

# UNITED ONLINE INC

## FORM 10-Q (Quarterly Report)

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Sector	Technology
Fiscal Year	12/31

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

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**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 December 31, 2002

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 000-33367

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**UNITED ONLINE, INC.**

(Exact name of registrant as specified in its charter)

**Delaware**

(State or other jurisdiction of  
incorporation or organization)

**77-0575839**

(I.R.S Employer Identification No.)

**2555 Townsgate Road,  
Westlake Village, California**  
(Address of principal executive office)

**91361**  
(Zip Code)

**(805) 418-2000**

(Registrant's telephone number, including area code)

**Not Applicable**

(Former name, former address and former fiscal year, if changed since last report)

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Indicate by check mark whether the registrant (1) has filed all documents and 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

There were 41,783,355 shares of the registrant's common stock outstanding as of January 31, 2003.

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In this document, "United Online," the "Company," "we," "us" and "our" collectively refer to United Online, Inc. and its wholly-owned subsidiaries.

### PART I. FINANCIAL INFORMATION

#### ITEM 1. FINANCIAL STATEMENTS

##### UNITED ONLINE, INC. CONSOLIDATED BALANCE SHEETS (in thousands)

	December 31, 2002	June 30, 2002
	(unaudited)	
<b>Assets</b>		
Current assets:		
Cash and cash equivalents	\$ 63,301	\$ 41,543
Short-term investments	96,479	97,812
Restricted cash	111	5,880
Accounts receivable, net	11,312	7,977
Other current assets	5,396	3,577
	176,599	156,789
Total current assets	176,599	156,789
Property and equipment, net	13,303	16,500
Restricted cash	700	305
Goodwill	10,940	10,940

Intangible assets, net		46,581	47,179
Other assets		1,668	1,880
		<u>          </u>	<u>          </u>
Total assets	\$	249,791	\$ 233,593
		<u>          </u>	<u>          </u>
<b>Liabilities and Stockholders' Equity</b>			
Current liabilities:			
Accounts payable	\$	25,906	\$ 21,575
Accrued liabilities		13,120	11,212
Deferred revenue		20,157	18,815
Capital leases		748	3,205
		<u>          </u>	<u>          </u>
Total current liabilities		59,931	54,807
Commitments and contingencies (Note 10)			
Stockholders' equity:			
Common stock		4	4
Additional paid-in capital		542,408	539,626
Notes receivable from stockholders		(1,558)	(1,575)
Deferred stock-based charges		(42)	(107)
Accumulated other comprehensive income		2,989	1,015
Accumulated deficit		(353,941)	(360,177)
		<u>          </u>	<u>          </u>
Total stockholders' equity		189,860	178,786
		<u>          </u>	<u>          </u>
Total liabilities and stockholders' equity	\$	249,791	\$ 233,593
		<u>          </u>	<u>          </u>

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

**UNITED ONLINE, INC.**  
**UNAUDITED CONSOLIDATED STATEMENTS OF OPERATIONS**  
**AND COMPREHENSIVE INCOME (LOSS)**  
(in thousands, except per share amounts)

	Three Months Ended December 31,		Six Months Ended December 31,	
	2002	2001	2002	2001
Revenues:				
Billable services	\$ 58,149	\$ 41,035	\$ 109,343	\$ 48,698
Advertising and commerce	7,651	7,012	14,525	13,457
	<u>          </u>	<u>          </u>	<u>          </u>	<u>          </u>
Total revenues	65,800	48,047	123,868	62,155
	<u>          </u>	<u>          </u>	<u>          </u>	<u>          </u>
Operating expenses:				
Cost of billable services (including stock-based charges, see Note 9)	21,990	23,265	42,690	31,542
Cost of free services (including stock-based charges, see Note 9)	3,161	8,722	6,897	21,978
Sales and marketing (including stock-based charges, see Note 9)	19,863	10,059	36,530	13,998
Product development (including stock-based charges, see Note 9)	5,740	7,418	11,661	12,081
General and administrative (including stock-based charges, see Note 9)	7,087	9,151	12,740	17,164
Amortization of intangible assets	3,798	4,685	8,483	4,786
Restructuring charges	—	2,075	—	2,435
	<u>          </u>	<u>          </u>	<u>          </u>	<u>          </u>
Total operating expenses	61,639	65,375	119,001	103,984

Income (loss) from operations	4,161	(17,328)	4,867	(41,829)
Interest income, net	1,073	1,585	2,061	2,943
Other income, net	—	—	—	1,007
Income (loss) before income taxes	5,234	(15,743)	6,928	(37,879)
Provision for income taxes	523	—	692	—
Net income (loss)	\$ 4,711	\$ (15,743)	\$ 6,236	\$ (37,879)
Unrealized gain (loss) on short-term investments, net of tax	139	(463)	1,974	(355)
Comprehensive income (loss)	\$ 4,850	\$ (16,206)	\$ 8,210	\$ (38,234)
Net income (loss) per share—basic	\$ 0.12	\$ (0.41)	\$ 0.15	\$ (1.19)
Net income (loss) per share—diluted	\$ 0.11	\$ (0.41)	\$ 0.14	\$ (1.19)
Shares used to calculate basic net income (loss) per share	40,937	38,863	40,553	31,795
Shares used to calculate diluted net income (loss) per share	44,563	38,863	44,119	31,795

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

**UNITED ONLINE, INC.**  
**UNAUDITED CONSOLIDATED STATEMENTS OF CASH FLOWS**  
(in thousands)

	Six Months Ended December 31,	
	2002	2001
Cash flows from operating activities:		
Net income (loss)	\$ 6,236	\$ (37,879)
Adjustments to reconcile net income (loss) to net cash provided by (used for) operating activities:		
Depreciation and amortization	14,869	14,067
Stock-based charges	65	3,565
Other	597	(243)
Changes in operating assets and liabilities (excluding the effects of acquisitions):		
Restricted cash	5,374	9,150
Accounts receivable	(1,724)	2,910
Other assets	(1,606)	2,130
Accounts payable and accrued liabilities	5,426	(17,533)
Deferred revenue	298	3,220
Net cash provided by (used for) operating activities	29,535	(20,613)
Cash flows from investing activities:		
Purchases of property and equipment	(2,633)	(436)
Purchases of patent rights	—	(18)
Purchases of short-term investments	(26,818)	(34,605)
Proceeds from maturities of short-term investments	29,945	27,945
Proceeds from sales of assets, net	—	1,190
Cash paid for acquisitions, net of cash acquired	(8,388)	32,307

Net cash provided by (used for) investing activities	(7,894)	26,383
Cash flows from financing activities:		
Payments on capital leases	(2,306)	(2,581)
Payments on notes payable	—	(1,952)
Repayment of notes receivable from stockholders	56	—
Proceeds from employee stock purchase plan	843	111
Proceeds from exercise of stock options	3,689	—
Repurchases of common stock and option shares exercised	(2,165)	(1,088)
Net cash provided by (used for) financing activities	117	(5,510)
Change in cash and cash equivalents	21,758	260
Cash and cash equivalents, beginning of period	41,543	60,087
Cash and cash equivalents, end of period	\$ 63,301	\$ 60,347
Supplemental disclosure of non cash investing and financing activities:		
Issuance of common stock and options assumed for acquisitions	\$ —	\$ 81,266

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

**UNITED ONLINE, INC.**  
**NOTES TO UNAUDITED CONSOLIDATED FINANCIAL STATEMENTS**

**1. Organization and Business.**

United Online, Inc. ("United Online" or the "Company") is a leading Internet Service Provider ("ISP"). The Company, under the NetZero, Juno and BlueLight Internet brand names, offers consumers value-priced Internet access and e-mail. United Online also offers consumers free Internet access under the NetZero and Juno brands. In addition to offering consumers access to the Internet, United Online offers marketers a variety of online advertising products, including online market research and measurement services. The Company is headquartered in Westlake Village, California, with additional offices in New York City, San Francisco and Hyderabad, India.

United Online was incorporated in Delaware in June 2001 and was formed in connection with the merger of NetZero, Inc. ("NetZero") and Juno Online Services, Inc. ("Juno") into two of United Online's wholly-owned subsidiaries, which was consummated on September 25, 2001 (the "Merger"). The Merger was accounted for under the purchase method of accounting and NetZero was the acquiror for financial accounting purposes and the Company's predecessor for financial reporting purposes. As a result of the Merger, NetZero and Juno each became wholly-owned subsidiaries of United Online. On November 4, 2002, the Company, through its wholly-owned NetBrand subsidiary, acquired the Internet access assets of BlueLight.com LLC ("BlueLight").

From inception through the fiscal year ended June 30, 2002, the Company and NetZero, as the Company's predecessor, have incurred losses from operations and have reported negative annual operating cash flows. As of December 31, 2002, the Company had an accumulated deficit of \$353.9 million, cash and cash equivalents of \$63.3 million and short-term investments of \$96.5 million. The Company has no material financial commitments other than for capital and operating lease agreements and telecommunications and marketing services agreements. The Company believes that its existing cash, cash equivalents and short-term investments, and cash generated from operations will be sufficient to fund its working capital requirements, capital expenditures and other obligations through at least the next twelve months. However, additional capital may be needed in order to fund the Company's operations, expand marketing activities, develop new or enhance existing services or products, to respond to competitive pressures or to acquire complementary services, businesses or technologies. If the Company's existing cash resources and cash generated from operations are insufficient, additional capital through public or private financings, strategic relationships or other arrangements will be necessary. This additional funding might not be available on acceptable terms, or at all. Failure to raise sufficient capital when needed could have a material adverse effect on the business, results of operations and financial condition of the Company. If additional funds are raised through the issuance of equity securities, the percentage of stock owned by the then-current stockholders will be reduced. Furthermore, such equity securities might have rights, preferences or privileges senior to those of the common stockholders.

**2. Basis of Presentation.**

The consolidated financial statements and notes for the three and six months ended December 31, 2002 reflect the consolidated results of United Online, including the results of BlueLight subsequent to its acquisition. The consolidated financial statements and notes for the six

months ended December 31, 2001 reflect the financial results of NetZero prior to September 25, 2001, as predecessor to United Online. As a result, the operating results presented for the six months ended December 31, 2001 exclude the results of Juno prior to the Merger. In addition, since the operating results for the six months ended December 31, 2001 only include Juno's results subsequent to the Merger, the results do

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not reflect the additional amortization expense that would have been incurred if the Merger had occurred at the beginning of fiscal 2002.

