, taxation, gambling, security, illegal or obscene content, retransmission of media, personal privacy and data protection apply to the Internet. The vast majority of such laws were adopted before the advent of the Internet and related technologies and do not address the unique issues associated with the Internet and related technologies. Most of the laws that relate to the Internet have not yet been interpreted. In addition to potential legislation from local, state and federal governments, labor guild agreements and other laws and regulations that impose fees, royalties or unanticipated payments regarding the distribution of media over the Internet may directly or indirectly affect our business. While we and our customers may be directly affected by such agreements, we are not a party to such agreements and have little ability to influence the degree such agreements favor or disfavor Internet distribution or our business models. Changes to or the interpretation of these laws and the entry into such industry agreements could:

- limit the growth of the Internet;
- create uncertainty in the marketplace that could reduce demand for our products and services;
- increase our cost of doing business;
- expose us to increased litigation risk, substantial defense costs and significant liabilities associated with content available on our web sites or distributed or accessed through our products or services, with our provision of products and services and with the features or performance of our products and web sites;
- lead to increased product development costs or otherwise harm our business; or
- decrease the rate of growth of our user base and limit our ability to effectively communicate with and market to our user base.

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The Child Online Protection Act and the Child Online Privacy Protection Act impose civil and criminal penalties on persons distributing material harmful to minors (e.g., obscene material) over the Internet to persons under the age of 17, or collecting personal information from children under the age of 13. We do not knowingly distribute harmful materials to minors or collect personal information from children under the age of 13. The manner in which these Acts may be interpreted and enforced cannot be fully determined, and future legislation similar to these Acts could subject us to potential liability if we were deemed to be non-compliant with such rules and regulations, which in turn could harm our business.

There are a large number of legislative proposals before the United States Congress and various state legislatures regarding intellectual property, digital rights management, copy protection requirements, privacy, email marketing and security issues related to our business. Furthermore, as part of our regular business activities now, and in the past, we engage in the issuance of gift cards redeemable for our services. It is possible that money received by us for the sale of gift cards could be subject to state and federal escheat, or unclaimed property, laws in the future. If this were the case, our business could be adversely impacted. It is not possible to predict whether or when such legislation may be adopted, and certain proposals, if adopted, could materially and adversely affect our business through a decrease in user registration and revenue, and influence how and whether we can communicate with our customers.

We may need to make additional future acquisitions to remain competitive. The process of identifying, acquiring and integrating future acquisitions may constrain valuable management resources, and our failure to effectively integrate future acquisitions may result in the loss of key employees and the dilution of stockholder value and have an adverse effect on our operating results.

We have completed several acquisitions and may continue to pursue strategic acquisitions in the future. Completing any potential future acquisitions could cause significant diversions of management time and resources. Financing for future acquisitions may not be available on favorable terms, or at all. If we identify an appropriate acquisition candidate, we may not be able to negotiate the terms of the acquisition successfully, finance the acquisition or integrate the acquired business, products, technologies or employees into our existing business and operations. Future acquisitions may not be well-received by the investment community, which may cause our stock price to fall. We have not entered into any agreements or understandings regarding any future acquisitions and cannot ensure that we will be able to identify or complete any acquisition in the future.

If we acquire businesses, new products or technologies in the future, we may be required to amortize significant amounts of identifiable intangible assets, and we may record significant amounts of goodwill that will be subject to annual testing for impairment. If we consummate one or more significant future acquisitions in which the consideration consists of stock or other securities, our existing stockholders' ownership could be significantly diluted. If we were to proceed with one or more significant future acquisitions in which the consideration included cash, we could be required to use a substantial portion of our available cash.

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We may be subject to market risk and legal liability in connection with the data collection capabilities of our products and services.

Many of our products are interactive Internet applications which by their very nature require communication between a client and server to operate. To provide better consumer experiences and to operate effectively, our products send information to servers. Many of the services we provide also require that a user provide certain information to us. We post an extensive privacy policy concerning the collection, use and disclosure of user data involved in interactions between our client and server products. Any failure by us to comply with our posted privacy policy and existing or new legislation regarding privacy issues could impact the market for our products and services, subject us to litigation and harm our business.

If, in the future, we conclude that our internal control over financial reporting is not adequate, or if our auditors conclude that our evaluation of internal controls over financial reporting is not adequate, investors could lose confidence in the reliability of our financial statements, which could result in a decrease in the value of our common stock.

As directed by Section 404 of the Sarbanes-Oxley Act of 2002, the Securities and Exchange Commission ("SEC") adopted rules requiring public companies to include a report of management on the company's internal control over financial reporting in their annual reports on Form 10-K. This report is required to contain an assessment by management of the effectiveness of such company's internal control over financial reporting. In addition, the independent registered public accounting firm auditing a public company's financial statements must attest to and report on management's assessment of the effectiveness of the company's internal control over financial reporting. There is a risk that in the future we may identify internal control deficiencies that suggest that our controls are no longer effective. This could result in an adverse reaction in the financial markets due to a loss of confidence in the reliability of our financial statements, which could cause the market price of our common stock to decline and make it more difficult for us to finance its operations.

The effectiveness of our disclosure and internal controls may be limited.

Our disclosure controls and procedures and internal control over financial reporting may not prevent all errors and misrepresentations. In the event that there are errors or misrepresentations in our historical financial statements or the SEC disagrees with our accounting, we may need to restate our financial statements. For example, in November 2004 we restated our financial statements in order to correct the valuation of a previously issued warrant and to adjust the purchase accounting of our former subsidiary, MGI Software, and in May 2005 we restated our financial statements to reallocate the tax benefit of certain operating losses from our discontinued operation to our continuing operations. Any system of internal controls can only provide reasonable assurance that all control objectives are met. Some of the potential risks involved could include but are not limited to management judgments, simple errors or mistakes, willful misconduct regarding controls or misinterpretation. There is no guarantee that existing controls will prevent or detect all material issues or be effective in future conditions, which could materially and adversely impact our financial results in the future.

We hold cash in foreign subsidiaries, which we may repatriate to the United States, and which may result in income taxes that could negatively impact our results of operations and financial position.

We are in the process of completing a corporate restructuring to close the overseas operations of certain dormant subsidiaries of our former consumer software division. We may repatriate our cash from these foreign subsidiaries to the United States. We may incur additional income taxes from the repatriation, which could negatively affect our results of operations and financial position.

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The asset purchase agreement with Sonic Solutions exposes us to contingent liabilities.

Under the asset purchase agreement with Sonic Solutions, we have retained various liabilities relating to the consumer software division and have agreed to indemnify Sonic Solutions under certain circumstances, such as if we breach our representations and warranties contained in the asset purchase agreement and for other matters, including all liabilities retained by us under that agreement. For example, an indemnification claim by Sonic Solutions might result if we breach or default on any of our representations about the assets comprising our consumer software division. Under the terms of the asset purchase agreement, if claims are made by Sonic Solutions, we may be required to expend significant cash resources in defense and settlement of such claims, which may adversely affect our business, results of operations and financial condition.

Provisions in our agreements, charter documents, stockholder rights plan and Delaware law may delay or prevent acquisition of us, which could decrease the value of our stock.

Our certificate of incorporation and bylaws and Delaware law contain provisions that could make it more difficult for a third party to acquire us without the consent of our board of directors. These provisions include a classified board of directors and limitations on actions by our stockholders by written consent. In addition, our board of directors has the right to issue preferred stock without stockholder approval, which could be used to dilute the stock ownership of a potential hostile acquirer. Delaware law also imposes some restrictions on mergers and other business combinations between us and any holder of 15% or more of our outstanding common stock. In addition, we have adopted a stockholder rights plan that makes it more difficult for a third party to acquire us without the approval of our board of directors. Although we believe these provisions provide for an opportunity to receive a higher bid by requiring potential acquirers to negotiate with our board of directors, these provisions apply even if the offer may be considered beneficial by some stockholders.

ITEM 1B. UNRESOLVED STAFF COMMENTS

None

ITEM 2. PROPERTIES

Our principal executive offices are located in Los Angeles, California. The table below lists our principal leased or licensed facilities as of June 1, 2006.

Location	Description	Approximate Square Footage	Lease Expiration
Los Angeles, California	Corp. Headquarters	15,000	April 2007
San Diego, California	Office	6,150	May 2007

We believe that our leased facilities are adequate to meet our current needs and that additional facilities will be available to meet our development and expansion needs on commercially reasonable terms.

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ITEM 3. LEGAL PROCEEDINGS

Napster and Pressplay have been notified by a number of companies that the Pressplay and Napster digital music services may infringe patents owned by those companies. We are investigating the nature of these claims and the extent to which royalties may be owed to these entities. The ultimate resolution of these claims cannot be determined at this time.

On October 8, 2004, SightSound Technologies, Inc. ("SightSound") filed a lawsuit against Napster and Napster, LLC in U.S. District Court for the Western District of Pennsylvania, Case No. 04-1549, alleging infringement of certain of its patents by the Napster service. SightSound is demanding monetary damages and injunctive relief. We were served with the complaint in the lawsuit on November 5, 2004. We have answered the complaint and filed an application with the United States Patent and Trademark Office for reexamination of the patents. In January 2005 we moved for a stay of the proceedings pending the outcome of our reexamination application. On February 28, 2005, the court granted our motion to stay. On March 22, 2005, SightSound filed a Petition to Cancel certain trademark registrations owned by Napster before the Trademark Trial and Appeals Board ("TTAB"), claiming that we did not acquire the rights to these trademarks when we purchased them through the bankruptcy estate. We believe that this petition is entirely without merit, and it has been stayed by TTAB pending resolution of the litigation in Pennsylvania. On May 19, 2005, we filed a motion with the U.S. Bankruptcy Court for the District of Delaware to reopen the Napster bankruptcy case and enforce the order assigning all of the assets of the former Napster, Inc. (including trademarks and goodwill) to us. On August 23, 2005, an order confirming the sale to us of the Napster trademarks, including goodwill, was granted by the Bankruptcy Court. In or around November 2005, SightSound sold the patents in question to a subsidiary of General Electric for an undisclosed amount. Management believes that it is not currently possible to estimate the impact, if any, that the ultimate resolution of these matters will have on our business, results of operations, financial position or cash flows.

On August 5, 2005, Ho Keung Tse filed suit against Apple Computer, Inc., Napster, MusicMatch, Inc., Sony Connect, Inc., Yahoo, Inc. and RealNetworks, Inc. in U.S. District Court for the District of Maryland alleging infringement of U.S. Patent No. 6665797 by the defendants' respective music distribution services. Mr. Tse is demanding monetary damages and injunctive relief. The defendants have formed a joint defense group, have moved for change of venue, and intend to defend themselves vigorously. Management believes that it is not currently possible to estimate the impact, if any, that the ultimate resolution of these matters will have on our business, results of operations, financial position or cash flows.

We are a party to other litigation matters and claims from time to time in the ordinary course of our operations, including copyright infringement litigation for which we are entitled to indemnification by content providers. While the results of such litigation and claims cannot be predicted with certainty, we believe that the final outcome of such matters will not have a material adverse impact on our business, financial position, cash flows or results of operations.

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ITEM 4. SUBMISSION OF MATTERS TO A VOTE OF SECURITY HOLDERS

None

EXECUTIVE OFFICERS OF THE REGISTRANT

The following table sets forth certain information with respect to our executive officers:

Name	Age	Position
Wm. Christopher Gorog	53	Chief Executive Officer and Chairman of the Board of Directors
Bradford D. Duea	37	President
Laura B. Goldberg	38	Chief Operating Officer
Nand Gangwani	38	Vice President and Chief Financial Officer

Wm. Christopher Gorog has served as our chief executive officer and director since September 2000. From September 2000 through May 2003, Mr. Gorog also served as our president. In September 2001, Mr. Gorog was elected chairman of our Board of Directors. From February 1999 to September 2000, Mr. Gorog served as a consultant in the entertainment and media industry, including serving as advisor to J.H. Whitney, an asset management company, in HOB Entertainment, Inc.'s acquisition of Universal Concerts. From November 1995 to February 1999, Mr. Gorog served as president of new business development at Universal Studios, an entertainment company. From January 1995 to November 1995, Mr. Gorog served as executive vice president of group operations at Universal Studios. Mr. Gorog serves on the board of directors of HOB Entertainment, Inc. (aka House of Blues), a North American concert producer and club owner. Mr. Gorog earned a B.A.S. in Telecommunications and Film from San Diego State University.

Bradford D. Duea has served as our president since January 2004. Prior to that, from February 2001 through January 2004, Mr. Duea served in various roles with us, including vice president of business development and vice president of worldwide OEM sales. From January 2000 to February 2001, Mr. Duea served as vice president, corporate development and corporate secretary of People Support, Inc., a provider of electronic customer relationship management solutions. From September 1996 to January 2000, Mr. Duea was an associate of O'Melveny & Myers LLP, a law firm. Mr. Duea holds a B.A. in Law and Society from the University of California at Santa Barbara, an M.B.A. in Finance and International Business from the University of Southern California, and a J.D. from the University of San Diego.

Laura B. Goldberg has served as our chief operating officer since January 2004. Prior to that, Ms. Goldberg served as our senior vice president operations from May 2003 to January 2004. From April 2001 to May 2003, Ms. Goldberg served as senior vice president operations of Duet GP d/b/a Pressplay. From August 1999 to April 2001, Ms. Goldberg served as general manager at Universal Music Group, an entertainment company. Ms. Goldberg holds a B.S. in Industrial Management from Carnegie Mellon University and an M.B.A. from the Harvard Business School.

Nand Gangwani has served as our vice president and chief financial officer since November 2003. Prior to that, Mr. Gangwani served as our vice president of strategic planning and M&A from January 2002 to November 2003. From May 2000 to November 2001, Mr. Gangwani served as vice president of corporate and business development at Evolve Software, Inc., a software company. From November 1997 to April 2000, Mr. Gangwani served as manager of corporate development at Intuit Inc., a software company. Mr. Gangwani holds a B.S. in Chemical Engineering from the Indian Institute of Technology and an M.B.A. in Finance from Bentley College.

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PART II

ITEM 5. MARKET FOR REGISTRANT'S COMMON EQUITY, RELATED STOCKHOLDER MATTERS AND ISSUER PURCHASES OF EQUITY SECURITIES

Dividend Policy

We have never declared or paid any cash dividends on our capital stock. We currently intend to retain all available funds and any future earnings for use in the operation and expansion of our business and do not anticipate paying any cash dividends in the foreseeable future. The terms of our line of credit agreement with Silicon Valley Bank restrict our ability to pay dividends.

Price Range of Common Stock

Our common stock is listed on the Nasdaq National Market under the symbol "NAPS". The approximate number of holders of record of our common stock as of June 1, 2006 was 820.

Our common stock was first listed on the Nasdaq National Market on May 4, 2001. The range of high and low sales prices of our common stock, as reported by the Nasdaq National Market System, for fiscal 2005 and 2006 is as follows:

Quarter Ended	High	Low
June 30, 2004	$ 5.35	$3.83
September 30, 2004	$ 5.36	$3.35
December 31, 2004	$10.40	$5.01
March 31, 2005	$10.20	$6.20
June 30, 2005	$ 7.55	$3.75
September 30, 2005	$ 5.40	$3.85
December 31, 2005	$ 4.25	$2.95
March 31, 2006	$ 4.95	$2.95

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ITEM 6. SELECTED HISTORICAL CONSOLIDATED FINANCIAL AND OTHER DATA

The following selected consolidated financial data of Napster reflect our historical operating results and balance sheet data. Our consolidated statement of operations data set forth below for the years ended March 31, 2006, 2005, 2004, 2003 and 2002 and the consolidated balance sheet data as of March 31, 2006, 2005, 2004, 2003, and 2002 are derived from consolidated financial statements. The audited consolidated statements of operations for the years ended March 31, 2006, 2005 and 2004 and the audited consolidated balance sheets as of March 31, 2006 and 2005 are included elsewhere in this annual report. This selected historical consolidated financial data is not necessarily indicative of our future performance and should be read in conjunction with those financial statements and the notes thereto and with "Management's Discussion and Analysis of Financial Condition and Results of Operations" also included elsewhere in this annual report.

The following selected financial information reflects our online music division as a continuing operation and our previously owned consumer software division as a discontinued operation. In addition, the financial information for part of the fiscal year ended March 31, 2002 was carved out from Adaptec's consolidated financial statements and thus did not necessarily reflect what our financial position and operating results would have been had we operated as a separate, stand-alone entity during that fiscal year.

	Year Ended March 31,				
	2006	2005	2004	2003	2002
	(in thousands, except per share amounts)				
Net revenues	$ 94,691	$ 46,729	$ 11,964	$ —	$ —
Cost of revenues(1)	69,208	37,550	10,530	—	—
Gross margin	25,483	9,179	1,434	—	—
Operating expenses:					
Research and development(1)	13,137	12,112	11,952	—	—
Sales and marketing(1)	51,741	39,249	15,701	—	—
General and administrative(1)	20,881	23,953	22,055	18,591	17,073
Restructuring charges	—	—	1,119	—	—
Amortization of intangible assets	1,265	1,936	2,172	666	—
Total operating expenses	87,024	77,250	52,999	19,257	17,073
Loss from continuing operations	(61,541)	(68,071)	(51,565)	(19,257)	(17,073)
Loss from unconsolidated entity	(289)	—	—	—	—
Other income, net	2,811	1,091	634	914	1,154
Loss before income tax benefit	(59,019)	(66,980)	(50,931)	(18,343)	(15,919)
Income tax benefit	1,160	15,547	4,515	7,182	6,130
Loss from continuing operations, after income taxes	(57,859)	(51,433)	(46,416)	(11,161)	(9,789)
Income (loss) from discontinued operations, net of tax effect	2,914	21,927	2,003	(489)	12,015
Net income (loss)	$(54,945)	$(29,506)	$(44,413)	$(11,650)	$ 2,226
Earnings per share:					
Net loss per share from continuing operations					
Basic and diluted	$ (1.35)	$ (1.43)	$ (1.69)	$ (0.57)	$ (0.57)
Net income (loss) per share from discontinued operations					
Basic and diluted	$ 0.07	$ 0.61	$ 0.07	$ (0.03)	$ 0.70
Net income (loss) per share					
Basic and diluted	$ (1.28)	$ (0.82)	$ (1.62)	$ (0.60)	$ 0.13
Weighted average shares used in computing net loss per share					
Basic and diluted	42,989	36,065	27,496	19,477	17,216

(1) Amounts reported include stock-based compensation expense as follows (in thousands):

	Year Ended March 31,				
	2006	2005	2004	2003	2002
Cost of revenues	$ 5	$ —	$ —	$ —	$ —
Research and development	164	5	12	—	—
Sales and marketing	74	34	54	—	—
General and administrative	699	637	838	773	754
	$ 942	$ 676	$ 904	$ 773	$ 754

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	March 31,				
	2006	2005	2004	2003	2002
	(in thousands)				
Consolidated Balance Sheet Data:					
Working capital	$ 74,406	$131,535	$ 35,373	$ 45,451	$ 53,404
Total assets	155,541	220,882	201,987	157,134	162,836
Long-term obligations(2)	17	30	68	5,490	921
Total owner's net investment/stockholders' equity	115,773	171,393	143,020	114,831	121,390

(2) Consisting of long term capital lease and debt obligations.

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ITEM 7. MANAGEMENT'S DISCUSSION AND ANALYSIS OF FINANCIAL CONDITION AND RESULTS OF OPERATIONS

The following discussion should be read in conjunction with the financial statements and notes thereto included elsewhere in this annual report. The following discussion contains forward-looking statements that involve risks and uncertainties. Our actual results could differ materially from the results contemplated by these forward-looking statements due to certain factors, including those discussed in Item IA, "Risk Factors", and elsewhere in this annual report.

As discussed further in the "Executive Summary" section below, we completed the sale of our Consumer Software Division ("CSD") in December 2004. Unless otherwise indicated, the Management's Discussion and Analysis of Financial Condition and Results of Operations relate to our continuing operations.

Overview

This overview provides our perspective on the following individual sections of MD&A:

- *Executive Summary*—a high level discussion of the business including a discussion of our strategy, opportunities, challenges and risks.
- *Significant Transactions*—a discussion of our significant acquisitions and divestitures.
- *Critical Accounting Policies and Estimates*—a discussion of accounting policies that require critical judgments and estimates.
- *Results of Operations*—an analysis of our consolidated results of operations for the years presented in our financial statements.
- *Liquidity and Capital Resources*—an analysis of cash flows, sources and uses of cash, and contractual obligations.
- *Litigation*—a discussion of pending litigation, claims and other matters.
- *Recent Accounting Pronouncements*—information on recent accounting pronouncements.

