

# SCO GROUP INC

## FORM 10-Q (Quarterly Report)

Filed 9/18/2007 For Period Ending 7/31/2007

Address	355 S 520 W, SUITE 100 LINDON, Utah 84042
Telephone	801-765-4999
CIK	0001102542
Industry	Software & Programming
Sector	Technology
Fiscal Year	10/31

Powered By **EDGAR**Online

<http://www.edgar-online.com/>

© Copyright 2006. All Rights Reserved.

Distribution and use of this document restricted under EDGAR Onlines Terms of Use.



---

---

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 July 31, 2007

OR

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

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

Commission file number 0-29911

**THE SCO GROUP, INC.**

(Exact name of registrant as specified in its charter)

Delaware  
(State or other jurisdiction of  
incorporation or organization)

87-0662823  
(I.R.S. Employer Identification Number)

355 South 520 West  
Suite 100  
Lindon, Utah 84042  
(Address of principal executive offices and zip code)

(801) 765-4999  
(Registrant's telephone number, including area code)

Indicate by check mark whether the Registrant (1) has filed all reports required to be filed by Section 13 or 15(d) of the Securities Exchange Act of 1934 during the preceding 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). (Check one): YES  NO

As of September 12, 2007, there were 21,484,761 shares outstanding of the Registrant's common stock, \$0.001 par value per share.

---

---

**The SCO Group, Inc.**

**Table of Contents**

	<u>Page Number</u>
<b>PART I. FINANCIAL INFORMATION</b>	
Item 1. Unaudited Financial Statements	
Condensed Consolidated Balance Sheets as of July 31, 2007 and October 31, 2006	3
Condensed Consolidated Statements of Operations and Comprehensive Loss for the three and nine months ended July 31, 2007 and 2006	4
Condensed Consolidated Statements of Cash Flows for the nine months ended July 31, 2007 and 2006	5
Notes to Condensed Consolidated Financial Statements	6
Item 2. Management's Discussion and Analysis of Financial Condition and Results of Operations	18
Item 3. Quantitative and Qualitative Disclosures About Market Risk	36
Item 4. Controls and Procedures	37
<b>PART II. OTHER INFORMATION</b>	
Item 1. Legal Proceedings	37
Item 1A. Risk Factors	38
Item 6. Exhibits	47
Signatures	48
EXHIBIT 31.1	
EXHIBIT 31.2	
EXHIBIT 32.1	
EXHIBIT 32.2	

**THE SCO GROUP, INC. AND SUBSIDIARIES**  
**CONDENSED CONSOLIDATED BALANCE SHEETS**  
(in thousands, except per share data)

	<i>July 31,</i> <u>2007</u>	<i>October 31,</i> <u>2006</u>
<b>ASSETS</b>		
<b>CURRENT ASSETS:</b>		
Cash and cash equivalents	\$ 7,393	\$ 5,369
Restricted cash	3,020	8,024
Available-for-sale marketable securities	—	2,249
Accounts receivable, net of allowance for doubtful accounts of \$87 and \$106, respectively	3,133	5,123
Other	<u>1,328</u>	<u>1,514</u>
Total current assets	<u>14,874</u>	<u>22,279</u>
<b>PROPERTY AND EQUIPMENT:</b>		
Computer and office equipment	1,990	2,259
Leasehold improvements	266	316
Furniture and fixtures	<u>78</u>	<u>78</u>
	2,334	2,653
Less accumulated depreciation and amortization	<u>(1,918)</u>	<u>(2,045)</u>
Net property and equipment	<u>416</u>	<u>608</u>
<b>OTHER ASSETS</b>		
	<u>504</u>	<u>522</u>
Total assets	<u>\$ 15,794</u>	<u>\$ 23,409</u>
<b>LIABILITIES AND STOCKHOLDERS' EQUITY</b>		
<b>CURRENT LIABILITIES:</b>		
Accounts payable	\$ 1,944	\$ 2,338
Payable to Novell, Inc.	431	2,978
Accrued payroll and benefits	1,380	2,507
Accrued liabilities	2,805	3,059
Deferred revenue	2,561	2,994
Royalties payable	249	439
Income taxes payable	<u>767</u>	<u>820</u>
Total current liabilities	<u>10,137</u>	<u>15,135</u>
LONG-TERM LIABILITIES	<u>186</u>	<u>192</u>
<b>COMMITMENTS AND CONTINGENCIES (Note 3)</b>		
<b>STOCKHOLDERS' EQUITY:</b>		
Common stock, \$0.001 par value; 45,000 shares authorized, 21,782 and 21,391 shares outstanding, respectively	22	21
Additional paid-in capital	262,158	260,259
Common stock held in treasury, 297 shares	(2,446)	(2,446)
Warrants outstanding	856	856
Accumulated other comprehensive income	986	932
Accumulated deficit	<u>(256,105)</u>	<u>(251,540)</u>
Total stockholders' equity	<u>5,471</u>	<u>8,082</u>
Total liabilities and stockholders' equity	<u>\$ 15,794</u>	<u>\$ 23,409</u>

See accompanying notes to condensed consolidated financial statements.

**THE SCO GROUP, INC. AND SUBSIDIARIES**  
**CONDENSED CONSOLIDATED STATEMENTS OF OPERATIONS AND COMPREHENSIVE LOSS**  
(in thousands, except per share data)

	<i>Three Months Ended July 31,</i>		<i>Nine Months Ended July 31,</i>	
	<u>2007</u>	<u>2006</u>	<u>2007</u>	<u>2006</u>
<b>REVENUE:</b>				
Products	\$ 3,690	\$ 6,201	\$ 13,451	\$ 17,904
SCOsourcelicensing	—	31	23	95
Services	996	1,189	3,241	3,891
Total revenue	<u>4,686</u>	<u>7,421</u>	<u>16,715</u>	<u>21,890</u>
<b>COST OF REVENUE:</b>				
Products	329	478	1,041	1,559
SCOsourcelicensing	1,156	2,315	2,876	10,087
Services	448	666	1,553	2,012
Total cost of revenue	<u>1,933</u>	<u>3,459</u>	<u>5,470</u>	<u>13,658</u>
<b>GROSS MARGIN</b>	<u>2,753</u>	<u>3,962</u>	<u>11,245</u>	<u>8,232</u>
<b>OPERATING EXPENSES:</b>				
Sales and marketing	2,463	3,111	7,296	8,656
Research and development	1,424	2,029	4,737	5,786
General and administrative	1,377	1,829	4,051	5,139
Amortization of intangibles	—	593	—	1,778
Total operating expenses	<u>5,264</u>	<u>7,562</u>	<u>16,084</u>	<u>21,359</u>
<b>LOSS FROM OPERATIONS</b>	<u>(2,511)</u>	<u>(3,600)</u>	<u>(4,839)</u>	<u>(13,127)</u>
<b>EQUITY IN INCOME (LOSS) OF AFFILIATE</b>	<u>9</u>	<u>—</u>	<u>115</u>	<u>(8)</u>
<b>OTHER INCOME (EXPENSE):</b>				
Interest income	112	191	351	542
Other income (expense), net	20	(64)	29	46
Total other income, net	<u>132</u>	<u>127</u>	<u>380</u>	<u>588</u>
<b>LOSS BEFORE PROVISION FOR INCOME TAXES</b>	(2,370)	(3,473)	(4,344)	(12,547)
<b>PROVISION FOR INCOME TAXES</b>	<u>(28)</u>	<u>(107)</u>	<u>(221)</u>	<u>(308)</u>
<b>NET LOSS</b>	<u>\$ (2,398)</u>	<u>\$ (3,580)</u>	<u>\$ (4,565)</u>	<u>\$ (12,855)</u>
<b>BASIC AND DILUTED NET LOSS PER COMMON SHARE</b>	<u>\$ (0.11)</u>	<u>\$ (0.17)</u>	<u>\$ (0.21)</u>	<u>\$ (0.62)</u>
<b>WEIGHTED AVERAGE BASIC AND DILUTED COMMON SHARES OUTSTANDING</b>	<u>21,372</u>	<u>21,063</u>	<u>21,264</u>	<u>20,703</u>
<b>OTHER COMPREHENSIVE LOSS:</b>				
Net loss	\$ (2,398)	\$ (3,580)	\$ (4,565)	\$ (12,855)
Foreign currency translation adjustment	21	37	54	57
Unrealized gain on available-for-sale marketable securities	—	4	—	49
<b>COMPREHENSIVE LOSS</b>	<u>\$ (2,377)</u>	<u>\$ (3,539)</u>	<u>\$ (4,511)</u>	<u>\$ (12,749)</u>

See accompanying notes to condensed consolidated financial statements.

**THE SCO GROUP, INC. AND SUBSIDIARIES**  
**CONDENSED CONSOLIDATED STATEMENTS OF CASH FLOWS**  
(in thousands)

	<i>Nine Months Ended July 31,</i>	
	<u>2007</u>	<u>2006</u>
<b>CASH FLOWS FROM OPERATING ACTIVITIES:</b>		
Net loss	\$ (4,565)	\$(12,855)
Adjustments to reconcile net loss to net cash used in operating activities:		
Stock-based compensation	1,407	1,323
Depreciation and amortization	239	226
Loss on disposition of long-lived assets	35	8
Equity in (income) loss of affiliate	(115)	8
Amortization of intangibles (including \$0 and \$252 classified as cost of SCOsource licensing revenue)	—	2,030
Changes in operating assets and liabilities:		
Restricted cash	2,457	1,314
Accounts receivable, net	1,990	2,271
Other current assets	319	734
Accounts payable	(394)	42
Accrued payroll and benefits	(1,127)	(922)
Accrued liabilities	(254)	(31)
Deferred revenue	(433)	(966)
Royalties payable	(190)	(134)
Income taxes payable	(53)	13
Long-term liabilities	(6)	(111)
Net cash used in operating activities	<u>(690)</u>	<u>(7,050)</u>
<b>CASH FLOWS FROM INVESTING ACTIVITIES:</b>		
Purchase of property and equipment	(81)	(265)
Dividend received	—	308
Purchase of available-for-sale marketable securities	—	(6,441)
Proceeds from sale of available-for-sale marketable securities	2,249	7,507
Net cash provided by investing activities	<u>2,168</u>	<u>1,109</u>
<b>CASH FLOWS FROM FINANCING ACTIVITIES:</b>		
Proceeds from sale of common stock through employee stock purchase program	436	613
Proceeds from exercise of common stock options	57	35
Repurchase of common stock	—	(32)
Proceeds from sale of common stock in a private placement, net of issuance costs	—	9,809
Net cash provided by financing activities	<u>493</u>	<u>10,425</u>
<b>NET INCREASE IN CASH AND CASH EQUIVALENTS</b>	1,971	4,484
<b>EFFECT OF FOREIGN EXCHANGE RATES ON CASH</b>	53	105
<b>CASH AND CASH EQUIVALENTS, beginning of period</b>	5,369	4,272
<b>CASH AND CASH EQUIVALENTS, end of period</b>	<u>\$ 7,393</u>	<u>\$ 8,861</u>
<b>SUPPLEMENTAL DISCLOSURE OF CASH FLOW INFORMATION:</b>		
Cash paid for income taxes	\$ 150	\$ 247
<b>SUPPLEMENTAL SCHEDULE OF NONCASH FINANCING ACTIVITIES:</b>		
Decrease in common stock subject to rescission	\$ —	\$ (1,018)

See accompanying notes to condensed consolidated financial statements.

**THE SCO GROUP, INC. AND SUBSIDIARIES**  
**NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS**  
**(Unaudited)**

**(1) ORGANIZATION AND DESCRIPTION OF BUSINESS**

The business of The SCO Group, Inc. (the “Company”) focuses on marketing reliable, cost-effective UNIX software products and related services for the small-to-medium sized business market as well as replicated site franchises of Fortune 1000 companies. The Company has operations in a number of countries that provide support services to customers and resellers. The Company acquired certain intellectual property rights surrounding UNIX and UNIX System V source code in May 2001 from The Santa Cruz Operation. During the year ended October 31, 2003, the Company initiated its SCOSource business to protect and defend its UNIX intellectual property rights.

The Company incurred a net loss of \$4,565,000 for the nine months ended July 31, 2007, and, during that same period, used cash of \$690,000 in its operating activities. As of July 31, 2007, the Company had a total of \$7,393,000 in cash and cash equivalents and \$3,020,000 in restricted cash, of which \$2,589,000 is designated to pay for experts, consultants and other costs in connection with the litigation between the Company and IBM, Novell and Red Hat (the “SCO Litigation”), and the remaining \$431,000 of restricted cash is payable to Novell for its retained binary royalty stream.

On August 10, 2007, the federal judge overseeing the Company’s lawsuit with Novell, Inc. (“Novell”) ruled in favor of Novell on several of the summary judgment motions that were before the United States District Court in Utah (the “Court”). The effect of these rulings was to significantly reduce or to eliminate certain of the Company’s claims in both the Novell and IBM cases, and possibly others. The Court ruled that Novell was the owner of the UNIX and UnixWare copyrights that existed at the time of the 1995 Asset Purchase Agreement and that Novell retained broad rights to waive the Company’s contract claims against IBM. The Company was directed to accept Novell’s waiver of its UNIX contract claims against IBM. In addition, the Court determined that certain SCOSource licensing agreements that the Company executed in fiscal year 2003 included SVRx technology and that the Company was required to remit some portion of the proceeds to Novell. Over the Company’s objection, a bench trial was set to begin on September 17, 2007 and the federal judge was to determine what portion, if any, of the proceeds of the fiscal year 2003 SCOSource agreements is attributable to SVRx technology and should be remitted to Novell. The range of the payment to Novell could have been from a de minimis amount to in excess of \$30,000,000, the latter amount being the amount claimed by Novell, including interest. Novell has sought to impose a constructive trust on the Company’s current funds derived from these sources, which could result in a freeze of the Company’s assets, and the Court indicated that it would address that issue as well. The trial of these issues, however, was stayed as a result of the Company’s filing a voluntary petition for relief under Chapter 11 of the Bankruptcy Code on September 14, 2007. The Company’s management and Board of Directors determined that filing for relief under Chapter 11 of the United States Bankruptcy Code was appropriate and necessary. As a result of both the Court’s August 10, 2007 ruling and the Company’s entry into Chapter 11, there is substantial doubt about the Company’s ability to continue as a going concern. Absent a significant cash payment to Novell for this matter, management believes it is remote that the undiscounted future cash flows generated by the Company would not be sufficient to recover the carrying values of the long-lived assets over their expected remaining useful lives. However, if a significant cash payment is

## Table of Contents

required, or significant assets are put under a constructive trust, the carrying amount of the Company's long-lived assets may not be recovered. The accompanying financial statements do not include any adjustments that might result from the outcome of these uncertainties.

The Company intends to maintain business operations throughout the bankruptcy case. Subject to the Bankruptcy Court's approval, the Company will use its cash, cash equivalents, restricted cash and subsequent cash inflows to meet its working capital needs throughout the reorganization process.

## (2) SIGNIFICANT ACCOUNTING POLICIES

### Basis of Presentation

The accompanying unaudited condensed consolidated financial statements have been prepared by the Company pursuant to the rules and regulations of the Securities and Exchange Commission ("SEC") on a basis consistent with the Company's audited annual financial statements and, in the opinion of management, reflect all adjustments, consisting only of normal recurring adjustments, necessary to present fairly the financial information set forth therein. Certain information and note disclosures normally included in financial statements prepared in accordance with U.S. generally accepted accounting principles have been condensed or omitted pursuant to SEC rules and regulations, although the Company believes that the following disclosures, when read in conjunction with the audited annual financial statements and the notes thereto included in the Company's most recent annual report on Form 10-K, are adequate to make the information presented not misleading. Operating results for the three and nine months ended July 31, 2007 are not necessarily indicative of the operating results that may be expected for the year ending October 31, 2007.

### Use of Estimates in the Preparation of Financial Statements

The preparation of financial statements in conformity with U.S. generally accepted accounting principles 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 financial statements and the reported amounts of revenue and expenses during the reporting periods. Actual results could differ from these estimates. The Company's critical accounting policies and estimates include: revenue recognition, allowances for doubtful accounts receivable, useful lives and impairment of long-lived assets, litigation reserves, and valuation allowances against deferred income tax assets.

### Revenue Recognition

The Company recognizes revenue in accordance with Statement of Position ("SOP") 97-2, as modified by SOP 98-9. The Company's revenue has historically been from three sources: (i) product license revenue, primarily from product sales to resellers, end users and original equipment manufacturers ("OEMs"); (ii) technical support service revenue, primarily from providing technical support and consulting services to end users; and (iii) revenue from SCOSource licensing.

The Company recognizes product revenue upon shipment if a signed contract exists, the fee is fixed or determinable, collection of the resulting receivable is probable and product returns are reasonably estimable.

The majority of the Company's revenue transactions relate to product-only sales. On occasion, the Company has revenue transactions that have multiple elements (such as software products, maintenance, technical support services, and other services). For software agreements

## Table of Contents

that have multiple elements, the Company allocates revenue to each component of the contract based on the relative fair value of the elements. The fair value of each element is based on vendor specific objective evidence (“VSOE”). VSOE is established when such elements are sold separately. The Company recognizes revenue when the criteria for product revenue recognition set forth above have been met. If VSOE of all undelivered elements exists, but VSOE does not exist for one or more delivered elements, then revenue is recognized using the residual method. Under the residual method, the fair value of the undelivered elements is deferred and the remaining portion of the license fee is recognized as revenue in the period when persuasive evidence of an arrangement is obtained assuming all other revenue recognition criteria are met.