The accompanying consolidated financial statements are unaudited except for the balance sheet information at June 30, 2002 and include United Online and its wholly-owned subsidiaries. The Company's interim financial statements have been prepared in accordance with accounting principles generally accepted in the United States of America ("GAAP") including those for interim financial information and with the instructions for Form 10-Q and Article 10 of Regulation S-X issued by the Securities and Exchange Commission ("SEC"). Accordingly, they do not include all of the information and note disclosures required by GAAP for complete financial statements. These statements are unaudited and, in the opinion of management, all adjustments (which include only normal recurring adjustments) considered necessary for a fair presentation, have been included. The preparation of financial statements in accordance with GAAP requires management to make estimates and assumptions that affect the reported amounts of assets and liabilities and disclosure of contingent liabilities and the reported amounts of revenues and expenses. Actual results could differ from those estimates. The results of operations for these interim periods are not necessarily indicative of the operating results for a full year. Certain reclassifications have been made to the prior year financial statements to conform to the current year presentation. These consolidated financial statements should be read in conjunction with the audited financial statements and related notes for the year ended June 30, 2002 included in the Company's Annual Report on Form 10-K filed on September 30, 2002 with the SEC.

### 3. Recent Accounting Pronouncements.

In June 2001, the Financial Accounting Standards Board ("FASB") issued Statement of Financial Accounting Standards ("SFAS") No. 142, *Goodwill and Other Intangible Assets*. Under SFAS No. 142, goodwill and indefinite-lived intangible assets are no longer amortized but are reviewed annually (or more frequently if impairment indicators arise) for impairment. Separable intangible assets that are not deemed to have indefinite lives will continue to be amortized over their useful lives (but with no maximum life). The adoption of SFAS No. 142 in the first quarter of fiscal 2003 did not have any impact on the Company's financial position, results of operations or cash flows.

In August 2001, the FASB issued SFAS No. 144, *Accounting for the Impairment or Disposal of Long-Lived Assets*, which is applicable to financial statements issued for fiscal years beginning after December 15, 2001. The FASB's new rules on asset impairment supersede SFAS No. 121, *Accounting for the Impairment of Long-Lived Assets and for Long-Lived Assets to Be Disposed of*, and portions of APB Opinion No. 30, *Reporting the Results of Operations*. SFAS No. 144 provides a single accounting model for long-lived assets to be disposed of and significantly changes the criteria that would have to be met to classify an asset as held-for-sale. Classification as held-for-sale is an important distinction since such assets are not depreciated and are stated at the lower of fair value or carrying amount. SFAS No. 144 also requires expected future operating losses from discontinued operations to be displayed in the period(s) in which the losses are incurred, rather than as of the measurement date as presently required. The adoption of SFAS No. 144 in the first quarter of fiscal 2003 did not have any impact on the Company's financial position, results of operations or cash flows.

In June 2002, the FASB issued SFAS No. 146, *Accounting for Costs Associated with Exit or Disposal Activities*. SFAS No. 146 requires that a liability for a cost associated with an exit or disposal activity be recognized when the liability is incurred and nullifies the guidance of Emerging Issues Task Force ("EITF") Issue No. 94-3, *Liability Recognition for Certain Employee Termination Benefits and Other Costs to Exit an Activity (including Certain Costs Incurred in a Restructuring)*, which recognized a liability for an exit cost at the date of an entity's commitment to an exit plan. SFAS No. 146 requires that the initial measurement of a liability be at fair value. SFAS No. 146 will be effective for exit or disposal activities that are initiated after December 31, 2002 with early adoption encouraged. The adoption of

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SFAS No. 146 in the third quarter of fiscal 2003 will not have any impact on the Company's financial position, results of operations or cash flows.

In December 2002, the FASB issued SFAS No. 148, *Accounting for Stock-Based Compensation—Transition and Disclosure—an amendment of FAS 123*. SFAS No. 148 amends SFAS No. 123, *Accounting for Stock-Based Compensation*, to provide alternative methods of transition for an entity that voluntarily changes to the fair value based method of accounting for stock-based employee compensation. It also amends the disclosure provisions of SFAS No. 123 to require prominent disclosure about the effects on reported net income of an entity's accounting policy decisions with respect to stock-based employee compensation. This Statement also amends APB Opinion No. 28, *Interim Financial Reporting*, to require disclosure about those effects in interim financial information. SFAS No. 148 is effective for annual and interim periods beginning after December 15, 2002. As the Company has elected not to change to the fair value based method of accounting for stock-based employee compensation, SFAS No. 148 will not have any impact on the Company's financial position, results of operations or cash flows.

### 4. Income Taxes.

For the three and six months ended December 31, 2002, the Company recorded a provision for income taxes of \$0.5 million and \$0.7 million, respectively, for California state income taxes. In September 2002, the State of California enacted legislation that suspends the utilization of net operating loss carryforwards to offset current taxable income for a two-year period beginning in fiscal 2003, which required the Company to record a California state income tax provision for the period. For federal income tax purposes, pre-tax income for the period was fully offset by net operating loss carryforwards. Because the benefit of net operating loss carryforwards was not recognized in prior periods, such benefit is recognized in the current period and, as a result, no federal income tax provision has been recorded.

Consistent with prior periods, the Company's net deferred tax assets, consisting primarily of federal and state net operating loss carryforwards, have been offset by a full valuation allowance. In determining the need for a valuation allowance, management has reviewed both positive and negative evidence, including current and historical operating results, future income projections and potential tax-planning strategies. Based upon management's assessment of all available evidence, the Company has concluded that it is not more likely than not that deferred tax assets will be realized. This conclusion is based primarily on the Company's history of net operating losses and the need to generate significant amounts of taxable income in future periods in order to utilize existing deferred tax assets. Accordingly, the Company has not released all or a portion of the valuation allowance against its otherwise recognizable deferred tax assets. However, the Company will continue to monitor all available evidence and reassess the potential realization of its deferred tax assets, especially given that the Company has recently begun to generate current taxable income. If the Company continues to meet its financial projections and improve its results from operations, or if circumstances otherwise change, it is reasonably possible that the Company may release all or a portion of the valuation allowance in the near term.

Federal and state net operating loss carryforwards available to offset future taxable income have been adjusted to reflect utilization limitations under Section 382 of the Internal Revenue Code (the "Code") resulting from the Merger. In addition, utilization of the net operating loss carryforwards is subject to annual usage limitations as determined under Section 382 of the Code. Net operating loss limitations under Section 382 and the carryforward suspension under California state tax law may significantly impact the timing and amount of future income tax obligations, if any, and the Company's ability to utilize its deferred tax assets.

## 5. Acquisitions.

### *Juno Online Services, Inc.*

On September 25, 2001, NetZero and Juno merged into two wholly-owned subsidiaries of United Online. The Merger was accounted for under the purchase method of accounting in accordance with SFAS No. 141, *Business Combinations*, and NetZero was the acquiror for financial accounting purposes. The primary reasons for the Merger were to accelerate the Company's growth in pay users, leverage NetZero's and Juno's operating and cost infrastructures to create a lower cost structure for providing Internet access and to create a more attractive base of users for advertising customers. The historical consolidated results of operations reflect only the operating results of NetZero and its subsidiaries prior to September 25, 2001 as predecessor to United Online.

### *BlueLight*

On November 4, 2002, the Company acquired the Internet access assets of BlueLight. The acquisition has been accounted for under the purchase method of accounting in accordance with SFAS No. 141. The primary reason for the acquisition was to acquire BlueLight's pay subscriber base in order to accelerate the Company's pay user growth and leverage its operating and cost infrastructure.

The purchase price of approximately \$8.4 million, including \$0.1 million of acquisition-related costs, was paid in cash and allocated to the assets acquired based on their estimated fair values, including identifiable intangible assets. The following table summarizes the net assets acquired in connection with the acquisition (in thousands):

Asset Description	Estimated Fair Value	Estimated Amortizable Life
<b>Net tangible assets acquired:</b>		
Accounts receivable	\$ 1,611	
Property and equipment	585	
Accounts payable	(649)	
Deferred service liabilities	(1,044)	
	503	
<b>Intangible assets acquired:</b>		
Pay subscriber base	7,500	4 years

Proprietary rights	235	3 years
Software and technology	150	2.5 years
Total intangible assets acquired	7,885	
Total purchase price	\$ 8,388	

The weighted average amortizable life of all acquired intangible assets is 3.9 years.

The following summarized unaudited pro forma financial information for the six months ended December 31, 2001 assumes that the Merger had occurred at the beginning of the period presented (in

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thousands, except per share amounts). The information excludes the acquisition of the Internet access assets of BlueLight since the pro forma effect of that transaction is immaterial.

		<b>Six Months Ended December 31, 2001</b>
		(unaudited)
Revenues	\$	90,063
Net loss	\$	(39,621)
Net loss per share	\$	(1.02)

## 6. Short-Term Investments.

Short-term investments consist of debt securities classified as available-for-sale and have maturities greater than 90 days from the date of purchase. The Company has invested primarily in U.S. commercial paper, all of which have a minimum investment rating of A, and government agency notes. The Company had no realized gains or losses from the sale of investments for the three and six month periods ended December 31, 2002.

Short-term investments as of December 31, 2002 consist of the following (in thousands):

	Amortized Cost	Gross Unrealized Gains	Gross Unrealized Losses	Estimated Fair Value
Commercial paper	\$ 38,294	\$ 1,372	\$ (25)	\$ 39,641
Government agencies	55,032	1,808	(2)	56,838
Total	\$ 93,326	\$ 3,180	\$ (27)	\$ 96,479

Gross unrealized gains and gross unrealized losses are presented net of tax in accumulated other comprehensive income on the consolidated balance sheet.

## 7. Concentration of Credit Risk.

At December 31, 2002, two customers comprised approximately 18% and 15%, respectively, of the consolidated accounts receivable balance. At June 30, 2002, one customer comprised approximately 21% of the consolidated accounts receivable balance.

For the three and six months ended December 31, 2002 and 2001, we did not have any individual customer that comprised more than 10% of total revenues.

## 8. Net Income (Loss) per Share.

The following table sets forth the computation of basic and diluted net income (loss) per share:

	Three Months Ended December 31,		Six Months Ended December 31,	
	2002	2001	2002	2001
<b>Numerator:</b>				
Net income (loss)	\$ 4,711	\$ (15,743)	\$ 6,236	\$ (37,879)
<b>Denominator:</b>				
Weighted average common shares—basic	41,246	39,965	40,921	33,031
Adjustment for weighted average common shares subject to repurchase	(309)	(1,102)	(368)	(1,236)
Adjusted weighted average common shares—basic	40,937	38,863	40,553	31,795
<b>Effect of dilutive securities:</b>				
Stock options, restricted shares, warrants and employee stock purchase plan shares	3,626	—	3,566	—
Weighted average common shares—diluted	44,563	38,863	44,119	31,795
Net income (loss) per share—basic	\$ 0.12	\$ (0.41)	\$ 0.15	\$ (1.19)
Net income (loss) per share—diluted	\$ 0.11	\$ (0.41)	\$ 0.14	\$ (1.19)

The diluted per share computations exclude unvested options, restricted shares, warrants and employee stock purchase plan shares which are antidilutive. The number of antidilutive options excluded from the diluted net income per share calculation for the three and six months ended December 31, 2002 is 1.4 million and 1.7 million, respectively. The number of antidilutive options, restricted shares, warrants and employee stock purchase plan shares excluded from the net loss per share calculation for the three and six months ended December 31, 2001 is 9.5 million and 10.3 million, respectively. As of December 31, 2002, there were approximately 8.7 million options outstanding with a weighted average exercise price of \$11.55 per share.