Executive Summary

Napster, among the most recognized brands in online music, is a leading provider of digital music for the consumer market. Our digital music distribution services enable fans to sample, listen to and purchase from one of the world's largest and most diverse online music catalogues utilizing a secure and legal platform. Napster users have access to songs from all major labels and hundreds of independent labels, and have many ways to discover, share and acquire new music and old favorites.

On May 1, 2006 we launched the new Napster.com, the only legal, advertising-supported service that offers free, on-demand listening without monthly restrictions. This free music site allows members in the United States to listen to nearly every song in Napster's more than 2 million song subscription catalog five times each for free anywhere on the web without downloading any software. Napster.com members outside the United States enjoy free access to 30 second clips of these tracks.

For those consumers who want access to unlimited music, including the ability to download music with high quality sound, enjoy their music in an advertising-free environment and access many features including radio, Billboard charts and many community features, we continue to offer Napster and Napster To Go subscriptions for use on the PC or portable devices. The paid Napster service is also currently available in Canada, the United Kingdom and Germany. We expect to launch our paid service in Japan through our joint venture with Tower Records in fiscal 2007.

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Napster is headquartered in Los Angeles with sales offices in London and Frankfurt.

Until December 17, 2004, Napster was known as "Roxio, Inc.", and we operated our business in two divisions, the consumer software division ("CSD") and the online music distribution division, also known as the Napster division.

On December 17, 2004, we completed the sale of substantially all of the assets and liabilities of CSD to Sonic Solutions, a California corporation ("Sonic"), including all of the capital stock of certain international subsidiaries. Sonic paid us a total of $74.7 million in cash and 653,837 shares of Sonic common stock, valued at approximately $13.6 million as of the closing date. We are using the proceeds for general working capital purposes and to operate and expand our Napster business.

Since the sale of CSD, we have focused exclusively on our online music distribution business under the Napster brand and, since January 3, 2005, have been traded on the Nasdaq Stock Market under the symbol "NAPS".

Napster was incorporated in Delaware in August 2000. We maintain executive offices and principal facilities at 9044 Melrose Avenue, Los Angeles, California 90069. Our telephone number is 310-281-5000.

We have historically derived our primary revenues from online subscriptions and permanent music downloads. In the future, we also expect to derive revenues from advertising. The paid Napster service offers subscribers on-demand access to a wide variety of music that can be streamed or downloaded as well as the ability to purchase individual tracks or albums on an a la carte basis. Subscription and permanent download fees are paid by end user customers in advance either via credit card, online payment systems or redemption of pre-paid cards, gift certificates or promotional codes. Napster also periodically licenses merchandising rights and resells hardware that our end users may utilize to store and replay their digital music content. Since the acquisition of Pressplay on May 19, 2003, our digital music distribution business has operated at a loss and negative cash flow. We expect to continue to operate at a loss and net negative cash flow due to our significant investments to enhance service capabilities, market our products and grow worldwide.

The market for digital music is rapidly growing and we expect our digital music distribution business to continue to grow as the industry expands. This market is highly competitive and we expect competition to continue to increase in the future as the market expands. We believe that our unique technology and feature set positions us ahead of many of our competitors. Our overall strategy is to drive consumers to Napster.com as a means to generate ad revenue and reduce our subscriber customer acquisition cost, continue to innovate by investing in new services and technologies, and continue to pursue and execute strategic partnerships.

Discontinued Operations

On December 17, 2004, we sold substantially all of the assets and liabilities of CSD. From the acquisition of Pressplay in May 2003 through the divestiture of CSD in December 2004, CSD accounted for substantially all of our revenues. Prior to the acquisition of Pressplay, CSD accounted for all of our revenues. We derived CSD revenue from distributors and direct sales to end users through the Company's website and toll-free number. Distributors resold our consumer software products to retailers of computer software products. We also sold our software products to OEMs such as PC manufacturers and CD- and DVD-recordable drive manufacturers and integrators.

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Significant Transactions

Investment in Unconsolidated Entity

On October 14, 2005, we entered into a Joint Venture Operating Agreement with Tower Records Japan, Inc. ("Tower Japan"), relating to the formation and operation of a Japan-based joint venture company (the "Joint Venture") for the purpose of operating the Napster online music service in Japan. Under the terms of this agreement, we licensed intellectual property rights to the Joint Venture, including platform technology and trademarks, in exchange for certain guaranteed royalties, and Tower Japan will support the Joint Venture's marketing and advertising activities. The Joint Venture will have exclusive rights to operate the Napster service in Japan.

On October 14, 2005, we contributed 151,200,000 Japanese Yen ($1.3 million at the exchange rate on the date the capital was contributed) to the Joint Venture, and on February 27, 2006, we contributed an additional 157,500,000 Japanese Yen ($1.4 million at the exchange rate on the date the capital was contributed) to the Joint Venture, in exchange for a total 31.5% ownership interest. Tower Japan contributed a total of 671,300,000 Japanese Yen for a 68.5% ownership interest. The parties each have customary shareholder rights in the Joint Venture, including veto rights, rights to appoint directors and officers and rights of first refusal. Tower Japan is obligated to arrange or provide debt or equity funding, including through an unsecured revolving loan facility. We have no obligation to fund future losses or provide contributions to the Joint Venture other than the investments described above. We have accounted for our investment in the Joint Venture under the equity method of accounting based on our ability to exert significant influence over but not control the venture.

Issuance of Common Stock

On January 24, 2005, we issued 7,100,000 shares of common stock in a private placement to certain accredited investors. The shares were sold at a price of $7.35 per share with gross proceeds of $52.2 million. The gross proceeds were reduced by placement fees and legal fees totaling approximately $3.6 million.

Sale of Consumer Software Division

On December 17, 2004, we sold substantially all of the assets and liabilities of CSD, including all of the capital stock of certain international subsidiaries historically included in CSD, to Sonic. The remaining international subsidiaries historically included in CSD have been substantially liquidated as of December 17, 2004. Sonic paid us a total of $74.7 million in cash and 653,837 shares of Sonic common stock, valued at approximately $13.6 million as of the closing date. The transaction was structured as an asset sale. The disposition is accounted for as a discontinued operation in accordance with SFAS No. 144, "Accounting for Impairment or Disposal of Long-Lived Assets". Therefore, the results of operations of CSD have been reclassified to results of operations from discontinued operations for all periods presented.

Common Stock Purchase Agreement

On June 17, 2004, we entered into a Common Stock Purchase Agreement with Best Buy Co., Inc. ("Best Buy"). Under the terms of a related agreement, which expires in June 2006, Best Buy's affiliate, Best Buy Stores, L.P., agreed to promote Napster as its leading digital music distribution service through comprehensive in-store marketing activities as well as extensive broadcast, print and online advertising. Best Buy Stores, L.P. also agreed to market a co-branded version of Napster which is made available to customers via retail and online through Bestbuy.com. On June 17, 2004, Napster issued approximately 1.1 million shares of common stock valued at approximately $5.0 million to Best Buy at a cash purchase price of $0.01 per share. The difference between the fair value of the shares and the cash purchase price was recorded as prepaid marketing expenses upon issuance of the shares in June 2004.

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Acquisition of Napster, LLC

In May 2003, we acquired substantially all of the ownership of Napster, LLC (formerly known as Pressplay), a provider of an online music service. Pressplay served as the foundation for Napster's online music service, which was launched on October 29, 2003 under the Napster brand. In consideration of the acquisition, Napster exchanged $12.5 million in cash, issued 3.9 million shares of Napster's common stock valued at $23.5 million and obligated itself to pay up to $12.4 million in contingent payments based on Napster's cumulative positive cash flows from the online music business. We incurred approximately $1.8 million in professional fees, including legal, valuation and accounting fees related to the acquisition, which were included as part of the purchase price of the transaction. This acquisition was accounted for as a purchase and Napster, LLC's results of operations are included in our financial statements from the date of acquisition. Prior to the launch of the Napster branded online music services in October 2003, online music revenues were minimal.

Critical Accounting Policies and Estimates

The preparation of financial statements in conformity with generally accepted accounting principles requires management to make estimates and assumptions that affect the amounts reported in the consolidated financial statements and accompanying notes. Note 1 to the Consolidated Financial Statements provides a summary of our significant accounting policies. Certain of these policies require substantial judgment on the part of management. On an ongoing basis, we evaluate significant estimates used in preparing our financial statements, including those related to:

- revenue recognition,
- music publishing rights and music royalty accruals,
- capitalized software development costs,
- income taxes,
- equity instruments, and
- contingencies

Actual results could differ from these estimates. Certain of our critical accounting policies are impacted significantly by judgments, assumptions and estimates used in the preparation of the financial statements. These critical accounting policies and the effect that changes in management's estimates could have on our consolidated financial statements are further described below.

Revenue Recognition

We recognize revenues in accordance with Staff Accounting Bulletin ("SAB") No. 104, "Revenue Recognition in Financial Statements" ("SAB 104"), Emerging Issues Task Force ("EITF") 00-21, "Revenue Arrangements with Multiple Deliverables" ("EITF 00-21") and EITF 99-19, "Reporting Revenue Gross as a Principal versus Net as an Agent" ("EITF 99-19"). In general, we recognize revenue when there is persuasive evidence of an arrangement, the fee is fixed or determinable, the product or services have been delivered and collectibility of the resulting receivable is reasonably assured.

Music subscriptions are paid in advance, typically for monthly or annual periods. Music subscription revenues are recognized on a daily basis over the subscription period. Revenues from sales of individual songs or albums by download are recognized at the time the music is delivered, digitally, to the end user. Revenues from pre-paid cards and promotions are deferred and then recognized as (i) tracks are downloaded by the end users, (ii) if redeemed for a subscription, over the subscription period or (iii) when the Company has no further obligation to provide services or refund the associated prepayments. Revenues from licenses of Napster merchandising rights are recognized upon receipt of royalty reports from the licensee or on prepaid royalties when the Company has no further obligation to pay royalties.

We have arrangements whereby customers pay one price for multiple products and services. In some cases, these arrangements involve a combination of hardware and services. In other cases, the customer pays a single price for multiple music downloads and months of music subscriptions. For arrangements with multiple deliverables, revenue is recognized upon the delivery of the separate units in accordance with EITF 00-21. Consideration from multiple element arrangements is allocated among the separate elements based on their relative fair values. In the event that there is no objective and reliable evidence of fair value, the revenue recognized upon delivery is the total arrangement consideration less the fair value of the undelivered items. The maximum revenue recognized on a delivered element is limited to the amount that is not contingent upon the delivery of additional items.

We have arrangements with certain customers whereby the customer provides goods or services to us. Our revenue and the charges for the goods or services provided by a customer are accounted for in accordance with EITF 01-09, "Accounting for Consideration Given by a Vendor to a Customer" ("EITF 01-09")", including subsequent interpretations. The costs of separately identifiable goods or services received from a customer are valued at the cost we would incur to procure the same goods or services from a non-customer third party. If the goods or services cannot be separated, the total consideration is recorded as a reduction of revenues. Consideration paid to customers under these arrangements that exceed the separately identifiable value of the goods or services provided would be reflected as a reduction of the customer's revenue.

We recognize revenue gross or net in accordance with EITF 99-19. In most arrangements, we contract directly with the end user customers, are the primary obligor and carry all collectibility risk. Revenue in these arrangements is recorded on a gross basis. In some cases, we utilize third party distributors to sell products or services directly to end user customers, and we carry no collectibility risk. In some cases, we pay operating expenses for the distributor and are reimbursed at cost plus a small mark-up. In those instances, in accordance with EITF 99-19, we report the revenue net of the amount paid to the distributor.

Management exercises significant judgment in determining the fair value of multiple elements within revenue arrangements or separately identified goods or services and in assessing when prepaid cards or prepaid royalties no longer involve a future obligation. These estimates represent our best estimates, but changes in circumstances relating to the products and services sold in these arrangements may result in one-time expense or revenue charges.

Music Publishing Rights and Music Royalty Accruals

Under copyright law we are required to pay licensing fees for compositions embodied in digital sound recordings and for the sound recordings themselves that we deliver in our Napster service. Copyright law generally does not specify the rate and terms of the licenses, which are determined by voluntary negotiations among the parties or, for certain compulsory publishing licenses where voluntary negotiations are unsuccessful, by arbitration. There are certain geographies and agencies for which we have not yet completed negotiations or arbitration with regard to the royalty rate to be applied to publishing rights for the current or historic sales of our digital music offerings. We accrue for the cost of these fees in accordance with Statement of Financial Accounting Standards ("SFAS") No. 5, "Accounting for Contingencies" ("SFAS No. 5"), based on contracted or statutory rates, when established, or management's best estimates based on facts and circumstances regarding the specific music services and agreements in similar geographies or with similar agencies. While Napster bases its estimates on historical experience and on various other assumptions that management believes to be reasonable under the circumstances, actual results may differ significantly from these estimates under different assumptions or conditions and, as a result, could have a material impact on our financial position, results of operations, and cash flows.

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Capitalized Software Development Costs

Internal use software. We comply with AICPA SOP No. 98-1 "Accounting for Cost of Computer Software Developed or Obtained for Internal Use" ("SOP 98-1"), and EITF 00-2, "Accounting for Website Development Costs". In accordance with SOP 98-1, software development costs incurred as part of an approved project plan that result in additional functionality to internal use software are capitalized and amortized on a straight-line basis over the estimated useful life of the software, generally three years.

Software held for sale. In accordance with SFAS No. 86, "Computer Software to be Sold, Leased, or Otherwise Marketed", development costs of computer software to be sold, leased or otherwise marketed are subject to capitalization beginning when a product's technological feasibility has been established and ending when a product is available for general release to customers. We have not capitalized any software development costs as technological feasibility is generally not established until a working model is completed, at which time substantially all development is complete.

Management applies significant judgment when determining whether products under development are technologically feasible or whether it is probable that they will result in additional functionality. These judgments include assessments of our development progress and expected performance. Additionally, the future realizability of capitalized software costs is subject to regular review by management, who consider expected future benefits. The estimates of expected future benefits include judgments about growth in demand for our products, performance by our strategic partners and fair values for related services. Changes in these estimates could require us to write down the carrying value of these capitalized amounts and could materially impact our financial position and results of operations.

Income Taxes

We account for income taxes in accordance with SFAS No. 109, "Accounting for Income Taxes." As part of the process of preparing our consolidated financial statements we are required to determine our income taxes in each of the jurisdictions in which we operate. This process involves determining our current tax expense together with assessing temporary differences resulting from differing treatment of items for tax and accounting purposes. These differences result in deferred tax assets and liabilities, which are included within our consolidated balance sheet. We must assess the likelihood that our deferred tax assets will be recovered from various means, including future taxable income, and, to the extent we believe that recovery is not more likely than not, we must establish a valuation allowance. To the extent we establish a valuation allowance or increase this allowance in a period, we must include an expense within the tax provision in the statement of operations. The above process is computed separately for each of continuing operations, the discontinued operation and elements of other comprehensive income.

Significant management judgment is required in determining our provision for income taxes, our deferred tax assets and liabilities and any valuation allowance recorded against our net deferred tax assets. As of March 31, 2006, we have recorded a full valuation allowance against our deferred tax assets, net of reversing deferred tax liabilities, due to uncertainties related to our ability to utilize our deferred tax assets, primarily consisting of net operating losses and accrued liabilities and other provisions not currently deductible for tax purposes. The timing of the reversal of the remaining deferred tax liability related to the election to step up the tax basis of the Pressplay goodwill is indefinite. The valuation allowance is based on our estimates of taxable income by jurisdiction in which we operate and the period over which our deferred tax assets will be recoverable. In the event that actual results differ from these estimates or we adjust these estimates in future periods, we may need to establish an additional valuation allowance, which could materially impact our financial position and results of operations.

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Equity Instruments

We account for stock-based compensation in accordance with Accounting Principles Board Opinion ("APB") No. 25, "Accounting for Stock Issued to Employees" ("APB No. 25"), and comply with the disclosure provisions of SFAS No. 123, "Accounting for Stock-Based Compensation" ("SFAS No. 123"), as amended by SFAS No. 148, "Accounting for Stock-Based Compensation—Transition and Disclosure—an amendment of SFAS No. 123". Under APB No. 25, compensation expense is recognized based on the difference, if any, on the measurement date between the fair value of Napster's common stock and the amount an employee must pay to acquire the common stock. The compensation expense is recognized over the periods the employee performs the related services, generally the vesting period of four years.

We account for equity instruments issued to non-employees in accordance with the provisions of SFAS No. 123 and 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", which requires that such equity instruments are recorded at their fair value on the measurement date.

Management generally estimates the fair value of stock options using the Black-Scholes model. The Black-Scholes model was developed for use in estimating the fair value of traded options that have no vesting restrictions and are fully transferable. This model requires the input of highly subjective assumptions including the expected stock price volatility. Changes in the subjective input assumptions can materially affect the fair value estimate, which could materially impact our financial position and results of operations.

Contingencies

We account for contingent liabilities in accordance with SFAS No. 5, pursuant to which contingent liabilities are recorded when it is probable that a liability has been incurred and the amount of the liability can be reasonably estimated.

Management applies significant judgment when estimating probable amounts of contingent liabilities. Future negotiations regarding the contingent obligations could cause the ultimate obligation to be less than or greater than the amount estimated. Changes in these estimates could require us to take additional charges or benefits in future periods and could materially impact our financial position and results of operations.

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Results of Operations

Fiscal 2006 as compared to fiscal 2005

The following table sets forth our results as a percentage of total net revenues for the periods indicated. These operating results are not necessarily indicative of the results for any future period.

	As a Percentage of Net Revenues For the Year Ended March 31,	
	2006	2005
Net revenues	100%	100%
Cost of revenues	73%	80%
Gross margin	27%	20%
Operating expenses:		
Research and development	14%	26%
Sales and marketing	55%	84%
General and administrative	22%	51%
Amortization of intangible assets	1%	4%
Total operating expenses	92%	165%
Loss from continuing operations	(65)%	(145)%
Loss from unconsolidated entity	—%	—%
Other income, net	3%	2%
Loss before income tax benefit	(62)%	(143)%
Income tax benefit	1%	33%
Loss from continuing operations	(61)%	(110)%
Income from discontinued operations, net of tax effect	3%	47%
Net loss	(58)%	(63)%

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Net Revenues

The following table sets forth, for the periods indicated, the summary of our revenues from continuing operations:

	Year Ended March 31,		As a Percentage of Net Revenues For the Year Ended March 31,	
	2006	2005	2006	2005
	(in thousands)			
Online music revenues:				
Content	$ 90,784	$ 44,724	96%	96%
Hardware & license	3,907	2,005	4%	4%
Total online music revenues	$ 94,691	$ 46,729	100%	100%

Content revenues increased approximately 103% to $90.8 million in fiscal 2006 from $44.7 million in fiscal 2005. These increases are due primarily to growth in the online music market, consumer adoption of our products and international expansion. The Napster paid service was launched in the United States during October 2003, in the United Kingdom and Canada during May 2004 and in Germany in December 2005. Since these launches, excluding the cyclical impact of university subscribers, our subscriber base has increased steadily. Total paid subscribers including university subscribers were 606,000 as of March 31, 2006 compared to 412,000 as of March 31, 2005. In fiscal 2007, we expect revenues to be positively impacted as we begin recognizing revenue on prepaid cards for which the likelihood of redemption is remote and we have no further legal obligation to remit the unused value to the relevant jurisdictions. In the long term, we anticipate that content revenues will continue to increase as a result of marketing activities and initiatives designed to continue subscriber growth, expand internationally and decrease customer churn.

Hardware and license revenues increased approximately $1.9 million to $3.9 million in fiscal 2006 from $2.0 million in fiscal 2005, primarily due to increased hardware promotions in fiscal 2006 as compared to fiscal 2005. We anticipate that hardware and license revenues will fluctuate depending on the hardware promotions and licenses that we enter into each period.

Geographic Revenues

The following table sets forth, for the periods indicated, the summary of our revenues from continuing operations:

	Year Ended March 31,		As a Percentage of Net Revenues For the Year Ended March 31,	
	2006	2005	2006	2005
	(in thousands)			
Online music revenues:				
North America	$ 83,054	$ 41,842	88%	90%
Europe	11,637	4,887	12%	10%
Total online music revenues	$ 94,691	$ 46,729	100%	100%

The increase in revenues is related to the steady growth of the online music service in the United States and the launches of the service in the United Kingdom and Canada in May 2004 and Germany in December 2005. We anticipate that the proportion of revenue outside of the United States will fluctuate as a result of continued marketing activities and initiatives focused on world-wide customer growth and international expansion.