The Company recognizes product revenue from OEMs when the software is sold by the OEM to an end-user customer. Revenue from technical support services and consulting services is recognized as the related services are performed. Revenue for maintenance is recognized ratably over the maintenance period.

The Company considers an arrangement with payment terms longer than the Company’s normal business practice not to be fixed or determinable and revenue is recognized when the fee becomes due. The Company typically provides stock rotation rights for sales made through its distribution channel and sales to distributors are recognized upon shipment by the distributor to end users. For direct sales not through the Company’s distribution channel, sales are typically non-refundable and non-cancelable. The Company estimates its product returns based on historical experience and maintains an allowance for estimated returns, which is recorded as a reduction to accounts receivable and revenue.

The Company’s SCOSource revenue to date has been primarily generated from agreements to utilize the Company’s UNIX source code as well as from intellectual property agreements. The Company recognizes revenue from SCOSource agreements when a signed contract exists, the fee is fixed or determinable, collection of the receivable is probable and delivery has occurred. If the payment terms extend beyond the Company’s normal payment terms, revenue is recognized as the payments become due.

### **Cash and Cash Equivalents**

The Company considers all investments purchased with original maturities of three or fewer months to be cash equivalents. Cash equivalents were \$4,146,000 and \$2,555,000 as of July 31, 2007 and October 31, 2006, respectively. Cash was \$3,247,000 and \$2,814,000 as of July 31, 2007 and October 31, 2006, respectively. The Company has \$100,000 of cash that is federally insured. All remaining amounts of cash and cash equivalents as well as restricted cash exceed federally insured limits.

### **Available-for-Sale Marketable Securities**

Available-for-sale marketable securities are recorded at fair market value, based on quoted market prices, and unrealized gains and losses are recorded as a component of comprehensive loss. Realized gains and losses, which are calculated based on the specific-identification method, are recorded in operations as incurred. Available-for-sale marketable securities totaled \$0 and \$2,249,000 as of July 31, 2007 and October 31, 2006, respectively.

### **Net Loss Per Common Share**

Basic net income or loss per common share (“Basic EPS”) is computed by dividing net income or loss by the weighted average number of common shares outstanding. Diluted net income or loss per common share (“Diluted EPS”) is computed by dividing net income or loss by the sum of the weighted average number of common shares outstanding and the dilutive

## Table of Contents

potential common share equivalents then outstanding. Potential common share equivalents consist of the weighted average number of shares issuable upon the exercise of outstanding stock options and warrants to acquire common stock. If dilutive, the Company computes Diluted EPS using the treasury stock method.

Due to the fact that for all periods presented, the Company has incurred net losses, common share equivalents of 5,646,000 and 5,080,000 for the three and nine months ended July 31, 2007 and 2006, respectively, are not included in the calculation of diluted net loss per common share because they are anti-dilutive.

### (3) COMMITMENTS AND CONTINGENCIES

#### Litigation

##### *IBM Corporation*

On or about March 6, 2003, the Company filed a civil complaint against IBM. The case is pending in the United States District Court for the District of Utah, styled *The SCO Group, Inc. v. International Business Machines Corporation*, Civil No. 2:03CV0294. In this action, the Company claims that IBM breached its UNIX source code licenses (both the IBM and Sequent Computer Systems, Inc. (“Sequent”) licenses) by disclosing restricted information concerning the UNIX source code and derivative works and related information in connection with its efforts to promote the Linux operating system. The Company’s complaint includes, among other things, claims for breach of contract, unfair competition, tortious interference and copyright infringement. The Company is seeking damages in an amount to be proven at trial and seeking injunctive relief.

On or about March 6, 2003, the Company notified IBM that IBM was not in compliance with the Company’s UNIX source code license agreement and on or about June 13, 2003, the Company delivered to IBM a notice of termination of that agreement, which underlies IBM’s AIX software. On or about August 11, 2003, the Company sent a similar notice terminating the Sequent source code license. IBM disputes the Company’s right to terminate those licenses. In the event the Company’s termination of those licenses is valid, the Company believes IBM is exposed to substantial damages and injunctive relief claims based on its continued use and distribution of the AIX operating system. On June 9, 2003, Novell sent the Company a notice purporting to waive the Company’s claims against IBM regarding its license breaches.

On February 27, 2004, the Company filed a second amended complaint which alleges 9 causes of action that are similar to those set forth above, adds a new claim for copyright infringement, and removes the claim for misappropriation of trade secrets. IBM filed an answer and 14 counterclaims. Among other things, IBM has asserted that the Company does not have the right to terminate IBM’s UNIX license and IBM has claimed that the Company has breached the GNU General Public License and has infringed certain patents held by IBM. IBM’s counterclaims include claims for breach of contract, violation of the Lanham Act, unfair competition, intentional interference with prospective economic relations, unfair and deceptive trade practices, promissory estoppel, patent infringement and a declaratory judgment claim for non-infringement of copyrights. On October 6, 2005, IBM voluntarily dismissed with prejudice its claims for patent infringement.

On December 22, 2005, the Company filed a voluminous report detailing IBM’s misuse of the Company’s proprietary material. The Company’s December 2005 report included 293 total disclosures, which the Company claims violate its contractual rights and copyrights. These reports and the disclosures identified are the result of analysis from experienced outside technical consultants.

## Table of Contents

On February 13, 2006, IBM filed a motion with the court seeking to limit the Company's claims as set forth in the December 2005 report. IBM argued that of the 293 items the Company had identified, 201 did not meet the level of specificity required by the Court. IBM requested that the Company be limited to 93 items set forth in the December 2005 filing, which IBM claims meet the required level of specificity. On June 28, 2006, the Magistrate Judge issued a ruling striking over 180 of the technology disclosures challenged by the Company from the case. This ruling is a limitation of the number of technology disclosures the Company challenged in its December 2005 filing, but means that over 100 of the challenged items remain in the case. On July 13, 2006, the Company filed objections to the Magistrate Judge's order with the District Court; those objections challenged the process and the result embodied in the Magistrate Judge's order. On November 29, 2006, the District Court issued a ruling sustaining in full the Magistrate Judge's ruling of June 28, 2006. The Company has filed a motion to reconsider this ruling and a motion to amend its technology disclosures of December 2005.

On June 8, 2006, IBM filed a motion to confine the Company's claims to, and strike allegations in excess of, the final disclosures. In this motion, IBM claims that the Company's technology expert reports go beyond the disclosures contained in the Company's December 2005 submission to the Court and that those expert reports should be restricted to that extent. On December 21, 2006, the Magistrate Judge granted IBM's motion. The Company has filed objections to that order with the District Court.

Both parties have filed expert reports and substantially finished expert discovery. IBM has filed 6 motions for summary judgment that, if granted in whole or in substantial part, could resolve the Company's claims in IBM's favor or substantially reduce the Company's claims. The Company has filed 3 motions for summary judgment. The summary judgment motions were heard by the Court on March 1, 5 and 7, 2007, as scheduled, and the Court took all motions under advisement and will issue rulings at some point in the future. A trial date will be set pending the outcome of those motions.

As a result of the judge's order of August 10, 2007, in the SCO v. Novell case, several of the Company's claims against IBM will be dismissed. These claims will include its claims that IBM breached its UNIX license agreement and the Company's claims arising from its termination of IBM's license. The Company believes that the Court's August 10, 2007 ruling does not resolve certain claims in the case, or aspects of those claims, including the Company's claim for unfair competition arising out of the Project Monterey initiative in the late 1990's. IBM has taken the position that the Court's ruling of August 10, 2007 in the Novell case resolves all of the Company's claims against IBM in IBM's favor; the Company disputes this. IBM's counterclaims against the Company would remain in the case subject to pending motions for summary judgment.

### *Novell, Inc.*

On January 20, 2004, the Company filed suit in Utah state court against Novell, Inc. for slander of title seeking relief for its alleged bad faith effort to interfere with the Company's ownership of copyrights related to the Company's UNIX source code and derivative works and the Company's UnixWare product. The case is pending in the United States District Court for the District of Utah under the caption, The SCO Group, Inc. v. Novell, Inc., Civil No. 2:04CV00139. In the lawsuit, the Company requested preliminary and permanent injunctive relief as well as damages. Through these claims, the Company seeks to require Novell to assign to the Company all copyrights that the Company believes Novell has wrongfully registered, to prevent Novell from claiming any ownership interest in those copyrights, and to require Novell to retract or withdraw all representations it has made regarding its purported ownership of those copyrights and UNIX itself.

## Table of Contents

Novell filed two motions to dismiss claiming, among other things, that Novell's false statements were not uttered with malice and are privileged under the law. The court denied both of Novell's motions to dismiss. On July 29, 2005, Novell filed its answer and counterclaims against the Company, asserting counterclaims for the Company's alleged breaches of the Asset Purchase Agreement between Novell and the Company's predecessor-in-interest, The Santa Cruz Operation, for slander of title, restitution/unjust enrichment, an accounting related to Novell's retained binary royalty stream, and for declaratory relief regarding Novell's alleged rights under the Asset Purchase Agreement. On or about December 30, 2005, the Company filed a motion for leave to amend its complaint to assert additional claims against Novell including copyright infringement, unfair competition and a breach of Novell's limited license to use the Company's UNIX code. Novell consented to the Company's filing of these additional claims.

On or about April 10, 2006, Novell filed a motion to stay the case in Utah pending a request for arbitration that Novell and SuSE Linux, GmbH ("SuSE") filed on the same date in the International Court of Arbitration. Through these proceedings, Novell claims that the Company granted SuSE the right to use its intellectual property through the Company's participation in the UnitedLinux initiative in 2002 and through its acquisition of SuSE, Novell acquired SuSE's rights as a member of UnitedLinux. On August 21, 2006, the District Court ordered that portions of claims relating to the SuSE arbitration should be stayed but the other portions of claims in the case should proceed. Trial for the remaining matters has been set for September 2007.

The three-person arbitration panel has been selected for the SuSE arbitration and that process has commenced. The arbitration has been set for December 2007.

In September 2006, Novell filed an Amended Counterclaim asserting 9 claims for relief including, among other things, claims for slander of title, breach of contract, declaratory relief and claims for an accounting, and for a constructive trust over certain revenue the Company collected from Sun and Microsoft in 2003. In September 2006, Novell also filed a motion for summary judgment or a preliminary injunction. The Company has opposed the motion and filed a cross-motion for summary judgment or partial summary judgment. Those motions were argued on January 23, 2007, before the District Court in Utah.

Novell has also filed motions for summary judgment asking the Court to rule that Novell retained the UNIX and UnixWare copyrights under the Asset Purchase Agreement ("APA"), that the Company has not met its burden of establishing special damages on its slander of title claim, that Novell retained broad rights to waive the Company's contract claims against IBM, and that the portion of the Company's contract and unfair competition claims based on non-compete provisions in the APA and a related agreement should not proceed to a jury trial. The Company has filed its own motions for summary judgment seeking a ruling that it owns the UNIX and UnixWare copyrights under the APA, and that Novell's retained rights under the APA are much narrower than Novell now claims.

On August 10, 2007, the federal judge ruled in favor of Novell on several of the summary judgment motions that were before the Court. The effect of these rulings was to significantly reduce or to eliminate certain of the Company's claims in both the Novell and IBM cases, and possibly others. The Court ruled that Novell was the owner of the UNIX and UnixWare copyrights that existed at the time of the 1995 Asset Purchase Agreement and that Novell retained broad rights to waive the Company's contract claims against IBM and the Company was directed to accept Novell's waiver of its UNIX contract claims against IBM. In addition, the Court determined that certain SCOsource licensing agreements that the Company executed in fiscal year 2003 included SVRx technology and that the Company was required to remit some portion of the proceeds to Novell. Over the Company's objection, a bench trial was set to begin on September 17, 2007 and the federal judge was to determine what portion, if any, of the

## Table of Contents

proceeds of the fiscal year 2003 SCOsource agreements is attributable to SVRx technology and should be remitted to Novell. The range of the payment to Novell could have been from a de minimis amount to in excess of \$30,000,000, the latter amount being the amount claimed by Novell, including interest. Novell has sought to impose a constructive trust on the Company's current funds derived from those sources, which could result in a freeze of the Company's assets, and the Court would address that issue as well. The trial of these issues, however, was stayed as a result of the Company's filing a voluntary petition for relief under Chapter 11 of the Bankruptcy Code on September 14, 2007.

### *IPO Class Action Matter*

The Company is an issuer defendant in a series of class action lawsuits involving over 300 issuers that have been consolidated under; In re Initial Public Offering Securities Litigation, 21 MC 92 (SAS). The consolidated complaint alleges, among other things, certain improprieties regarding the underwriters' conduct during the Company's initial public offering and the failure to disclose such conduct in the registration statement in violation of the Securities Act of 1933, as amended. Class standing was certified for all of these cases by the United States District Court for the Southern District Court of New York.

The plaintiffs, the issuers and the insurance companies negotiated and executed an agreement to settle the dispute between the plaintiffs and the issuers. While the settlement agreement was awaiting approval by the district court, the court of appeals overturned the class certification on December 5, 2006. It is unlikely a settlement of a class action can remain effective as the class is de-certified. If the decision by the court of appeals is not reversed, the Company does not believe the settlement will stand, and it is possible the lawsuit may fragment into individual actions. At this time, the Company does not know and cannot predict the legal or procedural results of such an action. If the de-certification is reversed, and if thereafter the settlement agreement is approved by the court, and if no cross-claims, counterclaims or third-party claims are later asserted, this action will be dismissed with respect to the Company and its directors. If the settlement agreement is not approved by the court, the matter will continue unless another settlement agreement is reached.

The Company has notified its underwriters and insurance companies of the existence of the claims. Management presently believes, after consultation with legal counsel, that the ultimate outcome of this matter will not have a material adverse effect on the Company's results of operations or financial position and will not exceed the \$200,000 self-insured retention already paid or accrued by the Company.

### *Red Hat, Inc.*

On August 4, 2003, Red Hat, Inc. filed a complaint against the Company. The action is pending in the United States District Court for the District of Delaware under the case caption, Red Hat, Inc. v. The SCO Group, Inc., Civil No. 03-772. Red Hat asserts that the Linux operating system does not infringe on the Company's UNIX intellectual property rights and seeks a declaratory judgment for non-infringement of copyrights and no misappropriation of trade secrets. In addition, Red Hat claims the Company has engaged in false advertising in violation of the Lanham Act, deceptive trade practices, unfair competition, tortious interference with prospective business opportunities, trade libel and disparagement. On April 6, 2004, the court denied the Company's motion to dismiss this case; however, the court stayed the case and requested status reports every 90 days regarding the case against IBM. Red Hat filed a motion for reconsideration, which the court denied on March 31, 2005. The Company intends to vigorously defend this action. In the event that the stay is lifted and Red Hat is allowed to pursue its claims, the Company will likely assert counterclaims against Red Hat.

## Table of Contents

### *Other Matters*

In April 2003, the Company's former Indian distributor filed a claim in India, requesting summary judgment for payment of approximately \$1,428,000, and an order that the Company trade in India only through the distributor and/or give a security deposit until the claim is paid. The distributor claims that the Company is responsible to repurchase certain software products and to reimburse the distributor for certain other operating costs. Management does not believe that the Company is responsible to reimburse the distributor for any operating costs and also believes that the return rights related to any remaining inventory have lapsed. The distributor additionally requested that the Indian courts grant interim relief in the form of attachment of local assets. These requests for interim relief have failed in the court, discovery has commenced, and hearings on the main claims have been held and are ongoing. The Company intends to vigorously defend this action.

Pursuit and defense of the above-mentioned matters will be costly, and management expects the costs for legal fees and related expenses will be substantial. A material, negative impact on the Company's results of operations or financial position from the Red Hat, Inc., IPO Class Action, or Indian Distributor matters, or the IBM or Novell counterclaims is not estimable.

The Company is a party to certain other legal proceedings arising in the ordinary course of business. Management believes, after consultation with legal counsel, that the ultimate outcome of these legal proceedings will not have a material adverse effect on the Company's results of operations, financial position or liquidity.

## **(4) STOCKHOLDERS' EQUITY**

### **Issuance of Common Stock**

On November 29, 2005, the Company entered into a Common Stock Purchase Agreement ("Purchase Agreement") with several institutional investors and one member of the Company's board of directors. On November 30, 2005, the Company sold to the investors approximately 2,852,000 shares of the Company's common stock for gross proceeds of approximately \$10,005,000. The costs to facilitate the private placement of the common stock were approximately \$196,000. The shares issued to the institutional investors were issued at \$3.50 per share and the shares issued to the board member were issued at \$3.92 per share. Pursuant to the Purchase Agreement, the Company agreed to use its best efforts to file a registration statement with the SEC covering the resale of this common stock, and to use its commercially reasonable efforts to have such registration statement declared effective. On May 25, 2006, this registration statement was declared effective by the SEC.