## 9. Stock-based Charges.

The Company accounts for stock-based employee compensation arrangements in accordance with the provisions of APB No. 25, *Accounting for Stock Issued to Employees*, and complies with the disclosure provisions of SFAS No. 123. Under APB No. 25, compensation expense is recognized over the vesting period based on the difference, if any, on the date of grant between the deemed fair value for accounting purposes of the Company's stock and the exercise price on the date of grant.

The following table summarizes the stock-based charges that have been included in the following captions for each of the periods presented (in thousands):

	Three Months Ended December 31,		Six Months Ended December 31,	
	2002	2001	2002	2001
<b>Operating expenses:</b>				
Cost of billable services	\$ 2	\$ 52	\$ 4	\$ 67
Cost of free services	—	27	—	60
Sales and marketing	5	238	12	(154)
Product development	2	569	4	893
General and administrative	20	1,638	45	2,699
Total stock-based charges	\$ 29	\$ 2,524	\$ 65	\$ 3,565

## 10. Litigation.

In April 2001, a complaint was filed against NetZero, certain of its officers and directors and the investment firms Goldman Sachs, BancBoston Robertson Stephens and Salomon Smith Barney alleging violations of the federal securities laws. A number of other complaints brought by different plaintiffs have since been filed and/or served against NetZero containing similar allegations and were brought as purported stockholder class action lawsuits. The complaints generally allege that the prospectus through which NetZero conducted its initial public offering in September 1999 was materially false and misleading because it failed to disclose, among other things, that (i) the underwriters of NetZero's initial public offering had solicited and received excessive and undisclosed commissions from certain investors in exchange for which the underwriters allocated to those investors material portions of the restricted number of NetZero shares issued in connection with initial public offering; and (ii) the underwriters had entered into agreements with customers whereby they agreed to allocate NetZero shares to those customers in the initial public offering in exchange for which the customers agreed to purchase additional NetZero shares in the aftermarket at pre-determined prices. The complaints against NetZero have been consolidated with similar complaints filed against other companies and investment firms. The defendants, including NetZero, in these consolidated cases have moved to dismiss the plaintiffs' complaints and the motion to dismiss has been argued and is pending before the court.

In May 2001, a complaint was filed against Juno alleging that Juno was unjustly enriched and deceived consumers by: (a) advertising "free" Internet access services and limiting the usage of heavier users of the service, and (b) advertising a free trial month for its premium service and not disclosing that the free month begins when the software is requested, rather than when it is first used, resulting in users receiving less than one month of free use. The plaintiff is seeking class certification and unspecified compensatory damages. Juno filed a motion to dismiss the complaint for failure to state a claim. On November 29, 2002 the court issued a ruling granting Juno's motion to dismiss in part and denying the motion in part. Plaintiff filed an amended complaint in accordance with the court's ruling. Juno has filed an answer denying the material allegations of the amended complaint and asserting certain affirmative defenses.

In August 2001, Juno commenced a proceeding against Smart World Technologies, LLC, or "Freewwwweb," a provider of free Internet access that had elected to cease operations and had sought the protection of Chapter 11 of the Bankruptcy Code. In this action, Juno is seeking a declaratory judgment as well as monetary damages against Freewwwweb. In June 2000, Juno entered into a subscriber referral agreement with Freewwwweb under which Juno was obligated to pay certain amounts based on the number of "Qualified Referred Subscribers" generated by referral activities specified in

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the agreement. A new Juno subscriber referred to Juno by Freewwwweb was considered a Qualified Referred Subscriber if he or she met certain qualification criteria defined in the subscriber referral agreement. Under the terms of the agreement, Juno has the right to settle a portion of the liabilities incurred in connection with acquiring the Qualified Referred Subscribers through the issuance of shares of its common stock. Freewwwweb filed a claim against Juno asserting that Juno is obligated to pay Freewwwweb an amount in excess of \$80 million under the terms of its agreement with Juno. Juno has requested that the court rule on this issue, and is seeking unspecified monetary damages against Freewwwweb. In connection with the Freewwwweb bankruptcy proceeding, WorldCom provided telecommunications services to Freewwwweb. Juno is required to pay WorldCom certain amounts owing for such services, although Juno and WorldCom are in disagreement as to the amounts owing, with WorldCom claiming in excess of \$1 million and Juno claiming less than \$300,000. At a status conference held on October 23, 2002, the court ordered the parties to participate in a court sponsored non-binding mediation of all outstanding issues. The mediation date has been scheduled for March 5, 2003. At December 31, 2002, the Company had liabilities recorded of approximately \$5.0 million as an estimate of the amounts for which it believes the WorldCom and Freewwwweb claims will be resolved. There can be no assurance that the outcome of the litigation will be positive or that the Company will not be required to pay Freewwwweb and WorldCom an amount in excess of the amount currently reserved.

In November 2001, a complaint was filed against Juno, NetZero and United Online, alleging breach of contract, fraud and unjust enrichment arising out of an agreement between Juno and Activeworlds for advertising, distribution and other services. Specifically, the plaintiff alleges that Juno failed to advise of a planned change in Juno's business policy that had an adverse impact on the value of the agreement to the plaintiff. The plaintiff is seeking damages in excess of \$500,000, plus punitive damages and other relief. Juno has filed its answer denying the material allegations of the complaint and asserting certain affirmative defenses.

In January 2002, a nationwide class action lawsuit was filed against United Online, NetZero and Juno alleging unlawful, unfair or deceptive business practices. The plaintiffs allege that the defendants used misleading marketing and promotional materials regarding their billable Internet access services. The plaintiffs are seeking injunctive relief, restitution, disgorgement of profits, the establishment of a constructive trust and attorneys' fees. The Company filed a demurrer to the complaint, which the court granted in part and denied in part. The plaintiffs filed an amended complaint in August 2002, naming only United Online and NetZero as defendants. The Company has filed an answer denying the material allegations of the amended complaint and asserting certain affirmative defenses. The parties are currently engaged in settlement discussions. The parties have agreed to participate with the court in a non-binding mediation of certain issues relating to the settlement, to be conducted on March 4, 2003. The Company has established a reserve for such litigation.

In September 2002, Sprint filed a lawsuit against Juno for amounts allegedly due under an agreement between the parties for the provision

of certain dial-up access and other services. The plaintiff is seeking damages of \$550,000 plus costs. Juno has filed an answer denying the material allegations of the complaint and asserting certain counterclaims and affirmative defenses.

In December 2002, a complaint was filed against Juno alleging that Juno was unjustly enriched and deceived consumers by: (a) advertising "free" Internet access services and limiting the usage of heavier users of the service, and (b) advertising a free trial month for its premium service and not disclosing that the free month begins when the software is requested, rather than when it is first used, resulting in users receiving less than one month of free use. The plaintiff is seeking class certification and unspecified compensatory damages. Juno will respond to the complaint on or before March 17, 2003.

The pending lawsuits involve complex questions of fact and law and may require the expenditure of significant funds and the diversion of other resources to defend. Although the Company does not

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believe the outcome of the above outstanding legal proceedings, claims and litigation will have a material adverse effect on its business, the results of litigation are inherently uncertain and the Company can provide no assurance that the Company's financial position, results of operations or cash flows will not be materially and adversely impacted by the results of such proceedings. The Company is unable to estimate the range of possible loss from outstanding litigation and, other than the reserves discussed above, no amounts have been provided for in our consolidated financial statements. There is no assurance the reserves that have been established are sufficient to cover the possible losses from outstanding litigation.

The Company is subject to various other legal proceedings and claims that arise in the ordinary course of business. The Company believes the amount, and ultimate liability, if any, with respect to these actions will not materially affect our financial position, results of operations or cash flows. There can be no assurance, however, that such actions will not be material or adversely affect the Company's financial position, results of operations or cash flows.

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

*This Quarterly Report on Form 10-Q and the documents incorporated herein by reference contain forward-looking statements based on our current expectations, estimates and projections about our operations, industry, financial condition and liquidity. Statements containing words such as "anticipate," "expect," "intend," "plan," "believe," "may," "will" or similar expressions constitute forward-looking statements. These forward-looking statements include, but are not limited to, statements about our user base, the advertising market, the dial-up Internet access market, operating expenses and operating efficiencies, income, revenues, capital requirements, the impact of inflation and our cash position. In addition, any statements that refer to expectations, projections or other characterizations of future events or circumstances, including any underlying assumptions, are forward-looking statements. Forward-looking statements are not guarantees of future performance and are subject to risks, uncertainties and assumptions that are difficult to predict. Therefore, our actual results could differ materially and adversely from those expressed in any forward-looking statements as a result of various factors. The sections entitled "Risk Factors" in this Form 10-Q, our Annual Report on Form 10-K as filed with the SEC on September 30, 2002 and our other filings with the SEC set forth some of the important risk factors that may affect our business, results of operations and financial condition. We undertake no obligation to revise or update publicly any forward-looking statements, other than as required by law.*

### **Overview**

United Online commenced operations on September 25, 2001, following the merger of NetZero and Juno into two of its wholly-owned subsidiaries (the "Merger"). The Merger was accounted for under the purchase method of accounting for business combinations as an acquisition of Juno by NetZero, which is considered the predecessor company to United Online. On November 4, 2002, we acquired the Internet access assets of BlueLight.com LLC ("BlueLight"). Our financial results include Juno's results since the date of the Merger and BlueLight's results since the date we acquired such assets.

We are a leading Internet Service Provider ("ISP") offering consumers free and value-priced Internet access and e-mail. Our Internet services, currently offered through the NetZero, Juno and BlueLight Internet brands, are available in more than 6,000 cities across the United States and Canada. In addition, we offer marketers numerous online advertising products as well as online market research and measurement services. At December 31, 2002, we had approximately 2.18 million subscribers to our pay services and approximately 5.0 million active users, including pay users. "Active" users include all pay users and those free users who have logged onto our services during the preceding 31-day period.

Juno launched its first service, a free dial-up e-mail service, in April 1996. NetZero launched its free Internet access service in

October 1998. Both Juno's and NetZero's free services were predicated on generating advertising revenues to fund their operations. Due to a variety of factors, including reductions in online advertising rates, both NetZero and Juno have taken various measures to limit the cost of providing free services.