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Gross Margin

The following table sets forth, for the periods indicated, our gross margin from continuing operations:

	Year Ended March 31,		As a Percentage of Net Revenues For the Year Ended March 31,	
	2006	2005	2006	2005
	(in thousands)			
Online music gross margin:				
Content	$ 26,316	$ 9,227	28%	20%
Hardware & license	(833)	(48)	(1)%	—%
Total online music gross margin	$ 25,483	$ 9,179	27%	20%

Content gross margin is the profit from revenues after deducting the cost of royalties to content providers and publishers, technical support, bandwidth and hosting costs, depreciation and amortization of infrastructure assets related to the delivery of our online services, and any other direct costs of providing the services or products. Hardware and license gross margin is the profit from revenues after deducting the cost of hardware sold, order fulfillment services, product shipping costs and any other direct expenses related to hardware and license sales.

Content gross margin increased 8 percentage points to 28% in fiscal 2006 from 20% in fiscal 2005 (in dollars, an increase of approximately 185% to $26.3 million from $9.2 million). This improvement is primarily due to the change in revenue mix from download revenues to subscription revenues, which have a higher margin, offset by additional ongoing expenditures for infrastructure to support our digital music distribution services.

Hardware and license gross margins fluctuate based on the nature of the hardware promotions and the volume of trademark licenses in each period. We also offer several product bundles, the revenues from which are allocated between content revenues and hardware and license revenues on a pro-rata basis in accordance with EITF 00-21. Hardware and license gross margin decreased to (1%) in fiscal 2006. This decrease is due primarily to more negative margin hardware promotions in fiscal 2006 as compared to fiscal 2005.

Online service headcount dedicated to maintaining content and providing customer care was 12 at March 31, 2006 and 10 at March 31, 2005.

We expect online music gross margins as a percentage of revenue to be adversely impacted to the extent that we continue to fund low margin promotions or spend to improve our online service infrastructure. Excluding one-time items and low margin hardware promotions, we expect margins to be impacted negatively near term as label fees associated with portable music subscriptions increase. We expect advertising revenues from the Napster.com free music service to positively impact gross margin in the future.

Operating Expenses

We classify operating expenses as research and development, sales and marketing and general and administrative. Each category includes related expenses for salaries, employee benefits, incentive compensation, stock-based compensation, travel, telephone, communications, rent and allocated facilities and professional fees. Our sales and marketing expenses include additional expenditures specific to the marketing group, such as public relations, advertising, trade shows, marketing collateral materials and subscriber acquisition costs, as well as expenditures specific to the sales group, such as commissions and referral fees paid to marketing partners. In addition, we include restructuring charges and certain amortization of identifiable intangible assets as operating expenses.

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The following table sets forth, for the periods indicated, our operating expenses from continuing operations:

	Year Ended March 31,		As a Percentage of Net Revenues For the Year Ended March 31,	
	2006	2005	2006	2005
	(in thousands)			
Research and development	$ 13,137	$ 12,112	14%	26%
Sales and marketing	51,741	39,249	55%	84%
General and administrative	20,881	23,953	22%	51%
Amortization of intangible assets	1,265	1,936	1%	4%
Total operating expenses	$ 87,024	$ 77,250	92%	165%

Research and Development

Research and development expenses consist primarily of salary, benefits and contractors' fees for our development and other costs associated with the minor enhancements of existing products, development of new features for the online service and development of new products.

Research and development expenses increased $1.0 million or 8% to $13.1 million in fiscal 2006 from $12.1 million in fiscal 2005 due primarily to additional headcount and contractors throughout fiscal 2006 that were hired in the third quarter of fiscal 2005 to work on the free music service, integration of the paid Napster service with other technology platforms, such as XM satellite radio and wireless, and international expansion.

Research and development headcount was 63 at March 31, 2006 and at March 31, 2005.

We anticipate that research and development expenses will increase near term as we focus on the continued investment in new products and functionality.

Sales and Marketing

Sales and marketing expenses consist primarily of salary and benefits for sales and marketing personnel, referral fees paid to marketing partners, other subscriber acquisition costs, as well as costs associated with advertising and promotions.

Sales and marketing expenses increased $12.5 million or 32% to $51.7 million in fiscal 2006 from $39.2 million in fiscal 2005. This increase was primarily due to $2.2 million of additional personnel-related charges associated with headcount added during fiscal 2006 and 2005, and $10.2 million of increased marketing program spending in fiscal 2006. The headcount increase is partially associated with our European expansion. The increase in marketing program expenses is related to planned marketing programs in fiscal 2006, including completion of the Napster To Go launch and marketing associated with the German launch.

Sales and marketing headcount was 32 at March 31, 2006 and 25 at March 31, 2005.

We expect sales and marketing expenses to decrease over the next 12 months as we continue to control spending and focus on lowering customer acquisition costs. In the long-term, sales and marketing expenses may increase due to advertising sales commissions.

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General and Administrative

General and administrative expenses consist primarily of salary and benefit costs for executive and administrative personnel, professional services, administrative outsources and other general corporate activities. General and administrative charges for the continuing operations in fiscal 2005 include all corporate overhead charges that are not directly attributable to CSD.

General and administrative expenses decreased $3.1 million or 13% to $20.9 million in fiscal 2006 from $24.0 million in fiscal 2005. Personnel related costs decreased $1.6 million in fiscal 2006 compared to fiscal 2005 because of lower head count following the CSD divesture in the third quarter of fiscal 2005. In addition, depreciation and facility expense decreased $1.3 million as a result of the CSD divesture and outside services increased $200,000 as the result of lower fees for SOX compliance, offset by increases in legal expenses and other outsourced administrative services.

General and administrative headcount, including all corporate general and administrative employees, was 38 at March 31, 2006 compared to 37 at March 31, 2005.

We expect general and administrative expenses to remain flat in the near term as we focus on controlling operating expenses.

Amortization of Intangible Assets

Amortization of intangible assets consists of amortization expense related to the intangible assets recorded in connection with our acquisition of Napster's name in December 2002 and Napster, LLC, formerly known as Pressplay, in May 2003.

Amortization of intangible assets in operating expenses decreased approximately $600,000 or 35% to $1.3 million in fiscal 2006 from $1.9 million in fiscal 2005. The decrease is primarily because certain intangible assets became fully amortized during the third quarter of fiscal 2006. The remaining net book value of intangible assets at March 31, 2006 is zero. Unless we acquire new intangible assets, we do not expect future amortization expense.

Loss from Unconsolidated Entity

The $289,000 loss from unconsolidated entity represents our 31.5% portion of the loss incurred by our Japan joint venture during the year. The joint venture was formed during October 2005, and this loss represents our share of initial costs to form the company. We expect losses from the joint venture to increase as it prepares for the launch of the Napster service in Japan in fiscal 2007. Napster, LLC has no obligation to fund future losses or provide contributions to Napster Japan other than the $2.2 million net investment.

Other Income, Net

Other income, net, consists primarily of interest income on our cash equivalents and short-term investments, realized gains (losses) on short-term investments, interest expense, change in the fair value of the hedge and other miscellaneous income. Other income, net increased $1.7 million in fiscal 2006 to $2.8 million from $1.1 million in fiscal 2005 primarily due to $1.1 million of increased investment income from the cash received from the sale of CSD in fiscal 2005, a $1.2 million one-time gain on the sale of the Sonic common stock in fiscal 2006, and reduced interest expense of $600,000 due primarily to the repayment of the line of credit in early fiscal 2006. Such positive increases were partially offset by a $1.1 million increase in foreign currency losses.

We expect other income, net to decrease in the future as investments are used to fund operations. Other income, net will also fluctuate due to foreign currency fluctuations.

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Income Tax Benefit

We have recorded a valuation allowance to reduce deferred tax assets to the amount we believe is more likely than not to be realized. In the event that deferred tax assets would be realizable in the future in excess of the net recorded amount, an adjustment to the valuation allowance on deferred tax assets would increase income in the period such determination was made.

During January 2005, following the divestiture of CSD, which utilized substantially all of our tax operating losses, Napster made a tax election to step up the basis in Pressplay goodwill for tax purposes. As a result, the Pressplay goodwill is deductible for tax purposes, which creates a tax timing difference that is presented as a deferred tax liability and deferred tax expense. As realization of this taxable temporary difference is not assured, a net tax expense related to this item is recorded.

Income tax benefit decreased $14.3 million or 93% to $1.2 million in fiscal 2006 from $15.5 million in fiscal 2005. The significant decrease in the tax benefit is due to the fiscal 2005 utilization of losses from continuing operations to offset income from the discontinued operations. The fiscal 2006 expense represents primarily foreign taxes and the timing difference related to the Pressplay goodwill. In the near term we expect to continue to incur operating losses from continuing operations and no longer have income from discontinued operations against which we can offset the losses.

We are subject to various tax rates in the jurisdictions in which we do business. Our tax provision does not take into account any future benefit from loss carryforwards, which may be realized if we again achieve profitability and begin generating taxable income.

Income from Discontinued Operations

Income from discontinued operations was $2.9 million in fiscal 2006 or a decrease of 87% as compared to $21.9 million in fiscal 2005. The income from discontinued operations in fiscal 2006 primarily reflects the $2.7 million final after-tax purchase price settlement with Sonic for the sale of CSD in December 2004. The income from discontinued operations in fiscal 2005 primarily included the $18 million after-tax gain on the divestiture.

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Fiscal 2005 as compared to fiscal 2004

The following table sets forth our results as a percentage of total net revenues for the periods indicated. These operating results are not necessarily indicative of the results for any future period.

	As a Percentage of Net Revenues For the Year Ended March 31,	
	2005	2004
Net revenues	100%	100%
Cost of revenues:		
Cost of revenues	80%	87%
Amortization of purchased technology	—%	1%
Total cost of revenues	80%	88%
Gross margin	20%	12%
Operating expenses:		
Research and development	26%	100%
Sales and marketing	84%	131%
General and administrative	51%	185%
Restructuring charges	—%	9%
Amortization of intangible assets	4%	18%
Total operating expenses	165%	443%
Loss from continuing operations	(145)%	(431)%
Loss from unconsolidated entity	—%	—%
Other income, net	2%	5%
Loss before income tax benefit	(143)%	(426)%
Income tax benefit	33%	38%
Loss from continuing operations	(110)%	(388)%
Income from discontinued operations, net of tax effect	47%	17%
Net loss	(63)%	(371)%

We began to generate online music revenues with the acquisition of Napster, LLC in May 2003. As a result, unless otherwise indicated, the following discussions and analysis of our results of operations from continuing operations relate only to the fiscal years ended March 31, 2005 and 2004.

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Net Revenues

The following table sets forth, for the periods indicated, the summary of our revenues from continuing operations:

	Year Ended March 31,		As a Percentage of Net Revenues For the Year Ended March 31,	
	2005	2004	2005	2004
	(in thousands)			
Online music revenues:				
Content	$ 44,724	$ 11,657	96%	97%
Hardware & license	2,005	307	4%	3%
Total online music revenues	$ 46,729	$ 11,964	100%	100%

Content revenues increased to $44.7 million in fiscal 2005 from $11.7 million in fiscal 2004. This increase was primarily due to subscriber growth. The Napster service was launched in the United States during October 2003 and in the United Kingdom and Canada during May 2004. Since these launches, our subscriber base has increased steadily, reaching 412,000 as of March 31, 2005, comprised of 56,000 University subscribers and 356,000 full-paying subscribers.

Hardware and license revenues increased approximately $1.7 million to $2.0 million in fiscal 2005 from $307,000 in fiscal 2004, primarily due to increased hardware promotions in fiscal 2005.

Geographic Revenues

The following table sets forth, for the periods indicated, the summary of our revenues from continuing operations:

	Year Ended March 31,		As a Percentage of Net Revenues For the Year Ended March 31,	
	2005	2004	2005	2004
	(in thousands)			
Online music revenues:				
North America	$ 41,842	$ 11,964	90%	100%
Europe	4,887	—	10%	—%
Total online music revenues	$ 46,729	$ 11,964	100%	100%

The increase in revenues is related to the launch of the online music service in the United States during October 2003 and the launches of the service in the United Kingdom and Canada in May 2004.

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Gross Margin

The following table sets forth, for the periods indicated, our gross margin from continuing operations:

	Gross Margin For the Year Ended March 31,		As a Percentage of Net Revenues For the Year Ended March 31,	
	2005	2004	2005	2004
	(in thousands)			
Online music gross margin:				
Content	$ 9,227	$ 1,434	20%	12%
Hardware & license	(48)	—	—%	—%
Total online music gross margin	$ 9,179	$ 1,434	20%	12%

Content gross margin is the profit from revenues after deducting the cost of royalties to content providers and publishers, technical support, bandwidth and hosting costs, depreciation and amortization of infrastructure assets related to the delivery of our online services, and any other direct costs of the net revenues.

Gross margin on content revenue increased to 20% in fiscal 2005 from 12% in fiscal 2004, due primarily to the revenue mix which transitioned to a higher percentage of subscriptions during fiscal 2005. Additionally, our continuing operations have a relatively fixed cost base that was put in place in October 2003 as part of the launch of the online music service. Margins are improving steadily as revenues have grown in contrast to those fixed costs.

Hardware and license gross margins fluctuate based on the nature of the hardware promotions and the volume of trademark licenses in each period. During the year ended March 31, 2005, Napster sponsored hardware promotions at break-even and offered several product bundles. Revenue from product bundles is allocated between content revenues and hardware and license revenues on a pro-rata basis in accordance with EITF No. 00-21. Napster had immaterial license revenues in fiscal 2004.

Online service headcount dedicated to maintaining content and providing customer care was 10 at March 31, 2005 and 3 at March 31, 2004.

Operating Expenses

We classify operating expenses as research and development, sales and marketing and general and administrative. Each category includes related expenses for salaries, employee benefits, incentive compensation, travel, telephone, communications, rent and allocated facilities and professional fees. Our sales and marketing expenses include additional expenditures specific to the marketing group, such as public relations and advertising, trade shows, and marketing collateral materials and expenditures specific to the sales group, such as commissions. In addition, we include restructuring charges, certain amortization of identifiable intangible assets and stock-based compensation charges associated with individuals in operating expense departments as operating expenses.

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The following table sets forth, for the periods indicated, our operating expenses from continuing operations:

	For the Year Ended March 31,		As a Percentage of Net Revenues For the Year Ended March 31,	
	2005	2004	2005	2004
	(in thousands)			
Research and development	$ 12,112	$ 11,952	26%	100%
Sales and marketing	39,249	15,701	84%	131%
General and administrative	23,953	22,055	51%	185%
Restructuring charges	—	1,119	—%	9%
Amortization of intangible assets	1,936	2,172	4%	18%
Total operating expenses	$ 77,250	$ 52,999	165%	443%

Research and Development

Research and development expenses consist primarily of salary, benefits and contractors' fees for our development and other costs associated with the minor enhancements of existing products and development of new features for the online service.

Research and development expenses increased $160,000 or 1% to $12.1 million in fiscal 2005 from $12.0 million in fiscal 2004. This net increase was primarily due to a $1.4 million increase in research and development in fiscal 2005, offset by $1.2 million of non-recurring expenses in the quarter ended December 31, 2003 for one-time costs associated with launching the Napster service in October 2003. The $1.4 million increase is primarily due to a full year of research and development activity in fiscal 2005 compared to ten months of activity in fiscal 2004 following the May 2003 Pressplay acquisition.

Research and development headcount for Napster was 63 at March 31, 2005 and 65 at March 31, 2004.

Sales and Marketing

Sales and marketing expenses consist primarily of salary and benefits for sales and marketing personnel, and costs associated with advertising and promotions.

Sales and marketing expenses increased to $39.2 million in fiscal 2005 from $15.7 million in fiscal 2004. This increase was primarily due to $22.6 million of additional advertising and promotional spending during fiscal 2005 compared to the prior year, because the Napster service was not launched until the third quarter of fiscal 2004 and because we undertook an extensive marketing campaign during February and March 2005 related to the launch of Napster To Go. The increase was also due to $1.0 million of additional staff and overhead expenses because fiscal 2005 included a full year, whereas fiscal 2004 included only ten months from the date the acquisition of Pressplay in May 2003.

Sales and marketing headcount for Napster was 25 at March 31, 2005 and 15 at March 31, 2004.

General and Administrative

General and administrative expenses consist primarily of salary and benefit costs for executive and administrative personnel, professional services and other general corporate activities. General and administrative charges in continuing operations include all corporate overhead charges that are not directly attributable to CSD.

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General and administrative expenses increased $1.9 million or 9% to $24.0 million in fiscal 2005 from $22.0 million in fiscal 2004. General and administrative expenses reflect $4.1 million of additional professional service fees related to the transaction with Sonic, compliance with the Sarbanes-Oxley Act and legal costs related to the SightSound litigation in fiscal 2005, and an additional $1.1 million of general and administrative expenses related to international expansion. These increased expenses were offset by a $3.1 million reduction in headcount and related expenses in corporate functions due to the fiscal 2004 restructurings and the divestiture of CSD in December 2004 and a $201,000 reduction in stock based-compensation due to most deferred charges being fully amortized.

General and administrative headcount for Napster was 37 at March 31, 2005 and 14 at March 31, 2004. The general and administrative headcount at March 31, 2004 included all corporate general and administrative employees.

Restructuring Charges

During fiscal 2004, Napster recorded a restructuring charge in the continuing operations of approximately $1.1 million. The restructuring charge was primarily in connection with the reorganization of Napster's domestic operations. This restructuring charge was primarily related to severance and benefits associated with involuntary terminations.

Amortization of Intangible Assets

Amortization of intangible assets consists of amortization expense related to the intangible assets recorded in connection with our acquisition of Napster's name in December 2002 and Napster, LLC, formerly known as Pressplay, in May 2003.

Amortization of intangible assets decreased $236,000 or 11% to $1.9 million in fiscal 2005 from $2.2 million in fiscal 2004. The decrease is primarily due to certain identifiable intangible assets that were fully amortized during the first half of fiscal 2005.

Other Income, Net

Other income, net, consists primarily of interest income on our cash equivalents and short-term investments, realized gains (losses) on short-term investments, interest expense, change in the fair value of the hedge and other miscellaneous income. Other income, net increased $457,000 in fiscal 2005 to $1.1 million from $634,000 in fiscal 2004 primarily due to a $1.5 million increase in investment income offset by a $536,000 increase in interest expense, a $139,000 foreign currency loss and a $342,000 expense for the discount on the fair market value hedge. We had no foreign currency gains or losses and no hedges in fiscal 2004.

Income Tax Benefit

Income tax benefit primarily relates to the tax benefit of utilizing the operating losses from continuing operations to offset taxable gains in the discontinued operation. We have recorded a valuation allowance to reduce deferred tax assets to the amount we believe is more likely than not to be realized. Conversely, we have recognized a provision in continuing operations in each period that a valuation allowance was recorded against beginning of the period deferred tax assets.

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During January 2005, following the divestiture of CSD, which utilized substantially all of our tax operating losses, Napster made a tax election to step up the basis in Pressplay goodwill for tax purposes. As a result, the Pressplay goodwill is deductible for tax purposes. In accordance with SFAS No. 109, this tax deduction represents a tax timing difference that is shown as a provision for income taxes.

Income tax benefit increased to $15.5 million in fiscal 2005 from $4.5 million in fiscal 2004. The increase in fiscal 2005 is primarily due to the taxable gain on the divestiture of CSD during fiscal 2005, which was completely offset by operating losses from continuing operations. This benefit is offset by a $1.7 million tax provision for the deductibility of the Pressplay goodwill.

Income (Loss) from Discontinued Operations

Income (loss) from discontinued operations increased to $21.9 million in fiscal 2005 from $2.0 million in fiscal 2004. The increase is primarily due to the $18 million after-tax gain on the sale of CSD in December 2004 and $1.9 million of after-tax profits from CSD prior to the divestiture.

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Liquidity and Capital Resources

We ended fiscal 2006 with $104.2 million in cash, cash equivalents, short-term investments and foreign currency conversion in transit. These amounts consist principally of commercial paper, corporate bonds, money market funds and U.S. government securities. This balance represents a $63.6 million decrease as compared to March 31, 2005. Our primary ongoing source of cash is receipts from revenues and proceeds from private equity placements. The primary uses of cash are payroll (salaries and related benefits), general operating expenses (marketing, travel and office rent), payments to content providers, payments for products held for resale, and purchases of property and equipment, including software development costs. Our working capital was $74.4 million at March 31, 2006.

Line of Credit

In March 2004, we entered into an agreement with Silicon Valley Bank to provide a $15.0 million revolving line of credit, collateralized by substantially all of our assets. In June 2004, we amended the line of credit agreement to increase the available borrowings to $17.0 million. In December 2004, we amended the line to release the lender's security in assets sold to Sonic and to extend the maturity date to December 2006. At March 31, 2005, we had borrowed $15.0 million under the line of credit. During May 2005, we repaid the $15.0 million line of credit balance, plus $73,000 of accrued interest.