### **Equity Plans**

The Company has established the 1998 Stock Option Plan (the "1998 Plan"), 1999 Omnibus Stock Incentive Plan (the "1999 Plan"), the 2002 Omnibus Stock Incentive Plan (the "2002 Plan") and the 2004 Omnibus Stock Incentive Plan (the "2004 Plan") for the award of stock options, stock appreciation rights, restricted stock, phantom stock rights, and stock bonuses to employees, executive officers, members of the Board of Directors and outside consultants. The Compensation Committee of the Board of Directors has the ability to determine the terms of the option, the exercise price, the number of shares subject to each option, and the exercisability of the options. The Company's current practice is for the Compensation Committee to recommend option grants subject to the approval and ratification of the entire Board of Directors at regularly scheduled board meetings. Under the terms of the 1998, 1999, 2002 and 2004 Plans, options generally expire 10 years from the date of grant or within 90 days of termination. Options granted under these plans generally vest 25 percent after the completion of one year of service

## Table of Contents

and then 1/36 per month for the remaining three years and become fully vested at the end of four years. Pursuant to the terms of their grant agreements, certain of the options granted under these plans may be subject to accelerated vesting upon a change in control of the Company.

The Company has also established an employee stock purchase plan, which is designed to allow eligible employees of the Company and its participating subsidiaries to purchase shares of the Company's common stock, at semi-annual intervals, through periodic payroll deductions.

Prior to October 31, 2005, as permitted under Statement of Financial Accounting Standards ("SFAS") No. 123, the Company accounted for its stock option plans following the recognition and measurement principles of Accounting Principles Board ("APB") Opinion No. 25, "Accounting for Stock issued to Employees," and related interpretations. Accordingly, no stock-based compensation expense had been reflected in the Company's statements of operations as all options granted had an exercise price equal to the market value of the underlying common stock on the date of grant and the related number of shares granted was fixed at that point in time.

In December 2004, the Financial Accounting Standards Board ("FASB") issued SFAS No. 123(R), "Share Based Payment." This statement revised SFAS No. 123 by eliminating the option to account for employee stock options under APB No. 25 and requiring companies to recognize the cost of employee services received in exchange for awards of equity instruments based on the grant-date fair value of those awards.

Effective November 1, 2005, the Company adopted the fair value recognition provisions of SFAS No. 123(R) using the modified prospective application method. Under this transition method, the Company recorded compensation expense on a straight-line basis for the three and nine months ended July 31, 2007 and 2006, for: (a) the vesting of options granted prior to November 1, 2005 (based on the grant-date fair value estimated in accordance with the original provisions of SFAS No. 123, and previously presented in the pro-forma note disclosures), and (b) stock-based awards granted subsequent to November 1, 2005 (based on the grant-date fair value estimated in accordance with the provisions of SFAS No. 123(R)).

The effect of accounting for stock-based awards under SFAS No. 123(R) for the three months ended July 31, 2007 and 2006 was to record \$396,000 and \$490,000, respectively, of stock-based compensation expense. For the nine months ended July 31, 2007 and 2006, \$1,407,000 and \$1,323,000, respectively, of stock-based compensation expense was recorded. For the three and nine months ended July 31, 2007 and 2006, the Company has allocated stock-based compensation expense to the following statement of operations captions:

	<i>Three Months Ended July 31,</i>		<i>Nine Months Ended July 31,</i>	
	<i>2007</i>	<i>2006</i>	<i>2007</i>	<i>2006</i>
Cost of products	\$ 2,000	\$ 5,000	\$ 5,000	\$ 12,000
Cost of SCOSource licensing	66,000	61,000	211,000	171,000
Cost of services	12,000	17,000	29,000	46,000
Sales and marketing	68,000	102,000	286,000	261,000
Research and development	51,000	41,000	147,000	97,000
General and administrative	197,000	264,000	729,000	736,000
Total stock-based compensation	<u>\$ 396,000</u>	<u>\$ 490,000</u>	<u>\$ 1,407,000</u>	<u>\$ 1,323,000</u>

## Table of Contents

With respect to stock options granted during the three and nine months ended July 31, 2007 and 2006, the assumptions used in the Black-Scholes option-pricing model are as follows:

	<i>Three Months Ended July 31,</i>		<i>Nine Months Ended July 31,</i>	
	<i>2007</i>	<i>2006</i>	<i>2007</i>	<i>2006</i>
Risk-free interest rate	4.7%	5.0%	4.7%	4.8%
Expected dividend yield	0.0%	0.0%	0.0%	0.0%
Volatility	96.9%	66.2%	90.0%	63.4%
Expected exercise life (in years)	5.0	5.0	5.0	5.0

The estimated fair value of stock options and ESPP shares are amortized over the vesting period of the award.

During the nine months ended July 31, 2007, the Company granted options to purchase approximately 1,229,000 shares of common stock with an average exercise price of \$1.90 per share. None of these stock options were granted with an exercise price below the quoted market price on the date of grant. During the nine months ended July 31, 2007, options to purchase approximately 52,000 shares of common stock were exercised with an average exercise price of \$1.09 per share. As of July 31, 2007, there were approximately 5,411,000 stock options outstanding with a weighted average exercise price of \$3.54 per share.

### Change in Control Provision for Employees

On March 26, 2007, the Company's Board of Directors approved a modification to certain stock option awards to allow for full vesting on stock option awards for employees who are non-executive officers in the event of a Change in Control, as defined. The adoption of this provision represents a modification to the outstanding underlying stock option awards. The Company determined that the fair value of the awards on the modification date, in accordance with SFAS No. 123(R), was \$0.

### (5) SEGMENT INFORMATION

The Company's resources are allocated and operating results managed to the operating income (loss) level for each of the Company's segments: UNIX and SCOSource. Both segments are based on the Company's UNIX intellectual property. The UNIX business sells and distributes UNIX products and services through an extensive distribution channel and to corporate end-users and the SCOSource business enforces and protects the Company's UNIX intellectual property. Segment disclosures for the Company are as follows:

	<i>Three Months Ended July 31, 2007</i>		
	<i>UNIX</i>	<i>SCOSource</i>	<i>Total</i>
Revenue	\$ 4,686,000	\$ —	\$ 4,686,000
Cost of revenue	777,000	1,156,000	1,933,000
Gross margin (deficit)	3,909,000	(1,156,000)	2,753,000
Sales and marketing	2,463,000	—	2,463,000
Research and development	1,424,000	—	1,424,000
General and administrative	1,377,000	—	1,377,000
Total operating expenses	5,264,000	—	5,264,000
Loss from operations	\$ (1,355,000)	\$ (1,156,000)	\$ (2,511,000)

## Table of Contents

	<i>Three Months Ended July 31, 2006</i>		
	<i>UNIX</i>	<i>SCOsorce</i>	<i>Total</i>
Revenue	\$ 7,390,000	\$ 31,000	\$ 7,421,000
Cost of revenue	1,144,000	2,315,000	3,459,000
Gross margin (deficit)	6,246,000	(2,284,000)	3,962,000
Sales and marketing	3,111,000	—	3,111,000
Research and development	1,932,000	97,000	2,029,000
General and administrative	1,781,000	48,000	1,829,000
Amortization of intangibles	593,000	—	593,000
Total operating expenses	7,417,000	145,000	7,562,000
Loss from operations	\$(1,171,000)	\$(2,429,000)	\$(3,600,000)

	<i>Nine Months Ended July 31, 2007</i>		
	<i>UNIX</i>	<i>SCOsorce</i>	<i>Total</i>
Revenue	\$16,692,000	\$ 23,000	\$16,715,000
Cost of revenue	2,594,000	2,876,000	5,470,000
Gross margin (deficit)	14,098,000	(2,853,000)	11,245,000
Sales and marketing	7,296,000	—	7,296,000
Research and development	4,737,000	—	4,737,000
General and administrative	4,051,000	—	4,051,000
Total operating expenses	16,084,000	—	16,084,000
Loss from operations	\$(1,986,000)	\$(2,853,000)	\$(4,839,000)

	<i>Nine Months Ended July 31, 2006</i>		
	<i>UNIX</i>	<i>SCOsorce</i>	<i>Total</i>
Revenue	\$21,795,000	\$ 95,000	\$ 21,890,000
Cost of revenue	3,571,000	10,087,000	13,658,000
Gross margin (deficit)	18,224,000	(9,992,000)	8,232,000
Sales and marketing	8,655,000	1,000	8,656,000
Research and development	5,501,000	285,000	5,786,000
General and administrative	4,994,000	145,000	5,139,000
Amortization of intangibles	1,778,000	—	1,778,000
Total operating expenses	20,928,000	431,000	21,359,000
Loss from operations	\$(2,704,000)	\$(10,423,000)	\$(13,127,000)

## (6) SUBSEQUENT EVENTS

On September 14, 2007, the Company and its wholly owned subsidiary, SCO Operations, Inc. (the “Debtors”) filed voluntary petitions for relief under Chapter 11 of the United States Bankruptcy Code (the “Bankruptcy Code”), in the United States Bankruptcy Court for the District of Delaware (the “Bankruptcy Court”). The Debtors’ Chapter 11 cases are being jointly administered under Case Nos. 07-11337 and 07-11338. The Debtors will continue to operate their businesses as “debtors-in-possession” under the jurisdiction of the Bankruptcy Court and in

## Table of Contents

accordance with the applicable provisions of the Bankruptcy Code and orders of the Bankruptcy Court. The Company's foreign subsidiaries were not included in the filings and will continue their business operations without supervision from the Bankruptcy Court and will not be subject to the requirements of the Bankruptcy Code. In connection with this proceeding, the Company has filed motions with the Bankruptcy Court requesting permission to go forward on a "business as usual" basis as a debtor-in-possession. Accordingly, the Company expects to continue to have jurisdiction over its assets and business subject to the supervision and orders of the Bankruptcy Court. The Company will continue operating and will file a plan of reorganization with the Bankruptcy Court.

Among other things, and unless the Bankruptcy Court modifies or removes it, and with limited exceptions, a company that files for relief under Chapter 11 of the Bankruptcy Code is protected by an automatic stay against the continuation or commencement of lawsuits to collect or adjudicate prepetition claims against the company and its assets. Accordingly, the litigation pending against the Company was stayed effective with the Chapter 11 filing on September 14, 2007.

As a result of the Chapter 11 filings, realization of assets and liquidation of liabilities are subject to uncertainty. While operating as debtors-in-possession under the protection of Chapter 11 of the Bankruptcy Code, and subject to Bankruptcy Court approval or otherwise as permitted in the normal course of business, the Debtors may sell or otherwise dispose of assets and liquidate or settle liabilities for amounts other than those reflected in the condensed consolidated financial statements.

In addition, under the priority scheme established by the Bankruptcy Code, unless creditors agree otherwise, post-petition liabilities and prepetition liabilities must be satisfied in full before shareholders are entitled to receive any distribution or retain any property under a plan of reorganization. The ultimate recovery to creditors and/or shareholders, if any, will not be determined until confirmation of a plan or plans of reorganization. No assurance can be given as to what values, if any, will be ascribed in the Chapter 11 cases to each of these constituencies or what types or amounts of distributions, if any, they would receive. A plan of reorganization could result in holders of the Company's stock receiving no distribution on account of their interests and cancellation of their existing stock. If certain requirements of the Bankruptcy Code are met, a plan of reorganization can be confirmed notwithstanding its rejection by the Company's equity security holders and notwithstanding the fact that such equity security holders do not receive or retain any property on account of their equity interests under the plan.

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

*Management’s Discussion and Analysis of Financial Condition and Results of Operations and other parts of this quarterly report on Form 10-Q contain forward-looking statements that involve risks and uncertainties. Forward-looking statements can also be identified by words such as “intends,” “anticipates,” “expects,” “believes,” “plans,” and similar terms. Forward-looking statements are not guarantees of future performance and our actual results may differ significantly from the results discussed in the forward-looking statements. Factors that might cause such differences include, but are not limited to, those set forth below under “Forward-Looking Statements and Factors that May Affect Future Results and Financial Condition” and Part II, Item 1A – Risk Factors, and elsewhere in this Form 10-Q. The following discussion should be read in conjunction with our unaudited condensed consolidated financial statements and notes thereto included in this Form 10-Q and our audited consolidated financial statements included in our annual report on Form 10-K for the year ended October 31, 2006 filed with the Securities and Exchange Commission and management’s discussion and analysis contained therein. All information presented herein is based on the three and nine months ended July 31, 2007 and 2006. We assume no obligation to revise or update any forward-looking statements for any reason, except as required by law.*

**Recent Developments**

*Novell, Inc. Ruling*

On August 10, 2007, the federal judge overseeing our lawsuit with Novell, Inc. (“Novell”) ruled in favor of Novell on several of the summary judgment motions that were before the United States District Court in Utah (the “Court”). The effect of these rulings was to significantly reduce or eliminate certain of our claims in both the Novell and IBM cases, and possibly others. The Court ruled that Novell was the owner of the UNIX and UnixWare copyrights that existed at the time of the 1995 Asset Purchase Agreement and that Novell retained broad rights to waive our contract claims against IBM. We were directed to accept Novell’s waiver of our UNIX contract claims against IBM. In addition, the Court determined that certain SCOSource licensing agreements that we executed in fiscal year 2003 included SVRx technology and that we were required to remit some portion of the proceeds to Novell. Over our objection, a bench trial was set to begin on September 17, 2007 and the federal judge was to determine what portion, if any, of the proceeds of the fiscal year 2003 SCOSource agreements is attributable to SVRx technology and should be remitted to Novell. The range of the payment to Novell could have been from a de minimis amount to in excess of \$30,000,000, the latter amount being the amount claimed by Novell, including interest. Novell has sought to impose a constructive trust on our current funds derived from those sources, which could result in a freeze of our assets, and the Court indicated that it would address that issue as well. The trial of these issues, however, was stayed as a result of our filing a voluntary petition for relief under Chapter 11 of the Bankruptcy Code on September 14, 2007. Our management and Board of Directors determined that filing for relief under Chapter 11 of the United States Bankruptcy Code was appropriate and necessary. As a result of both the Court’s August 10, 2007 ruling and our entry into Chapter 11, there is substantial doubt about our ability to continue as a going concern. Absent a significant cash payment to Novell for this matter, management believes it is remote that the undiscounted future cash flows generated by us would not be sufficient to recover the carrying values of the long-lived assets over their expected remaining useful lives. However, if a significant cash payment is required, or significant assets are put under a constructive trust, the carrying amount of our long-lived assets may not be recovered. The accompanying financial statements do not include any adjustments that might result from the outcome of these uncertainties.

## Table of Contents

We intend to maintain business operations throughout the bankruptcy case. Subject to the Bankruptcy Court's approval, we will use our cash, cash equivalents, restricted cash and subsequent cash inflows to meet our working capital needs throughout the reorganization process.

### Bankruptcy Filing

On September 14, 2007, The SCO Group, Inc. and its wholly-owned subsidiary, SCO Operations, Inc. (the "Debtors") filed voluntary petitions for relief under Chapter 11 of the United States Bankruptcy Code (the "Bankruptcy Code"), in the United States Bankruptcy Court for the District of Delaware (the "Bankruptcy Court"). The Debtors' Chapter 11 cases are being jointly-administered under Case Nos. 07-11337 and 07-11338. The Debtors will continue to operate their businesses as "debtors-in-possession" under the jurisdiction of the Bankruptcy Court and in accordance with the applicable provisions of the Bankruptcy Code and orders of the Bankruptcy Court. Our foreign subsidiaries were not included in the filings and will continue their business operations without supervision from the Bankruptcy Court and will not be subject to the requirements of the Bankruptcy Code. In connection with this proceeding, we have filed motions with the Bankruptcy Court requesting permission to go forward on a "business as usual" basis as a debtor in possession. Accordingly, we expect to continue to have jurisdiction over our assets and business subject to the supervision and orders of the Bankruptcy Court. We will continue operating and will file a plan of reorganization with the Bankruptcy Court.

As a result of the Chapter 11 filings, realization of assets and liquidation of liabilities are subject to uncertainty. While operating as debtors-in-possession under the protection of Chapter 11 of the Bankruptcy Code, and subject to Bankruptcy Court approval or otherwise as permitted in the normal course of business, the Debtors may sell or otherwise dispose of assets and liquidate or settle liabilities for amounts other than those reflected in the condensed consolidated financial statements.

In addition, under the priority scheme established by the Bankruptcy Code, unless creditors agree otherwise, post-petition liabilities and prepetition liabilities must be satisfied in full before shareholders are entitled to receive any distribution or retain any property under a plan of reorganization. The ultimate recovery to creditors and/or shareholders, if any, will not be determined until confirmation of a plan or plans of reorganization. No assurance can be given as to what values, if any, will be ascribed in the Chapter 11 cases to each of these constituencies or what types or amounts of distributions, if any, they would receive. A plan of reorganization could result in holders of our stock receiving no distribution on account of their interests and cancellation of their existing stock. If certain requirements of the Bankruptcy Code are met, a plan of reorganization can be confirmed notwithstanding its rejection by our equity security holders and notwithstanding the fact that such equity security holders do not receive or retain any property on account of their equity interests under the plan. Accordingly, we urge that the appropriate caution be exercised with respect to existing and future investments in any of these securities as the value and prospects are highly speculative.

Under the supervision of the Bankruptcy Court, we may decide to pursue various strategic alternatives as deemed appropriate by our Board of Directors to serve the best interests of the Company and our stakeholders, including assets sales or strategic partnerships.

### Business Focus

*UNIX Business.* Our UNIX business serves the needs of small-to-medium sized businesses as well as replicated site franchisees of Fortune 1000 companies, by providing reliable, cost effective UNIX software technology for distributed, embedded and network-based systems.