Juno started offering fee-based Internet services in 1998, NetZero started offering fee-based Internet services in January 2001 and we acquired the fee-based Internet access assets of BlueLight in November 2002. NetZero's, Juno's and BlueLight's current fee-based Internet services are offered through various pricing plans, generally \$9.95 per month. The NetZero and Juno pay services differ from their respective free services in that hourly and other limitations set for the free services do not apply, and the services feature small toolbars without a persistent on-screen advertising banner. BlueLight does not currently offer free services.

As a result of imposing limitations on our free services and focusing our marketing on our pay services, we have experienced increases in our pay user base and decreases in our active free user base.

We may experience, in the future, periodic fluctuations in our pay user base as a result of a number of factors including, but not limited to, the imposition of additional limitations on our free services; changes in our free services user base; promotional free trial periods of our pay services; increases or decreases in our marketing expenditures; acquisitions; competitive factors, including competition in the value-priced segment of the ISP market; the effects of customer churn and seasonality; and changes in the prices of our billable services plans. Our active free user base may continue to decrease and may fluctuate as a result of a number of factors including, but not limited to, changes to the limitations imposed on our free services and the extent to which we market our free services.

We previously operated a broadband service, Juno Express. However, due to a variety of factors including the failure of several providers of high-speed services, this broadband service was terminated. Prior to the Merger, Juno entered into an agreement with AOL Time Warner to utilize their cable network to offer cable broadband services, but there are numerous operational and other issues that could impact whether Juno will offer these services over AOL Time Warner's cable systems in the near term, or at all. Furthermore, the agreement with AOL Time Warner is subject to termination by either party and is also subject to the approval of the Federal Trade Commission. In February 2002, we signed an agreement with Comcast Cable Communications, Inc. to offer high-speed Internet service over Comcast's cable systems. We have launched this service in a small number of markets and have had limited success in offering this service. We did not incur significant costs or capital expenditures to launch this service. We cannot assure you, however, that there will not be unanticipated costs associated with offering this service. We also cannot assure you that we will be able to implement the service successfully, that the service will be offered on other than a limited basis or that we will generate a significant number of subscribers to the service.

### **Billable Services Revenues**

We provide billable dial-up Internet access services under a number of pricing plans, generally ranging from \$1.95 to \$29.95 per month. Currently, the most common pricing plan for our basic dial-up access services is \$9.95 per month. We have experimented with the use of a variety of pricing plans both in connection with offers extended to some of our existing users and through external marketing channels. We may continue testing a variety of pricing plans in the future to determine their impact on profitability, pay user acquisition, conversion rates of free users to pay and pay user retention rates. We intend to continually evaluate the desirability and effectiveness of our pricing plans and may, in the future, make changes to these plans. We may also offer promotions such as a free month of service or a discounted rate for an initial or prepaid period, as well as a wide range of discounted flat-rate plans. Future changes in our pricing plans and promotional discounts may adversely impact the number of pay users and the amount of billable services revenues we receive from such users.

Billable services revenues may fluctuate from period-to-period primarily as a result of changes in the average number of pay users. Average number of pay users is calculated based on the number of pay users at the beginning and end of such period. We may also experience periodic fluctuations in billable services revenues as a result of fluctuations from period-to-period in the average monthly revenue per user. Average monthly revenue per user is calculated by dividing billable services revenues for a period by the average number of pay users for that period, calculated based on the number of pay users at the beginning and end of such period. Average monthly revenue per user may fluctuate due to a variety of factors, including but not limited to, the use of discounted pricing plans, the use of promotions such as a free month of service and the timing of pay users joining and leaving our services during the period.

### **Advertising and Commerce Revenues**

Our advertising and commerce revenues consist of fees from the placement of media, direct marketing agreements, referring our users to partners' Web sites and enabling customer registrations

for partners. We also generate revenues from our online market research and measurement services. Our advertising and commerce revenues are

generated from both our pay and free users.

Advertising on the Internet, particularly the products and services we offer, is a relatively new and changing industry, and we cannot assure you that the products and services we offer now, or in the future, will meet with commercial acceptance. Internet advertising rates have declined significantly, and it is possible that rates will continue to decline. Many of the purchasers of Internet advertising have been companies with Internet-based business models. Certain of these companies have come under financial pressure and have not been able to access the capital markets to fund their operations. This trend has impacted our ability to generate advertising and commerce revenues and could continue to do so in the future.

Due to market forces and other factors, our advertising and commerce revenues have in the past fluctuated, and may continue to fluctuate from period-to-period. In the past, we have experienced sequential quarters of decreased advertising and commerce revenues, and we cannot assure you that we will not experience decreased advertising and commerce revenues in future periods. Factors impacting our advertising and commerce revenues include, but are not limited to, the state of the online advertising market, changes in orders from significant customers, increases or decreases in our active user base, limitations on our free services and reductions in advertising inventory available for sale. Limitations on our free services have adversely impacted our volume of advertising inventory.

In general, we do not enter into barter transactions. There is no barter revenue in our revenues for the three and six months ended December 31, 2002 and 2001.

### **Cost of Billable Services**

Cost of billable services includes costs that have been allocated to billable services based on the aggregate hourly usage of our pay users as a percentage of total hourly usage of both our free and pay users. Allocated costs consist primarily of telecommunications costs, personnel and related overhead costs associated with operating our network and data centers and depreciation of network computers and equipment. In addition, cost of billable services includes direct costs incurred in providing technical and customer support and costs associated with providing customer billing and billing support.

Historically, we have expended significant funds on our network infrastructure. While we may expend significant funds on capital expenditures in the future, such expenditures are dependent upon our expectation of user growth and usage patterns, the need to upgrade our existing network infrastructure, as well as needs associated with acquired businesses and new products. Telecommunications costs for network access are expensed as incurred. Our failure to accurately forecast users' needs could result in significant overcapacity, which would adversely impact our results of operations. Conversely, under-forecasting usage could adversely impact the ability of users to receive adequate service and adversely impact our reputation and our ability to maintain or increase our user base. We cannot assure you that we will be able to accurately forecast user requirements in the future.

### **Cost of Free Services**

Cost of free services includes costs that have been allocated to free services based on the aggregate hourly usage of our free users as a percentage of total hourly usage of both our free and pay users. Allocated costs consist primarily of telecommunications costs, personnel and related overhead costs associated with operating our network and data centers, and depreciation of network computers and equipment. In addition, cost of free services includes certain direct costs incurred in providing technical and customer support to our free users.

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### **Sales and Marketing**

Sales and marketing expenses include advertising and promotion expenses, compensation, sales commissions, employee benefits, travel and related expenses for our direct sales force and telemarketing costs incurred to acquire and retain pay users. We have expended significant amounts on sales and marketing, including national branding campaigns comprised of television, sponsorships, radio, outdoor and print advertising and a variety of other promotions. Marketing costs have, in the past, and may, in the future, fluctuate significantly from quarter-to-quarter. Marketing and advertising costs to promote our products and services are expensed in the period incurred. Advertising and promotion expenses include media, agency and promotion expenses. Production costs are expensed the first time the advertisement is aired. Media and agency costs are expensed when the advertising runs.

### **Product Development**

Product development expenses include expenses for the development of new or improved technologies and products, including compensation and related expenses for the software engineering department, as well as costs for contracted services, facilities, and equipment. Costs incurred by us to develop, enhance, manage, monitor and operate our software and services are generally expensed as incurred, except for certain costs relating to the acquisition and development of internal-use software that are capitalized and depreciated over their estimated useful lives, generally three years or less.

## General and Administrative

General and administrative expenses include compensation, employee benefits and expenses for executive, finance, legal, human resources and internal support personnel. In addition, general and administrative expenses include fees for professional services, non-income taxes and occupancy and other overhead-related costs, as well as the expenses incurred and credits received as a result of certain legal settlements.

## Restructuring Charges

Restructuring charges consist of employee severance costs, contract termination fees, lease exit costs and the write-off of leasehold improvements associated with terminated leases.

## Amortization of Intangible Assets

Amortization of intangible assets includes amortization of acquired subscribers, purchased technologies and other identifiable intangible assets. At December 31, 2002, we had approximately \$46.6 million in identifiable intangible assets primarily resulting from the Merger and the acquisition of the Internet access assets of BlueLight. We expect to incur significant amortization expense in connection with our intangible assets in future periods. At December 31, 2002, we had approximately \$10.9 million in goodwill resulting from the Merger. In accordance with the provisions set forth in Statement of Financial Accounting Standards ("SFAS") No. 142, *Goodwill and Other Intangible Assets*, goodwill acquired in connection with the Merger is not being amortized.

## Stock-based Charges

We recorded deferred stock-based charges in connection with the grant of stock options and restricted stock to employees and the issuance of restricted shares of stock in connection with prior acquisitions, which are amortized over the vesting period of the applicable shares.

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## Interest Income, Net

Interest income consists of earnings on our cash and cash equivalents, short-term investments and restricted cash. Interest expense consists of interest expense on capital leases and notes payable balances.

## Acquisitions

### *Juno Online Services, Inc.*

On September 25, 2001, NetZero and Juno merged into two wholly-owned subsidiaries of United Online. The Merger was accounted for under the purchase method of accounting in accordance with SFAS No. 141, *Business Combinations*, and NetZero was the acquiror for financial accounting purposes. The purchase price of approximately \$89.2 million, including acquisition costs, was allocated to Juno's net assets based on their fair values. The excess of the purchase price over the estimated fair values of the net assets acquired, including identifiable intangible assets, was recorded as goodwill. The primary reasons for the Merger were to accelerate our growth in pay users, leverage NetZero's and Juno's operating and cost infrastructures to create a lower cost structure for providing Internet access and to create a more attractive base of users for advertising customers. The historical consolidated results of operations reflect only the operating results of NetZero and its subsidiaries prior to September 25, 2001 as predecessor to United Online.

### *BlueLight*

On November 4, 2002, we acquired the Internet access assets of BlueLight. The acquisition has been accounted for under the purchase method of accounting in accordance with SFAS No. 141. The primary reason for the acquisition was to acquire BlueLight's subscriber base in order to accelerate the Company's pay user growth and leverage its operating and cost infrastructure. At closing, BlueLight had approximately 174,000 pay users. Upon the close of the acquisition, BlueLight pay users were notified that their monthly service fee would increase to \$9.95 from a monthly fee of \$8.95, effective in the March 2003 quarter.

The purchase price of approximately \$8.4 million, including \$0.1 million of acquisition-related costs, was paid in cash and allocated to the assets acquired based on their estimated fair values, including identifiable intangible assets. The following table summarizes the net assets acquired in connection with the acquisition (in thousands):

Asset Description	Estimated Fair Value	Estimated Amortizable Life
Net tangible assets acquired:		

Accounts receivable	\$	1,611	
Property and equipment		585	
Accounts payable		(649)	
Deferred service liabilities		(1,044)	
		<hr/>	
Total net tangible assets acquired		503	
		<hr/>	
<b>Intangible assets acquired:</b>			
Pay subscriber base		7,500	4 years
Proprietary rights		235	3 years
Software and technology		150	2.5 years
		<hr/>	
Total intangible assets acquired		7,885	
		<hr/>	
Total purchase price	\$	8,388	
		<hr/>	

The weighted average amortizable life of all acquired intangible assets is 3.9 years.