As of June 1, 2006, $17.0 million is available for borrowing under the line. The line of credit bears interest at a variable rate of prime plus 0.5% per annum. The line of credit contains a material adverse conditions clause and covenants that require us to maintain certain financial ratios. The covenants require at the end of each month and throughout the term of the agreement (i) a minimum tangible net worth of $45.0 million, (ii) a ratio of unrestricted cash, cash equivalents and short-term investments, plus 10% of net accounts receivable, to total borrowings under the line of credit of not less than 2.00 to 1.00. At March 31, 2006, we were in compliance with all covenants under the line of credit.

Financial Position

We believe that the liquidity provided by existing cash, cash equivalents, short-term investments and foreign currency conversion in transit will provide sufficient capital to meet our requirements for at least the next 12 months. Napster operates and will continue to operate in the near term at a loss and net negative cash flow due to significant investments required to expand its service capabilities and to expand internationally.

We do not currently hold any variable interest rate debt, and we have no outstanding borrowings under our revolving line of credit. Accordingly, we have not been exposed to near-term adverse changes in interest rates or other market prices. We may, however, experience such adverse changes if we incur debt or hold other derivative financial instruments in the future.

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Cash Flows

Operating Activities

The following table sets forth, for the periods indicated, the components of cash flows from operating activities (in thousands):

	For the Year Ended March 31,		
	2006	2005	2004
Net loss	$(54,945)	$(29,506)	$(44,413)
Gain on sale of businesses	(6,540)	(32,077)	(10,622)
Non-cash expenses	9,996	17,936	18,993
Changes in operating assets and liabilities:			
Deferred revenue	4,603	8,068	905
Prepaid and other current and long-term assets	(1,422)	862	1,005
Trade accounts receivable	1,074	2,454	1,984
Accounts payable and accruals	2,759	1,907	(923)
Other long-term liabilities	(53)	(178)	2,296
	$(44,528)	$(30,534)	$(30,775)

Operating cash flows in fiscal 2006 were negatively impacted by an increase in net loss, and by the $6.5 million non-cash gains on the sale of CSD and the sale of Sonic common stock. Such items were partially offset by $10.0 million in non-cash expenses and $7.0 million of changes in operating assets and liabilities. The decrease in non-cash expenses to $10.0 million in fiscal 2006 compared to $17.9 million in fiscal 2005 is primarily due to the decreases of $4.2 million in depreciation and amortization expense, $2.0 million in amortization of prepaid marketing expenses and $1.6 million in stock-based compensation charges. Other non-cash expenses primarily include deferred tax expense, the change in fair market value of the investment hedge, the non-cash loss from our investment in an unconsolidated entity and a non-cash gain from the remeasurement of cash balances. The decrease of $3.5 million in cash flows from deferred revenue in fiscal 2006 from $8.1 million in fiscal 2005 is primarily due to the relative reduction in the subscriber growth from that experienced in fiscal 2005, which was impacted by a full year's growth following the launch of the online music service in October 2003. The change in cash flows related to prepaid and other current and long term assets in fiscal 2006 compared to fiscal 2005 was due primarily to a decrease in fair value hedge receivable of $4.6 million, which was partially offset by an increase of $2.2 million related to the receivable from Sonic arising from the fiscal 2005 CSD divestiture. Changes in other working capital items are primarily related to timing of payments and receipts.

Operating cash flows in fiscal 2005 were impacted by a lower net loss, offset by increased investment in working capital as our business grew. The decrease in non-cash expenses to $17.9 million in fiscal 2005 compared to $19.0 million in fiscal 2004 is primarily due to a $1.9 million decrease in deferred income taxes associated with an increased valuation allowance offset by the impact of the election to deduct Pressplay goodwill, a $1.8 million decrease in depreciation and amortization expense and a $1.8 million decrease in asset impairment charges. Such non-cash decreases were partially offset by $4.0 million fiscal 2005 non-cash marketing expenses associated with stock issued as part of the Best Buy strategic marketing agreement. Other non-cash expenses primarily include stock-based compensation charges. The increase in deferred revenues to $8.1 million in fiscal 2005 from $905,000 in fiscal 2004 is primarily associated with subscriber growth following the launch of the online music service in October 2003. The increase in payables and accrued liabilities to a source of $1.9 million in fiscal 2005 from a usage of $923,000 in fiscal 2004 is associated with payment timing.

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Investing Activities

Net cash used in investing activities was $28.4 million in fiscal 2006, primarily as a result of $13.1 million net purchases of short-term investments, $7.5 million in foreign currency conversion in transit, $5.0 million in capital expenditures, and a $2.7 million investment in our Japan Joint Venture. The decrease in cash attributable to foreign currency conversion in transit in 2006 is the result of a third party holding U.S. dollar funds that had been converted from Danish Kroner to U.S. dollars on March 30, 2006 and were re-deposited into our bank account in Denmark by the third party on April 3, 2006.

Net cash provided by investing activities was $76.8 million in fiscal 2005, primarily as a result of the $71.7 million investment proceeds from the sale of the CSD and GoBack product line, $7.3 million of additional cash from the net proceeds from short term investments, offset by $2.3 million of capital expenditures.

Net cash used in investing activities was $21.2 million in fiscal 2004, primarily as a result of $4.8 million used to purchase capital equipment, primarily for the online music distribution division, $30.1 million used to purchase short-term investments, $14.6 million used to acquire Napster, LLC, formerly known as Pressplay and $1.7 million transferred to a restricted cash account. The outflows of cash were offset by proceeds of $10.0 million received from the sale of our GoBack product line and $20.1 million from the sales and maturities of our marketable securities.

Financing Activities

Net cash used in financing activities was $14.9 million in fiscal 2006, primarily due to the $15.0 million repayment of the total principal amount of the borrowings under the line of credit in fiscal 2004.

Net cash provided by financing activities was $53.2 million in fiscal 2005, primarily due to $48.6 million of net proceeds from the issuance of common stock through a private equity financing, $5.2 million of net proceeds from the exercise of stock options and the employee stock purchase plan, slightly offset by $594,000 of principal cash payments made on our capital lease obligations. In January, 2005, we issued 7.1 million shares of common stock in a private placement to certain accredited investors. The shares were sold at a price of $7.35 per share with gross proceeds of $52.2 million. The gross proceeds were reduced by placement fees and legal fees totaling approximately $3.6 million.

Net cash provided by financing activities was $53.3 million in fiscal 2004, primarily due to $41.4 million of net proceeds from the issuance of common stock through two private equity financings, $2.5 million in proceeds from the exercise of stock options and the employee stock purchase plan and $15.0 million of cash drawn on our line of credit. The inflows of cash were partially offset by $5.0 million used to repay our former line of credit and $613,000 of principal cash payments made on our capital lease obligations. In January 2004, we issued 5.5 million shares of common stock in a private placement to certain accredited investors. The shares were sold at a price of $4.10 per share with gross proceeds of $22.6 million. The gross proceeds were reduced by placement fees and legal and accounting fees of approximately $1.7 million. In June 2003, Napster issued 4.0 million shares of common stock in a private equity placement to certain accredited investors. The shares were sold at a price of $5.50 per share with gross proceeds of $22.0 million. The gross proceeds were reduced by placement fees and legal and accounting fees of approximately $1.8 million.

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Contractual obligations

At March 31, 2006, we had open purchase orders of approximately $9.3 million primarily related to marketing, professional service and facility related activities. We also have commitments that consisted of obligations to pay content fees and royalties on music delivered to our customers, debt obligations and non-cancelable leases. These purchase commitments and lease obligations are reflected in our consolidated financial statements after goods or services have been received or at such time when we are obligated to make payments related to these royalties, goods, services or leases.

Content fees and royalties on music are due to our partners based upon net revenues and online music distribution volumes. As online service volumes increase or decrease, our obligations for content fees and royalties increase or decrease proportionally. As of March 31, 2006 there are no fixed minimum obligations for content fees or royalties.

At March 31, 2006 we had no outstanding letters of credit.

Future contractual minimum payments due under our agreements and non-cancelable leases at March 31, 2006 are as follows (in thousands):

Year Ending March 31,	Non-Cancelable Capital Leases	Non-Cancelable Operating Leases	Total
2007	$ 36	$ 1,151	$1,187
2008	6	258	264
2009	6	122	128
2010	6	19	25
2011	3	5	8
Total	$ 57	$ 1,555	$1,612

We expect that as our existing capital leases and operating leases terminate over the next few years, we will enter into new agreements which will result in new obligations.

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Off-Balance Sheet Arrangements

As of March 31, 2006, we did not have any off-balance-sheet arrangements, as defined in Item 303(a)(4)(ii) of SEC Regulation S-K.

Litigation

Information concerning our litigation matters is included in Part I, Item 3 above.

Recent Accounting Pronouncements

For recent accounting pronouncements, see Note 1—Description of Business and Summary of Significant Accounting Policies to the consolidated financial statements appearing in Item 15 to this annual report, which are incorporated by reference into this Item 7.

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ITEM 7A. QUANTITATIVE AND QUALITATIVE DISCLOSURES ABOUT MARKET RISK

Interest rate risk

The primary objective of our investment activities is to preserve principal while at the same time maximizing the income we receive from our investments without significantly increasing risk. We maintain our cash, cash equivalents and short-term investments with high quality financial institutions and, as part of our cash management process, we perform periodic evaluations of the relative credit standing of these financial institutions. Amounts deposited with these institutions may exceed federal depository insurance limits. In addition, the portfolio of investments conforms to our policy regarding concentration of investments, maximum maturity and quality of investment.

Some of the securities in which we have invested may be subject to market risk. This means that a change in prevailing interest rates may cause the principal amount of the investment to fluctuate. For example, if we hold a security that was issued with a fixed interest rate at the then-prevailing rate and the prevailing interest rate later rises, the principal amount of our investment will probably decline in value. To reduce this risk, we maintain our portfolio of cash equivalents and short-term investments in a variety of securities, including commercial paper, corporate bonds, U.S. agencies securities, asset-backed securities and money market funds. In general, money market funds are not subject to interest rate risk because the interest paid on these funds fluctuates with the prevailing interest rate. All of our short-term investments mature in less than two years.

The following table presents the amounts of our short-term investments that are subject to market risk by range of expected maturity and weighted-average interest rates as of March 31, 2006. Our cash equivalents are invested in money market funds, commercial paper and municipal securities, which are not included in the table because those funds are not subject to interest rate risk due to their short maturities (in thousands, except interest rates).

	Maturing in			
	Less than One Year	More than One Year	Total	Estimated Fair Value
Short-term investments	$47,011	$ 2,801	$49,812	$49,812
Weighted-average interest rate	4.27%	5.44%		

We have available to us a $17 million revolving line of credit. We had borrowed $15 million against this line of credit as of March 31, 2005. The entire $15 million, plus $73,000 of accrued interest, was paid in full during May 2005. We do not have any outstanding variable interest rate debt as of March 31, 2006.

Financial instruments that potentially subject us to significant concentrations of credit risk consist principally of trade accounts receivable and accounts payable.

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Exchange rate risk

We market our Napster service in the United States, Canada, the United Kingdom and Germany, resulting in sales denominated in U.S. dollars, Canadian dollars, United Kingdom pounds and Euro. As such, our financial results could be affected by factors such as changes in foreign currency exchange rates or weak economic conditions in foreign markets.

Transactions denominated in currencies other than the functional currency of the legal entity are remeasured to the functional currency of the legal entity at the period-end exchange rates. Any associated currency re-measurement gains and losses are recognized in current operations.

For our foreign subsidiaries whose functional currency is the local currency, we translate assets and liabilities to U.S. dollars using period-end exchange rates and translate revenues and expenses using average exchange rates during the period. Exchange gains and losses arising from translation of foreign entity financial statements are included as a component of other comprehensive income (loss).

Cash and cash equivalents are predominantly denominated in U.S. dollars. As of March 31, 2006 we held $2.3 million of cash and cash equivalents in United Kingdom pounds, $1.8 million in Euro and $900,000 in other foreign currencies.

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ITEM 8. CONSOLIDATED FINANCIAL STATEMENTS AND SUPPLEMENTARY DATA

The Consolidated Financial Statements and Supplementary Data required by this Item are set forth at the pages indicated in Item 15(a).

Unaudited Quarterly Results of Operations

	Three Months Ended							
	Mar. 31, 2006	Dec. 31, 2005	Sep. 30, 2005	June 30, 2005	Mar. 31, 2005	Dec. 31, 2004	Sep. 30, 2004	June 30, 2004
	(in thousands, except per share data)							
Net revenues	$26,779	$ 23,532	$ 23,379	$ 21,001	$ 17,436	$12,111	$ 9,315	$ 7,867
Gross margin	$ 7,490	$ 6,305	$ 5,092	$ 6,596	$ 3,530	$ 2,422	$ 1,807	$ 1,420
Net loss from continuing operations	$ (7,314)	$(17,007)	$(13,612)	$(19,926)	$(24,124)	$ (3,653)	$(16,073)	$ (7,583)
Net income (loss)	$ (4,400)	$(17,007)	$(13,612)	$(19,926)	$(24,338)	$12,785	$(15,313)	$ (2,640)
Net loss per share from continuing operations:								
Basic and diluted	$ (0.17)	$ (0.40)	$ (0.32)	$ (0.46)	$ (0.59)	$ (0.10)	$ (0.46)	$ (0.22)
Net income (loss) per share:								
Basic and diluted	$ (0.10)	$ (0.40)	$ (0.32)	$ (0.46)	$ (0.60)	$ 0.36	$ (0.44)	$ (0.08)
Weighted average shares used in computing net income (loss) per share:								
Basic and diluted	43,026	42,994	42,977	42,961	40,877	35,097	34,729	33,726

ITEM 9. CHANGES IN AND DISAGREEMENTS WITH ACCOUNTANTS ON ACCOUNTING AND FINANCIAL DISCLOSURE

None.

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ITEM 9A. CONTROLS AND PROCEDURES

Evaluation of disclosure controls and procedures.

Our management has evaluated, with the participation of our Chief Executive Officer and our Chief Financial Officer, the effectiveness of our disclosure controls and procedures (as defined in Rule 13a-15(e) and Rule 15d-15(e) under the Securities Exchange Act of 1934, as amended) as of the end of the period covered by this Annual Report on Form 10-K. Based on this evaluation, our Chief Executive Officer and our Chief Financial Officer have concluded that our disclosure controls and procedures were effective to ensure that information we are required to disclose in reports that we file or submit under the Securities Exchange Act (i) is recorded, processed, summarized and reported within the time periods specified in Securities and Exchange Commission rules and forms, and (ii) is accumulated and communicated to our management, including our Chief Executive Officer and our Chief Financial Officer, as appropriate, to allow timely decisions regarding required disclosure. Our disclosure controls and procedures are designed to provide reasonable assurance that such information is accumulated and communicated to our management. Our disclosure controls and procedures include components of our internal control over financial reporting.

Management's Annual Report on Internal Control Over Financial Reporting.

Management of our Company is responsible for establishing and maintaining adequate internal control over financial reporting as such term is defined in Rules 13a-15(f) and 15(d)-15(f) under the Securities Exchange Act of 1934, as amended. Our internal control over financial reporting is designed to provide reasonable assurance regarding the reliability of financial reporting and the preparation of financial statements for external purposes in accordance with generally accepted accounting principles. Internal control over financial reporting includes those policies and procedures that:

- pertain to the maintenance of records that, in reasonable detail, accurately and fairly reflect the transactions and dispositions of the assets of our Company;
- provide reasonable assurance that transactions are recorded as necessary to permit preparation of financial statements in accordance with generally accepted accounting principles, and that receipts and expenditures of our Company are being made only in accordance with the authorization of management and directors of our Company; and
- provide reasonable assurance regarding prevention or timely detection of unauthorized acquisition, use or disposition of our Company's assets that could have a material effect on the financial statements.

Because of its inherent limitations, internal control over financial reporting may not prevent or detect misstatements. Also, projections of any evaluation of effectiveness to future periods are subject to the risk that controls may become inadequate because of changes in conditions or that the degree of compliance with the policies or procedures may deteriorate.

Management assessed the effectiveness of our internal control over financial reporting as of March 31, 2006. In making this assessment, our management used the criteria set forth in Internal Control-Integrated Framework issued by the Committee of Sponsoring Organizations of the Treadway Commission ("COSO").

Based on our assessment of internal controls over financial reporting, management has concluded that, as of March 31, 2006, our internal control over financial reporting was effective.

Our management's assessment of the effectiveness of the Company's internal control over financial reporting as of March 31, 2006 has been audited by PricewaterhouseCoopers, LLP, an independent registered public accounting firm, as stated in their report that appears on page F-2.

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Attestation Report of the Registered Public Accounting Firm.

The report required by this item is set forth on page F-2.

Changes in Internal Control over Financial Reporting.

During the quarter ended March 31, 2006, there were no changes in our internal control over financial reporting that have materially affected, or are reasonably likely to materially affect, our internal control over financial reporting.

ITEM 9B. OTHER INFORMATION

None.

PART III

ITEM 10. DIRECTORS AND EXECUTIVE OFFICERS OF THE REGISTRANT

Information in response to this item is incorporated herein by reference to our definitive proxy statement for our 2006 annual meeting of stockholders to be held on September 21, 2006. Information concerning our executive officers is included in Part I.

ITEM 11. EXECUTIVE COMPENSATION

Information in response to this item is incorporated herein by reference to our definitive proxy statement for our 2006 annual meeting of stockholders to be held on September 21, 2006.

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ITEM 12. SECURITY OWNERSHIP OF CERTAIN BENEFICIAL OWNERS AND MANAGEMENT AND RELATED STOCKHOLDER MATTERS

Information in response to this item is incorporated herein by reference to our definitive proxy statement for our 2006 annual meeting of stockholders to be held on September 21, 2006.

Equity Compensation Plan Information

We currently maintain six equity compensation plans: the Amended and Restated 2000 Stock Option Plan (the "2000 Plan"), the Amended and Restated 2001 Stock Plan (the "2001 Plan"), the Amended and Restated 2001 Directors Option Plan (the "Directors Plan"), the Amended and Restated 2001 Employee Stock Purchase Plan (the "ESPP"), the 2002 Stock Plan (the "2002 Plan") and the 2003 Stock Plan (the "2003 Plan").

Equity Compensation Plans Approved by Stockholders. Each of our 2000 Plan, 2001 Plan, Directors Plan and ESPP was approved by Adaptec, our sole stockholder at the time each plan was adopted. The 2003 Plan was approved by our stockholders at our annual meeting of stockholders on September 18, 2003.

Under each of the 2000 Plan, 2001 Plan and 2003 Plan, our Board of Directors, or a committee of the Board, may grant stock options and restricted stock awards to employees and consultants of Napster or our subsidiaries and to Napster directors. The purchase price of any shares of our common stock subject to an award granted under either plan will be determined by our Board or a committee of the Board at the time of grant, and may be less than the fair market value of the underlying stock at that time. Awards granted under these plans may be fully vested at grant or subject to a vesting schedule determined by our Board or a committee of the Board. Each option granted under these plans will expire not more than ten years after its date of grant. Unvested shares of restricted stock are subject to cancellation or to repurchase by Napster upon the termination of the holder's employment or service. As of March 31, 2006, 801,713 restricted stock awards, net of cancellations, have been granted.

Under the Directors Plan and the 2001 Plan, stock options are automatically granted to Napster's non-employee directors. Options are granted at fair market value on the date of grant, vest on a quarterly basis over a four-year period and expire not more than ten years after the date of grant. On October 24, 2005, the Board of Directors terminated the authority to grant additional awards under the Directors Plan. The termination of grant authority under the Directors Plan will not affect the terms or validity of outstanding awards under the Directors Plan, and the terms of the Directors Plan will continue with respect to such outstanding awards. On October 24, 2005 the Company amended the 2001 Plan to provide that, effective January 1, 2006, restricted stock awards will be automatically granted to non-employee directors in lieu of granting stock options. The restricted stock awards granted to non-employee directors vest ratably over a four year period in equal quarterly installments and have full voting rights until forfeited. Unvested shares are forfeited upon termination of services on the Board of Directors.

Employees participating in the ESPP may purchase common stock at the end of each purchase period at a purchase price equal to 85% of the lower of the fair market value of the stock at the beginning or the end of the period. Employees generally may contribute up to 10% of their base compensation to the purchase of stock under the plan. The plan operates in overlapping 24-month offering periods, and each offering period consists of four six-month purchase periods.