## Table of Contents

Our UNIX business includes our mobility product and services offerings. Our largest source of UNIX business revenue is derived from existing customers through our worldwide, indirect, leveraged channel of partners, which includes distributors and independent solution providers. We have a presence in a number of countries that provide support and services to customers and resellers. The other principal channel for selling and marketing our UNIX products is through existing customers that have a large number of replicated sites or franchisees.

We access these corporations through their information technology or purchasing departments with our Area Sales Managers (“ASMs”) in the United States and through our reseller channel in countries outside the United States. In addition, we also sell our operating system products to original equipment manufacturers (“OEMs”). Our sales of UNIX products and services during the last several years have been primarily to existing UNIX customers and not newly acquired customers. Our UNIX business revenue depends significantly on our ability to market and sell our products to existing customers and to generate upgrades from existing customers.

The following table shows the operating results of the UNIX business for the three and nine months ended July 31, 2007 and 2006:

	<i>Three Months Ended July 31,</i>		<i>Nine Months Ended July 31,</i>	
	<i>2007</i>	<i>2006</i>	<i>2007</i>	<i>2006</i>
Revenue	\$ 4,686,000	\$ 7,390,000	\$16,692,000	\$21,795,000
Cost of revenue	777,000	1,144,000	2,594,000	3,571,000
Gross margin	3,909,000	6,246,000	14,098,000	18,224,000
Sales and marketing	2,463,000	3,111,000	7,296,000	8,655,000
Research and development	1,424,000	1,932,000	4,737,000	5,501,000
General and administrative	1,377,000	1,781,000	4,051,000	4,994,000
Amortization of intangibles	—	593,000	—	1,778,000
Total operating expenses	5,264,000	7,417,000	16,084,000	20,928,000
Loss from operations	<u>\$(1,355,000)</u>	<u>\$(1,171,000)</u>	<u>\$(1,986,000)</u>	<u>\$(2,704,000)</u>

Revenue from the UNIX business decreased by \$2,704,000, or 37%, for the three months ended July 31, 2007 compared to the three months ended July 31, 2006 and revenue from the UNIX business decreased by \$5,103,000, or 23%, for the nine months ended July 31, 2007 compared to the nine months ended July 31, 2006. The revenue from this business has been declining over the last several years primarily as a result of increased competition from alternative operating systems, particularly Linux, and from the negative publicity of the SCO Litigation. We believe the inclusion of UNIX code and derivative works in Linux has been a contributor to the decline in our UNIX business because users of Linux generally do not pay for the operating system itself, but pay for services and maintenance. The Linux operating system competes directly with our OpenServer and UnixWare products and has taken significant market share from these products.

Operating costs for the UNIX business decreased from \$7,417,000 for the three months ended July 31, 2006 to \$5,264,000 for the three months ended July 31, 2007 and operating costs for the UNIX business decreased from \$20,928,000 for the nine months ended July 31, 2006 to \$16,084,000 for the nine months ended July 31, 2007. These decreases were primarily attributable to reduced headcount and related costs as well as from the elimination of amortization expense from intangible assets. Our intangible assets became fully amortized during the three months ended October 31, 2006.

The decline in our UNIX business revenue may be accelerated if industry partners withdraw their support for our products. The decline in our UNIX business and our SCOsource

## Table of Contents

business may cause industry partners, developers and hardware and software vendors to choose not to support or certify to our UNIX operating system products. This would lead to an accelerated decline in revenue and an increase in negative cash flows from our UNIX business.

*SCOsorce Business.* During the year ended October 31, 2003, we became aware that our UNIX code and derivative works had been inappropriately included by others in the Linux operating system. We believe the inclusion of UNIX code and derivative works in Linux has been a contributor to the decline in our UNIX business because users of Linux generally do not pay for the operating system itself, but pay for services and maintenance. The Linux operating system competes directly with our OpenServer and UnixWare products and has taken significant market share from these products.

In an effort to protect and defend our UNIX intellectual property rights, we initiated our SCOsorce business. We have incurred significant legal costs in an effort to defend and protect our UNIX intellectual property rights and expect that costs and expenses for this business for the year ending October 31, 2007 will be material.

The following table shows the operating results of the SCOsorce business for the three and nine months ended July 31, 2007 and 2006:

	<i>Three Months Ended July 31,</i>		<i>Nine Months Ended July 31,</i>	
	<i>2007</i>	<i>2006</i>	<i>2007</i>	<i>2006</i>
Revenue	\$ —	\$ 31,000	\$ 23,000	\$ 95,000
Cost of revenue	1,156,000	2,315,000	2,876,000	10,087,000
Gross deficit	(1,156,000)	(2,284,000)	(2,853,000)	(9,992,000)
Sales and marketing	—	—	—	1,000
Research and development	—	97,000	—	285,000
General and administrative	—	48,000	—	145,000
Total operating expenses	—	145,000	—	431,000
Loss from operations	\$(1,156,000)	\$(2,429,000)	\$(2,853,000)	\$(10,423,000)

Revenue from our SCOsorce business decreased from \$31,000 for the three months ended July 31, 2006 to \$0 for the three months ended July 31, 2007. Revenue also decreased from \$95,000 for the nine months ended July 31, 2006 to \$23,000 for the nine months ended July 31, 2007. Revenue in the above mentioned periods was primarily attributable to sales of our SCOsorce IP agreements.

Cost of revenue, which primarily includes legal and professional fees incurred in connection with defending our UNIX intellectual property rights in the SCO Litigation, decreased from \$2,315,000 for the three months ended July 31, 2006 to \$1,156,000 for the three months ended July 31, 2007 and decreased from \$10,087,000 for the nine months ended July 31, 2006 to \$2,876,000 for the nine months ended July 31, 2007. The decrease in the cost of revenue for the three months ended July 31, 2007 as compared to July 31, 2006 was primarily attributable to decreased legal services provided by technical, industry, damage and other experts in connection with the SCO Litigation. The decreases in cost of revenue for the nine months ended July 31, 2007 as compared to the nine months ended July 31, 2006 was primarily attributable to the absence of the \$2,000,000 quarterly payment to Boies, Schiller & Flexner LLP and Kevin McBride (the "Law Firms") (which quarterly payments ended during the three months ended January 31, 2006), and by significant decreases in legal services provided by technical, industry, damage and other experts in connection with the SCO Litigation. Berger Singerman, P.A. ("Berger") was also a member of this group of Law Firms. With the consent of

## Table of Contents

the Company, the engagement of this firm was mutually terminated. The last payment received by Berger was on November 24, 2004. In addition to the expenses incurred above, we must pay one or more contingency fees upon any amount that we or our stockholders may receive as a result of a settlement, judgment, or a sale of our company.

Because of the unique and unpredictable nature of the SCO Litigation, the occurrence and timing of certain expenses such as damage, industry and technical review and other consultants is difficult to predict, and it will be difficult to predict the total cost of revenue for the upcoming quarters.

### Critical Accounting Policies

Our critical accounting policies and estimates include the following:

- Revenue recognition;
- Valuation allowances against deferred income tax assets;
- Litigation reserves;
- Useful lives and impairment of property and equipment; and
- Allowances for doubtful accounts.

*Revenue Recognition* . We recognize revenue in accordance with Statement of Position (“SOP”) 97-2, as modified by SOP 98-9. Our revenue has historically been from three sources: (i) product license revenue, primarily from product sales to resellers, end users and OEMs; (ii) technical support service revenue, primarily from providing technical support and consulting services to end users; and (iii) revenue from SCOSource licensing.

We recognize product revenue upon shipment if a signed contract exists, the fee is fixed or determinable, collection of the resulting receivable is probable and product returns are reasonably estimable.

The majority of our revenue transactions relate to product-only sales. On occasion, we have revenue transactions that have multiple elements (such as software products, maintenance, technical support services, and other services). For software agreements that have multiple elements, we allocate revenue to each component of the contract based on the relative fair value of the elements. The fair value of each element is based on vendor specific objective evidence (“VSOE”). VSOE is established when such elements are sold separately. We recognize revenue when the criteria for product revenue recognition set forth above have been met. If VSOE of all undelivered elements exists, but VSOE does not exist for one or more delivered elements, then revenue is recognized using the residual method. Under the residual method, the fair value of the undelivered elements is deferred and the remaining portion of the license fee is recognized as revenue in the period when persuasive evidence of an arrangement is obtained assuming all other revenue recognition criteria are met.

We recognize product revenue from OEMs when the software is sold by the OEM to an end-user customer. Revenue from technical support services and consulting services is recognized as the related services are performed. Revenue for maintenance is recognized ratably over the maintenance period.

## Table of Contents

We consider an arrangement with payment terms longer than our normal business practice not to be fixed or determinable and revenue is recognized when the fee becomes due. We typically provide stock rotation rights for sales made through our distribution channel and sales to distributors are recognized upon shipment by the distributor to end users. For direct sales not through our distribution channel, sales are typically non-refundable and non-cancelable. We estimate our product returns based on historical experience and maintain an allowance for estimated returns, which is recorded as a reduction to accounts receivable and revenue.

Our SCOSource revenue to date has been primarily generated from agreements to utilize our UNIX source code as well as from intellectual property compliance agreements. We recognize revenue from SCOSource agreements when a signed contract exists, the fee is fixed or determinable, collection of the receivable is probable and delivery has occurred. If the payment terms extend beyond our normal payment terms, revenue is recognized as the payments become due.

*Valuation Allowances Against Deferred Income Tax Assets* . The amount, and ultimate realization, of our deferred income tax assets depends, in part, upon the tax laws in effect, our future earnings, if any, and other future events, the effects of which cannot be determined. We provided a valuation allowance of \$76,385,000 against our entire net deferred income tax assets as of October 31, 2006. The valuation allowance was recorded because of our history of net operating losses and the uncertainties regarding our future operating profitability and taxable income.

*Litigation Reserves*. We are party to a number of legal matters described in more detail elsewhere in this Form 10-Q, including under Part II, Item I – Legal Proceedings. Pursuit and defense of these matters will be costly, and management expects the costs for legal fees and related expenses will be substantial. A material, negative impact on our results of operations or financial position from the Red Hat, Inc., IPO Class Action, or Indian Distributor matters, or the IBM and Novell counterclaims is not estimable. Because these matters are not estimable, we have not recorded any reserves or contingencies related to these legal matters. In the event that our assumptions used to evaluate these matters change in future periods, we may be required to record a liability for an adverse outcome, which could have a material adverse effect on our results of operations, financial position and liquidity.

*Useful Lives and Impairment of Property and Equipment* . We review our long-lived assets for impairment at each balance sheet date and when events or changes in circumstances indicate that the carrying value of an asset may not be recoverable. The carrying value of a long-lived asset is considered impaired when the anticipated cumulative undiscounted cash flows of the related asset or group of assets is less than the carrying value. In that event, a loss is recognized based on the amount by which the carrying value exceeds the estimated fair market value of the long-lived asset. Economic useful lives of long-lived assets are assessed and adjusted as circumstances dictate.

Write-downs of long-lived assets may be necessary if the future fair value of these assets is less than the carrying value. If the operating trends for our UNIX or SCOSource businesses continue to decline, or a definitive negative judgment requiring cash payments to third parties or significant assets to be placed under a constructive trust is issued in various litigation matters, we may be required to record an impairment charge in a future period related to the carrying value of our long-lived assets.

*Allowance for Doubtful Accounts Receivable* . We offer credit terms on the sale of our products to a majority of our customers and require no collateral from these customers. We

## Table of Contents

perform ongoing credit evaluations of our customers' financial condition and maintain an allowance for doubtful accounts based upon our historical collection experience and a specific review of customer balances to determine expected collectibility. Our policies for determining allowances for doubtful accounts have been applied consistently. Our allowance for doubtful accounts receivable was \$87,000 as of July 31, 2007. We have not experienced material differences from the actual amounts provided for bad debts and our recorded estimates. However, our actual bad debts in future periods may differ from our current estimates and the differences may be material, which may have an adverse impact on our future accounts receivable and cash position.

### Results of Operations

The following table presents our results of operations for the three and nine months ended July 31, 2007 and 2006:

Statement of Operations Data:	Three Months Ended July 31,		Nine Months Ended July 31,	
	2007	2006	2007	2006
<b>Revenue:</b>				
Products	\$ 3,690,000	\$ 6,201,000	\$13,451,000	\$ 17,904,000
SCOsourcelicensing	—	31,000	23,000	95,000
Services	996,000	1,189,000	3,241,000	3,891,000
<b>Total revenue</b>	<b>4,686,000</b>	<b>7,421,000</b>	<b>16,715,000</b>	<b>21,890,000</b>
<b>Cost of revenue:</b>				
Products	329,000	478,000	1,041,000	1,559,000
SCOsourcelicensing	1,156,000	2,315,000	2,876,000	10,087,000
Services	448,000	666,000	1,553,000	2,012,000
<b>Total cost of revenue</b>	<b>1,933,000</b>	<b>3,459,000</b>	<b>5,470,000</b>	<b>13,658,000</b>
<b>Gross margin</b>	<b>2,753,000</b>	<b>3,962,000</b>	<b>11,245,000</b>	<b>8,232,000</b>
<b>Operating expenses:</b>				
Sales and marketing	2,463,000	3,111,000	7,296,000	8,656,000
Research and development	1,424,000	2,029,000	4,737,000	5,786,000
General and administrative	1,377,000	1,829,000	4,051,000	5,139,000
Amortization of intangibles	—	593,000	—	1,778,000
<b>Total operating expenses</b>	<b>5,264,000</b>	<b>7,562,000</b>	<b>16,084,000</b>	<b>21,359,000</b>
Loss from operations	(2,511,000)	(3,600,000)	(4,839,000)	(13,127,000)
Equity in income (loss) of affiliate	9,000	—	115,000	(8,000)
Other income (expense), net	132,000	127,000	380,000	588,000
Provision for income taxes	(28,000)	(107,000)	(221,000)	(308,000)
<b>Net loss</b>	<b>\$(2,398,000)</b>	<b>\$(3,580,000)</b>	<b>\$(4,565,000)</b>	<b>\$(12,855,000)</b>

### THREE AND NINE MONTHS ENDED JULY 31, 2007 AND 2006

#### Revenue

Revenue	Three Months Ended July 31,		
	2007	Change	2006
Revenue	\$4,686,000	(37)%	\$7,421,000

  

Revenue	Nine Months Ended July 31,		
	2007	Change	2006
Revenue	\$16,715,000	(24)%	\$21,890,000

## Table of Contents

Revenue for the three months ended July 31, 2007 decreased by \$2,735,000, or 37%, from the three months ended July 31, 2006, and revenue for the nine months ended July 31, 2007 decreased by \$5,175,000, or 24%, from the nine months ended July 31, 2006. These decreases were primarily attributable to a continued decline in our UNIX business as a result of continued competitive pressure from competing operating systems, particularly Linux, and from continuing negative publicity from the SCO Litigation which has adversely impacted and delayed our customers' buying decisions.

Revenue generated from our UNIX business and SCOSource business is as follows:

	<i>Three Months Ended July 31,</i>		
	<i>2007</i>	<i>Change</i>	<i>2006</i>
UNIX revenue	\$4,686,000	(37)%	\$7,390,000
Percent of total revenue	100%		100%
SCOSource revenue	—	(100)%	31,000
Percent of total revenue	0%		0%

  

	<i>Nine Months Ended July 31,</i>		
	<i>2007</i>	<i>Change</i>	<i>2006</i>
UNIX revenue	\$16,692,000	(23)%	\$21,795,000
Percent of total revenue	100%		100%
SCOSource revenue	23,000	(76)%	95,000
Percent of total revenue	0%		0%

The decrease in revenue in the UNIX business of \$2,704,000, or 37%, for the three months ended July 31, 2007 compared to the three months ended July 31, 2006 and the decrease in revenue in the UNIX business of \$5,103,000, or 23%, for the nine months ended July 31, 2007 compared to the nine months ended July 31, 2006 was primarily attributable to continued competition from other operating systems, particularly Linux, and from continuing negative publicity from the SCO Litigation which has adversely impacted and delayed our customers' buying decisions. We anticipate that for the remainder of the year ending October 31, 2007 our UNIX business and the related revenue from the UNIX business will continue to face significant competition from Linux and other operating systems.

Sales of our UNIX products and services during the three and nine months ended July 31, 2007 and 2006 were primarily to existing customers. Our UNIX business revenue depends significantly on our ability to market our products to existing customers and to generate upgrades from existing customers. Our UNIX revenue may be lower than currently anticipated if (1) we are not successful with our existing customers, (2) we lose the support of any of our existing hardware and software vendors, or (3) our key industry partners withdraw their marketing and certification support or direct their support to our competitors.

## Table of Contents

### Products Revenue

	<i>Three Months Ended July 31,</i>		
	<u>2007</u>	<u>Change</u>	<u>2006</u>
Products revenue	\$3,690,000	(40)%	\$6,201,000
Percent of total revenue	79%		84%

	<i>Nine Months Ended July 31,</i>		
	<u>2007</u>	<u>Change</u>	<u>2006</u>
Products revenue	\$13,451,000	(25)%	\$17,904,000
Percent of total revenue	81%		82%

Our products revenue consists of software licenses for UNIX products such as OpenServer and UnixWare, as well as sales of UNIX-related products. Products revenue also includes revenue derived from OEMs, distribution partners and large accounts. We rely heavily on our two-tier distribution channel and any disruption in our distribution channel could have an adverse impact on future revenue.