## Critical Accounting Policies and Estimates

### General

Our discussion and analysis of our financial condition and results of operations is based upon our unaudited consolidated financial statements, which have been prepared in accordance with accounting principles generally accepted in the United States of America ("GAAP"). The preparation of these financial statements requires us to make estimates and judgments that affect the reported amounts of assets, liabilities, revenues and expenses, and related disclosure of contingent assets and liabilities. On an ongoing basis, we evaluate our estimates, including those related to revenue recognition, uncollectible receivables, intangible and other long-lived assets, income taxes and legal contingencies. We base our estimates on historical experience and on various other assumptions that are believed to be reasonable under the current circumstances, the results of which form the basis for making judgments about the carrying values of assets and liabilities that are not readily apparent from other sources. Actual results may differ from these estimates under different assumptions or conditions.

We believe the following critical accounting policies affect our more significant judgments and estimates used in the preparation of our unaudited consolidated financial statements.

### Revenue Recognition

We apply the provisions of SEC Staff Accounting Bulletin ("SAB") No. 101, *Revenue Recognition in Financial Statements*, which provides guidance on the recognition, presentation and disclosure of revenue in financial statements filed with the SEC. SAB No. 101 outlines the basic criteria that must be met to recognize revenue and provides guidance for disclosure related to revenue recognition policies. In general, we recognize revenue related to our billable services and advertising products when (i) persuasive evidence of an arrangement exists, (ii) delivery has occurred, (iii) the fee is fixed or determinable and (iv) collectibility is reasonably assured.

Billable services revenues are recognized in the period in which fees are fixed or determinable and the related products or services are provided to the user. Our pay users generally pay in advance for their service by credit card and revenue is then recognized ratably over the period in which the related services are provided. Advance payments from users are recorded on the balance sheet as deferred revenue. We offer alternative payment methods to credit cards for certain service plans. These alternative payment methods currently include payment by check, money order and payment via monthly phone bill. In circumstances where payment is not received in advance, revenue is only recognized if collectibility is reasonably assured.

Advertising and commerce revenues include banner advertisements, placements and sponsorships, referrals of users to search engines or other Web sites, performance-based agreements and advertising messages delivered to users via e-mail. We recognize banner advertising and sponsorship revenues in the periods in which the advertisement or sponsorship placement is displayed, based upon the lesser of (i) impressions delivered over the total number of guaranteed impressions or (ii) ratably over the period in which the advertisement is displayed, provided that no significant obligations remain, fees are fixed or determinable, and collection of the related receivable is reasonably assured. Our obligations typically include the guarantee of a minimum number of impressions or the satisfaction of other performance criteria. Revenue from performance-based arrangements is recognized as the related performance criteria are met. Referral revenues are recognized when the referrals are made to advertisers' or sponsors' Web sites, provided that no significant obligations remain, fees are fixed or determinable, and collection of the related receivable is reasonably assured. In determining whether an arrangement exists, we ensure that a binding contract is in place, such as

a standard insertion order or a fully executed customer-specific agreement. We assess whether performance criteria have been met and whether the fees are fixed or determinable based on a reconciliation of the performance criteria and the payment terms associated with the transaction. The reconciliation of the performance criteria

includes a comparison of internally tracked performance data to the contractual performance obligation and to third-party or customer performance data in circumstances where that data is available. Probability of collection is assessed based on a number of factors, including past transaction history with the customer and the creditworthiness of the customer. If it is determined that collection is not reasonably assured, revenue is not recognized until collection becomes reasonably assured, which is generally upon receipt of cash.

#### *Accounting for Business Combinations*

The companies that we have acquired have all been accounted for as purchase business combinations. Under the purchase method of accounting, the costs, including transaction costs, are allocated to the underlying net assets, based on their respective estimated fair values. The excess of the purchase price over the estimated fair values of the net assets acquired is recorded as goodwill.

The judgments made in determining the estimated fair value and expected useful lives assigned to each class of assets and liabilities acquired can significantly impact net income. For example, different classes of assets will have useful lives that differ (i.e., the useful life of users may not be the same as the useful life of acquired technologies). Consequently, to the extent a longer-lived asset is ascribed greater value under the purchase method than a shorter-lived asset, there may be less amortization recorded in a given period.

Determining the fair value of certain assets and liabilities acquired is judgmental in nature and often involves the use of significant estimates and assumptions. As provided by the accounting rules, we use the one-year period following the consummation of acquisitions to finalize estimates of the fair value of assets and liabilities acquired. One of the areas that requires more judgment in determining fair values and useful lives is intangible assets. To assist in this process, we have obtained appraisals from third-party valuation firms for certain intangible assets. While there were a number of different methods used in estimating the value of the intangibles acquired, there were two approaches primarily used: the discounted cash flow and market comparison approaches. Some of the more significant estimates and assumptions inherent in the two approaches include: projected future cash flows (including timing); discount rate reflecting the risk inherent in the future cash flows; perpetual growth rate; determination of appropriate market comparables; and the determination of whether a premium or a discount should be applied to comparables. Most of the foregoing assumptions were made based on available historical information.

The value of our intangible and other long-lived assets, including goodwill, is exposed to future adverse changes if we experience declines in operating results or experience significant negative industry or economic trends or if future performance results in increasing losses from operations. We periodically review intangible assets and goodwill for impairment using the guidance in the appropriate accounting literature. We continually review the events and circumstances related to our financial performance and economic environment for factors that would provide evidence of impairment.

#### *Impairment of Goodwill*

We adopted SFAS No. 142, *Goodwill and Other Intangible Assets*, on July 1, 2002. Under SFAS No. 142, goodwill is no longer amortized, but is tested for impairment at a reporting unit level on an annual basis and between annual tests if an event occurs or circumstances change that would more likely than not reduce the fair value of a reporting unit below its carrying value amount. Events or circumstances which could trigger an impairment review include a significant adverse change in legal factors or in the business climate, an adverse action or assessment by a regulator, unanticipated competition, a loss of key personnel, significant changes in the manner of our use of the acquired assets or the strategy for our overall business, significant negative industry or economic trends, significant declines in our stock price for a sustained period or significant underperformance relative to

expected historical or projected future operating results. For purposes of financial reporting and impairment testing in accordance with SFAS No. 142, we operate in one principal business segment, a provider of Internet access services.

In testing for a potential impairment of goodwill, we first compare the estimated fair value of the Company with book value, including goodwill. If the estimated fair value exceeds book value, goodwill is considered not to be impaired and no additional steps are necessary. If, however, the fair value of the Company is less than book value, then we are required to compare the carrying amount of the goodwill with its implied fair value. The estimate of implied fair value of goodwill may require independent valuations of certain internally generated and unrecognized intangible assets such as our subscriber base, software and technology and patents and trademarks. If the carrying amount of our goodwill exceeds the implied fair value of that goodwill, an impairment loss would be recognized in an amount equal to the excess.

In accordance with SFAS No. 142, we performed a transitional goodwill impairment test as of July 1, 2002 and concluded that, as of that date, there was no impairment of our \$10.9 million of goodwill.

### *Impairment of Long-lived Assets*

We assess the impairment of long-lived assets, which include property and equipment and identifiable intangible assets, whenever events or changes in circumstances indicate that such assets might be impaired and the carrying value may not be recoverable. Events and circumstances that may indicate that an asset is impaired include significant decreases in the market value of an asset, significant underperformance relative to expected historical or projected future operating results, a change in the extent or manner in which an asset is used, significant declines in our stock price for a sustained period, shifts in technology, loss of key management or personnel, changes in our operating model or strategy and competitive forces.

If events and circumstances indicate that the carrying amount of an asset may not be recoverable and the expected undiscounted future cash flows attributable to the asset are less than the carrying amount of the asset, an impairment loss equal to the excess of the asset's carrying value over its fair value is recorded. Fair value is determined based on the present value of estimated expected future cash flows using a discount rate commensurate with the risk involved, quoted market prices or appraised values, depending on the nature of the assets.

### *Income Taxes*

Our net deferred tax assets, consisting primarily of federal and state net operating loss carryforwards, have been offset by a full valuation allowance. In determining the need for a valuation allowance, we review both positive and negative evidence, including current and historical operating results, future income projections and potential tax-planning strategies. Based upon our assessment of all available evidence, we have concluded that it is not more likely than not that deferred tax assets will be realized. This conclusion is based primarily on our history of net operating losses and the need to generate significant amounts of taxable income in future periods in order to utilize existing deferred tax assets. Accordingly, we have not released all or a portion of the valuation allowance against our otherwise recognizable deferred tax assets. However, we will continue to monitor all available evidence and reassess the potential realization of our deferred tax assets, especially given that we have recently begun to generate current taxable income. If we continue to meet our financial projections and improve our results from operations, or if circumstances otherwise change, it is reasonably possible that we may release all or a portion of the valuation allowance in the near term.

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### *Legal Contingencies*

We are currently involved in certain legal proceedings, certain of which are discussed further elsewhere in this Form 10-Q. We record liabilities related to pending litigation when an unfavorable outcome is probable and we can reasonably estimate the amount of loss. We have not recorded liabilities for some of our pending litigation because of the uncertainties related to assessing both the amount and the probable outcome of those claims. As additional information becomes available, we continually assess the potential liability related to all of our pending litigation. While we currently believe that the liabilities recorded on our balance sheet are sufficient to cover pending litigation for which an unfavorable outcome is probable and the amount of loss can be reasonably estimated, the outcome of litigation is inherently uncertain, and there can be no assurance that such estimates will be accurate.

### **Significant Financial Trends**

In September 2001 we acquired Juno, which added over 875,000 users to our pay user base. In October 2001 we implemented limitations on the NetZero free service, which resulted in a significant number of NetZero free users upgrading to pay services. Additionally, we shifted our marketing strategy to focus on the promotion of our pay services. These efforts resulted in a significant shift in our revenue base, from advertising and commerce revenues, to billable services revenues. For the six months ended December 31, 2002, we derived approximately 88% of our total revenue from billable services, compared to approximately 78% for the six months ended December 31, 2001. In November 2002, we acquired the Internet access assets of BlueLight, which added 174,000 users to our pay user base. We continue to focus on growing our pay user base and we may continue to derive an increasing percentage of our total revenue from billable services.