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Equity Compensation Plan Not Approved by Stockholders. The 2002 Plan did not require approval of, and has not been approved by, our stockholders. The 2002 Plan allows our Board of Directors, or a committee of the Board, to grant stock options and restricted stock awards to employees and consultants of Napster or our subsidiaries. Employees who are Napster officers and Napster directors are not eligible to receive awards under the 2002 Plan. To date, only stock options have been granted under the 2002 Plan. The purchase price of any shares of our common stock subject to an award granted under the 2002 Plan will be determined by our Board or a committee of the Board at the time of grant and may be less than the fair market value of the underlying stock at that time. Restricted stock awards granted under the 2002 Plan may be fully vested at grant or subject to a vesting schedule determined by our Board or a committee of the Board. Each option granted under the 2002 Plan will expire not more than ten years after its date of grant. Unvested shares of restricted stock are subject to repurchase by Napster upon the termination of the holder's employment or service. To date, no restricted stock awards have been granted under the 2002 Plan.

Summary Table. The following table sets forth, for each of Napster's equity compensation plans, the number of our shares of common stock subject to outstanding options, the weighted-average exercise price of outstanding options, and the number of shares remaining available for future award grants as of March 31, 2006.

Plan category	Number of shares of Napster common stock to be issued upon exercise of outstanding options(1)	Weighted average exercise price of outstanding options(2)	Number of shares of Napster common stock remaining available for future issuance under equity compensation plans (excluding shares reflected in the first column)
Equity compensation plans approved by stockholders	4,256,637	$ 7.42	5,731,112(3), (4)
Equity compensation plans not approved by stockholders	65,000	$ 14.09	538,281(5)
	4,321,637	$ 7.52	6,269,393

(1) This column does not reflect shares that may be acquired under the ESPP in the current purchase period because that number is not determinable until the end of the period.
(2) This column does not reflect the price of shares that may be acquired under the ESPP in the current purchase period because that price is not determinable until the end of the period.
(3) Of these shares, 357,216 were available under the ESPP and the balance is available for option grants under our other stockholder-approved equity compensation plans. Up to 3,838,480 of these shares are available for restricted stock award grants under the 2001 Plan and 2003 Plan.
(4) On April 1 of each year during the term of the 2001 Plan, the total number of shares available for award purposes under the 2001 Plan will increase by the lesser of 2,000,000 shares or 6% of the total number of common shares issued and outstanding as of the immediately preceding March 31, or a lesser number determined by the Board of Directors. On April 1 of each year during the term of the Employee Stock Purchase Plan, the total number of shares available for purchase under the ESPP will increase by the lesser of 100,000 shares or 1.5% of the total number of common shares issued and outstanding as of the immediately preceding March 31, or a lesser number determined by the Board of Directors. Accordingly, on April 1, 2006, the aggregate number of shares available for issuance under the 2001 Plan increased by 2,000,000 shares and the aggregate number of shares available for issuance under the ESPP increased by 100,000 shares. The information presented in this table was calculated as of March 31, 2006 and does not reflect these increases, or any possible future increases, to the number of shares available under these plans.
(5) All of these shares are available for option and restricted stock award grants under the 2002 Plan.

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ITEM 13. CERTAIN RELATIONSHIPS AND RELATED TRANSACTIONS

The information in response to this item is incorporated herein by reference to our definitive proxy statement for our 2006 annual meeting of stockholders to be held on September 21, 2006.

ITEM 14. PRINCIPAL ACCOUNTING FEES AND SERVICES

Information in response to this item is incorporated herein by reference to our definitive proxy statement for our 2006 annual meeting of stockholders to be held on September 21, 2006.

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PART IV

ITEM 15. EXHIBITS AND FINANCIAL STATEMENT SCHEDULE

(a) The following documents are filed as part of this annual report:

1. Financial Statements

   See Index to Financial Statements at page F-1 of this Form 10-K.

2. Financial Statement Schedule

   Schedule II—Valuation and Qualifying Accounts and Reserves.

   All other schedules have been omitted because the required information is not present or not present in amounts sufficient to require the submission of the schedules, or because the information required is included in the consolidated financial statements or the notes thereto.

3. Exhibits:

   The exhibits listed in the accompanying index to exhibits are filed as part of this Form 10-K.

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NAPSTER, INC.
INDEX TO CONSOLIDATED FINANCIAL STATEMENTS

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Consolidated Balance Sheets as of March 31, 2006 and 2005	F-4
Consolidated Statements of Operations for the years ended March 31, 2006, 2005 and 2004	F-5
Consolidated Statement of Changes in Stockholders' Equity for the years ended March 31, 2006, 2005 and 2004	F-6
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NAPSTER, INC.

REPORT OF INDEPENDENT REGISTERED PUBLIC ACCOUNTING FIRM

To the Board of Directors and Stockholders of Napster, Inc.:

We have completed integrated audits of Napster, Inc.'s 2006 and 2005 consolidated financial statements and of its internal control over financial reporting as of March 31, 2006, and an audit of its 2004 consolidated financial statements in accordance with the standards of the Public Company Accounting Oversight Board (United States). Our opinions, based on our audits, are presented below.

Consolidated financial statements and financial statement schedule

In our opinion, the consolidated financial statements listed in the index under Item 15(a)(1) present fairly, in all material respects, the financial position of Napster, Inc. and its subsidiaries at March 31, 2006 and 2005, and the results of their operations and their cash flows for each of the three years in the period ended March 31, 2006 in conformity with accounting principles generally accepted in the United States of America. In addition, in our opinion, the financial statement schedule listed in the index appearing under Item 15(a)(2) present fairly, in all material respects, the information set forth therein when read in conjunction with the related consolidated financial statements. These financial statements and financial statement schedule are the responsibility of the Company's management. Our responsibility is to express an opinion on these financial statements and financial statement schedule based on our audits. We conducted our audits of these statements in accordance with the standards of the Public Company Accounting Oversight Board (United States). Those standards require that we plan and perform the audit to obtain reasonable assurance about whether the financial statements are free of material misstatement. An audit of financial statements includes examining, on a test basis, evidence supporting the amounts and disclosures in the financial statements, assessing the accounting principles used and significant estimates made by management, and evaluating the overall financial statement presentation. We believe that our audits provide a reasonable basis for our opinion.

Internal control over financial reporting

Also, in our opinion, management's assessment, included in Management's Annual Report on Internal Control over Financial Reporting appearing in Item 9A, that the Company maintained effective internal control over financial reporting as of March 31, 2006 based on criteria established in *Internal Control—Integrated Framework* issued by the Committee of Sponsoring Organizations of the Treadway Commission (COSO), is fairly stated, in all material respects, based on those criteria. Furthermore, in our opinion, the Company maintained, in all material respects, effective internal control over financial reporting as of March 31, 2006, based on criteria established in *Internal Control—Integrated Framework* issued by the COSO. The Company's management is responsible for maintaining effective internal control over financial reporting and for its assessment of the effectiveness of internal control over financial reporting. Our responsibility is to express opinions on management's assessment and on the effectiveness of the Company's internal control over financial reporting based on our audit. We conducted our audit of internal control over financial reporting in accordance with the standards of the Public Company Accounting Oversight Board (United States). Those standards require that we plan and perform the audit to obtain reasonable assurance about whether effective internal control over financial reporting was maintained in all material respects. An audit of internal control over financial reporting includes obtaining an understanding of internal control over financial reporting, evaluating management's assessment, testing and evaluating the design and operating effectiveness of internal control, and performing such other procedures as we consider necessary in the circumstances. We believe that our audit provides a reasonable basis for our opinions.

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A company's internal control over financial reporting is a process designed to provide reasonable assurance regarding the reliability of financial reporting and the preparation of financial statements for external purposes in accordance with generally accepted accounting principles. A company's internal control over financial reporting includes those policies and procedures that (i) pertain to the maintenance of records that, in reasonable detail, accurately and fairly reflect the transactions and dispositions of the assets of the company; (ii) provide reasonable assurance that transactions are recorded as necessary to permit preparation of financial statements in accordance with generally accepted accounting principles, and that receipts and expenditures of the company are being made only in accordance with authorizations of management and directors of the company; and (iii) provide reasonable assurance regarding prevention or timely detection of unauthorized acquisition, use, or disposition of the company's assets that could have a material effect on the financial statements.

Because of its inherent limitations, internal control over financial reporting may not prevent or detect misstatements. Also, projections of any evaluation of effectiveness to future periods are subject to the risk that controls may become inadequate because of changes in conditions, or that the degree of compliance with the policies or procedures may deteriorate.

/s/ PricewaterhouseCoopers LLP

Los Angeles, California
June 5, 2006

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NAPSTER, INC.
CONSOLIDATED BALANCE SHEETS
(In thousands, except per share data)

	March 31,	
	2006	2005
ASSETS		
Current assets:		
Cash and cash equivalents	$ 46,812	$135,416
Short-term investments	49,812	32,380
Foreign currency conversion in transit	7,545	—
Accounts receivable, net of allowance for doubtful accounts of $7 at March 31, 2006 and $6 at March 31, 2005	1,042	1,545
Prepaid expenses and other current assets	6,182	9,775
Total current assets	111,393	179,116
Property and equipment, net	7,012	5,337
Goodwill	34,658	34,658
Intangible assets, net	—	1,349
Investment in unconsolidated entity	2,203	—
Other assets	275	422
Total assets	$ 155,541	$220,882
LIABILITIES AND STOCKHOLDERS' EQUITY		
Current liabilities:		
Accounts payable	$ 3,279	$ 6,547
Income taxes payable	4,139	4,125
Accrued liabilities	16,712	11,381
Deferred revenues	12,824	8,345
Deferred gain on divestiture	—	2,073
Short-term debt	33	15,110
Total current liabilities	36,987	47,581
Long-term liabilities		
Deferred income taxes	2,622	1,696
Other long-term liabilities	159	212
Total liabilities	39,768	49,489
Commitments and contingencies (Note 14)		
Stockholders' equity:		
Common stock, $0.001 par value; Authorized: 100,000 shares; Issued and outstanding: 43,826 shares at March 31, 2006 and 42,961 shares at March 31, 2005	44	43
Additional paid-in capital	260,198	256,586
Deferred stock-based compensation	(2,934)	(533)
Accumulated deficit	(141,368)	(86,423)
Accumulated other comprehensive income (loss)	(167)	1,720
Total stockholders' equity	115,773	171,393
Total liabilities and stockholders' equity	$ 155,541	$220,882

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

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NAPSTER, INC.
CONSOLIDATED STATEMENTS OF OPERATIONS
(In thousands, except per share data)

	Year Ended March 31,		
	2006	2005	2004
Net revenues	$ 94,691	$ 46,729	$ 11,964
Cost of revenues (1)	69,208	37,550	10,530
Gross margin	25,483	9,179	1,434
Operating expenses:			
Research and development (1)	13,137	12,112	11,952
Sales and marketing (1)	51,741	39,249	15,701
General and administrative (1)	20,881	23,953	22,055
Restructuring charges	—	—	1,119
Amortization of intangible assets	1,265	1,936	2,172
Total operating expenses	87,024	77,250	52,999
Loss from continuing operations	(61,541)	(68,071)	(51,565)
Loss from unconsolidated entity	(289)	—	—
Other income, net	2,811	1,091	634
Loss before income tax benefit	(59,019)	(66,980)	(50,931)
Income tax benefit	1,160	15,547	4,515
Loss from continuing operations, after income taxes	(57,859)	(51,433)	(46,416)
Income from discontinued operations, net of tax effect (1)	2,914	21,927	2,003
Net loss	$(54,945)	$(29,506)	$(44,413)
Earnings per share:			
Net loss per share from continuing operations, after income taxes			
Basic and diluted	$ (1.35)	$ (1.43)	$ (1.69)
Net income per share from discontinued operations, net of tax effect			
Basic and diluted	$ 0.07	$ 0.61	$ 0.07
Net loss per share			
Basic and diluted	$ (1.28)	$ (0.82)	$ (1.62)
Weighted average shares used in computing net income (loss) per share			
Basic and diluted	42,989	36,065	27,496

(1) Amounts reported include stock-based compensation expense as follows:

	2006	2005	2004
Cost of revenues	$ 5	$ —	$ —
Research and development	164	5	12
Sales and marketing	74	34	54
General and administrative	699	637	838
Discontinued operations	—	1,895	1,169
	$ 942	$ 2,571	$ 2,073

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

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NAPSTER, INC.
CONSOLIDATED STATEMENT OF CHANGES IN STOCKHOLDERS' EQUITY
(in thousands)

	Common Stock		Additional Paid-in Capital	Deferred Stock-Based Compensation	Accumulated Deficit	Accumulated Other Comprehensive Income (Loss)	Total Stockholders' Equity
	Shares	Amount					
Balance at March 31, 2003	19,574	$ 20	$ 128,272	$ (2,886)	$ (12,504)	$ 1,929	$ 114,831
Net loss	—	—	—	—	(44,413)	—	(44,413)
Foreign currency translation adjustment	—	—	—	—	—	3,689	3,689
Unrealized loss on short-term investments	—	—	—	—	—	(300)	(300)
Total comprehensive loss							(41,024)
Issuance of common stock under employee stock plans	555	1	1,611	—	—	—	1,612
Deferred stock-based compensation on stock issued to employees	—	—	897	(897)	—	—	—
Issuance of common stock in connection with the acquisition of Napster, LLC	3,914	4	23,483	—	—	—	23,487
Amortization of deferred stock-based compensation	—	—	—	2,970	—	—	2,970
Employee termination adjustment to stock-based compensation	—	—	573	(573)	—	—	—
Issuance of common stock from private equity funding	9,500	9	41,135	—	—	—	41,144
Balance at March 31, 2004	33,543	34	195,971	(1,386)	(56,917)	5,318	143,020
Net loss	—	—	—	—	(29,506)	—	(29,506)
Foreign currency translation adjustments	—	—	—	—	—	(4,481)	(4,481)
Unrealized gain on short-term investments	—	—	—	—	—	883	883
Total comprehensive loss							(33,104)
Issuance of common stock to Best Buy, Inc. in connection with marketing agreement	1,100	1	4,909	—	—	—	4,910
Issuance of common stock under employee stock plans	1,152	1	5,184	—	—	—	5,185
Issuance of common stock upon exercise of warrant	66	—	—	—	—	—	—
Stock-based compensation related to option acceleration	—	—	1,663	—	—	—	1,663
Amortization of deferred stock-based compensation and other	—	—	21	853	—	—	874
Stock-based compensation related to option issued to non-employee	—	—	34	—	—	—	34
Issuance of common stock from private equity funding	7,100	7	48,804	—	—	—	48,811
Balance at March 31, 2005	42,961	43	256,586	(533)	(86,423)	1,720	171,393
Net loss	—	—	—	—	(54,945)	—	(54,945)
Foreign currency translation adjustment	—	—	—	—	—	(1,169)	(1,169)
Unrealized loss on short-term investments	—	—	—	—	—	(718)	(718)
Total comprehensive loss							(56,832)
Issuance of common stock under							

employee stock plans, net	865	1	3,538	(3,269)	—	—	270
Amortization of deferred stock-based compensation	—	—	—	868	—	—	868
Stock-based compensation related to stock awards issued to non-employees	—	—	74	—	—	—	74
Balance at March 31, 2006	43,826	$ 44	$ 260,198	$ (2,934)	$ (141,368)	$ (167)	$ 115,773

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

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NAPSTER, INC.
CONSOLIDATED STATEMENTS OF CASH FLOWS
(in thousands)

	Year Ended March 31,		
	2006	2005	2004
Cash flows from operating activities:			
Net loss	$ (54,945)	$ (29,506)	$(44,413)
Adjustments to reconcile net loss to net cash used in operating activities:			
Depreciation and amortization	4,699	8,849	10,619
Amortization of prepaid marketing expenses	1,932	3,961	—
Stock-based compensation charges	942	2,571	2,073
Impairment of assets	—	611	2,416
Change in fair market value of investment hedge	684	342	—
Non-cash purchase of long -term investment-IseeMedia	—	(200)	—
Non-cash loss from remeasurement of cash balance	524	—	—
Loss on retirement of assets	—	106	326
Gain on sale of businesses	(6,540)	(32,077)	(10,622)
Deferred tax expense	926	1,696	3,559
Loss from unconsolidated entity	289	—	—
Change in operating assets and liabilities, net of effects of acquisition and divestiture:			
Accounts receivable	1,074	2,454	1,984
Prepaid expenses and other current and long term assets	(1,422)	862	1,005
Accounts payable	(3,260)	4,418	(5,152)
Income taxes payable	21	(45)	1,483
Accrued liabilities	5,998	(2,466)	2,746
Deferred revenues	4,603	8,068	905
Other long-term liabilities	(53)	(178)	2,296
Net cash used in operating activities	(44,528)	(30,534)	(30,775)
Cash flows from investing activities:			
Purchases of property and equipment	(5,003)	(2,266)	(4,793)
Proceeds from sale of Consumer Software Division, net	—	68,966	—
Proceeds from sale of GoBack product line, net	—	2,760	9,980
Purchases of other intangible assets	—	—	(63)
Purchases of short-term investments	(151,911)	(74,820)	(30,147)
Proceeds from maturities and sale of short-term investments	138,807	80,424	20,115
Foreign currency conversion in transit	(7,545)	—	—
Transfer from (to) restricted cash	—	1,735	(1,735)
Investment in unconsolidated entity	(2,714)	—	—
Acquisition of Napster, LLC, net of cash acquired	—	—	(14,552)
Net cash provided by (used in) investing activities	(28,366)	76,799	(21,195)
Cash flows from financing activities:			
Principal payment of capital lease obligation	(112)	(594)	(613)
Payments of short-term debt	—	—	(5,000)
Proceeds from (repayment of) line of credit	(15,000)	—	15,000
Issuance of common stock under employee stock plan	202	5,185	2,508
Issuance of common stock from private equity financing, net	—	48,624	41,424
Net cash provided by (used in) financing activities	(14,910)	53,215	53,319
Effect of exchange rates on cash	(800)	(975)	823
Change in cash and cash equivalents	(88,604)	98,505	2,172
Cash and cash equivalents at beginning of period	135,416	36,911	34,739
Cash and cash equivalents at end of period	$ 46,812	$135,416	$ 36,911

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

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NAPSTER, INC.
CONSOLIDATED STATEMENTS OF CASH FLOWS—(Continued)
(in thousands)

	Year Ended March 31,		
	2006	2005	2004
Supplemental cash flow information:			
Cash paid for interest	$ 161	$ 711	$ 490
Cash paid for income taxes	$ 295	$ 803	$ 1,313
Non-cash disclosure of investing and financing activities:			
Unrealized gains (losses) on short-term investments, net	$ (718)	$ 883	$ (300)
Assets acquired under capital leases	$ 22	$ 593	$ —
Goodwill resulting from the acquisition of Napster, LLC	$ —	$ 51	$34,709
Issuance of stock in connection with strategic marketing agreement and purchase acquisition	$ —	$4,999	$23,487
Deferred stock-based compensation related to issuance of common stock options and restricted awards to employees, net of terminations	$3,269	$ —	$ 897

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

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NAPSTER, INC.

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

NOTE 1—DESCRIPTION OF BUSINESS AND SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES

Description of business

Napster was incorporated in Delaware in August 2000 and is a leading provider of online music for the consumer market. Napster users have access to songs from all major labels and hundreds of independent labels and are able to stream or download those songs and store them on a variety of media including personal computers, CDs, DVDs and MP3 players.

On May 1, 2006 Napster launched the new Napster.com, the only legal, advertising-supported service that offers free, on-demand listening without monthly restrictions. This free music site allows members in the United States to listen to nearly every song in Napster's more than 2 million song subscription catalog five times each for free anywhere on the web without downloading any software. Napster.com members outside the United States enjoy free access to 30 second clips of most of these tracks.

For those consumers who want access to unlimited music, including the ability to download music with high quality sound, enjoy their music in an advertising-free environment and access many features including radio, Billboard charts and many community features, Napster continues to offer Napster and Napster to Go subscriptions for use on the PC or portable devices. The paid Napster service is also currently available in Canada, the United Kingdom and Germany. Napster expects to launch its paid service in Japan through its joint venture with Tower Records in fiscal 2007.

Until December 17, 2004, Napster was known as "Roxio, Inc." and operated its business in two divisions, the consumer software division ("CSD") and the online music distribution division, also known as the Napster division. On December 17, 2004, Napster completed the sale of substantially all of the assets and liabilities of CSD to Sonic Solutions, a California corporation ("Sonic"). The divestiture of CSD was accounted for as a discontinued operation in accordance with Statement of Financial Accounting Standards ("SFAS") No. 144, "Accounting for the Impairment or Disposal of Long-Lived Assets" ("SFAS No. 144"), and, accordingly, the results of operations of the CSD are no longer presented within continuing operations.

Since the sale of CSD in December 2004, Napster has focused exclusively on the online music distribution business under the Napster brand and, since January 3, 2005, has been traded on the Nasdaq Stock Market under the symbol "NAPS".