The decrease in products revenue of \$2,511,000, or 40%, for the three months ended July 31, 2007 compared to the three months ended July 31, 2006 and the decrease in products revenue of \$4,453,000, or 25%, for the nine months ended July 31, 2007 compared to the nine months ended July 31, 2006 was primarily attributable to decreased sales of OpenServer and UnixWare and other products revenue primarily resulting from increased competition in the operating system market, particularly from Linux, and from continuing negative publicity from the SCO Litigation which has adversely impacted and delayed our customers' buying decisions.

Our products revenue was derived primarily from sales of our OpenServer and UnixWare products. Other products revenue consists mainly of product maintenance and other UNIX-related products. Revenue for these products was as follows:

	<i>Three Months Ended July 31,</i>		
	<u>2007</u>	<u>Change</u>	<u>2006</u>
OpenServer revenue	\$2,135,000	(33)%	\$3,184,000
Percent of products revenue	58%		51%
UnixWare revenue	1,172,000	(55)%	2,592,000
Percent of products revenue	32%		42%
Other products revenue	383,000	(10)%	425,000
Percent of products revenue	10%		7%

	<i>Nine Months Ended July 31,</i>		
	<u>2007</u>	<u>Change</u>	<u>2006</u>
OpenServer revenue	\$8,202,000	(19)%	\$10,176,000
Percent of products revenue	61%		57%
UnixWare revenue	3,820,000	(35)%	5,901,000
Percent of products revenue	28%		33%
Other products revenue	1,429,000	(22)%	1,827,000
Percent of products revenue	11%		10%

The decrease in revenue for OpenServer and UnixWare for the three and nine months ended July 31, 2007 compared to the three and nine months ended July 31, 2006 is primarily the result of continued competition from other operating systems, particularly Linux, and from

## Table of Contents

continuing negative publicity from the SCO Litigation which has adversely impacted and delayed our customers' buying decisions. The decrease in other products revenue for the three and nine months ended July 31, 2007 compared to the three and nine months ended July 31, 2006 is primarily attributable to decreased sales of UNIX-related products and decreased sales of product maintenance. These trends may continue or be enhanced as a result of the adverse rulings on summary judgment motions in our lawsuit with Novell and our bankruptcy filings.

### SCOSource Licensing Revenue

	<i>Three Months Ended July 31,</i>		
	<u>2007</u>	<u>Change</u>	<u>2006</u>
SCOSource licensing revenue	\$—	(100)%	\$31,000

  

	<i>Nine Months Ended July 31,</i>		
	<u>2007</u>	<u>Change</u>	<u>2006</u>
SCOSource licensing revenue	\$23,000	(76)%	\$95,000

We initiated our SCOSource business for the purpose of protecting and defending our intellectual property rights in our UNIX source code and derivative works. SCOSource licensing revenue was \$0 for the three months ended July 31, 2007 compared to \$31,000 for the three months ended July 31, 2006 and was \$23,000 for the nine months ended July 31, 2007 compared to \$95,000 for the nine months ended July 31, 2006. Revenue in the above mentioned periods was primarily attributable to sales of our SCOSource IP agreements.

### Services Revenue

	<i>Three Months Ended July 31,</i>		
	<u>2007</u>	<u>Change</u>	<u>2006</u>
Services revenue	\$996,000	(16)%	\$1,189,000
Percent of total revenue	21%		16%

  

	<i>Nine Months Ended July 31,</i>		
	<u>2007</u>	<u>Change</u>	<u>2006</u>
Services revenue	\$3,241,000	(17)%	\$3,891,000
Percent of total revenue	19%		18%

Services revenue consists primarily of technical support fees, engineering services fees, professional services fees and consulting fees. These fees are typically charged and invoiced separately from UNIX products sales. The decrease in services revenue of \$193,000, or 16%, for the three months ended July 31, 2007 compared to the three months ended July 31, 2006 and the decrease in services revenue of \$650,000, or 17%, for the nine months ended July 31, 2007 compared to the nine months ended July 31, 2006 was primarily attributable to the renewal of fewer support and engineering services contracts as a result of lower UNIX product revenue.

The majority of our support and professional services revenue continues to be derived from services for UNIX-based operating system products. Our future level of services revenue depends in part on our ability to generate UNIX products revenue from new customers as well as to renew annual support and services agreements with existing UNIX customers.

## Table of Contents

### Cost of Products Revenue

	<i>Three Months Ended July 31,</i>		
	<u>2007</u>	<u>Change</u>	<u>2006</u>
Cost of products revenue	\$329,000	(31)%	\$478,000
Percent of products revenue	9%		8%

	<i>Nine Months Ended July 31,</i>		
	<u>2007</u>	<u>Change</u>	<u>2006</u>
Cost of products revenue	\$1,041,000	(33)%	\$1,559,000
Percent of products revenue	8%		9%

Cost of products revenue consists of manufacturing costs, royalties to third-party vendors, technology costs and overhead costs. Cost of products revenue decreased by \$149,000, or 31%, for the three months ended July 31, 2007 as compared to the three months ended July 31, 2006 and decreased by \$518,000, or 33%, for the nine months ended July 31, 2007 as compared to the nine months ended July 31, 2006. The decrease in the dollar amount of cost of products revenue was primarily attributable to lower products revenue as margins did not vary considerably.

### Cost of SCOSource Licensing Revenue

	<i>Three Months Ended July 31,</i>		
	<u>2007</u>	<u>Change</u>	<u>2006</u>
Cost of SCOSource licensing revenue	\$1,156,000	(50)%	\$2,315,000

	<i>Nine Months Ended July 31,</i>		
	<u>2007</u>	<u>Change</u>	<u>2006</u>
Cost of SCOSource licensing revenue	\$2,876,000	(71)%	\$10,087,000

Cost of SCOSource licensing revenue includes legal and professional fees incurred in connection with our SCO Litigation, the salaries and related personnel costs of SCOSource employees, and an allocation of corporate costs.

Cost of SCOSource licensing revenue decreased by \$1,159,000, or 50%, during the three months ended July 31, 2007 as compared to the three months ended July 31, 2006 and decreased by \$7,211,000, or 71%, for the nine months ended July 31, 2007 as compared to the nine months ended July 31, 2006. The decrease in the cost of SCOSource licensing revenue for the three months ended July 31, 2007 as compared to the three months ended July 31, 2006 was primarily attributable to decreases in services provided by technical, damage, industry and other experts in connection with the SCO Litigation. The decrease in cost of SCOSource licensing revenue for the nine months ended July 31, 2007 as compared to the nine months ended July 31, 2006 was primarily attributable to the absence of the \$2,000,000 quarterly payment and related expense to the Law Firms (which quarterly payments ended during the three months ended January 31, 2006), and significant decreases in services provided by technical, industry, damage and other experts in connection with the SCO Litigation.

Because of the unique and unpredictable nature of the SCO Litigation and our entry into Chapter 11, the occurrence and timing of certain expenses is difficult to predict, and will be difficult to predict for the upcoming quarters. We will continue to make payments for technical, damage and industry experts, consultants and for other fees. However, future legal fees may include contingency

## Table of Contents

payments made to the Law Firms as a result of a settlement, judgment, or a sale of our company, which could cause the cost of SCOSource licensing revenue for the three months ending October 31, 2007 or for future periods to be higher than the costs incurred for the three months ended July 31, 2007.

### Cost of Services Revenue

	<i>Three Months Ended July 31,</i>		
	<u>2007</u>	<u>Change</u>	<u>2006</u>
Cost of services revenue	\$448,000	(33)%	\$666,000
Percent of services revenue	45%		56%

  

	<i>Nine Months Ended July 31,</i>		
	<u>2007</u>	<u>Change</u>	<u>2006</u>
Cost of services revenue	\$1,553,000	(23)%	\$2,012,000
Percent of services revenue	48%		52%

Cost of services revenue includes the salaries and related personnel costs of employees delivering services revenue as well as third-party service agreements. Cost of services revenue decreased by \$218,000, or 33%, for the three months ended July 31, 2007 compared to the three months ended July 31, 2006 and decreased by \$459,000, or 23%, for the nine months ended July 31, 2007 compared to the nine months ended July 31, 2006. These decreases were primarily attributable to reduced employee and employee-related costs.

### Sales and Marketing

	<i>Three Months Ended July 31,</i>		
	<u>2007</u>	<u>Change</u>	<u>2006</u>
Sales and marketing expenses	\$2,463,000	(21)%	\$3,111,000
Percent of total revenue	53%		42%

  

	<i>Nine Months Ended July 31,</i>		
	<u>2007</u>	<u>Change</u>	<u>2006</u>
Sales and marketing expenses	\$7,296,000	(16)%	\$8,656,000
Percent of total revenue	44%		40%

Sales and marketing expenses consist of the salaries, commissions and other personnel costs of employees involved in the revenue generation process, as well as advertising and corporate allocations. The decrease in sales and marketing expenses of \$648,000, or 21%, for the three months ended July 31, 2007 compared with the three months ended July 31, 2006 and the decrease of \$1,360,000, or 16%, for the nine months ended July 31, 2007 compared with the nine months ended July 31, 2006 was primarily attributable to lower commissions, lower travel expenses, reduced discretionary marketing spending and lower co-operative advertising as a result of lower revenue. Included in sales and marketing expenses for the three months ended July 31, 2007 and 2006 was \$68,000 and \$102,000, respectively, for stock-based compensation. Included in sales and marketing expenses for the nine months ended July 31, 2007 and 2006 was \$286,000 and \$261,000, respectively, for stock-based compensation.

## Table of Contents

### Research and Development

	<i>Three Months Ended July 31,</i>		
	<u>2007</u>	<u>Change</u>	<u>2006</u>
Research and development expenses	\$1,424,000	(30)%	\$2,029,000
Percent of total revenue	30%		27%

	<i>Nine Months Ended July 31,</i>		
	<u>2007</u>	<u>Change</u>	<u>2006</u>
Research and development expenses	\$4,737,000	(18)%	\$5,786,000
Percent of total revenue	28%		26%

Research and development expenses consist of the salaries and benefits of software engineers, consulting expenses and corporate allocations. Research and development expenses decreased by \$605,000, or 30%, for the three months ended July 31, 2007 compared with the three months ended July 31, 2006 and decreased by \$1,049,000, or 18%, for the nine months ended July 31, 2007 compared with the nine months ended July 31, 2006. The decrease in research and development expenses was primarily attributable to reduced employee and employee-related costs. Included in research and development expenses for the three months ended July 31, 2007 and 2006 was \$51,000 and \$41,000, respectively, of stock-based compensation. Included in research and development expenses for the nine months ended July 31, 2007 and 2006 was \$147,000 and \$97,000, respectively, of stock-based compensation.

### General and Administrative

	<i>Three Months Ended July 31,</i>		
	<u>2007</u>	<u>Change</u>	<u>2006</u>
General and administrative expenses	\$1,377,000	(25)%	\$1,829,000
Percent of total revenue	29%		25%

	<i>Nine Months Ended July 31,</i>		
	<u>2007</u>	<u>Change</u>	<u>2006</u>
General and administrative expenses	\$4,051,000	(21)%	\$5,139,000
Percent of total revenue	24%		23%

General and administrative expenses consist of the salaries and benefits of finance, human resources, and executive management and expenses for professional services and corporate allocations. General and administrative expenses decreased by \$452,000, or 25%, during the three months ended July 31, 2007 as compared to the three months ended July 31, 2006 and decreased by \$1,088,000, or 21%, during the nine months ended July 31, 2007 as compared to the nine months ended July 31, 2006. The decrease in general and administrative expenses was primarily attributable to decreased personnel and personnel-related costs and from decreased professional services costs for services rendered by external consultants. Included in general and administrative expenses for the three months ended July 31, 2007 and 2006 was \$197,000 and \$264,000, respectively, of stock-based compensation. Included in general and administrative expenses for the nine months ended July 31, 2007 and 2006 was \$729,000 and \$736,000, respectively, of stock-based compensation.

## Table of Contents

### Amortization of Intangibles

	<i>Three Months Ended July 31,</i>		
	<i>2007</i>	<i>Change</i>	<i>2006</i>
Amortization of intangibles	\$—	(100)%	\$593,000
Percent of total revenue	0%		8%

	<i>Nine Months Ended July 31,</i>		
	<i>2007</i>	<i>Change</i>	<i>2006</i>
Amortization of intangibles	\$—	(100)%	\$1,778,000
Percent of total revenue	0%		8%

As of October 31, 2006, all intangible assets had been fully amortized and, therefore, no amortization expense was recorded during the three and nine months ended July 31, 2007.

### Equity in Income (Loss) of Affiliate

We account for our ownership interests in companies in which we own at least 20% and less than 50% using the equity method of accounting. Under the equity method, we record our portion of the entities' net income or net loss in our consolidated statements of operations. As of July 31, 2007, the carrying value of our investment of \$504,000 was for our 30% ownership in a Chinese company.

During the three months ended July 31, 2007 and 2006, we recorded \$9,000 and \$0, respectively, representing our portion of the net income (loss) in this entity. During the nine months ended July 31, 2007 and 2006, we recorded \$115,000 and \$(8,000), respectively, representing our portion of the net income (loss) in this entity.

### Other Income (Expense), net

Other income (expense), net, consisted of the following components for the three and nine months ended July 31, 2007 and 2006:

	<i>Three Months Ended July 31,</i>		<i>Nine Months Ended July 31,</i>	
	<i>2007</i>	<i>2006</i>	<i>2007</i>	<i>2006</i>
Interest income	\$112,000	\$191,000	\$351,000	\$542,000
Other income (expense), net	20,000	(64,000)	29,000	46,000
Total	\$132,000	\$127,000	\$380,000	\$588,000

Interest income decreased by \$79,000 for the three months ended July 31, 2007 as compared to the three months ended July 31, 2006 and decreased by \$191,000 for the nine months ended July 31, 2007 as compared to the nine months ended July 31, 2006 and was primarily attributable to lower cash and available-for-sale marketable securities balances.

The change in other income (expense), net, of \$84,000 for the three months ended July 31, 2007 as compared to the three months ended July 31, 2006 and the change of \$17,000 for the nine months ended July 31, 2007 as compared to the nine months ended July 31, 2006 was primarily attributable to changes in foreign currency rates.

## Table of Contents

### *Provision for Income Taxes*

The provision for income taxes was \$28,000 for the three months ended July 31, 2007 and \$107,000 for the three months ended July 31, 2006 and was \$221,000 for the nine months ended July 31, 2007 and \$308,000 for the nine months ended July 31, 2006. Our provision for income taxes is primarily related to earnings in foreign subsidiaries as well as from withholding taxes on revenue generated in certain foreign locations.

### **Liquidity and Capital Resources**

On September 14, 2007, The SCO Group, Inc. and its wholly owned subsidiary, SCO Operations, Inc. (the “Debtors”) filed voluntary petitions for relief under Chapter 11 of the United States Bankruptcy Code (the “Bankruptcy Code”), in the United States Bankruptcy Court for the District of Delaware (the “Bankruptcy Court”). The Debtors’ Chapter 11 cases are being jointly-administered under Case Nos. 07-11337 and 07-11338. The Debtors will continue to operate their businesses as “debtors-in-possession” under the jurisdiction of the Bankruptcy Court and in accordance with the applicable provisions of the Bankruptcy Code and orders of the Bankruptcy Court. Our foreign subsidiaries were not included in the filings and will continue their business operations without supervision from the Bankruptcy Court and will not be subject to the requirements of the Bankruptcy Code. In connection with this proceeding, we have filed motions with the Bankruptcy Court requesting permission to go forward on a “business as usual” basis as a debtor-in-possession. Accordingly, we expect to continue to have jurisdiction over our assets and business subject to the supervision and orders of the Bankruptcy Court. We will continue operating and will file a plan of reorganization with the Bankruptcy Court. For a further description of our bankruptcy filing, see “Management’s Discussion and Analysis of Financial Condition and Results of Operations—Recent Developments, Bankruptcy Filing”.

We intend to maintain business operations throughout the bankruptcy case. Subject to the Bankruptcy Court approval, we will use our cash, cash equivalents, restricted cash, and subsequent cash inflows to meet our working capital needs throughout the reorganization process.

Under the supervision of the Bankruptcy Court, we may decide to pursue various strategic alternatives as deemed appropriate by our Board of Directors to serve the best interests of the Company and our stakeholders, including asset sales or strategic partnerships.

Our cash and cash equivalents balance increased from \$5,369,000 as of October 31, 2006 to \$7,393,000 as of July 31, 2007. During this same time period, our investment in available-for-sale marketable securities decreased from \$2,249,000 as of October 31, 2006 to \$0 as of July 31, 2007. As of July 31, 2007, we also had \$3,020,000 of restricted cash, of which \$2,589,000 is set aside to cover expert and other costs related to the SCO Litigation and \$431,000 is set aside for royalties payable to Novell.

Subject to the Bankruptcy Court’s oversight and approval, we intend to use the cash and cash equivalents as of July 31, 2007 to run our UNIX business, which includes our mobility products and services offerings, and to pursue related initiatives.

Our net cash used in operating activities during the nine months ended July 31, 2007 was \$690,000 and was attributable to a net loss of \$4,565,000, non-cash items of \$1,566,000 and changes in operating assets and liabilities of \$2,309,000.

Our net cash used in operating activities during the nine months ended July 31, 2006 was \$7,050,000 and was attributable to a net loss of \$12,855,000, non-cash items of \$3,595,000 and changes in operating assets and liabilities of \$2,210,000.