Our net loss was \$15.7 million for the quarter ended December 31, 2001 and decreased to a net loss of \$7.3 million and \$2.7 million for the quarters ended March 31, 2002 and June 30, 2002, respectively. Our net income was \$1.5 million and \$4.7 million for the quarters ended September 30, 2002 and December 31, 2002, respectively. Our results of operations have continued to improve as a result of increases in billable services revenues and pay users, decreases in cost of billable services as a percentage of billable services revenues and decreasing cost of free services, partially offset by increases in sales and marketing expenses. We currently anticipate that we will continue to increase our net income in the near term. However, any increase will depend on a number of factors including, but not limited to, growth in our pay user base, fluctuations in telecommunications costs, increased levels of marketing expenditures, acquisitions and resolution of outstanding legal contingencies, and there can be no assurance that net income will increase going forward.

Our billable services revenues have increased as a result of an increase in the average number of pay users. Our pay user base has increased as a result of the Merger, the acquisition of the Internet access assets of BlueLight, usage and geographical limitations imposed on our free services during fiscal 2002, which resulted in a significant number of free users upgrading to our pay services, and an increase in marketing

expenditures promoting our pay services. Due to decreases in our free user base, the aggregate number of free users who convert to pay users has been decreasing and, we believe, may continue to decrease. While we believe we can continue to grow our pay user base through traditional marketing activities, we cannot assure you that we will be able to do so.

Cost of billable services as a percentage of billable services revenues has decreased as a result of decreased telecommunications costs, decreased customer billing and support costs per pay user and decreased depreciation expense. Telecommunications cost per hour has decreased as a result of improved capacity utilization and industry-wide price declines. We do not anticipate further significant decreases in average hourly telecommunications costs, and may experience increased hourly telecommunications costs in future periods, particularly if we expand our service coverage to additional

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areas where telecommunications costs are higher. Additionally, telecommunications costs may increase if we experience increased hourly usage per pay user, which we currently anticipate occurring during the March 2003 quarter. Customer billing and support costs per pay user decreased as a result of synergies gained through the consolidation of NetZero's and Juno's customer billing and support functions and we do not anticipate significant reductions in such costs per pay user in the future. Depreciation expense has decreased due to assets placed in service in fiscal 2000 becoming fully depreciated and lower levels of capital expenditures during the past two fiscal years versus fiscal 2000. We currently anticipate cost of billable services as a percentage of billable services revenues to stabilize or be slightly higher in the March 2003 quarter.

Cost of free services has decreased as a result of hourly and geographical limitations that were imposed on our free service, which has resulted in a decrease in active free users and a decrease in the average monthly usage per user of our free services. We currently do not anticipate further significant decreases in costs of free services in future periods and cost of free services may increase in future periods.

During fiscal 2002, we significantly decreased our level of spending on marketing from the level in fiscal 2001. However, we have been increasing our marketing expenditures on a sequential quarterly basis since the September 2001 quarter, and we currently anticipate increasing our marketing expenditures in the near term. Our future marketing expenditures may vary significantly from quarter-to-quarter, as many of our marketing commitments are short term in nature. We may choose to increase or decrease quarterly marketing expenditures in future periods, depending on a variety of factors, including the effectiveness of our marketing activities, changes in the number of pay users, and the impact of such activities on our operating results. Decreases in marketing expenditures may impact our ability to grow our pay user base.

## Inflation

We do not currently anticipate that inflation will have a material impact on our results of operations.

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## Results of Operations

The consolidated results of operations reflect only the operating results of NetZero and its subsidiaries prior to September 25, 2001, as predecessor to United Online. These results reflect only the financial impact of the Merger subsequent to September 25, 2001 and the impact of the acquisition of the Internet access assets of BlueLight since November 4, 2002. The following table sets forth, for the periods presented, selected unaudited historical results of operations data:

### Three and Six Months Ended December 31, 2002 Compared to the Three and Six Months Ended December 31, 2001

	Three Months Ended December 31,		Six Months Ended December 31,	
	2002	2001	2002	2001
<b>Revenues:</b>				
Billable services	\$ 58,149	\$ 41,035	\$ 109,343	\$ 48,698
Advertising and commerce	7,651	7,012	14,525	13,457
Total revenues	65,800	48,047	123,868	62,155
<b>Operating expenses:</b>				
Cost of billable services	21,990	23,265	42,690	31,542
Cost of free services	3,161	8,722	6,897	21,978

Sales and marketing	19,863	10,059	36,530	13,998
Product development	5,740	7,418	11,661	12,081
General and administrative	7,087	9,151	12,740	17,164
Amortization of intangible assets	3,798	4,685	8,483	4,786
Restructuring charges	—	2,075	—	2,435
<b>Total operating expenses</b>	<b>61,639</b>	<b>65,375</b>	<b>119,001</b>	<b>103,984</b>
Income (loss) from operations	4,161	(17,328)	4,867	(41,829)
Interest income, net	1,073	1,585	2,061	2,943
Other income, net	—	—	—	1,007
<b>Income (loss) before income taxes</b>	<b>5,234</b>	<b>(15,743)</b>	<b>6,928</b>	<b>(37,879)</b>
Provision for income taxes	523	—	692	—
<b>Net income (loss)</b>	<b>\$ 4,711</b>	<b>\$ (15,743)</b>	<b>\$ 6,236</b>	<b>\$ (37,879)</b>

## Revenues

### *Billable Services*

Billable services revenues increased by \$17.1 million, or 42%, to \$58.1 million for the three months ended December 31, 2002, compared to \$41.0 million for the three months ended December 31, 2001. Billable services revenues increased as a result of an increase in our average number of pay users. Our average number of pay users were approximately 2.0 million during the quarter ended December 31, 2002, compared to 1.4 million during the quarter ended December 31, 2001. The increase in our average number of pay users is a result of free users upgrading to pay services, increased marketing of our pay services and the acquisition of approximately 174,000 pay users from BlueLight in November 2002. The increase in billable services revenues was partially offset by a decrease in average monthly revenue per user, which decreased as a result of the timing of pay users joining and leaving our pay services during the December 2002 and 2001 quarters.

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Billable services revenues increased by \$60.6 million, or 124%, to \$109.3 million for the six months ended December 31, 2002, compared to \$48.7 million for the six months ended December 31, 2001. Billable services revenues increased as a result of an increase in our average number of pay users. Our average number of pay users were approximately 1.9 million during the six months ended December 31, 2002, compared to 0.8 million during the six months ended December 31, 2001. The increase in our average number of pay users is a result of the Merger in September 2001, which added over 875,000 users to our pay user base, free users upgrading to pay services, increased marketing of our pay services and the acquisition of approximately 174,000 pay users from BlueLight in November 2002. The increase in billable services revenues was partially offset by a decrease in average monthly revenue per user, which decreased as a result of the timing of pay users joining and leaving our pay services during the periods.

### *Advertising and Commerce*

Advertising and commerce revenues increased by \$0.7 million, or 10%, to \$7.7 million for the three months ended December 31, 2002, compared to \$7.0 million for the three months ended December 31, 2001. Advertising and commerce revenues increased primarily as a result of higher advertising revenues generated from General Motors ("GM") and increased revenues from search fees. We derived approximately 36% of our advertising and commerce revenues for the three months ended December 31, 2002 from GM, compared to approximately 34% for the three months ended December 31, 2001. The increases were partially offset by decreased advertising inventory as a result of decrease in active free users.

Advertising and commerce revenues increased by \$1.0 million, or 7%, to \$14.5 million for the six months ended December 31, 2002, compared to \$13.5 million for the six months ended December 31, 2001. Advertising and commerce revenues increased primarily as a result of higher advertising revenues generated from GM and increased revenues from search fees. We derived approximately 36% of our advertising and commerce revenues for the six months ended December 31, 2002 from GM, compared to approximately 29% for the six months ended December 31, 2001. The increases were partially offset by decreased advertising inventory as a result of a decrease in active free users and a decrease in revenue from Cisco. Our agreement with Cisco was terminated in August 2001, and during the six months ended December 31, 2001, we generated approximately \$0.9 million in revenues from Cisco.

### **Cost of Billable Services**

Cost of billable services decreased by \$1.3 million, or 6%, to \$22.0 million for the three months ended December 31, 2002, compared to

\$23.3 million for the three months ended December 31, 2001. Despite increased telecommunications costs as a result of an increase in the average number of pay users in the three months ended December 31, 2002, cost of billable services decreased as a result of a decrease in average hourly telecommunications costs from \$0.12 for the three months ended December 31, 2001 to \$0.09 for the three months ended December 31, 2002, a \$1.7 million decrease in customer support and billing related costs and a \$0.7 million decrease in depreciation costs allocated to billable services. Customer support and billing related costs decreased as a result of the consolidation of NetZero's and Juno's customer support and billing providers. Depreciation costs allocated to billable services decreased as a result of certain network related assets becoming fully depreciated in the September 2001 and December 2001 quarters. Average hourly telecommunications cost decreased due to improved capacity utilization and industry-wide price declines. These decreases were partially offset by a \$0.6 million increase in network personnel and overhead related costs allocated to billable services due to an increase in telecommunications hours utilized by pay users as a percentage of total telecommunications hours purchased.

Cost of billable services increased by \$11.2 million, or 36%, to \$42.7 million for the six months ended December 31, 2002, compared to \$31.5 million for the six months ended December 31, 2001.

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Cost of billable services increased as a result of a greater average number of users in the six months ended December 31, 2002, partially offset by a decrease in average hourly telecommunications costs from \$0.12 for the six months ended December 31, 2001 to \$0.10 for the six months ended December 31, 2002. The increase in average pay users resulted in a \$9.1 million increase in telecommunications costs, a \$1.9 million increase in network personnel and overhead-related costs allocated to pay services due to an increase in telecommunications hours utilized by pay users as a percentage of total telecommunications hours purchased, and a \$0.3 million increase in customer billing and support costs. Average hourly telecommunications cost decreased due to improved capacity utilization and industry-wide price declines. The increase in cost of billable services was partially offset by a \$0.2 million decrease in network depreciation allocated to billable services as a result of certain network related assets becoming fully depreciated in the September 2001 and December 2001 quarters.

#### **Cost of Free Services**

Cost of free services decreased by \$5.5 million, or 63%, to \$3.2 million for the three months ended December 31, 2002, compared to \$8.7 million for the three months ended December 31, 2001. The decrease is attributable to a decrease in the number of active free users and a decrease in average monthly usage per free user as a result of usage limitations imposed on our free services during October 2001. In addition, cost of free services decreased as a result of a decrease in average hourly telecommunications costs and a decrease in network depreciation, personnel and related overhead costs allocated to free services due to a decrease in telecommunications hours utilized by free users as a percentage of total telecommunications hours purchased. Our active free user base decreased 32% to approximately 2.8 million users as of December 31, 2002, compared to approximately 4.1 million users at December 31, 2001. Telecommunication hours related to our free user base decreased to 15%, as a percentage of total telecommunications hours purchased during the three months ended December 31, 2002, compared to 34% during the months ended December 31, 2001.