Liquidity and Capital Resources

Napster has incurred losses and negative cash flows from operations during the past two fiscal years. For the year ended March 31, 2006, we incurred an after tax net loss from continuing operations of $57.9 million, a net loss of approximately $54.9 million and negative cash flows from operations of approximately $52.1 million. Our cash balances may decline further, although we believe that our strategic actions to improve revenue and control costs, along with existing cash resources, will be adequate to fund our operations for at least the next 12 months. Failure to generate sufficient revenues or control spending could adversely affect our ability to achieve our business objectives.

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NAPSTER, INC.

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS—(Continued)

Consolidation and basis of presentation

The accompanying consolidated financial statements present the results of operations, financial position, changes in stockholder's equity and cash flows applicable to the operations of Napster and its wholly or majority-owned subsidiaries, after elimination of intercompany accounts and transactions. Napster owns 100% of all subsidiaries other than Napster, LLC, of which it owns 99.6%. There is no minority interest in Napster, LLC during the periods presented because the Company is obliged to fund all operating losses of the entity. Investments in entities where Napster does not have control are recorded on the equity basis of accounting in accordance with Accounting Principles Board Opinion ("APB") No. 18, "The Equity Method of Accounting for Investments in Common Stock" (APB No. 18).

Reclassification Certain reclassifications have been made to prior years' balances in order to conform to the current period presentation. We have changed the classification of stock-based compensation expenses in the consolidated statement of operations to their respective operating expense classification. Such reclassifications do not have an effect on Napster's consolidated financial condition, results of operations, or cash flows.

Foreign currency translation

The functional currency for most of Napster's foreign subsidiaries is the respective local currency. These subsidiaries consist of entities in the United Kingdom, Germany and Luxembourg, as well as one dormant CSD subsidiary that is substantially liquidated and, prior to December 2004, other subsidiaries sold to Sonic during December 2004 or since liquidated. For these entities, Napster translates assets and liabilities to U.S. dollars using period-end exchange rates and translates revenues and expenses using average exchange rates during the period. Exchange gains and losses arising from translation of foreign entity financial statements are included as a component of other comprehensive income (loss).

Transactions denominated in currencies other than the functional currency of the legal entity are remeasured to the functional currency of the legal entity at the period-end exchange rates. Any associated currency re-measurement gains and losses are recognized in current operations.

Use of estimates

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

Cash, cash equivalents and short-term investments

Napster considers all highly liquid investments purchased with an original maturity or remaining maturity at the date of purchase of three months or less to be cash equivalents, and investments maturing in three to twelve months to be short-term investments. Available-for-sale investments maturing in more than twelve months are classified as short-term investments as the amounts represent the investment of cash that will be available to fund current operations. Cash equivalents and short-term investments consist primarily of money market funds, corporate bonds, municipal securities, U.S. government securities and commercial paper.

NAPSTER, INC.

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS—(Continued)

Napster classifies its short-term investments into categories in accordance with the provisions of SFAS No. 115 "Accounting for Certain Investments in Debt and Equity Securities". Short-term investments are classified as available-for-sale, which are reported at fair market value with the related unrealized gains and losses, net of taxes, included in other comprehensive income. Realized gains and losses, declines in the value of securities judged to be other than temporary, and interest and dividends on all securities are included in interest and other income, net. The fair value of the Napster's investments is based on quoted market prices. Realized gains and losses are computed using the specific identification method.

Fair value of financial instruments

The carrying values of Napster's financial instruments, including cash and cash equivalents, short-term investments, accounts receivable, accounts payable and accrued liabilities, approximate fair market value due to their short maturities. In addition, the fair market value of short-term debt approximates its carrying value due to its variable interest rate.

Derivative instruments

The Company records derivative instruments as either assets or liabilities in the consolidated balance sheets and measures those instruments at fair value. The accounting for changes in the fair value of a derivative depends on the intended use of the derivative and the resulting designation. Napster evaluates all derivative instruments and classifies them in accordance with SFAS No. 133, "Accounting for Derivative Instruments and Hedging Activities". For a derivative instrument designated as a fair value hedge, the gain or loss is recognized in earnings in the period of change together with the offsetting loss or gain on the hedged item attributed to the risk being hedged. For a derivative instrument designated as a cash flow hedge, the effective portion of the derivative's gain or loss is initially reported as a component of accumulated other comprehensive income and subsequently reclassified into earnings when the hedged exposure affects earnings. The ineffective portion of the gain or loss is reported in earnings immediately.

Concentrations of credit risk

Financial instruments that potentially subject Napster to significant concentrations of credit risk consist principally of cash and cash equivalents, short-term investments and trade accounts receivable.

Napster maintains its cash and cash equivalents and short-term investments with high quality financial institutions and, as part of its cash management process, performs periodic evaluations of the relative credit standing of these financial institutions. Amounts deposited with these institutions may exceed federal depository insurance limits. In addition, the portfolio of investments conforms to Napster's policy regarding concentration of investments, maximum maturity and quality of investment.

No end-user customer accounts for more than 10% of net revenues. Substantially all customers remit payment for the service via a prepaid card or credit card. One distributor of prepaid cards accounted for approximately 62% of net accounts receivable at March 31, 2006 and approximately 34% of net accounts receivable at March 31, 2005. Receivables from the company that processes credit cards accounted for 9% of net accounts receivable at March 31, 2006 and 21% of net accounts receivable at March 31, 2005.

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NAPSTER, INC.

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS—(Continued)

Prepaid Marketing Expenses

Napster recognizes up front advance payments for marketing fees in prepaid expenses and other current assets. Prepaid marketing expenses consist of amounts paid to strategic marketing partners and media placement firms for future marketing services. These prepayments are expensed as marketing services are received, based on fair values of the services received, limited to the contractual value. The recoverability of these balances is subject to regular review by management.

Advertising costs

Advertising costs are expensed as incurred and were approximately $38.0 million in fiscal 2006, $26.5 million in fiscal 2005 and $10.3 million in fiscal 2004.

Property and equipment

Property and equipment are stated at cost and depreciated or amortized using the straight-line method over the estimated useful lives of the assets, or the lease term if shorter.

Capitalized software development costs

Internal use software. Napster complies with the American Institute of Certified Public Accountants ("AICPA") Statement of Position ("SOP") No. 98-1, "Accounting for Cost of Computer Software Developed or Obtained for Internal Use" ("SOP 98-1"), and Emerging Issues Task Force ("EITF") Issue 00-2, "Accounting for Website Development Costs". In accordance with SOP 98-1, software development costs incurred as part of an approved project plan that result in additional functionality to internal use software are capitalized and amortized on a straight-line basis over the estimated useful life of the software, generally three years.

Software held for sale. In accordance with SFAS No. 86, "Computer Software to be Sold, Leased, or Otherwise Marketed", development costs of computer software to be sold, leased or otherwise marketed are subject to capitalization beginning when a product's technological feasibility has been established and ending when a product is available for general release to customers. The Company has not capitalized any software development costs as technological feasibility is generally not established until a working model is completed at which time substantially all development is complete.

Goodwill and other intangible assets

Napster accounts for goodwill and other intangible assets in accordance with SFAS No. 142, "Goodwill and Other Intangible Assets". Napster evaluates the carrying value of goodwill on an annual basis. Napster will adjust the carrying value if the asset's value has been impaired and more frequently if certain impairment indicators are present. At March 31, 2006 and 2005, Napster compared its market value to its net book value and determined that goodwill was not impaired as the fair value exceeded the net book value.

Other intangible assets are amortized on the straight-line method over their estimated useful lives, generally three years. When circumstances warrant, Napster periodically evaluates any possible impairment of long-lived assets, including intangible assets other than goodwill, in accordance with SFAS No. 144, "Accounting for the Impairment or Disposal of Long-Lived Assets".

NAPSTER, INC.
NOTES TO CONSOLIDATED FINANCIAL STATEMENTS—(Continued)

Accrued publishing fees

Under copyright law we are required to pay licensing fees for compositions embodied in digital sound recordings and for the sound recordings themselves that we deliver in our Napster service. Copyright law generally does not specify the rate and terms of the licenses, which are determined by voluntary negotiations among the parties or, for certain compulsory licenses where voluntary negotiations are unsuccessful, by arbitration. There are certain geographies and agencies for which we have not yet completed negotiations with regard to the royalty rate to be applied to the current or historic sales of our digital music offerings. We accrue for the cost of these fees in accordance with Statement of Financial Accounting Standards ("SFAS") No. 5, "Accounting for Contingencies" ("SFAS No. 5"), based on contracted or statutory rates, when established, or management's best estimates based on facts and circumstances regarding the specific music services and agreements in similar geographies or with similar agencies.

Revenue recognition

Napster recognizes revenues in accordance with Staff Accounting Bulletin ("SAB") 104, "Revenue Recognition in Financial Statements" ("SAB 104"), EITF 00-21 "Revenue Arrangements with Multiple Deliverables" ("EITF 00-21"), and EITF 99-19, "Reporting Revenue Gross as a Principal versus Net as an Agent" ("EITF 99-19"). In general, Napster recognizes revenue when there is persuasive evidence of an arrangement, the fee is fixed or determinable, the product or services have been delivered and collectibility of the resulting receivable is reasonably assured.

Music subscriptions are paid in advance, typically for monthly or annual periods. Music subscription revenues are recognized ratably on a daily basis over the subscription period. Revenues from sales of individual songs or albums by download are recognized at the time the music is delivered, digitally, to the end user. Revenues from pre-paid cards and promotions are deferred and then recognized as (i) tracks are downloaded by the end users, (ii) if redeemed for a subscription, over the subscription period or (iii) when the Company has no further obligation to provide services or refund the associated prepayments. Revenues from licensing of Napster trademarks are recognized upon receipt of royalty reports from the licensee or, for prepaid royalties, when the Company provides or has no further obligation to provide services.

Napster has arrangements whereby customers pay one price for multiple products and services. In some cases, these arrangements involve a combination of hardware and services. In other cases, the customer pays a single price for multiple music downloads and months of music subscriptions. For arrangements with multiple deliverables, revenue is recognized upon the delivery of the separate units in accordance with EITF 00-21. Consideration from multiple element arrangements is allocated among the separate elements based on their relative fair values. In the event that there is no objective and reliable evidence of fair value, the revenue recognized upon delivery is the total arrangement consideration less the fair value of the undelivered items. The maximum revenue recognized on a delivered element is limited to the amount that is not contingent upon the delivery of additional items.

Napster has arrangements with certain customers whereby the customer provides goods or services to Napster. Our revenue and the charges for the goods or services provided by a customer are accounted for in accordance with EITF 01-09, "Accounting for Consideration Given by a Vendor to a Customer", including subsequent interpretations. The costs of separately identifiable goods or services received by Napster from a customer are valued at the cost Napster would incur to procure the same goods or services from a non-customer third party. If the goods or services cannot be separated, the total consideration is recorded as a reduction of revenues. Consideration paid to customers under these arrangements that exceeds the separately identifiable value of the goods or services provided would be reflected as a reduction of the customer's revenue.

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NAPSTER, INC.

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS—(Continued)

Napster recognizes revenue gross or net in accordance with EITF 99-19. In most arrangements, Napster contracts directly with the end user customers, is the primary obligor and carries all collectibility risk. Revenue in these arrangements is recorded on a gross basis. In some cases, Napster utilizes third party distributors to sell products or services directly to end user customers, and Napster carries no collectibility risk. In some cases, Napster pays operating expenses for the distributor and is reimbursed at cost plus a small mark-up. In both of those instances, Napster reports the revenue net of the amount paid to the distributor.

Income taxes

We account for income taxes in accordance with SFAS No. 109, "Accounting for Income Taxes". Deferred taxes result from differences between the financial and tax bases of Napster's assets and liabilities and are adjusted for changes in tax rates and tax laws when changes are enacted. Valuation allowances are recorded to reduce deferred tax assets when it is more likely than not that a tax benefit will not be realized by Napster.

In accordance with SFAS No. 109, we have recognized a tax benefit in continuing operations and an equal offsetting additional tax provision in the discontinued operation in each period that continuing operations had a loss that can be applied to offset income from the discontinued operation.

Comprehensive income

SFAS No. 130, "Reporting Comprehensive Income", requires the disclosure of comprehensive income to reflect changes in equity that result from transactions and economic events from non-owner sources. Accumulated other comprehensive income for the periods presented represents foreign currency translations associated with Napster's international operations and unrealized gains and losses on available for sale securities.

Net income (loss) per share

Basic net income (loss) per share is computed using the weighted-average number of common shares outstanding during the period, less unvested restricted stock as required by SFAS No. 128, "Earnings per Share", because issued and outstanding unvested restricted stock must be returned to the Company if vesting does not occur. Diluted net income (loss) per share is computed using the weighted-average number of common and dilutive potential shares outstanding during the period. Dilutive potential shares have consisted of warrants, common stock issuable upon exercise of stock options, computed using the treasury stock method, and unvested restricted stock.

Dilutive potential shares excluded from the calculation because their effect would have been anti-dilutive totaled 5.1 million in 2006, 5.0 million in fiscal 2005 and 6.2 million in fiscal 2004.

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NAPSTER, INC.

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS—(Continued)

Stock-based compensation

Napster accounts for stock-based compensation to employees in accordance with intrinsic value method specified in APB No. 25, "Accounting for Stock Issued to Employees" ("APB No. 25"). Under APB No. 25, compensation expense is recognized based on the difference, if any, on the measurement date between the fair value of Napster's common stock and the amount an employee must pay to acquire the common stock. The compensation expense is recognized over the periods the employee performs the related services, generally the vesting period of four years.

Napster accounts for equity instruments issued to non-employees in accordance with the provisions of SFAS No. 123 and EITF 96-18, "Accounting for Equity Instruments that Are Issued to Other than Employees for Acquiring, or in Conjunction with Selling, Goods or Services" ("EITF 96-18"), which requires that such equity instruments are recorded at their fair value on the measurement date, which is typically the date of grant.

The following table illustrates the effect on net loss and net loss per share if Napster had applied the fair value recognition provisions of SFAS No. 123 to stock-based employee compensation (in thousands, except per share amounts):

	Year Ended March 31,		
	2006	2005	2004
Net loss, as reported	$(54,945)	$(29,506)	$(44,413)
Add:			
Stock-based compensation expense included in reported net loss	867	2,537	2,073
Deduct:			
Stock-based employee compensation expense determined under fair value method for all awards	(4,208)	(10,768)	(10,225)
Pro forma net loss	$(58,286)	$(37,737)	$(52,565)
Net loss per share:			
Basic and diluted—as reported	$ (1.28)	$ (0.82)	$ (1.62)
Basic and diluted—pro forma	$ (1.36)	$ (1.05)	$ (1.91)
Weighted average shares used in computing net income and pro forma net income per share:			
Basic and diluted shares	42,989	36,065	27,496

Napster uses the straight-line method to amortize its SFAS No. 123 pro forma stock–based compensation expense over the vesting period, which is generally four years for stock options and restricted stock awards, and over the applicable purchase period, which ranges from six months to two years, for employee stock purchase plan ("ESPP") stock purchase rights.

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NAPSTER, INC.

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS—(Continued)

The fair value of stock option and ESPP stock purchase rights is estimated on the date of grant using the Black-Scholes model. The following table sets forth the weighted-average assumptions used to calculate the fair value of the stock options and ESPP stock purchase rights.

	Year Ended March 31,		
	2006	2005	2004
Stock options:			
Expected volatility	95%	95%	105%
Risk-free interest rate	3.80%	3.32%	2.65%
Expected life	4 years	4 years	4 years
Expected dividend yield	zero	zero	zero
ESPP stock purchase rights:			
Expected volatility	81%	97%	105%
Risk-free interest rate	4.28%	2.48%	1.48%
Expected life	1.3 years	1.2 years	1.2 years
Expected dividend yield	zero	zero	zero

Under the Black-Scholes option pricing model, the weighted average fair value of stock options at date of grant was $4.26, $3.21 and $5.22 per share for options granted during fiscal 2006, 2005 and 2004, respectively. The weighted average fair value of stock purchase rights under the ESPP was $2.18, $2.59, and $3.32 per share during fiscal 2006, 2005, and 2004, respectively.

The fair value of restricted stock awards is measured at the market price of unrestricted stock on the grant date. The weighted average fair value of restricted stock awards was $4.15 per share during fiscal 2006. No restricted stock was awarded prior to fiscal 2006.

Recent accounting pronouncements

Share-Based Payments

On December 16, 2004, the FASB issued SFAS No. 123(R), "Share-Based Payment" ("SFAS No. 123(R)"), which revises the previously effective SFAS No. 123 and supersedes APB No. 25, and on March 29, 2005 the SEC issued SAB 107, "Share-Based Payment" (SAB 107"). These pronouncements address the accounting for share-based payment transactions in which an enterprise receives employee services in exchange for either equity instruments of the enterprise or liabilities that are based on the fair value of the enterprise's equity instruments or that may be settled by the issuance of such equity instruments. SFAS No. 123(R) eliminates the ability to account for share-based compensation transactions using APB No. 25 and generally requires that such transactions be accounted for using a fair value-based method and recognized as expenses in our consolidated statements of operations. The effective date of the proposed standard for public companies is for the first annual reporting period beginning after June 15, 2005. We are evaluating the requirements under SFAS No. 123(R) and expect the adoption in fiscal 2007 to have an adverse impact on our consolidated statements of operations and net income (loss) per share.

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NAPSTER, INC.

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS—(Continued)

NOTE 2—BUSINESS ACQUISITIONS

Acquisition of Napster, LLC, formerly known as Pressplay

In May 2003, Napster acquired substantially all of the ownership of Napster, LLC, a provider of an online music service formerly known as Pressplay. Napster, LLC was not affiliated with Napster, Inc. Pressplay served as the foundation for Napster's online music service which was launched on October 29, 2003 under the Napster brand. In consideration of the acquisition, Napster paid $12.5 million in cash, issued 3.9 million shares of Napster's common stock valued at $23.5 million and obligated itself to pay up to $12.4 million in contingent payments based on Napster's cumulative positive cash flows from the online music business.

Napster accounted for the acquisition of Napster, LLC using the purchase method of accounting. The results of operations and the estimated assets acquired and liabilities assumed have been included in Napster's financial statements from the date of acquisition. Management determined the allocation and estimate of fair value with the assistance of a third party independent appraiser. The allocation of the purchase price to the tangible and identifiable intangible assets acquired is summarized below (in thousands):

Calculation of purchase price:	
Value of stock consideration and acquisition costs	$23,487
Cash consideration	14,321
Total costs	$37,808
Allocation of purchase price:	
Current and other assets	$ 4,163
Property and equipment	4,144
Identifiable intangible asset—Trademark	300
Goodwill	34,658
Total assets acquired	43,265
Current liabilities	(5,457)
Net assets acquired	$37,808

The trademark was amortized on a straight-line basis over its estimated useful life of one year. In accordance with SFAS No. 142, goodwill is not amortized but is tested at least annually for impairment.

NOTE 3—DISCONTINUED OPERATIONS

As described in Note 1, on December 17, 2004 Napster sold substantially all of the assets and liabilities constituting CSD, including all of the capital stock of certain international subsidiaries historically included in CSD. The remaining international subsidiaries historically included in CSD were substantially liquidated as of December 17, 2004. Sonic paid a total of $74.7 million in cash and 653,837 shares of Sonic's common stock, valued at approximately $13.6 million as of the closing date.

The disposition is accounted for by Napster as a discontinued operation in accordance with SFAS No. 144. During fiscal 2005 Napster recognized a $30.4 million gain on the sale of CSD and deferred $2.1 million of possible gain pending agreement on certain adjustments pursuant to the divestiture agreement. On March 27, 2006, Napster and Sonic settled all adjustments described in the divestiture agreement for $2.4 million of cash payable to Napster. As of March 31, 2006, Napster's only ongoing obligation under the divestiture agreement relates to indemnifications described in Note 14.

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NAPSTER, INC.

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS—(Continued)

Operating Results of Discontinued Operations

Napster had no ongoing activity in the discontinued operation during fiscal 2006. The gain on divestiture in fiscal 2006 is comprised of the recognition of the $2.1 million deferred gain, the $2.4 million working capital adjustment, and other miscellaneous adjustments.