## Table of Contents

Our investing activities have historically consisted of equipment purchases and the purchase and sale of available-for-sale marketable securities. During the nine months ended July 31, 2007, cash provided by investing activities was \$2,168,000, which was primarily a result of proceeds from the sale of available-for-sale marketable securities of \$2,249,000, offset by purchases of equipment of \$81,000.

During the nine months ended July 31, 2006, cash used in investing activities was \$1,109,000, which was primarily a result of sales, net of purchases, of available-for-sale marketable securities of \$1,066,000 and a dividend received from our 30% owned Chinese company of \$308,000, offset by purchases of equipment of \$265,000.

Our financing activities provided \$493,000 of cash during the nine months ended July 31, 2007. The primary sources of cash were from the exercise of options to acquire common stock of \$57,000 and proceeds of \$436,000 received from the sale of common stock through our employee stock purchase plan.

Our financing activities provided \$10,425,000 of cash during the nine months ended July 31, 2006. The primary sources of cash were the net proceeds from the issuance of approximately 2,852,000 shares of our common stock for \$9,809,000, the exercise of options to acquire common stock of \$35,000 and proceeds of \$613,000 received from the sale of common stock through our employee stock purchase plan, offset, in part, by the repurchase of shares of our common stock made in connection with the completion of our rescission offer of \$32,000.

Our net accounts receivable balance decreased from \$5,123,000 as of October 31, 2006 to \$3,133,000 as of July 31, 2007, primarily as a result of lower sales (and related invoicing) generated during the three months ended July 31, 2007 as compared to the three months ended October 31, 2006. The majority of our accounts receivable are current and our allowance for doubtful accounts was \$87,000 as of July 31, 2007, which represented approximately 3 percent of our gross accounts receivable balance and is consistent with our experience in prior periods, and we expect this trend to continue. Our write-offs of uncollectible accounts during the three and nine months ended July 31, 2007 and 2006 were not significant.

As described elsewhere in this Form 10-Q, we are continuing to pay for expert, consulting and other expenses relating to the SCO Litigation. These expenses have been material in the past and even though we expect these expenses to be lower for the year ending October 31, 2007 as compared to the year ended October 31, 2006, we expect them to continue to be material to our financial statements.

In addition to the cash expenditures mentioned above, we must pay one or more contingency fees upon any amount that we or our stockholders may receive as a result of a settlement, judgment, or a sale of our company. The contingency fee amounts payable to the Law Firms will be, subject to certain credits and adjustments, as follows:

- 33 percent of any aggregate recovery amounts received up to \$350,000,000;
- plus 25 percent of any aggregate recovery amounts above \$350,000,000 but less than or equal to \$700,000,000;
- plus 20 percent of any aggregate recovery amounts in excess of \$700,000,000.

The Engagement Agreement provides that, except for the compensation obligations specifically described above, we will not be obligated to pay any legal fees, whether hourly, contingent or otherwise, to the Law Firms, or any other law firms that may be engaged by the Law Firms, in connection with the SCO Litigation through the end of the current litigation

## Table of Contents

between us and IBM, including any appeals. In light of the Chapter 11 filings, these arrangements are subject to Bankruptcy Court approval.

We have entered into operating leases for our corporate offices located in the United States and our international sales offices. We have commitments under these leases that extend through the year ending October 31, 2010.

The following table summarizes our contractual operating lease obligations as of July 31, 2007:

	<u>Total</u>	<u>Less than 1 year</u>	<u>1 – 3 years</u>	<u>3 -5 years</u>	<u>More than 5 years</u>
Operating lease obligations	<u>\$1,061,000</u>	<u>647,000</u>	<u>\$414,000</u>	<u>\$—</u>	<u>\$—</u>

As of July 31, 2007, we did not have any long-term debt obligations, purchase obligations or material capital lease obligations.

Our ability to reduce costs to offset revenue declines in our UNIX business is limited because of contractual commitments to maintain and support our existing UNIX customers. The decline in our UNIX business may be accelerated if industry partners withdraw their support as a result of the SCO Litigation. In addition, our Chapter 11 filing and the SCO Litigation may cause industry partners, developers and hardware and software vendors to choose not to support or certify to our UNIX operating system products. This would lead to an accelerated decline in our UNIX products and services revenue. If our UNIX products and services revenue is less than expected, our liquidity will be adversely impacted.

In the event that cash required to fund operations and strategic initiatives exceeds our current cash and cash equivalents resources, we will be required to reduce costs and perhaps raise additional capital. We may not be able to reduce costs in a manner that does not impair our ability to maintain our UNIX business and pursue the SCO Litigation. We may not be able to raise capital for any number of reasons, including those listed under the section “Risk Factors” under Part II, Item 1A of this Form 10-Q. If additional equity financing is available, it may not be available to us on attractive terms and may be dilutive to our existing stockholders. In addition, if our stock price declines, we may not be able to access the public equity markets on acceptable terms, if at all. Our ability to effect acquisitions for our common stock would also be impaired.

On August 10, 2007, the federal judge overseeing our lawsuit with Novell ruled in favor of Novell on several of the summary judgment motions that were before the Court. The effect of these rulings was to significantly reduce or to eliminate certain of our claims in both the Novell and IBM cases, and possibly others. The Court ruled that Novell was the owner of the UNIX and UnixWare copyrights that existed at the time of the 1995 Asset Purchase Agreement and that Novell retained broad rights to waive our contract claims against IBM. We were directed to accept Novell’s waiver of our UNIX contract claims against IBM. In addition, the Court determined that certain SCOsource licensing agreements that we executed in fiscal year 2003 included SVRx technology and that we were required to remit some portion of the proceeds to Novell. Over our objection, a bench trial was set to begin on September 17, 2007 and the federal judge was to determine what portion, if any, of the proceeds of the fiscal year 2003 SCOsource agreements is attributable to SVRx technology and should be remitted to Novell. The range of the payment to Novell could have been from a de minimis amount to in excess of \$30,000,000, the latter amount being the amount claimed by Novell, including interest. Novell has sought to impose a constructive trust on our current funds derived from those sources, which could result in a freeze of our assets, and the Court indicated that it would address that issue as well. The

trial of these issues, however, was stayed as a result of us filing a voluntary petition for relief under Chapter 11 of the Bankruptcy Code on September 14, 2007. Our management and Board of Directors determined that filing for relief under Chapter 11 of the United States Bankruptcy Code was appropriate and necessary. As a result of both the Court's August 10, 2007 ruling and our entering into Chapter 11, there is substantial doubt about our ability to continue as a going concern. Absent a significant cash payment to Novell for this matter, management believes it is remote that the undiscounted future cash flows generated by us would not be sufficient to recover the carrying values of the long-lived assets over their expected remaining useful lives. However, if a significant cash payment is required, or significant assets are put under a constructive trust, the carrying amount of our long-lived assets may not be recovered. The accompanying financial statements do not include any adjustments that might result from the outcome of these uncertainties.

### **Forward-Looking Statements and Factors That May Affect Future Results and Financial Condition**

*With the exception of historical facts, the statements contained in Management's Discussion and Analysis of Financial Condition and Results of Operations are "forward-looking statements" within the meaning of the Private Securities Litigation Reform Act of 1995, which reflect our current expectations and beliefs regarding our future results of operations, performance and achievements. These statements are subject to risks and uncertainties and are based upon assumptions and beliefs that may or may not materialize. These forward-looking statements include, but are not limited to, statements concerning:*

- Our intention to maintain business operations throughout the bankruptcy proceeding;
- Our intention to use cash, cash equivalents, restricted cash and subsequent cash inflows to meet our working capital needs throughout the reorganization process;
- Our intention to continue operating and file a plan of reorganization with the Bankruptcy Court;
- The possibility that we may decide to pursue various strategic alternatives;
- Our intention to vigorously defend legal claims and counterclaims brought against us by others;
- Our intention to continue to pursue the SCO Litigation, as allowed by the Bankruptcy Court;
- Our belief that legal matters that we are a party to are not estimable;
- The strength of our intellectual property rights and contractual claims regarding UNIX generally and specifically the strength of our claim that unauthorized UNIX source code and derivatives of UNIX source code are prevalent in Linux;
- Our belief that competition from Linux will continue during the year ending October 31, 2007 and future periods;
- Our expectation that future services revenue will depend in part on our ability to generate UNIX products revenue from new customers as well as the renewal of annual support and services agreements from existing UNIX customers;
- Our intention to continue to pay for expert, consulting and other expenses through the conclusion of our litigation with IBM, and our expectation that although these expenses are expected to decrease for the year ending October 31, 2007 as compared to the year ended October 31, 2006, that they will continue to be material to our financial statements;
- Our expectation for the three months ending October 31, 2007 that because of the unique and unpredictable nature of the SCO Litigation, the occurrence and timing of certain expenses is difficult to predict, and will be difficult to predict for the upcoming quarters; and
- Our intention to use the cash and cash equivalents as of July 31, 2007 to run our UNIX business and to pursue the SCO Litigation.

We wish to caution readers that our operating results are subject to various risks and uncertainties that could cause our actual results and outcomes to differ materially from those discussed or anticipated, including the resolution of the SCO Litigation, competition from other operating systems, particularly Linux, the amount and timing of SCOSource licensing revenue, our ability to enhance our UNIX operating systems and maintain our UNIX business, the outcomes and developments in our Chapter 11 case, the impact of the Chapter 11 proceedings on our other pending litigation, our cash balances and available cash, continued competitive pressure on our operating system products, which could impact our results of operations, adverse developments in and increased or unforeseen legal costs related to the Company's litigation, the inability to devote sufficient resources to the development and marketing of our products, including the Me Inc. mobile services and development platform, and the possibility that customers and companies with whom we have formed partnerships will decide to terminate or reduce their relationships with us, and the factors set forth below in Part II, Item 1A-Risk Factors. We also wish to advise readers not to place any undue reliance on the forward-looking statements contained in this report, which reflect our beliefs and expectations only as of the date of this report. We assume no obligation to update or revise these forward-looking statements to reflect new events or circumstances or any changes in our beliefs or expectations, other than as required by law.

### **ITEM 3. QUANTITATIVE AND QUALITATIVE DISCLOSURES ABOUT MARKET RISK**

*Foreign Currency Risk.* We have foreign offices and operations in Europe and Asia. As a result, a portion of our revenue is derived from sales to customers outside the United States. Our international revenue is primarily denominated in U.S. dollars, Euros and United Kingdom Pounds. Most of the operating expenses related to our foreign-based operations are denominated in foreign currencies and therefore operating results are affected by changes in the U.S. dollar exchange rate in relation to foreign currencies such as the Euro, among others. If the U.S. dollar weakens compared to the Euro and other currencies, our operating expenses for foreign operations will be higher when translated back into U.S. dollars. Our revenue can also be affected by general economic conditions in the United States, Europe and other international markets. Our results of operations may be affected in the short term by fluctuations in foreign currency exchange rates.

*Interest Rate Risk.* The primary objective of our cash management strategy is to invest available funds in a manner that assures safety and liquidity and maximizes yield within such constraints. We believe that a hypothetical movement in interest rates, either up or down of up to 2%, would not have a material adverse impact on our cash and cash equivalents. We do not borrow money for short-term investment purposes.

*Investment Risk.* We have historically invested in equity instruments of privately held and public companies in the technology industry for business and strategic purposes. Investments are accounted for under the cost method if our ownership is less than 20 percent and we are not able to exercise influence over operations. We account for our ownership interests in companies in which we own at least 20% and less than 50% using the equity method of accounting. Under the equity method, we record our portion of the entities' net income or net loss in our consolidated statements of operations. Our investment policy is to regularly review the assumptions and operating performance of these companies and to record impairment losses when events and circumstances indicate that these investments may be impaired. As of July 31, 2007, we did not hold any cost method investments. As of July 31, 2007, the carrying value of our equity method investment of \$504,000 was for our 30% ownership in a Chinese company.

## Table of Contents

The stock market in general, and the market for shares of technology companies in particular, has experienced price fluctuations. In addition, factors such as new product introductions by our competitors or developments in the SCO Litigation may have a significant impact on the market price of our common stock. Furthermore, quarter-to-quarter fluctuations in our results of operations may have a significant impact on the market price of our common stock. These conditions could cause the price of our common stock to fluctuate substantially over short periods of time.

### ITEM 4. CONTROLS AND PROCEDURES

*Evaluation of disclosure controls and procedures.* Under the supervision and with the participation of our management, including our Chief Executive Officer and Chief Financial Officer, we evaluated the effectiveness of the design and operation of our disclosure controls and procedures (as defined in Rule 13a-15(e) under the Securities Exchange Act of 1934 (the “Exchange Act”). Based upon that evaluation, the Chief Executive Officer and Chief Financial Officer concluded that, as of the end of the period covered by this report, our disclosure controls and procedures were effective.

*Changes in internal control over financial reporting.* During the most recent fiscal quarter covered by this report, there has been no change in our internal control over financial reporting (as defined in Rule 13a-15(f) under the Exchange Act) that has materially affected, or is reasonably likely to materially affect, our internal control over financial reporting.

## PART II. OTHER INFORMATION

### ITEM 1. LEGAL PROCEEDINGS

Certain legal proceedings in which we are involved are discussed in Part I, Item 3, of our Annual Report on Form 10-K for the year ended October 31, 2006. In addition, for more information regarding our legal proceedings, please see Note 3 included in Part 1, Item 1. Unaudited Financial Statements – Notes to Condensed Consolidated Financial Statements, which information is incorporated herein by reference. The following is a description of certain material developments during and subsequent to the three months ended July 31, 2007.

#### *Novell*

On August 10, 2007, the federal judge ruled in favor of Novell on several of the summary judgment motions that were before the Court. The effect of these rulings was to significantly reduce or to eliminate certain of our claims in both the Novell and IBM cases, and possibly others. The Court ruled that Novell was the owner of the UNIX and UnixWare copyrights that existed at the time of the 1995 Asset Purchase Agreement and that Novell retained broad rights to waive our contract claims against IBM. We were directed to accept Novell’s waiver of its UNIX contract claims against IBM. In addition, the Court determined that certain SCOSource licensing agreements that we executed in fiscal year 2003 included SVRx technology and that we were required to remit some portion of the proceeds to Novell. Over our objection, a bench trial was set to begin on September 17, 2007 and the federal judge was to determine what portion, if any, of the proceeds of the fiscal year 2003 SCOSource agreements is attributable to SVRx technology and should be remitted to Novell. The range of the payment to Novell could have been from a de minimis amount to in excess of \$30,000,000, the latter amount being the amount claimed by Novell, including interest. Novell has sought to impose a constructive trust on our current funds derived from those sources, which could result in a freeze on our assets, and the Court indicated that it would address that issue as well. The trial of these issues, however, was

## Table of Contents

stayed as result of the Company's filing a voluntary petition for relief under Chapter 11 of the Bankruptcy Code on September 14, 2007.

### *IBM*

As a result of the judge's order of August 10, 2007, in the SCO v. Novell case, several of our claims against IBM will be dismissed. These claims will include our claims that IBM breached its UNIX license agreement and our claims arising from our termination of IBM's license. We believe that the Court's August 10, 2007 ruling does not resolve certain claims in the case, or aspects of those claims, including our claim for unfair competition arising out of the Project Monterey initiative in the late 1990's. IBM has taken the position that the Court's ruling of August 10, 2007 in the Novell case resolves all of our claims against IBM in IBM's favor; we dispute this. IBM's counterclaims against us would remain in the case subject to pending motions for summary judgment.

### **ITEM 1A. RISK FACTORS**

Investing in our securities involves a high degree of risk. In addition to the other information contained in this Form 10-Q, you should consider the following risk factors before investing in our securities.

*We do not have a history of profitable operations and our cash resources are limited.*

Our year ended October 31, 2003 was the first full year we were profitable in our operating history. Our profitability for the year ended October 31, 2003 resulted primarily from our SCOSource business. For the years ended October 31, 2006, 2005 and 2004, we incurred net losses of \$16,598,000, \$10,726,000 and \$16,227,000, respectively, and for the nine months ended July 31, 2007 we incurred a net loss of \$4,565,000. As of July 31, 2007, our accumulated deficit was \$256,105,000.

If our revenue from the sale of our UNIX products and services continues to decline, or if we continue to devote significant cash resources to the SCO Litigation, we will need to further reduce operating expenses to generate positive cash flows. During October 2006, we implemented a reduction in force and decreased our ongoing operating expenses in an effort to decrease our total costs. We may not be able to further reduce operating expenses without damaging our ability to support our existing UNIX business. Additionally, we may not be able to achieve profitability through additional cost-cutting actions.

As of July 31, 2007, we had a total of \$7,393,000 in cash and cash equivalents and an additional \$3,020,000 of restricted cash of which \$2,589,000 can be used to pursue the SCO Litigation. Since October 31, 2004, we have spent a total of \$12,411,000 for expert, consulting and other costs and fees as agreed to in the Engagement Agreement with our legal counsel in the SCO Litigation. Our limited cash resources may not be sufficient to fund continuing losses from operations and the expenses of the SCO Litigation.