Cost of free services decreased by \$15.1 million, or 69%, to \$6.9 million for the six months ended December 31, 2002, compared to \$22.0 million for the six months ended December 31, 2001. The decrease is attributable to a decrease in the number of active free users and a decrease in average monthly usage per free user as a result of usage limitations imposed on our free services in October 2001, which also resulted in a decrease in the number of active free users. In addition, cost of free services decreased as a result of a decrease in average hourly telecommunications costs and a decrease in network depreciation, personnel and related overhead costs allocated to free services due to a decrease in telecommunications hours utilized by free users as a percentage of total telecommunications hours purchased. Telecommunication hours related to our free user base decreased to 16% as a percentage of total telecommunications hours purchased during the six months ended December 31, 2002, compared to 49% during the six months ended December 31, 2001.

#### **Sales and Marketing**

Sales and marketing expenses increased by \$9.8 million, or 97%, to \$19.9 million for the three months ended December 31, 2002, compared to \$10.1 million for the three months ended December 31, 2001. The increase is attributable to an increase in advertising and promotion costs of approximately \$9.5 million as a result of our strategy to increase our pay user base through traditional marketing activities. Additionally, sales and marketing expenses increased as a result of a \$0.5 million increase in telemarketing expenses related to customer acquisition and retention activities and a \$0.3 million increase in occupancy-related expenses, which were partially offset by a \$0.2 million decrease in stock-based charges, a \$0.2 million decrease in overhead-related expenses and a \$0.1 million decrease in personnel-related expenses.

Sales and marketing expenses increased by \$22.5 million, or 161%, to \$36.5 million for the six months ended December 31, 2002, compared to \$14.0 million for the six months ended December 31,

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2001. The increase is attributable to an increase in advertising and promotion costs of approximately \$20.2 million as a result of our strategy to

increase our pay user base through traditional marketing activities. Additionally, sales and marketing expenses increased as a result of a \$2.0 million increase in telemarketing expenses related to customer acquisition and retention activities, a \$0.7 million increase in personnel-related expenses due to increased head count as a result of the Merger and a \$0.2 million increase in stock-based charges. These increases were partially offset by a \$0.5 million decrease in costs directly associated with NetZero's former RocketCash subsidiary, which was sold in August 2001.

### **Product Development**

Product development expenses decreased by \$1.7 million, or 23%, to \$5.7 million for the three months ended December 31, 2002, compared to \$7.4 million for the three months ended December 31, 2001. The decrease was due to a \$0.7 million net decrease in depreciation and overhead-related expenses as a result of efficiencies gained through the Merger, a \$0.6 million decrease in stock-based charges as a result of the sale of our Simpli subsidiary in the June 2002 quarter, which resulted in the accelerated vesting of previously granted restricted stock awards, and a \$0.3 million decrease in costs directly associated with NetZero's former RocketCash and Simpli subsidiaries and a \$0.1 million decrease in personnel-related expenses.

Product development expenses decreased by \$0.4 million, or 3%, to \$11.7 million for the six months ended December 31, 2002, compared to \$12.1 million for the six months ended December 31, 2001. The decrease was due to a \$0.9 million decrease in costs directly associated with NetZero's former RocketCash and Simpli subsidiaries, a \$0.9 million decrease in stock-based charges as a result of the sale of our Simpli subsidiary in the June 2002 quarter and the accelerated vesting of certain previously issued stock options and restricted stock awards and a \$0.7 million decrease in depreciation and overhead-related expenses. The decrease in product development expenses was partially offset by a \$2.1 million increase in personnel-related expenses as a result of increased headcount, salaries and bonuses resulting from the Merger.

### **General and Administrative**

General and administrative expenses decreased by \$2.1 million, or 23%, to \$7.1 million for the three months ended December 31, 2002, compared to \$9.2 million for the three months ended December 31, 2001. The decrease was due to a \$1.6 million decrease in stock-based charges as a result of the accelerated vesting of certain previously issued stock options and restricted awards, a \$1.0 million decrease in occupancy and overhead-related charges as a result of office consolidations and headcount reductions made in connection with the Merger and a \$0.2 million decrease in costs directly associated with NetZero's former Simpli subsidiary. These decreases were partially offset by a \$0.4 million increase in personnel-related expenses as a result of higher compensation costs and a \$0.3 million increase in legal settlement-related costs.

General and administrative expenses decreased by \$4.5 million, or 26%, to \$12.7 million for the six months ended December 31, 2002, compared to \$17.2 million for the six months ended December 31, 2001. The decrease in general and administrative expenses is due to a \$2.7 million decrease in stock-based charges as a result of the accelerated vesting of certain previously issued stock options and restricted stock awards, a \$0.8 million decrease in costs directly associated with NetZero's former RocketCash and Simpli subsidiaries, a \$0.7 million credit as a result of a favorable settlement of a contractual dispute with a former vendor and a \$0.5 million decrease in consulting and professional fees as a result of the Merger and a net \$0.3 million decrease in occupancy and overhead-related expenses as a result of the Merger. These decreases were partially offset by a \$0.5 million increase in legal settlement-related costs.

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### **Amortization of Intangible Assets**

Amortization of intangible assets decreased by \$0.9 million to \$3.8 million for the three months ended December 31, 2002, compared to \$4.7 million for the three months ended December 31, 2001 as a result of certain acquired intangible assets from the Merger being fully amortized as of September 30, 2002, partially offset by an increase in amortization expense resulting from the \$7.9 million of identifiable intangible assets acquired in connection the acquisition of the Internet access assets of BlueLight in November 2002.

Amortization of intangible assets increased by \$3.7 million to \$8.5 million for the six months ended December 31, 2002, compared to \$4.8 million for the six months ended December 31, 2001 as a result of the amortization of acquired intangible assets associated with the Merger in September 2001. Amortization of intangible assets related to these assets was not included in the results of operations prior to September 25, 2001. Additionally, amortization of intangibles increased as a result of the intangible assets acquired from the purchase of the Internet access assets of BlueLight in November 2002.

### **Restructuring Charges**

During the three months ended December 31, 2001, we recorded \$2.1 million of restructuring charges, which consisted of \$0.3 million in employee termination benefits and \$1.8 million in lease exit costs, which includes a charge of approximately \$0.8 million to write-off leasehold improvements associated with our former offices in New York. In an effort to streamline our operations in response to changing market conditions, we reduced our workforce by approximately 25 employees during the three months ended December 31, 2001. Of the 25 employees terminated, 18 were in general and administrative, 6 were in product development and 1 was in sales and marketing.

During the six months ended December 31, 2001, we recorded \$2.4 million of restructuring charges, which consisted of \$0.6 million in employee termination benefits and \$1.8 million in lease exit costs, which includes a charge of approximately \$0.8 million to write-off leasehold improvements associated with our former offices in New York. In an effort to streamline our operations in response to changing market conditions, we reduced our workforce by approximately 93 employees during the six months ended December 31, 2001. Of the 93 employees terminated, 35 were in sales and marketing, 26 were in general and administrative, 23 were in product development, 6 were at RocketCash and 3 were in network operations.

### **Interest Income, Net**

Interest income, net decreased by \$0.5 million, or 31%, to \$1.1 million for the three months ended December 31, 2002, compared to \$1.6 million for the three months ended December 31, 2001. Interest income, net decreased by \$0.8 million, or 28%, to \$2.1 million for the six months ended December 31, 2002, compared to \$2.9 million for the six months ended December 31, 2001. The decrease in interest income is due to lower interest rates, partially offset by reduced interest expense as a result of a decrease in capital lease and notes payable balances.

### **Other Income, Net**

Other income, net for the six months ended December 31, 2001 was \$1.0 million. In August 2001, we sold substantially all of the assets of RocketCash and recognized a gain of approximately \$1.0 million.

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### **Provision for Income Taxes**

For the three and six months ended December 31, 2002, we generated pre-tax income of \$5.2 million and \$6.9 million, respectively, and recorded a provision for income taxes of \$0.5 million and \$0.7 million, respectively for California state income tax purposes. In September 2002, the State of California enacted legislation that suspends our utilization of net operating loss carryforwards to offset current taxable income for a two-year period beginning in fiscal 2003. For federal income tax purposes, pre-tax income for the period was fully offset by net operating loss carryforwards. Because the benefit of net operating loss carryforwards was not recognized in prior periods, such benefit is recognized in the current period and no federal income tax provision has been recorded. For the three and six months ended December 31, 2001, we generated pre-tax losses of \$15.7 million and \$37.9 million, respectively, and recorded no provision for income taxes.

### **Liquidity and Capital Resources**

From inception to December 31, 2002, our operations have been financed primarily through the sale of equity securities and, to a lesser extent, cash generated from our billable services and advertising and commerce revenues, net cash acquired from acquisitions, and equipment lease financing. At December 31, 2002, we had approximately \$159.8 million in cash, cash equivalents and short-term investments and approximately \$0.8 million in restricted cash.

Cash provided by (used for) operating activities primarily consists of net income (loss) adjusted for certain non-cash items including depreciation and amortization, stock-based charges and changes in working capital. For the six months ended December 31, 2002, net cash provided by operating activities was \$29.5 million consisting of net income of \$6.2 million adjusted for non-cash items of \$15.5 million and a \$7.8 million decrease in working capital and other activities. For the six months ended December 31, 2001, cash used for operating activities was \$20.6 million consisting of net loss of \$37.9 million adjusted for non-cash items of \$17.4 million, partially offset by a \$0.1 million increase in working capital and other activities.

For the six months ended December 31, 2002, net cash used for investing activities was \$7.9 million, consisting of cash paid for the acquisition of the Internet access assets of BlueLight of \$8.4 million, purchases of property and equipment of \$2.6 million, partially offset by net proceeds from the maturities of short-term investments of \$3.1 million. For the six months ended December 31, 2001, net cash provided by investing activities was \$26.4 million, consisting of \$32.3 million of cash acquired from the acquisition of Juno, \$1.2 million from the net proceeds from sales of assets, partially offset by net purchases of short-term investments of \$6.7 million and purchases of property and equipment of \$0.4 million.

For the six months ended December 31, 2002, net cash provided by financing activities was \$0.1 million, consisting of proceeds from exercises of stock options and employee stock purchase plan shares of \$4.5 million and \$0.1 million of repayments of notes receivable from stockholders, partially offset by payments on capital leases of \$2.3 million and repurchases of common stock of \$2.2 million. For the six months ended December 31, 2001, net cash used for financing activities was \$5.5 million, consisting of \$4.5 million of payments on capital leases and notes payable and \$1.1 million of repurchases of common stock and option shares exercised, partially offset by proceeds from employee stock purchase plan shares of \$0.1 million.