Summarized selected condensed consolidated statement of operations for the discontinued operations are as follows (in thousands):

	Year Ended March 31,		
	2006	2005	2004
Net revenues	$ —	$ 54,513	$87,332
Gross profit	—	39,551	61,546
Operating expenses	—	31,820	60,055
Gain on divestiture	5,370	30,395	—
Income from discontinued operations before income tax provision	5,370	40,325	11,464
Income tax provision	(2,456)	(18,398)	(9,461)
Net income from discontinued operations	$ 2,914	$ 21,927	$ 2,003

NOTE 4—CASH, CASH EQUIVALENTS AND INVESTMENTS

Cash and cash equivalents

Napster's cash and cash equivalents consist of the following (in thousands):

	March 31,	
	2006 Fair Value	2005 Fair Value
Cash	$ 6,359	$ 19,493
Cash equivalents:		
Commercial paper	22,773	3,541
Government securities	—	1,963
Certificates of deposit	1,106	—
Money market securities	16,574	110,419
Total cash equivalents	40,453	115,923
Total cash and cash equivalents	$ 46,812	$ 135,416

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NAPSTER, INC.
NOTES TO CONSOLIDATED FINANCIAL STATEMENTS—(Continued)

Short-term investments

Napster's short-term investments consist of the following (in thousands):

	March 31,	
	2006 Fair Value	2005 Fair Value
Commercial paper	$ 5,041	$ 4,561
Certificates of deposit	3,979	—
Corporate securities, including Sonic common stock	25,399	20,497
Municipal securities	9,815	1,059
U.S. agencies securities	5,578	6,263
	$ 49,812	$ 32,380

Napster's investments in marketable securities and short-term investments are all considered available for sale. The fair values of these investments approximate carrying value, and realized and unrealized gains and losses on investments are determined on the specific identification method.

Approximately $47.0 million and $20.6 million of the short-term investments mature in less than one year as of March 31, 2006 and 2005, respectively. The remaining short-term investments generally have effective maturity dates between one and two years. Because the short-term investments represent the investment of cash available to fund current operations, the entire balance has been classified as short-term in the balance sheet.

Realized gains and losses, amortization and accretion on cash equivalents and short-term investments, net, excluding the realized gain on the Sonic common stock, totaled $625,000, $506,000 and $23,000 in fiscal 2006, 2005 and 2004, respectively. Gross realized losses on short-term investments in fiscal 2006, 2005 and 2004 were not significant. Additionally, gross unrealized gains on cash equivalents and short-term investments, excluding the unrealized gain on the Sonic common stock, were $4,000 and $79,000 as of March 31, 2006 and March 31, 2005, respectively, and gross unrealized losses were $114,000 and $642,000 as of March 31, 2006 and March 31, 2005, respectively.

Napster has determined that the gross unrealized losses on its available-for-sale securities as of March 31, 2006 are temporary in nature. Napster has reviewed its investment portfolio to identify and evaluate investments that have indications of possible impairment. Factors considered in determining whether a loss is temporary include the magnitude of the decline in market value, the length of time the market value has been below cost (or adjusted cost), credit quality, and Napster's ability and intent to hold the securities for a period of time sufficient to allow for any anticipated recovery in market value. Based on this assessment, Napster concluded that no impairment has occurred.

Investment in Sonic Solutions and fair market hedge

Napster received 653,837 shares of unregistered common stock of Sonic as partial consideration for the sale of CSD. In December 2004, Napster entered into a fair value hedge to eliminate its exposure to changes in fair value of the Sonic common stock. As of the date of entering into the hedge, an unrealized gain of $1.2 million was included in accumulated other comprehensive income. At March 31, 2005, the fair market value of the hedge was $4.6 million. During December 2005, Napster terminated the hedge and sold the Sonic common stock, which resulted in the recognition of the $1.2 million gain in the consolidated statement of operations.

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NAPSTER, INC.

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS—(Continued)

Foreign Currency Conversion In Transit

As of March 31, 2006, a third party held $7.5 million in U.S. dollar funds that had been converted from Danish Kroner to U.S. dollars on March 30, 2006. The U.S. dollars were re-deposited into Napster's bank account in Denmark by the third party on April 3, 2006.

NOTE 5—BALANCE SHEET DETAIL

Prepaid expenses and other current assets (in thousands)

	March 31,	
	2006	2005
Prepaid marketing expense	$1,381	$3,081
Fair value hedge receivable	—	4,619
Receivable from Sonic related to divestiture	2,200	—
Other prepaid expense	2,601	2,075
	$6,182	$9,775

Property and equipment

		March 31,	
		2006	2005
	Life	(in thousands)	
Computer equipment and software	3-5 years	$10,142	$ 8,327
Furniture and fixtures	3-8 years	390	293
Leasehold improvements	Life of lease	785	640
Capitalized software development costs	3-5 years	3,494	562
		14,811	9,822
Less: Accumulated depreciation and amortization		(7,799)	(4,485)
Property and equipment, net		$ 7,012	$ 5,337

Depreciation expense in continuing operations totaled $3.3 million in fiscal 2006, $2.9 million in fiscal 2005 and $3.6 million in fiscal 2004. In connection with the CSD divestiture in fiscal 2005 we sold property and equipment totaling $10.3 million gross, net of $7.7 million of accumulated depreciation. The amortization of capitalized software development costs, included in depreciation expense in continuing operations, totaled $217,000 in fiscal 2006, $162,000 in fiscal 2005 and $106,000 in fiscal 2004. Unamortized capitalized software development costs were $3.0 million and $294,000 at March 31, 2006 and 2005, respectively.

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NAPSTER, INC.
NOTES TO CONSOLIDATED FINANCIAL STATEMENTS—(Continued)

Property and equipment acquired under capital leases

	Life	March 31, 2006	March 31, 2005
		(in thousands)	
Computer equipment and software:			
Gross book value	3-5 years	$ 673	$ 651
Less: accumulated depreciation		(385)	(167)
		$ 288	$ 484

Depreciation expense on property and equipment acquired under capital leases in continuing operations was $218,000, $237,000, and $98,000 during fiscal 2006, 2005, and 2004, respectively.

Accrued liabilities (in thousands)

	March 31, 2006	March 31, 2005
Accrued affiliate and content liabilities	$ 9,328	$ 5,327
Accrued publishing fees	3,949	784
Accrued compensation and related expenses	1,152	1,745
Other accrued liabilities	2,283	3,525
	$16,712	$11,381

Deferred revenue (in thousands)

	March 31, 2006	March 31, 2005
Unearned subscription revenue	$ 4,592	$2,117
Unredeemed pre-paid card and promotional content	6,929	4,732
Unearned hardware and license revenue	1,012	1,017
Other	291	479
	$12,824	$8,345

All but approximately $1 million of deferred revenue and other benefits as of March 31, 2005 were earned during fiscal 2006. All deferred revenue and other benefits as of March 31, 2006 are expected to be earned during fiscal 2007 as the services are delivered or the items otherwise qualify for revenue recognition in accordance with SAB 104.

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NAPSTER, INC.

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS—(Continued)

NOTE 6—INTANGIBLE ASSETS

At March 31, 2006, intangible assets, consisting primarily of trademarks, were fully amortized. At March 31, 2005, intangible assets had a gross and net book value of $6.4 million and $1.3 million, respectively. Amortization of intangible assets for continuing operations was $1.3 million in fiscal 2006, $2.1 million in fiscal 2005 and $2.3 million in fiscal 2004.

NOTE 7—INVESTMENT IN UNCONSOLIDATED ENTITY

On October 14, 2005, Napster, LLC, a subsidiary of Napster, entered into a Joint Venture Operating Agreement with Tower Records Japan, Inc. ("Tower Japan"), relating to the formation and operation of a Japan-based joint venture company (the "Joint Venture") for the purpose of operating the Napster online music service in Japan. Under the principal terms of this agreement, Napster, LLC licensed intellectual property rights to the Joint Venture, including platform technology and trademarks, in exchange for certain guaranteed royalties beginning in fiscal 2007, and Tower Japan will support the Joint Venture's marketing and advertising activities. The Joint Venture has exclusive rights to operate the Napster service in Japan.

On October 14, 2005, Napster, LLC contributed 151,200,000 Japanese Yen ($1.3 million at the exchange rate on the date the capital was contributed) to the Joint Venture, and on February 27, 2006 Napster, LLC contributed an additional 157,500,000 Japanese Yen ($1.4 million at the exchange rate on the date the capital was contributed) to the Joint Venture, in exchange for a 31.5% ownership interest. Tower Japan contributed a total of 671,300,000 Japanese Yen for a 68.5% ownership interest. The parties each have customary shareholder rights in the Joint Venture, including veto rights, rights to appoint directors and officers and rights of first refusal. Tower Japan is also obligated to arrange or provide debt or equity funding, including through an unsecured revolving loan facility. Napster, LLC has no obligation to fund future losses or provide contributions to Napster Japan other than the investments described above.

In addition to the principal terms of the agreement, the Joint Venture is required to reimburse Napster, LLC for the cost of bandwidth, hosting, and related expenses incurred by Napster, LLC in providing Napster services in Japan when launched plus 8% and (ii) for software development. During fiscal 2006, Napster LLC received a fee of 50,000,000 Japanese Yen ($424,000 at the exchange rate on the date of receipt) to localize its existing software for use by the end users in Japan.

The Joint Venture is a variable interest entity in accordance with FASB Interpretation 46(R), "Consolidation of Variable Interest Entities, an interpretation of ARB No. 51". Napster, LLC does not consolidate the Joint Venture because Napster, LLC is not the primary beneficiary. Napster has accounted for its investment in the Joint Venture as an equity method investment under APB No. 18, based on its ability to exert significant influence over but not control the Joint Venture. Under this method, Napster records its investment at the amount of capital contributed plus its percentage interest in the Joint Venture's income or loss. Any cumulative loss recorded by Napster is limited to its contributed capital because it is not obligated to provide additional capital contributions to the Joint Venture.

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NAPSTER, INC.

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS—(Continued)

NOTE 8—RESTRUCTURING

Napster records restructuring provisions in accordance with SFAS No. 146, "Accounting for Exit Costs Associated with Exit or Disposal Activities".

In fiscal 2006 Napster did not have any restructuring activity.

The following table summarizes Napster's total restructuring activity during fiscal 2005 (in thousands):

	Lease Termination Costs	Severance and Other Benefits	Other Costs	Total
Balance, March 31, 2004	$ 3,603	$ 1,233	$ 478	$ 5,314
Additional provision in discontinued operations	—	773	312	1,085
Adjustment to provision	(316)	—	—	(316)
Cash payments	(1,001)	(1,878)	(640)	(3,519)
Non cash items	116	9	(150)	(25)
Liabilities assumed by Sonic Solutions upon divestiture	(2,402)	(137)	—	(2,539)
Balance, March 31, 2005	$ —	$ —	$ —	$ —

As part of the sale of CSD's assets and liabilities to Sonic in fiscal 2005, Napster terminated certain employees and incurred a $721,000 restructuring charge as part of discontinued operations. Sonic agreed to reimburse Napster for all severance costs for individuals terminated in connection with the transaction and assumed all pending restructuring obligations. At March 31, 2005, the $721,000 reimbursement was recorded as an offset to the associated restructuring charge in discontinued operations. Additionally, as part of the divestiture, Sonic agreed to assume all liabilities related to restructured facilities. Accordingly, the restructure provision as of March 31, 2005 is zero.

In fiscal 2004, Napster recorded approximately $10.3 million of restructuring charges related to the reorganizations of its foreign and domestic operations, of which $9.2 million related to discontinued operations and $1.1 million related to continuing operations. The total restructuring charge included $3.7 million of severance and benefits related to the involuntary termination of 210 employees, $2.4 million of equipment write-offs, $3.4 million of unused facility lease write-offs, and $786,000 of miscellaneous legal, tax and other expense.

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NAPSTER, INC.

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS—(Continued)

NOTE 9—INCOME TAXES

The components of loss from continuing operations before provision for income taxes are as follows (in thousands):

	Year Ended March 31,		
	2006	2005	2004
Continuing operations:			
Domestic	$(57,603)	$(67,222)	$(50,931)
Foreign	(1,416)	242	—
Continuing operations	$(59,019)	$(66,980)	$(50,931)

The components of the income tax benefit from continuing operations are as follows (in thousands):

	Year Ended March 31,		
	2006	2005	2004
Federal:			
Current	$1,880	$15,355	$ 7,047
Deferred	(810)	(1,485)	(3,106)
Foreign:			
Current	(49)	(115)	—
Deferred	—	—	—
State:			
Current	255	2,004	1,028
Deferred	(116)	(212)	(454)
	$1,160	$15,547	$ 4,515

Significant components of Napster's deferred tax assets and liabilities are as follows (in thousands):

	March 31,	
	2006	2005
Net operating loss	$ 38,028	$ 15,576
Accrued liabilities and other provisions	3,534	1,500
Deferred revenue	3,458	3,252
Compensatory accruals	1,755	656
Tax credit carryforwards	1,594	1,594
Other, net	122	70
Total	48,491	22,648
Less: Valuation allowance	(48,491)	(22,648)
Deferred tax assets	—	—
Deferred tax liabilities associated with tax deductible goodwill	(2,622)	(1,696)
Net deferred tax assets (liabilities)	$ (2,622)	$ (1,696)

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NAPSTER, INC.

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS—(Continued)

Napster has established a valuation allowance against its gross deferred tax assets which are not deemed more likely than not to be recoverable prior to expiration. In establishing the valuation allowance, Napster considered, among other factors, its historical losses of the online music business, and projections for the future. The valuation allowance increased by $25.8 million, $3.5 million and $15 million during fiscal years 2006, 2005 and 2004, respectively.

During January 2005, following the divestiture of CSD, which utilized substantially all of our tax operating losses, Napster decided to make a tax election to step up the basis in Pressplay goodwill for tax purposes. As a result, the Pressplay goodwill is deductible for tax purposes, and in accordance with SFAS No. 109, this tax deduction represents a taxable temporary difference. As of December 31, 2004, due to our history of losses and the fact that this deferred tax liability would reverse only if the business was sold or the goodwill impaired, reversal of the deferred tax liability is not reasonably assured. Accordingly a deferred tax liability and related expense for this item of approximately $2.6 million has been recorded.

At March 31, 2006, Napster had approximately $75.2 million and $71.7 million in federal and state net operating loss carryforwards with expirations beginning in 2024 and 2014, respectively. Additionally, Napster had approximately $1.6 million in tax credit carryforwards with expirations beginning in 2007.

The income tax benefit differs from the amount computed by applying the federal statutory tax rate to the loss from continuing operations as follows:

	Year Ended March 31,		
	2006	2005	2004
Federal statutory rate	35.0%	35.0%	35.0%
State tax benefit, net of federal benefit	5.0%	5.0%	5.0%
Increase in valuation allowance	(38.0)%	(16.4)%	(30.4)%
Stock-based compensation	—%	(0.4)%	(0.7)%
Effective income tax rate	2.0%	23.2%	8.9%

Napster has not accrued income taxes on accumulated undistributed earnings from continuing operations of its non-U.S. subsidiaries, as these earnings will be reinvested indefinitely.

Napster does not anticipate that it will incur any material U.S. income or foreign withholding taxes when cash is repatriated to the United States.

No tax effect has been provided on the elements of other comprehensive income for any period shown. Accumulated other comprehensive income from most subsidiaries was considered permanently invested, and there were losses on the other taxable elements of other comprehensive income. Since realizability is not assured on those other comprehensive losses, no tax benefit was recorded.

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NAPSTER, INC.

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS—(Continued)

NOTE 10—SHORT-TERM DEBT

Napster has an agreement with Silicon Valley Bank to provide a $17.0 million revolving line of credit, collateralized by substantially all of Napster's assets. The line of credit bears interest at a variable rate of prime plus 0.50% per annum, expires in December 2006 and has a commitment fee equal to twenty-five hundredths of one percent (0.25%) of the daily average unused balance per annum. The line of credit contains a material adverse conditions clause and covenants that require Napster to maintain certain financial ratios. The covenants require at the end of each month and throughout the term of the agreement (i) a minimum tangible net worth of $45.0 million, (ii) a ratio of unrestricted cash, cash equivalents and short-term investments, plus 10% of net accounts receivable to total borrowings under the line of credit of not less than 2.00 to 1.00. In addition, the terms of the line of credit restrict Napster's ability to pay dividends. At March 31, 2005, Napster had borrowed $15.0 million under the line of credit, which was repaid in May 2005 plus $73,000 of accrued interest. At March 31, 2006, no amounts were borrowed under the line of credit, and Napster was in compliance with all financial covenants.

NOTE 11—STOCKHOLDERS' EQUITY

Preferred Stock

Napster is authorized to issue 10 million shares of preferred stock, $0.001 par value. No shares of preferred stock were issued or outstanding at March 31, 2006 and at March 31, 2005.

Common Stock

On January 24, 2005, Napster issued 7,100,000 shares of common stock in a private placement to certain accredited investors. The shares were sold at a price of $7.35 per share with gross proceeds of $52.2 million. The gross proceeds were reduced by placement fees and legal fees totaling approximately $3.6 million.

On June 17, 2004, Napster entered into a Common Stock Purchase Agreement with Best Buy Enterprise Services, Inc. ("Best Buy"). Under the terms of a related multi-year agreement, Best Buy Stores, L.P., an affiliate of Best Buy would promote Napster as its leading digital music service through comprehensive in-store marketing activities as well as extensive broadcast, print and online advertising. Best Buy would also market a co-branded version of Napster which would be made available to customers via retail locations and online through Bestbuy.com. On June 17, 2004, Napster issued approximately 1.1 million shares of common stock valued at approximately $5.0 million to Best Buy at a cash purchase price of $0.01 per share. The shares of common stock were valued based on the closing selling price per share as reported by the National Association of Securities Dealers on the NASDAQ National Market and published in The Wall Street Journal on the date the stock purchase agreement was signed. The difference between the fair value of the shares and the cash purchase price was recorded as a prepaid marketing expense upon issuance of the shares in June 2004.

In fiscal 2004, Napster issued a total of 9,500,000 shares of common stock in private placements to certain accredited investors. The shares were sold at prices of $4.10 and $5.50 per share with gross proceeds of $44.6 million. The gross proceeds were reduced by placement fees and legal and accounting fees that totaled approximately $3.5 million.

On November 15, 2002, Napster entered into an agreement to acquire certain assets of Napster, Inc. As part of the agreement, Napster, Inc. received a warrant to purchase 100,000 shares of Napster's common stock at a price equal to $3.12 per share. On November 29, 2004, this warrant was exercised in a cashless transaction for 66,227 shares of common stock.

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NAPSTER, INC.

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS—(Continued)

NOTE 12—EMPLOYEE BENEFIT PLANS

Stock Plans

Under various stock plans, the Company may grant incentive and non-qualified stock options, restricted stock awards and other equity based awards to Company employees, officers, directors and consultants. Options generally vest 25% on the first anniversary of the grant and 6.25% per quarter thereafter for the next twelve quarters. Options generally have a term of ten years from the date of grant. The Board of Directors establishes the exercise price of stock options, which generally is not less than the fair market value of the Company's stock on the date of grant. Restricted stock awards granted to employees generally vest ratably over a four year period in equal annual cliffs, are forfeited if the employee leaves the Company prior to vesting and have full voting rights until forfeited.

On October 24, 2005 the Company amended its Napster, Inc. 2001 Stock Plan to provide, effective January 1, 2006, the granting of restricted stock awards to non-employee directors in lieu of granting stock options. The restricted stock awards granted to non-employee directors vest ratably over a four year period in equal quarterly cliffs, are forfeited upon termination of services on the Board of Directors prior to vesting, and have full voting rights until forfeited.

In fiscal 2006, the Company issued a total of 801,713 shares of restricted stock, net of forfeitures, having an average fair value per share of $4.15. Of the shares of restricted stock issued during the year, 16,903 shares were fully vested as of March 31, 2006. As of March 31, 2006, approximately 10.2 million shares of common stock were reserved for issuance under the various stock plans, including 5.9 million shares available for future grant.

The Company's stock plans provide that stock options and restricted stock awards will be vested in full in the event of a change in control, as defined in the respective stock plan. During December 2004, in connection with the CSD divestiture, which did not qualify as a change in control event under the stock plans, the Board authorized that all stock options for terminated CSD employees would be vested in full as of the employee's termination date. The vesting of options to purchase a total of 728,420 shares of common stock was accelerated pursuant to this authorization, and, in accordance with APB No. 25 and FIN No. 44, "Accounting for Certain Transactions Involving Stock Compensation", the Company recorded a $1.7 million stock based compensation charge in results from discontinued operations in fiscal 2005.

On December 13, 2004, an outside consultant was granted options to purchase 40,000 shares of common stock. This option grant has been accounted for in accordance with EITF 96-18. Approximately $14,000 and $34,000 of stock-based compensation was recorded during fiscal 2006 and 2005 associated with this option grant.

On January 2, 2006, the Company entered into a consulting agreement with a member of its Board of Directors. Pursuant to the terms of the consulting agreement, the Company awarded 16,903 shares of fully vested restricted common stock valued at approximately $60,000 in exchange for consulting services through March 31, 2006. In accordance with EITF 96-18, approximately $60,000 of stock-based compensation was recorded in fiscal 2006 associated with this award.