*A long period of operating under Chapter 11 may harm our business.*

A long period of operating under Chapter 11 could adversely affect our business and operations. So long as the Chapter 11 cases continue, our senior management will be required to spend a significant amount of time and effort dealing with the Bankruptcy reorganization instead of focusing exclusively on business operations. A prolonged period of operating under Chapter 11 will also make it more difficult to attract and retain management and other key personnel necessary to the success and growth of our business. In addition, the longer the Chapter 11 cases continue, the more likely it is that our customers and suppliers will lose

## Table of Contents

confidence in our ability to successfully reorganize our businesses and seek to establish alternative commercial relationships.

Furthermore, so long as the Chapter 11 cases continue, we will be required to incur substantial costs for professional fees and other expenses associated with the proceedings. A prolonged continuation of the Chapter 11 cases may also require us to seek additional financing. If we require additional financing during the Chapter 11 cases and we are unable to obtain the financing on favorable terms or at all, our chances of successfully reorganizing our businesses may be seriously jeopardized.

*We may not be able to obtain confirmation of our Chapter 11 plan.*

In order to successfully emerge from Chapter 11 bankruptcy protection as a viable entity, we believe that we must develop, and obtain requisite court and creditor approval of a viable Chapter 11 plan of reorganization (the “Plan”). This process requires us to meet certain statutory requirements with respect to adequacy of disclosure with respect to the Plan, soliciting and obtaining creditor acceptances of the Plan, and fulfilling other statutory conditions for confirmation. We may not receive the requisite acceptances to confirm the Plan. Even if the requisite acceptances of the Plan are received, the Bankruptcy Court may not confirm the Plan.

If our Plan is not confirmed by the Bankruptcy Court, it is unclear whether we would be able to reorganize our businesses and what, if any, distributions to holders of claims against us would ultimately receive with respect to their claims. If an alternative reorganization could not be agreed upon, it is possible that we would have to liquidate our assets, in which case it is likely that holders of claims would receive substantially less favorable treatment than they would receive if we were to emerge as a viable, reorganized entity.

*A plan of reorganization may result in holders of our common stock receiving no distribution on account of their interests and cancellation of their common stock .*

Under the priority scheme established by the Bankruptcy Code, unless creditors agree otherwise, post-petition liabilities and prepetition liabilities must be satisfied in full before shareholders are entitled to receive any distribution or retain any property under a plan of reorganization. The ultimate recovery to creditors and/or shareholders, if any, will not be determined until confirmation of a plan or plans of reorganization. No assurance can be given as to what values, if any, will be ascribed in the Chapter 11 cases to each of these constituencies or what types or amounts of distributions, if any, they would receive. A plan of reorganization could result in holders of our common stock receiving no distribution on account of their interests and cancellation of their existing stock. If certain requirements of the Bankruptcy Code are met, a plan of reorganization can be confirmed notwithstanding its rejection by our equity security holders and notwithstanding the fact that such equity security holders do not receive or retain any property on account of their equity interests under the Plan. Therefore, an investment in our common stock is highly speculative.

*Operating under the U.S. Bankruptcy Code may restrict our ability to pursue our business strategies.*

The U.S. Bankruptcy Code limits our ability, among other things, to:

- incur additional indebtedness;
- pay dividends, repurchase our capital stock or make certain other restricted payments or investments;
- make investments;
- sell assets;

## Table of Contents

- consolidate, merge, sell or otherwise dispose of all or substantially all of our assets;
- create liens;
- enter into strategic partnerships and other contracts;
- plan for or react to market conditions or meet capital needs or otherwise restrict our activities or business plans; and
- finance our operations, strategic acquisitions, investments or alliances or other capital needs or to engage in other business activities that would be in our interest.

In addition, if a trustee is appointed to operate us in Chapter 11, the trustee would assume control of our assets and the SCO Litigation, and we may not be able to pursue the SCO Litigation or the rest of our business plan as we would like to do.

*We have suffered a significant setback in our lawsuit with Novell that has significantly limited our claims and raises substantial doubt about our ability to continue as a going concern and we may not prevail in our lawsuits with IBM, Novell and others.*

On August 10, 2007, the federal judge overseeing our lawsuit with Novell ruled in favor of Novell on several of the summary judgment motions that were before the Court. The effect of these rulings was to significantly reduce or to eliminate certain of our claims in both the Novell and IBM cases, and possibly others. The Court ruled that Novell was the owner of the UNIX and UnixWare copyrights that existed at the time of the 1995 Asset Purchase Agreement and that Novell retained broad rights to waive our contract claims against IBM. We were directed to accept Novell's waiver of our UNIX contract claims against IBM. In addition, the Court determined that certain SCOSource licensing agreements that we executed in fiscal year 2003 included SVRx technology and that we were required to remit some portion of the proceeds to Novell. Over our objection, a bench trial was set to begin on September 17, 2007 and the federal judge was to determine what portion, if any, of the proceeds of the fiscal year 2003 SCOSource agreements is attributable to SVRx technology and should be remitted to Novell. The range of the payment to Novell could have been from a de minimis amount to in excess of \$30,000,000, the latter amount being the amount claimed by Novell, including interest. Novell has sought to impose a constructive trust on our current funds derived from those sources, which could result in a freeze of our assets, and the Court indicated that it would address that issue as well. The trial of these issues, however, was stayed as a result of the Company's filing a voluntary petition for relief under Chapter 11 of the Bankruptcy Code on September 14, 2007. Our management and Board of Directors determined that filing for relief under Chapter 11 of the United States Bankruptcy Code was appropriate and necessary. As a result of both the Court's August 10, 2007 ruling and our entering into Chapter 11, there is substantial doubt about our ability to continue as a going concern. Absent a significant cash payment to Novell for this matter, management believes it is remote that the undiscounted future cash flows generated by us would not be sufficient to recover the carrying values of the long-lived assets over their expected remaining useful lives. However, if a significant cash payment is required, or significant assets are put under a constructive trust, the carrying amount of our long-lived assets may not be recovered. The accompanying financial statements do not include any adjustments that might result from the outcome of these uncertainties.

We cannot guarantee whether our claims against IBM or Novell will be heard by a jury. The lawsuits with IBM and Novell will continue to be costly. In the event that we are not successful with the IBM or Novell motions, or the continuing litigation requires more cash than expected, our business and operations would be materially harmed.

## Table of Contents

We must continue to pay for expert, consulting and other expenses through the conclusion of our litigation with IBM and Novell. As we continue with discovery and other trial preparations, we may be required to place additional amounts into the escrow account, which could further reduce our liquidity position.

*If the Court imposes a constructive trust on proceeds of the fiscal year 2003 SCOsource agreements, we may not be able to continue in business.*

The federal judge overseeing our lawsuit with Novell had scheduled a bench trial that was set to begin on September 17, 2007. At that time the federal judge was to determine what portion, if any, of the proceeds of the fiscal year 2003 SCOsource agreements is attributable to SVRx technology and should be remitted to Novell. The range of the payment to Novell could have been from a de minimis amount to in excess of \$30,000,000, the latter amount being the amount claimed by Novell, including interest. Novell has sought to impose a constructive trust on our current funds derived from these sources, which could result in a freeze of our assets, and the Court indicated that it would address that issue as well. The trial of these issues, however, was stayed as a result of our filing a voluntary petition for relief under Chapter 11 of the Bankruptcy Code on September 14, 2007. If the automatic stay is lifted, and the Court imposes a constructive trust in an amount that exceeds our cash and cash equivalents and restricted cash, or if the amount of the constructive trust is otherwise significant, we may not be able to continue in business.

*Our claims relating to our UNIX intellectual property may subject us to additional legal proceedings.*

In August 2003, Red Hat brought a lawsuit against us asserting that the Linux operating system does not infringe our UNIX intellectual property rights and seeking a declaratory judgment for non-infringement of copyrights and no misappropriation of trade secrets. In addition, Red Hat claims we have engaged in false advertising in violation of the Lanham Act, deceptive trade practices, unfair competition, tortious interference with prospective business opportunities, and trade libel and disparagement. This case is currently stayed pending the resolution of our suit against IBM. If Red Hat is successful in its claim against us, our business and results of operations could be materially harmed.

*Our Engagement Agreement with the Law Firms representing us in the SCO Litigation requires us to pay for expert, consulting and other costs, which could harm our liquidity position.*

On October 31, 2004, the Company entered into an engagement agreement (the "Engagement Agreement") with Boies, Schiller & Flexner LLP, Kevin McBride and Berger Singerman P.A. (the "Law Firms"). This Engagement Agreement supercedes and replaces the original engagement agreement that was entered into in February 2003. The Engagement Agreement governs the relationship between the Law Firms and us in connection with the Law Firms' representation of us in the SCO Litigation. Berger Singerman P.A. was a member of this group of Law Firms. With the consent of us, the engagement of this firm was mutually terminated. The last payment received by Berger Singerman P.A. was on November 24, 2004.

On June 5, 2006, we entered into an amendment to the Engagement Agreement and agreed with the Law Firms to deposit an additional \$5,000,000 into the escrow account to cover additional expert, consulting and other expenses. During October 2006, we deposited an additional \$5,000,000 into the escrow account. In the event that we exhaust these funds, we must continue to pay for expert, consulting and other expenses through the conclusion of our litigation with IBM. As we continue with discovery and other trial preparations, we may be required to place additional amounts into the escrow account, which could further reduce our liquidity position. As of July 31, 2007, we had a total of \$7,393,000 in cash and cash equivalents and an

## Table of Contents

additional \$3,020,000 of restricted cash to be used to pursue the SCO Litigation. Since October 31, 2004, we have spent a total of \$12,411,000 for expert, consulting and other costs and fees as agreed to in the Engagement Agreement with our legal counsel in the SCO Litigation. In light of the Chapter 11 filings, these arrangements are subject to Bankruptcy Court approval.

*Developments in the SCO Litigation and fluctuations in our operating results or the failure of our operating results to meet the expectations of public market analysts and investors may negatively impact our stock price and our ability to continue in business.*

Developments in the SCO Litigation and fluctuations in our operating results or our failure to meet the expectations of analysts or investors, even in the short-term, could cause our stock price to decline significantly. Because of the potential for fluctuations in our expenses related to the SCO Litigation in any particular period, you should not rely on comparisons of our results of operations as an indication of future performance.

Factors that may affect our results include:

- our ability to operate effectively under Chapter 11 protection and changes in business attitudes toward UNIX as a viable operating system compared to other competing operating systems, especially Linux, as well as the possibility that the automatic stay triggered by our Chapter 11 filing will be lifted or modified, and a constructive trust will be imposed upon our cash in a significant amount;
- the outcome of pending motions for summary judgment in our lawsuit with IBM, adverse rulings relating to IBM's counterclaims, and results of, developments in, or costs of the SCO Litigation as well as adverse publicity regarding our business and the SCO Litigation;
- changes in general economic conditions, such as recessions, that could affect capital expenditures in the software industry;
- the interest level of resellers in recommending our UNIX business solutions to end users and the introduction, development, timing, competitive pricing and market acceptance of our products and services and those of our competitors;
- the contingency and other costs we may pay to the Law Firms representing us in our efforts to establish and defend our intellectual property rights;
- changes in attitudes of customers and partners due to the decline in our UNIX business and our position against the inclusion of our UNIX code and derivative works in Linux; and
- the activities of short sellers.

We also experience fluctuations in operating results in interim periods in Europe and the Asia Pacific regions due to seasonal slowdowns and economic conditions in these areas. Seasonal slowdowns in these regions typically occur during the summer months.

As a result of the factors listed above and elsewhere, it is possible that our results of operations may be below the expectations of public market analysts and investors in any particular period. This could cause our stock price to decline. If revenue falls below our expectations, and we are unable to quickly reduce our spending in response, our operating results will be lower than expected. Our stock price may fall in response to these events.

For a further description of recent developments in our litigation with Novell, see "Management's Discussion and Analysis of Financial Condition and Results of Operations—Recent Developments, Novell, Inc. Ruling". For a further description of the risks we face as a result of filing for Chapter 11, see "A long period of operating under Chapter 11 may harm our business", "We may not be able to obtain confirmation of our Chapter 11 plan", "A plan of

## Table of Contents

*reorganization may result in holders of our common stock receiving no distribution on account of their interests and cancellation of their common stock”, and “ Operating under the U.S. Bankruptcy Code may restrict our ability to pursue our business strategies ”.*

*If we are unable to retain key personnel in an intensely competitive environment, our operations could be adversely affected.*

We need to retain our key management, technical and support personnel. Competition for qualified professionals in the software industry is intense, and departures of existing personnel could be disruptive to our business and might result in the departure of other employees. During October 2006 we were required to reduce our operating expenses and eliminated certain positions within our worldwide workforce in an effort to reduce operating costs. The loss or departure of any officers or key employees could harm our ability to implement our business plan and could adversely affect our operations. Our future success depends to a significant extent on the continued service and coordination of our management team, particularly Darl C. McBride, our President and Chief Executive Officer and Ryan E. Tibbitts our General Counsel. For a discussion of the risks we face in attracting and retaining employees due to our Chapter 11 filing, see *“A long period of operating under Chapter 11 may harm our business.”*

*We operate in a highly competitive market and face significant competition from a variety of current and potential sources; many of our current and potential competitors have greater financial and technical resources than we do; thus, we may fail to compete effectively.*

In the operating system market, our competitors include IBM, Red Hat, Novell, Sun, Microsoft, and other UNIX and Linux distributors. These and other competitors are aggressively pursuing the current UNIX operating system market. Many of these competitors have access to substantially greater resources than we do. The major competitive alternative to our UNIX products is Linux. The expansion of our competitors’ offerings may restrict the overall market available for our UNIX products, including some markets where we have been successful in the past.

Our future success may depend in part on our ability to continue to meet the increasing needs of our customers by supporting existing and emerging technologies. If we do not have the resources to enhance our products to meet these evolving needs, we may not remain competitive and be able to sustain our business. Additionally, because technological advancement in the UNIX operating system market and alternative operating system markets is progressing at an advanced pace, we will have to develop and introduce enhancements to our existing products and any new products on a timely basis to keep pace with these developments, evolving industry standards, changing customer requirements and keeping current on certifications. Our failure to meet any of these and other competitive pressures may render our existing products and services obsolete, which would have an adverse impact on our revenue and operations.

The success of our UNIX business will depend on the level of commitment and certification we receive from industry partners and developers. In recent years, we have seen hardware and software vendors as well as software developers turn their certification and application development efforts toward Linux and elect not to continue to support or certify to our UNIX operating system products. If this trend continues, our competitive position will be adversely impacted and our future revenue from our UNIX business will decline. The decline in our UNIX business may be accelerated if industry partners withdraw their support from us for any reason, including our SCO Litigation.

## Table of Contents

*If the market for UNIX continues to contract, our business will be harmed.*

Our revenue from the sale of UNIX products has declined over the last several years. This decrease in revenue has been attributable primarily to increased competition from other operating systems, particularly Linux, and from the negative publicity we have received from the SCO Litigation. Our sales of UNIX products and services are primarily to existing customers. If the demand for UNIX products continues to decline, and we are unable to develop UNIX products and services that successfully address a market demand, our UNIX revenue will continue to decline, industry participants may not certify to our operating system and products, we may not be able to attract new customers or retain existing customers and our business and results of operations will be adversely affected. Additionally, with the recent adverse summary judgment rulings in our lawsuit with Novell and our entry into Chapter 11, customers will likely determine to no longer buy our products and services. Because of the long adoption cycle for operating system purchases and the long sales cycle of our operating system products, we may not be able to reverse these revenue declines quickly.

*We may lose the support of industry partners leading to an accelerated decline in our UNIX products and services revenue.*

The decline in our UNIX business, the recent rulings in our lawsuit with Novell and our filing for protection under Chapter 11 may cause industry partners, developers, customers and hardware and software vendors to choose not to support or certify to our UNIX operating system products. This would lead to an increased decline in our UNIX products and services revenue and would adversely impact our results of operations and liquidity.

*We rely on our indirect sales channel for distribution of our products, and any disruption of our channel at any level could adversely affect the sales of our products.*

We have a two-tiered distribution channel. The relationships we have developed with resellers allow us to offer our products and services to a much larger customer base than we would otherwise be able to reach through our own direct sales and marketing efforts. Some solution providers also purchase solutions through our resellers, and we anticipate they will continue to do so. Because we usually sell indirectly through resellers, we cannot control the relationships through which resellers, solution providers or equipment integrators purchase our products. In turn, we do not control the presentation of our products to end users. Therefore, our sales could be affected by disruptions in the relationships between us and our resellers, between our resellers and solution providers, or between solution providers and end users. Also, resellers and solution providers may choose not to emphasize our products to their customers. Any of these occurrences could diminish the effectiveness of our distribution channel and lead to decreased sales.

*Our foreign-based operations and sales create special problems, including the imposition of governmental controls and taxes and fluctuations in currency exchange rates that could hurt our results.*

We have employees or contractors in certain locations in Europe, the Middle East, Latin America, and Asia. These foreign operations are subject to certain inherent risks, including:

- potential loss of developed technology through piracy, misappropriation, or more lenient laws regarding intellectual property protection;
- imposition of governmental controls, including trade restrictions and other tax requirements;
- fluctuations in currency exchange rates and economic instability;
- longer payment cycles for sales in foreign countries; and
- seasonal reductions in business activity.

## Table of Contents

In addition, certain of our operating expenses are denominated in local currencies, creating risk of foreign currency translation losses that could reduce our financial results and cash flows. When we generate profits in foreign countries, our effective income tax rate is increased.

During the three months ended April 30, 2004, our Indian office was assessed withholding taxes by the Government of India Income Tax Department. The Tax Department assessed a 15% withholding tax on certain revenue transactions in India that the Tax Department deemed royalty revenue under the Income Tax Act. We have filed an appeal with the Tax Department and believe that revenue from our packaged software does not qualify for royalty treatment and therefore would not be subject to withholding tax. However, we may be unsuccessful in our appeal against the Tax Department and be obligated to pay the assessed taxable amounts. Because of our international operations, we may be subject to additional withholding or other taxes from other international jurisdictions.

*We could lose our listing on the Nasdaq Capital Market and the loss of our listing would make our stock significantly less liquid and would affect its value.*

There are certain qualitative and quantitative criteria for continued listing on the Nasdaq Capital Market, known as continued listing requirements. Failure to satisfy any one of these continued listing requirements could result in our securities being delisted from the Nasdaq Capital Market. On April 23, 2007, we received a letter from The Nasdaq Stock Market (“Nasdaq”) indicating that the bid price of our common stock for the last 30 consecutive business days had closed below the minimum \$1.00 per share required for continued listing under Nasdaq Marketplace Rule 4310(c)(4). Pursuant to Nasdaq Marketplace Rule 4310(c)(8)(D), we were provided an initial period of 180 calendar days, or until October 22, 2007, to regain compliance. On June 11, 2007, we received a letter from Nasdaq indicating that we regained compliance with Nasdaq Marketplace Rule 4310(c)(4). During the compliance period provided under the Marketplace Rules, the closing bid price of our common stock was at \$1.00 per share or greater for at least 10 consecutive business days. Accordingly, the Nasdaq Staff informed us that we had regained compliance with Marketplace Rule 4310(c)(4).

The closing price of our common stock on September 14, 2007 was \$0.37. There is the risk of being delisted from the Nasdaq Capital Market should our common stock fail to maintain a minimum bid price of \$1.00 per share for 30 consecutive days, or we fail to meet other continued listing requirements.

In addition, as a result of our having filed for protection under Chapter 11 of the U.S. Bankruptcy Code, Nasdaq may decide to use its authority under Marketplace Rules 4300, 4450(f) and IM-4300 to delist our securities from The Nasdaq Stock Market or suspend trading in our securities.

Upon delisting from the Nasdaq Capital Market, our stock would be traded over-the-counter, more commonly known as OTC. OTC transactions involve risks in addition to those associated with transactions in securities traded on the Nasdaq Capital Market. Many OTC stocks trade less frequently and in smaller volumes than securities traded on the Nasdaq Capital Market. Accordingly, our stock would be less liquid than it would otherwise be, and the value of our stock could decrease.

## Table of Contents

### *Our stock price is volatile.*

The trading price for our common stock has been volatile during the last several years and our share price has changed dramatically over short periods. We believe that changes in our stock price are affected by the factors mentioned above under the caption entitled “*Developments in the SCO Litigation and fluctuations in our operating results or the failure of our operating results to meet the expectations of public market analysts and investors may negatively impact our stock price and our ability to continue in business*” as well as from changing public perceptions concerning the strength of the SCO Litigation and other factors beyond our control. Public perception can change quickly and without any change or development in our underlying business or litigation position. An investment in our stock is subject to such volatility and, consequently, is subject to significant risk.

### *There are risks associated with the potential exercise of our outstanding options.*

As of August 31, 2007, we have issued outstanding options to purchase up to approximately 5,396,000 shares of common stock with an average exercise price of \$3.53 per share. The existence of such rights to acquire common stock at fixed prices may prove a hindrance to our efforts to raise future equity and debt funding, and the exercise of such rights will dilute the percentage ownership interest of our stockholders and may dilute the value of their ownership. The possible future sale of shares issuable on the exercise of outstanding options could adversely affect the prevailing market price for our common stock. Further, the holders of the outstanding stock options may exercise them at a time when we would otherwise be able to obtain additional equity capital on terms more favorable to us.

### *Common stock available for resale may depress the market price of our common stock.*

We have filed a post-effective amendment to a registration statement with the Securities and Exchange Commission (“SEC”), which has been declared effective, covering the potential resale by two of our stockholders of up to 923,019 shares of common stock, or 4.3% of our outstanding common stock. The selling stockholders are bound by certain selling limitations, which limit the numbers of shares of our common stock that may be sold at one time. In addition, we have filed a registration statement with the SEC, which has been declared effective, covering the potential resale by some of our stockholders of up to 2,852,449 shares of our common stock, or 13.3% of our outstanding common stock. The existence of a substantial number of shares of common stock subject to immediate resale could depress the market price for our common stock and impair our ability to raise needed capital.

### *Our stock price could decline further because of the activities of short sellers.*

Our stock has attracted significant interest from short sellers. The activities of short sellers could further reduce the price of our stock or inhibit increases in our stock price.

### *The right of our Board of Directors to authorize additional shares of preferred stock could adversely impact the rights of holders of our common stock.*

Our Board of Directors currently has the right, with respect to the 5,000,000 shares of our preferred stock, to authorize the issuance of one or more additional series of our preferred stock with such voting, dividend and other rights as our directors determine. The Board of Directors can designate new series of preferred stock without the approval of the holders of our common stock. The rights of holders of our common stock may be adversely affected by the rights of any holders of additional shares of preferred stock that may be issued in the future, including without limitation, further dilution of the equity ownership percentage of our holders of common stock and their voting power if we issue preferred stock with voting rights.

## Table of Contents

Additionally, the issuance of preferred stock could make it more difficult for a third party to acquire a majority of our outstanding voting stock.

*Our stockholder rights plan could make it more difficult for a hostile bid for our company or a change of control transaction to succeed at current market prices for our stock.*

We have adopted a stockholder rights plan. The power given to the Board of Directors by the stockholder rights plan may make it more difficult for a change of control of our company to occur or for our company to be acquired if the acquisition is opposed by our Board of Directors.

### ITEM 6. EXHIBITS

#### (a) Exhibits

- 3.1 Amended and Restated Certificate of Incorporation of Caldera International, Inc. (incorporated by reference to Exhibit 3.1 to SCO's Registration Statement on Form 8-A12G/A (File No. 000-29911)).
- 3.2 Certificate of Amendment to Amended and Restated Certificate of Incorporation regarding consolidation of outstanding shares (incorporated by reference to Exhibit 3.2 to SCO's Registration Statement on Form 8-A12G/A (File No. 000-29911)).
- 3.3 Certificate of Amendment to Amended and Restated Certificate of Incorporation regarding change of name to The SCO Group, Inc. (incorporated by reference to Exhibit 3.3 to SCO's Registration Statement on Form 8A12G/A (File No. 000-29911)).
- 3.4 Amended and Restated Bylaws (incorporated by reference to Exhibit 3.4 to SCO's Registration Statement on Form 8-A12G/A (File No. 000-29911)).
- 3.5 Certificate of Designation for Series A-1 Convertible Preferred Stock (incorporated by reference to Exhibit 4.1 to SCO's Current Report on Form 8-K filed on February 9, 2004 (File No. 000-29911)).
- 3.6 Certificate of Correction correcting the Certificate of Designation for Series A-1 Convertible Preferred Stock (incorporated by reference to Exhibit 4.2 to SCO's Current Report on Form 8-K filed on February 9, 2004 (File No. 000-29911)).
- 31.1 Certification of Darl C. McBride, President and Chief Executive Officer, pursuant to Rule 13a-14(a) of the Exchange Act, as adopted pursuant to Section 302 of the Sarbanes-Oxley Act of 2002.
- 31.2 Certification of Bert B. Young, Chief Financial Officer, pursuant to Rule 13a-14(a) of the Exchange Act, as adopted pursuant to Section 302 of the Sarbanes-Oxley Act of 2002.
- 32.1 Certification of Darl C. McBride, President and Chief Executive Officer, pursuant to Section 1350, Chapter 63 of Title 18, United States Code, as adopted pursuant to Section 906 of the Sarbanes-Oxley Act of 2002.
- 32.2 Certification of Bert B. Young, Chief Financial Officer, pursuant to Section 1350, Chapter 63 of Title 18, United States Code, as adopted pursuant to Section 906 of the Sarbanes-Oxley Act of 2002.

**ITEM 7. SIGNATURES**

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

Date: September 17, 2007

THE SCO GROUP, INC.

By: /s/ Bert B. Young  
Bert B. Young  
Duly Authorized Officer and Chief Financial Officer  
(Principal Financial and Accounting Officer)

EXHIBIT INDEX

<u>Exhibit Number</u>	<u>Exhibit Description</u>
3.1	Amended and Restated Certificate of Incorporation of Caldera International, Inc. (incorporated by reference to Exhibit 3.1 to SCO's Registration Statement on Form 8-A12G/A (File No. 000-29911)).
3.2	Certificate of Amendment to Amended and Restated Certificate of Incorporation regarding consolidation of outstanding shares (incorporated by reference to Exhibit 3.2 to SCO's Registration Statement on Form 8-A12G/A (File No. 000-29911)).
3.3	Certificate of Amendment to Amended and Restated Certificate of Incorporation regarding change of name to The SCO Group, Inc. (incorporated by reference to Exhibit 3.3 to SCO's Registration Statement on Form 8A12G/A (File No. 000-29911)).
3.4	Amended and Restated Bylaws (incorporated by reference to Exhibit 3.4 to SCO's Registration Statement on Form 8-A12G/A (File No. 000-29911)).
3.5	Certificate of Designation for Series A-1 Convertible Preferred Stock (incorporated by reference to Exhibit 4.1 to SCO's Current Report on Form 8-K filed on February 9, 2004 (File No. 000-29911)).
3.6	Certificate of Correction correcting the Certificate of Designation for Series A-1 Convertible Preferred Stock (incorporated by reference to Exhibit 4.2 to SCO's Current Report on Form 8-K filed on February 9, 2004 (File No. 000-29911)).
31.1	Certification of Darl C. McBride, President and Chief Executive Officer, pursuant to Rule 13a-14(a) of the Exchange Act, as adopted pursuant to Section 302 of the Sarbanes-Oxley Act of 2002.
31.2	Certification of Bert Young, Chief Financial Officer, pursuant to Rule 13a-14(a) of the Exchange Act, as adopted pursuant to Section 302 of the Sarbanes-Oxley Act of 2002.
32.1	Certification of Darl C. McBride, President and Chief Executive Officer, pursuant to Section 1350, Chapter 63 of Title 18, United States Code, as adopted pursuant to Section 906 of the Sarbanes-Oxley Act of 2002.
32.2	Certification of Bert Young, Chief Financial Officer, pursuant to Section 1350, Chapter 63 of Title 18, United States Code, as adopted pursuant to Section 906 of the Sarbanes-Oxley Act of 2002.



**CERTIFICATION PURSUANT TO RULE 13A-14  
OF THE SECURITIES EXCHANGE ACT OF 1934, AS AMENDED,  
AS ADOPTED PURSUANT TO  
SECTION 302 OF THE SARBANES-OXLEY ACT OF 2002**

I, Darl C. McBride, certify that:

1. I have reviewed this quarterly report on Form 10-Q of The SCO Group, Inc.;
2. Based on my knowledge, this report does not contain any untrue statement of a material fact or omit to state a material fact necessary to make the statements made, in light of the circumstances under which such statements were made, not misleading with respect to the period covered by this report;
3. Based on my knowledge, the financial statements, and other financial information included in this report, fairly present in all material respects the financial condition, results of operations and cash flows of the registrant as of, and for, the periods presented in this report;
4. The registrant's other certifying officer(s) and I are responsible for establishing and maintaining disclosure controls and procedures (as defined in Exchange Act Rules 13a-15(e) and 15d-15(e)) for the registrant and have:
  - (a) Designed such disclosure controls and procedures, or caused such disclosure controls and procedures to be designed under our supervision, to ensure that material information relating to the registrant, including its consolidated subsidiaries, is made known to us by others within those entities, particularly during the period in which this report is being prepared;
  - (b) [Paragraph omitted pursuant to SEC Release Nos. 33-8238 and 34-47986];
  - (c) Evaluated the effectiveness of the registrant's disclosure controls and procedures and presented in this report our conclusions about the effectiveness of the disclosure controls and procedures, as of the end of the period covered by this report based on such evaluation; and
  - (d) Disclosed in this report any change in the registrant's internal control over financial reporting that occurred during the registrant's most recent fiscal quarter (the registrant's fourth fiscal quarter in the case of an annual report) that has materially affected, or is reasonably likely to materially affect, the registrant's internal control over financial reporting; and
5. The registrant's other certifying officer(s) and I have disclosed, based on our most recent evaluation of internal control over financial reporting, to the registrant's auditors and the audit committee of the registrant's board of directors (or persons performing the equivalent functions):
  - (a) All significant deficiencies and material weaknesses in the design or operation of internal control over financial reporting which are reasonably likely to adversely affect the registrant's ability to record, process, summarize and report financial information; and
  - (b) Any fraud, whether or not material, that involves management or other employees who have a significant role in the registrant's internal control over financial reporting.

Date: September 17, 2007

/s/ Darl C. McBride

\_\_\_\_\_  
Darl C. McBride  
President and Chief Executive Officer



**CERTIFICATION PURSUANT TO RULE 13A-14  
OF THE SECURITIES EXCHANGE ACT OF 1934, AS AMENDED,  
AS ADOPTED PURSUANT TO  
SECTION 302 OF THE SARBANES-OXLEY ACT OF 2002**

I, Bert B. Young, certify that:

1. I have reviewed this quarterly report on Form 10-Q of The SCO Group, Inc.;
2. Based on my knowledge, this report does not contain any untrue statement of a material fact or omit to state a material fact necessary to make the statements made, in light of the circumstances under which such statements were made, not misleading with respect to the period covered by this report;
3. Based on my knowledge, the financial statements, and other financial information included in this report, fairly present in all material respects the financial condition, results of operations and cash flows of the registrant as of, and for, the periods presented in this report;
4. The registrant's other certifying officer(s) and I are responsible for establishing and maintaining disclosure controls and procedures (as defined in Exchange Act Rules 13a-15(e) and 15d-15(e)) for the registrant and have:
  - (a) Designed such disclosure controls and procedures, or caused such disclosure controls and procedures to be designed under our supervision, to ensure that material information relating to the registrant, including its consolidated subsidiaries, is made known to us by others within those entities, particularly during the period in which this report is being prepared;
  - (b) [Paragraph omitted pursuant to SEC Release Nos. 33-8238 and 34-47986];
  - (c) Evaluated the effectiveness of the registrant's disclosure controls and procedures and presented in this report our conclusions about the effectiveness of the disclosure controls and procedures, as of the end of the period covered by this report based on such evaluation; and
  - (d) Disclosed in this report any change in the registrant's internal control over financial reporting that occurred during the registrant's most recent fiscal quarter (the registrant's fourth fiscal quarter in the case of an annual report) that has materially affected, or is reasonably likely to materially affect, the registrant's internal control over financial reporting; and
5. The registrant's other certifying officer(s) and I have disclosed, based on our most recent evaluation of internal control over financial reporting, to the registrant's auditors and the audit committee of the registrant's board of directors (or persons performing the equivalent functions):
  - (a) All significant deficiencies and material weaknesses in the design or operation of internal control over financial reporting which are reasonably likely to adversely affect the registrant's ability to record, process, summarize and report financial information; and
  - (b) Any fraud, whether or not material, that involves management or other employees who have a significant role in the registrant's internal control over financial reporting.

Date: September 17, 2007

/s/ Bert B. Young  
\_\_\_\_\_  
Bert B. Young  
Chief Financial Officer



**CERTIFICATION PURSUANT TO  
18 U.S.C. SECTION 1350,  
AS ADOPTED PURSUANT TO  
SECTION 906 OF THE SARBANES-OXLEY ACT OF 2002**

In connection with the quarterly report of The SCO Group, Inc. (the "Company") on Form 10-Q, for the three months ended July 31, 2007, as filed with the Securities and Exchange Commission on the date hereof (the "Report"), I, Darl C. McBride, President and Chief Executive Officer of the Company, certify, pursuant to 18 U.S.C. Section 1350, as adopted pursuant to Section 906 of the Sarbanes-Oxley Act of 2002, that:

1. The Report fully complies with the requirements of Section 13(a) or 15(d) of the Securities Exchange Act of 1934; and
2. The information contained in the Report fairly presents, in all material respects, the financial condition and results of operations of the Company.

By: /s/ Darl C. McBride  
Darl C. McBride  
President and Chief Executive Officer

Date: September 17, 2007



**CERTIFICATION PURSUANT TO  
18 U.S.C. SECTION 1350,  
AS ADOPTED PURSUANT TO  
SECTION 906 OF THE SARBANES-OXLEY ACT OF 2002**

In connection with the quarterly report of The SCO Group, Inc. (the "Company") on Form 10-Q, for the three months ended July 31, 2007, as filed with the Securities and Exchange Commission on the date hereof (the "Report"), I, Bert B. Young, Chief Financial Officer of the Company, certify, pursuant to 18 U.S.C. Section 1350, as adopted pursuant to Section 906 of the Sarbanes-Oxley Act of 2002, that:

1. The Report fully complies with the requirements of Section 13(a) or 15(d) of the Securities Exchange Act of 1934; and
2. The information contained in the Report fairly presents, in all material respects, the financial condition and results of operations of the Company.

By: /s/ Bert B. Young  
Bert B. Young  
Chief Financial Officer

Date: September 17, 2007