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NAPSTER, INC.
NOTES TO CONSOLIDATED FINANCIAL STATEMENTS—(Continued)

During fiscal 2004, the Board of Directors granted to our chief executive officer options to purchase 300,000 shares of common stock. This grant was contingent upon the approval by stockholders. The options were granted at a price below the fair market value on the date of the stockholders' approval, which resulted in an $897,000 deferred stock compensation charge. This amount is being amortized over the vesting period of the options. Approximately $224,000, $224,000 and $140,000 of amortization expense was recorded and included in stock-based compensation charges in fiscal 2006, 2005 and 2004, respectively.

The following table summarizes information about stock option activity under Napster's stock plans:

	Year Ended March 31, 2006		Year Ended March 31, 2005		Year Ended March 31, 2004	
	Number of Shares	Weighted Average Exercise Price	Number of Shares	Weighted Average Exercise Price	Number of Shares	Weighted Average Exercise Price
Outstanding, beginning of year	5,016,826	$ 7.48	5,960,184	$ 9.13	6,254,579	$ 9.38
Granted:						
At fair market value	9,000	$ 6.25	1,944,100	$ 4.71	1,294,850	$ 7.24
At less than fair market value	—		—		300,000	$ 7.47
Exercised	—		(1,026,691)	$ 4.69	(294,846)	$ 5.80
Canceled	(704,189)	$ 7.26	(1,860,767)	$ 11.39	(1,594,399)	$ 8.83
Outstanding, end of year	4,321,637	$ 7.52	5,016,826	$ 7.48	5,960,184	$ 9.13
Exercisable, end of year	3,028,677	$ 8.52	2,320,244	$ 9.85	3,030,681	$ 10.22
Weighted average fair value of options granted during the year:						
At fair market value		$ 4.26		$ 3.26		$ 5.22
At less than fair market value		$ —		$ —		$ 7.47

The following table summarizes information about stock options outstanding as of March 31, 2006:

	Options Outstanding			Options Exercisable	
Range of Exercise Prices	Number Outstanding	Weighted Average Remaining Contractual Life (in years)	Weighted Average Exercise Price	Number Exercisable	Weighted Average Exercise Price
$3.48–$4.09	556,579	6.72	$ 3.89	431,898	$ 3.88
$4.13	1,152,329	8.35	$ 4.13	467,174	$ 4.13
$4.23–$7.22	269,630	7.81	$ 4.91	138,833	$ 4.95
$7.47	738,812	7.43	$ 7.47	493,687	$ 7.47
$7.78–$8.37	101,750	8.77	$ 8.09	34,188	$ 8.05
$8.50	668,850	5.05	$ 8.50	668,850	$ 8.50
$8.84–$16.55	833,687	5.75	$ 14.66	794,047	$ 14.92
	4,321,637	6.95	$ 7.52	3,028,677	$ 8.52

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NAPSTER, INC.

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS—(Continued)

Employee Stock Purchase Plan

In April 2001, the Board of Directors adopted and the sole shareholder approved the 2001 Employee Stock Purchase Plan (the "ESPP"). On April 1 of each year, the number of shares reserved for issuance under the ESPP will automatically increase by the lesser of 100,000 shares, 1.5% of the common shares outstanding on March 31 of that year or a number of shares determined by the Board of Directors. Additional shares may be reserved for issuance under the ESPP when approved by the shareholders. Offering periods are generally 24 months long and consist of four six-month purchase periods. Napster employees generally may contribute up to 10% of their base compensation to the purchase of Napster stock at a purchase price equal to 85% of the market price at the beginning of the offering period or the end of the purchase period, whichever price is lower. A total of 63,303 shares, 125,466 shares and 259,958 shares were issued under the ESPP in fiscal year 2006, 2005 and 2004, respectively. At March 31, 2006, 357,216 shares of common stock remained available for future issuance.

NOTE 13—BUSINESS SEGMENT AND GEOGRAPHIC INFORMATION

Segment information

Effective December 17, 2004, Napster operates in a single segment. Prior to December 17, 2004, Napster operated its business in two reportable segments or divisions: CSD and the online music distribution division. Following the sale of the CSD, only one reportable segment remains.

Geographic information

Net revenue, by countries

The following table presents net revenues from continuing operations by country based on the location of customers (in thousands):

	Year Ended March 31,		
	2006	2005	2004
United States	$83,054	$41,842	$11,964
United Kingdom	11,637	4,887	—
	$94,691	$46,729	$11,964

Cash and investments

The following table presents cash, cash equivalents, foreign currency conversion in transit and short-term investments by the country where the funds were held (in thousands):

	March 31,	
	2006	2005
United States	$ 93,948	$156,259
United Kingdom	1,837	3,242
Denmark	7,545	7,659
Other countries	839	636
	$104,169	$167,796

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NAPSTER, INC.

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS—(Continued)

Napster does not anticipate that it will incur any material U.S. income or foreign withholding taxes when cash is repatriated to the United States.

Long-lived assets

The following table presents long-lived assets, excluding goodwill and identifiable intangible assets, by country based on the location of the assets (in thousands):

	March 31,	
	2006	2005
United States	$7,201	$5,726
United Kingdom	86	33
	$7,287	$5,759

NOTE 14—COMMITMENTS AND CONTINGENCIES

Lease commitments

Napster leases its operating facilities and certain equipment under non-cancelable operating leases, which expire at various dates ranging from fiscal 2007 through fiscal 2011. Rent expense under all operating leases included in continuing operations was $1.5 million, $1.2 million and $1.1 million in fiscal 2006, 2005 and 2004, respectively.

At March 31, 2006, the future minimum lease payments under non-cancelable operating leases total $1.2 million, $258,000 and $146,000 for fiscal 2007, 2008 and 2009 and later, respectively.

Obligations to content and distribution providers

Napster has certain royalty commitments associated with the licensing of the music content. Future payments under these content agreements are due to partners based upon net revenues and online music distribution volumes.

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NAPSTER, INC.
NOTES TO CONSOLIDATED FINANCIAL STATEMENTS—(Continued)

Litigation

Napster and Pressplay have been notified by a number of companies that the Pressplay and Napster digital music services may infringe patents owned by those companies. Napster is investigating the nature of these claims and the extent to which royalties may be owed by Napster and Pressplay to these entities. The ultimate resolution of these claims cannot be determined at this time.

On October 8, 2004, SightSound Technologies, Inc. ("SightSound") filed a lawsuit against Napster and Napster, LLC in U.S. District Court for the Western District of Pennsylvania, Case No. 04-1549, alleging infringement of certain of its patents by the Napster service. SightSound is demanding monetary damages and injunctive relief. Napster was served with the complaint in the lawsuit on November 5, 2004. Napster has answered the complaint and filed an application with the United States Patent and Trademark Office for reexamination of the patents. In January 2005 Napster moved for a stay of the proceedings pending the outcome of Napster's reexamination application. On February 28, 2005, the court granted Napster's motion to stay. On March 22, 2005, SightSound filed a Petition to Cancel certain trademark registrations owned by Napster before the Trademark Trial and Appeals Board ("TTAB"), claiming that Napster did not acquire the rights to these trademarks when it purchased them through the bankruptcy estate. Napster believes that this petition is entirely without merit, and it has been stayed by TTAB pending resolution of the litigation in Pennsylvania. On May 19, 2005, Napster filed a motion with the U.S. Bankruptcy Court for the District of Delaware to reopen the Napster bankruptcy case and enforce the order assigning all of the assets of the former Napster, Inc. (including trademarks and goodwill) to us. On August 23, 2005, an order confirming the sale to Napster of the Napster trademarks, including goodwill, was granted by the Bankruptcy Court. In or around November 2005, SightSound sold the patents in question to a subsidiary of General Electric for an undisclosed amount. Management believes that it is not currently possible to estimate the impact, if any, that the ultimate resolution of these matters will have on Napster's business, results of operations, financial position or cash flows.

On August 5, 2005, Ho Keung Tse filed suit against Apple Computer, Inc., Napster, MusicMatch, Inc., Sony Connect, Inc., Yahoo, Inc. and RealNetworks, Inc. in U.S. District Court for the District of Maryland alleging infringement of U.S. Patent No. 6665797 by the defendants' respective music distribution services. Mr. Tse is demanding monetary damages and injunctive relief. The defendants have formed a joint defense group, have moved for change of venue, and intend to defend themselves vigorously. Management believes that it is not currently possible to estimate the impact, if any, that the ultimate resolution of these matters will have on Napster's business, results of operations, financial position or cash flows.

Napster is a party to other litigation matters and claims from time to time in the ordinary course of its operations, including copyright infringement litigation for which it is entitled to indemnification by content providers. While the results of such litigation and claims cannot be predicted with certainty, Napster believes that the final outcome of such matters will not have a material adverse impact on its business, financial position, cash flows or results of operations.

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NAPSTER, INC.

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS—(Continued)

Indemnification

Napster has agreed pursuant to the CSD divestiture agreement to indemnify Sonic for breaches of representations and warranties (other than those breaches related to tax matters) and covenants contained in the agreement, for undisclosed liabilities, and for defects with respect to the financial statements provided to Sonic relating to CSD. The agreement limits the maximum amount of potential future payments and the time period during which a claim may be made.

In addition, Napster has agreed to indemnify Sonic for unpaid tax liabilities with respect to any tax year ended on or before December 17, 2004 (or for any other tax year to the extent allocable to the portion of such period beginning before and ending on December 17, 2004), to the extent such tax liabilities neither are reflected in the closing working capital calculation pursuant to the agreement nor create a realized reduction in Sonic's tax liabilities. Napster will also indemnify Sonic for damages that relate to certain other tax-related matters, as described in the agreement. No limitation is set forth on the period of time by which a claim must be made pursuant to the foregoing indemnities nor is there a specified limitation on the maximum amount of potential future payments.

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SCHEDULE II
VALUATION AND QUALIFYING ACCOUNTS AND RESERVES
(In thousands)

Description	Beginning of Period	Additions	Deductions	Divestiture	End of Period
Allowance for bad debt:					
Year ended March 31, 2004	$ 850	(75)	216	—	$ 991
Year ended March 31, 2005	$ 991	(42)	(274)	(669)	$ 6
Year ended March 31, 2006	$ 6	1	—	—	$ 7
Allowance for sales returns and certain sales incentives					
Year ended March 31, 2004	$ 5,559	22,226	(18,619)	—	$ 9,166
Year ended March 31, 2005	$ 9,166	5,814	(8,595)	(6,385)	$ —
Year ended March 31, 2006	$ —	—	—	—	$ —
Deferred tax valuation allowance:					
Year ended March 31, 2004	$ 4,020	15,066	—	—	$19,086
Year ended March 31, 2005	$ 19,086	3,562	—	—	$22,648
Year ended March 31, 2006	$ 22,648	25,843	—	—	$48,491

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SIGNATURES AND POWER OF ATTORNEY

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

NAPSTER, INC.

By: /s/ WM. CHRISTOPHER GOROG	By: /s/ NAND GANGWANI
Wm. Christopher Gorog Chief Executive Officer and Chairman of the Board of Directors (Principal Executive Officer) Date: June 9, 2006	Nand Gangwani Vice President and Chief Financial Officer (Principal Financial and Accounting Officer) Date: June 9, 2006

Pursuant to the requirements of the Securities Exchange Act of 1934, this report has been signed below by the following persons on behalf of the registrant and in the capacities and on the dates indicated. Each person whose signature appears below hereby authorizes and appoints Wm. Christopher Gorog and Nand Gangwani, or either of them, as attorneys-in-fact and agents to execute and file with the applicable regulatory authorities any amendment to this report on his behalf individually and in each capacity stated below.

Name	Title	Date
/s/ WM. CHRISTOPHER GOROG Wm. Christopher Gorog	Chief Executive Officer and Chairman of the Board of Directors (Principal Executive Officer)	June 9, 2006
/s/ NAND GANGWANI Nand Gangwani	Vice President and Chief Financial Officer (Principal Financial and Accounting Officer)	June 9, 2006
/s/ VERNON E. ALTMAN Vernon E. Altman	Director	June 9, 2006
/s/ RICHARD J. BOYKO Richard J. Boyko	Director	June 9, 2006
/s/ PHILIP J. HOLTHOUSE Philip J. Holthouse	Director	June 9, 2006
/s/ JOSEPH C. KACZOROWSKI Joseph C. Kaczorowski	Director	June 9, 2006
/s/ BRIAN C. MULLIGAN Brian C. Mulligan	Director	June 9, 2006
/s/ ROBERT RODIN Robert Rodin	Director	June 9, 2006

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NAPSTER, INC.
INDEX TO EXHIBITS

Exhibit Number	Description of Exhibit
2.1	Purchase Agreement among the Registrant, UMG Duet Holdings, Inc., a Delaware corporation, and SMEI Duet Holdings, Inc., a Delaware corporation, dated May 19, 2003 (1)
2.2	Amended and Restated Asset Purchase Agreement between the Company and Sonic Solutions, dated December 17, 2004 (2)
3.1	Amended and Restated Certificate of Incorporation of the Registrant (3)
3.2	Amended and Restated Bylaws of the Registrant (4)
3.3	Certificate of Designation of Rights, Preferences and Privileges of Series A Participating Preferred Stock of Roxio, Inc. (5)
4.1	Form of Common Stock certificate of the Registrant (2)
4.2	Preferred Stock Rights Agreement, dated as of May 18, 2001, between Registrant and Mellon Investor Services, LLC, including the Certificate of Designation, the form of Rights Certificate and the Summary of Rights attached thereto as Exhibits A, B, and C, respectively (5)
4.3	Form of Purchase Agreement dated as of June 18, 2003 by and between the Registrant and certain Purchasers set forth on the signature page thereto (6)
4.4	Amended and Restated LLC Operating Agreement of Napster, LLC dated May 19, 2003 by and between Registrant, UMG Duet Holdings, Inc. and SMEI Duet Holdings, Inc. (4)
4.5	Form of Purchase Agreement dated as of January 13, 2004 by and between Napster and certain Purchasers set forth on the signature page thereto (7)
4.6	Registration Rights Agreement dated June 17, 2004 between the Registrant and Best Buy Enterprise Services Inc. (8)
4.7	Common Stock Purchase Agreement between Registrant and Best Buy Enterprise Services Inc. dated June 17, 2004 (8)
4.8	Form of Purchase Agreement dated as of January 20, 2005 by and between Registrant and certain Investors (9)
10.1	Amended and Restated 2001 Employee Stock Purchase Plan* (13)
10.2	Amended and Restated 2000 Stock Option Plan* (3)
10.3	Form of 2000 Stock Option Plan Agreements* (3)
10.4	Amended and Restated 2001 Director Option Plan* (4)
10.5	Form of 2001 Director Option Plan Agreements* (3)
10.6	Form of Indemnification Agreement between the Registrant and each of its directors and executive officers* (3)
10.7	Employment agreement effective as of August 15, 2003 between Wm. Christopher Gorog and the Registrant* (10)
10.8	Form of 2001 Stock Plan Option Agreements* (3)
10.9	2002 Stock Plan* (11)
10.10	Asset Purchase Agreement dated April 17, 2003 by and between Registrant, Roxio CI Ltd., Wildfile, Inc. Symantec Ltd. and Symantec Corporation (12)
10.11	2003 Stock Plan* (13)
10.12	Employment Agreement effective as of November 14, 2003 between Nand Gangwani and the Registrant* (14)

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Exhibit Number	Description of Exhibit
10.13	Employment agreement dated January 29, 2004 between Bradford D. Duea and the Registrant* (15)
10.14	Employment agreement dated January 29, 2004 between Laura B. Goldberg and the Registrant* (15)
10.15	Loan and Security Agreement between Registrant and Silicon Valley Bank dated March 25, 2004 (15)
10.16	Form of 2003 Stock Plan Agreements* (15)
10.17	First Amendment dated December 17, 2004 to Loan and Security Agreement by and among Registrant, Napster, LLC and Silicon Valley Bank dated March 25, 2004 (2)
10.18	Additional Borrower Joinder Supplement by and among Registrant, Napster LLC and Silicon Valley Bank dated December 17, 2004 (16)
10.19	Loan Modification and Consent Agreement by and among Registrant, Napster, LLC, and Silicon Valley Bank dated December 17, 2004 (16)
10.20	Standard Industrial/Commercial Single-Tenant Lease, between Registrant and Fox & Fields, dated September 7, 2001 (16)
10.21	Lease Extension and Lease Guaranty of Registrant, between Registrant and Fox & Fields, dated January 5, 2005 (16)
10.22	Form of Napster, Inc. Amended and Restated 2001 Stock Plan Restricted Stock Award Agreement (17)
10.23	Letter Agreement between the Company and Wm. Christopher Gorog, dated May 31, 2005 (17)
10.24	Joint Venture Operating Agreement dated as of October 14, 2005 between Napster, LLC and Tower Records Japan, Inc., Nikko Principal Investments Japan, Ltd. and Napster Japan, Inc.** (18)
10.25	License Agreement dated as of October 14, 2005 between Napster, LLC and Tower Records Japan, Inc.** (18)
10.26	Amended and Restated Napster, Inc. 2001 Stock Plan (19)
10.27	Form of Director Restricted Stock Award Agreement (19)
10.28	Consulting Agreement dated January 2, 2006, between Robert Rodin and Registrant
14.1	Amended and Restated Napster Code of Conduct
21.1	List of Subsidiaries
23.1	Consent of Independent Registered Public Accounting Firm
31.1	Certification of Chief Executive Officer required pursuant to Section 302 of the Sarbanes-Oxley Act of 2002
31.2	Certification of Chief Financial Officer required pursuant to Section 302 of the Sarbanes-Oxley Act of 2002
32.1	Certification pursuant to 18 U.S.C. Section 1350, as adopted pursuant to Section 906 of the Sarbanes-Oxley Act of 2002

* Management contract or compensatory plan or arrangement required to be filed as an exhibit to the Company's Annual Report on Form 10-K.

** Pursuant to 17 CFR 240.24b-2, confidential information has been omitted and has been filed separately with the Securities and Exchange Commission pursuant to a Confidential Treatment Application filed with the Commission.

(1) Incorporated by reference to the Registrant's Current Report on Form 8-K as filed with the Securities and Exchange Commission on May 19, 2003.

(2) Incorporated by reference to the Registrant's Current Report on Form 8-K as filed with the Securities and Exchange Commission on December 23, 2004.

(3) Incorporated by reference to the Registrant's Form 10 Registration Statement (No. 000-32373) as filed with the Securities and Exchange Commission on May 15, 2001.

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(4) Incorporated by reference to the Registrant's Annual Report on Form 10-K as filed with the Securities and Exchange Commission on June 30, 2003.
(5) Incorporated by reference to the Registrant's Registration Statement on Form 8-A as filed with the Securities and Exchange Commission on June 5, 2001.
(6) Incorporated by reference to the Registrant's Current Report on Form 8-K as filed with the Securities and Exchange Commission on June 20, 2003.
(7) Incorporated by reference to the Registrant's Current Report on Form 8-K as filed with the Securities and Exchange Commission on January 13, 2004.
(8) Incorporated by reference to the Registrant's Registration Statement on Form S-3 (No. 333-117520) as filed with the Securities and Exchange Commission on July 20, 2004.
(9) Incorporated by reference to the Registrant's Current Report on Form 8-K as filed with the Securities and Exchange Commission on January 21, 2005.
(10) Incorporated by reference to the Registrant's Quarterly Report on Form 10-Q as filed with the Securities and Exchange Commission on November 14, 2003.
(11) Incorporated by reference to the Registrant's Registration Statement on Form S-8 as filed with the Securities and Exchange Commission on January 28, 2002.
(12) Incorporated by reference to the Registrant's Current Report on Form 8-K as filed with the Securities and Exchange Commission on April 18, 2003.
(13) Incorporated by reference to the Registrant's Proxy Statement on Schedule 14A for the 2003 Annual Meeting of Stockholders as filed with the Securities and Exchange Commission on August 18, 2003.
(14) Incorporated by reference to the Registrant's Quarterly Report on Form 10-Q as filed with the Securities and Exchange Commission on February 17, 2004.
(15) Incorporated by reference to the Registrant's Annual Report on Form 10-K as filed with the Securities and Exchange Commission on June 14, 2004.
(16) Incorporated by reference to the Registrant's Registration Statement on Form S-3 (No. 333-122658) as filed with the Securities and Exchange Commission on February 9, 2005.
(17) Incorporated by reference to the Registrant's Current Report on Form 8-K as filed with the Securities and Exchange Commission on June 6, 2005.
(18) Incorporated by reference to the Registrant's Quarterly Report on Form 10-Q as filed with the Securities and Exchange Commission on February 8, 2006.
(19) Incorporated by reference to the Registrant's Current Report on Form 8-K as filed with the Securities and Exchange Commission on October 24, 2005.

E

This exhibit contains restricted information that is subject to a confidentiality agreement and has been redacted from the publicly filed version

F

This exhibit contains restricted information that is subject to a confidentiality agreement and has been redacted from the publicly filed version