In prior years, we invested significantly in our network infrastructure, software licenses, furniture, fixtures and equipment and may need to make further investments in the future. We anticipate that our annual capital expenditures will increase from \$1.5 million in fiscal 2002 to approximately \$5.5 to \$6.0 million for fiscal 2003, of which approximately \$2.6 million was expended during the six months ended

December 31, 2002. The actual amount of capital expenditures may increase due to a number of factors, including new business initiatives, which are difficult to predict and could change dramatically

over time. Technological advances may also require us to make capital expenditures to develop or acquire new equipment or technology in order to replace aging or technologically obsolete equipment. We intend to use our existing cash balances to fund any future operating losses, to repurchase outstanding common, to acquire complimentary services, businesses or technologies and to fund necessary future capital expenditures.

We currently anticipate that our existing cash, cash equivalents and short-term investments will be sufficient to fund our operating activities, capital expenditures and other obligations for at least the next twelve months. In the short-term, we do not anticipate the need for additional financing to fund our operating activities. However, we may raise additional capital for a variety of reasons including, without limitation, expanding our marketing activities, developing new or enhancing existing services or products to respond to competitive pressures, acquiring complementary services, businesses or technologies or funding unanticipated capital expenditures. If we need to raise additional capital through public or private financings, strategic relationships or other arrangements it might not be available to us on acceptable terms, or at all. Our failure to raise sufficient capital when needed could have a material adverse effect on the business, financial condition, results of operations and cash flows. If additional funds were raised through the issuance of equity securities, the percentage of stock owned by the then-current stockholders would be reduced. Furthermore, such equity securities might have rights, preferences or privileges senior to holders of our common stock.

## Financial Commitments

### *Operating Leases*

The Company leases its facilities and certain network equipment under operating leases expiring at various periods through 2010. The leases generally contain annual escalation provisions as well as renewal options. Future minimum lease payments under operating leases as of December 31, 2002 for the remainder of the fiscal year ending June 30, 2003 are \$1.5 million.

Future minimum lease payments under operating leases are as follows:

	<b>Year Ending June 30,</b>
	<b>(in thousands)</b>
2004	\$ 2,686
2005	2,549
2006	2,451
2007	2,292
2008	2,117
Thereafter	2,612
<b>Total</b>	<b>\$ 14,707</b>

### *Other Commitments*

Under the terms of several multi-year telecommunications services agreements with various service providers, we are currently contractually committed to purchase approximately \$6.1 million for the remainder of the fiscal year ending June 30, 2003. We are currently contractually committed to purchase approximately \$10.0 million, \$5.0 million and \$0.3 million in telecommunications services for the fiscal years ending June 30, 2004, 2005 and 2006, respectively. Under the terms of a marketing agreement, we are currently contractually committed to purchase \$2.5 million and \$3.5 million in advertising for the fiscal years ending June 30, 2003 and 2004, respectively.

## Recent Accounting Pronouncements

In June 2001, the Financial Accounting Standards Board ("FASB") issued SFAS No. 142. Under SFAS No. 142, goodwill and indefinite-lived intangible assets are no longer amortized but are reviewed annually (or more frequently if impairment indicators arise) for impairment.

Separable intangible assets that are not deemed to have indefinite lives will continue to be amortized over their useful lives (but with no maximum life). The adoption of SFAS No. 142 in the first quarter of 2003 did not have an impact on our financial position, results of operations or cash flows.

In August 2001, the FASB issued SFAS No. 144, *Accounting for the Impairment or Disposal of Long-Lived Assets*, which is applicable to financial statements issued for fiscal years beginning after December 15, 2001. The FASB's new rules on asset impairment supersede SFAS No. 121, *Accounting for the Impairment of Long-Lived Assets and for Long-Lived Assets to Be Disposed of*, and portions of APB Opinion No. 30, *Reporting the Results of Operations*. SFAS No. 144 provides a single accounting model for long-lived assets to be disposed of and significantly changes the criteria that would have to be met to classify an asset as held-for-sale. Classification as held-for-sale is an important distinction since such assets are not depreciated and are stated at the lower of fair value or carrying amount. SFAS No. 144 also requires expected future operating losses from discontinued operations to be displayed in the period(s) in which the losses are incurred, rather than as of the measurement date as presently required. The adoption of SFAS No. 144 in the first quarter of fiscal 2003 did not have any impact on our financial position, results of operations or cash flows.

In June 2002, the FASB issued SFAS No. 146, *Accounting for Costs Associated with Exit or Disposal Activities*. SFAS No. 146 requires that a liability for a cost associated with an exit or disposal activity be recognized when the liability is incurred and nullifies the guidance of Emerging Issues Task Force ("EITF") Issue No. 94-3, *Liability Recognition for Certain Employee Termination Benefits and Other Costs to Exit an Activity (including Certain Costs Incurred in a Restructuring)*, which recognized a liability for an exit cost at the date of an entity's commitment to an exit plan. SFAS No. 146 requires that the initial measurement of a liability be at fair value. SFAS No. 146 will be effective for exit or disposal activities that are initiated after December 31, 2002 with early adoption encouraged. The adoption of SFAS No. 146 in the third quarter of fiscal 2003 will not have any impact on our financial position, results of operations or cash flows.

In December 2002, the FASB issued SFAS No. 148, *Accounting for Stock-Based Compensation—Transition and Disclosure—an amendment of FAS 123*. SFAS No. 148 amends SFAS No. 123, *Accounting for Stock-Based Compensation*, to provide alternative methods of transition for an entity that voluntarily changes to the fair value based method of accounting for stock-based employee compensation. It also amends the disclosure provisions of SFAS No. 123 to require prominent disclosure about the effects on reported net income of an entity's accounting policy decisions with respect to stock-based employee compensation. This Statement also amends APB Opinion No. 28, *Interim Financial Reporting*, to require disclosure about those effects in interim financial information. SFAS No. 148 is effective for annual and interim periods beginning after December 15, 2002. As we have elected not to change to the fair value based method of accounting for stock-based employee compensation, SFAS No. 148 will not have any impact on our financial position, results of operations or cash flows.

#### **Future results of operations may vary due to certain factors.**

Our operating results may fluctuate substantially in the future as a result of a variety of factors, many of which are outside of our control, including those discussed elsewhere in this Form 10-Q. While we do not currently intend to significantly increase our operating expenses other than to increase our marketing expenses and to increase telecommunications expenses as necessary to service new users, we may increase other expenses and capital expenditures for a variety of reasons including, without limitation, unanticipated growth in our user base, enhancement of the features and functionality of our

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services, the development of new services and products, costs associated with integrating acquired companies, upgrading our internal network infrastructure, pursuing new distribution channels and hiring new personnel across all levels of the organization. Expenditures in each of these categories may vary significantly from period-to-period. While some expenses are fixed in the short-term, significant amounts of our operating expenses are determined on the basis of anticipated revenues. There are risks associated with the timing and achievement of revenue targets due to a variety of factors, and we cannot assure you that revenues will increase commensurately with expenses. As a result of these and other factors, operating results may vary substantially from quarter-to-quarter.

Seasonal trends could affect both revenues and operating expenses. However, because our business model has changed and our operating history is limited, it is difficult to accurately predict these trends and plan accordingly. Since current period operating expenses may be based on expectations of future revenues, it is possible that seasonal fluctuations could materially and adversely affect our business, results of operations and financial condition.

There are several other factors that may cause our quarter-to-quarter revenues to fluctuate significantly, including demand for online advertising, changes in advertising rates, increases or decreases in the pricing of our pay services, promotional discounts, fluctuations in our user count, and changes in orders from significant customers. These and other factors may cause significant fluctuations in our quarter-to-quarter revenues.

We purchase the vast majority of our telecommunications resources from third parties. From time to time we have disputes with vendors regarding such services and the accuracy of the invoices for such services. The resolution of such disputes has resulted, and may in the future result, in adjustments in the current period to expenses that were recorded in prior periods, or an increase in expenses in the period of resolution. Our results of operations may be impacted by disputes with vendors and the timing of the resolution of such disputes.

The timing of implementation of any further limitations on our free services may impact pay user registrations as well as the number of active users on our free services. In October 2001, we implemented additional limitations on NetZero's free service. This resulted in a substantial increase in sign-ups for our pay services in October 2001 and a decrease in the number of active free users. Historical quarterly fluctuations in our user base, both free and pay, may not be indicative of an ongoing trend.

Our billable services revenues and financial results are dependent on the number of pay users on our services. Each month, an average of four-to-five percent of our pay users cancel their accounts or have their accounts terminated. These percentages do not include those users who sign-up directly for our pay services without previously using our free services, but whose accounts are terminated within 30 days of registration. Since the inception of our pay services, the number of new pay users signing up for our services has exceeded the number of users canceling their service, in part as a result of limitations imposed on our free services. Increasing our pay user base involves two components: gaining new pay users who have not previously used our free services and converting our free services users to our pay services. We have experienced, and may in the future experience, decreases in our free user base, which we believe will cause us to rely more heavily on acquiring more pay users that have not previously used our free services. In addition, as our pay user base grows, we are required to obtain an increasing number of pay users to replace the users who cancel their service. The dial-up ISP industry is maturing and the aggregate number of dial-up accounts in the United States is likely to decrease. There is significant competition for new pay users and we cannot assure you that we will achieve success in acquiring new pay users. The average cost to acquire a new pay user in our industry is significantly higher than we anticipate spending, and we cannot assure you that we will be able to acquire new pay users at a reasonable acquisition cost. If we experience decreases in the number of

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new pay users signing up for our pay services, our pay user base is likely to decrease, and our business, results of operations and financial position will be adversely impacted.

We have previously experienced reductions in advertising and commerce revenues from significant customers and may experience additional reductions in the future. We derived approximately 36% of our advertising and commerce revenues and approximately 4% of our total revenues for the three and six months ended December 31, 2002 from our agreement with GM compared to approximately 34% and 29%, respectively, of advertising and commerce revenues and approximately 5% and 6%, respectively, of total revenues for the three and six months ended December 31, 2001. While we have had a long-term relationship with GM, our agreement with them expires in December 2003. They historically have been provided with reductions in their advertising commitments and may be provided additional reductions in the future. We can give no assurance that we will continue to derive the amount of anticipated advertising and commerce revenues from GM during the remainder of the term of the agreement. We do not anticipate that, following December 31, 2003, the agreement will be replaced by other arrangements, which will generate comparable revenues. The termination or renegotiation of agreements with significant customers, as well as the timing of orders under agreements with significant customers, may cause significant fluctuations in our quarterly advertising and commerce revenues. Our business, results of operations and financial condition may be materially and adversely affected if we are unable either to maintain or renew our agreements with significant customers or to replace such agreements with similar agreements with new customers.

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## RISK FACTORS

*Before deciding to invest in our company or to maintain or increase your investment, you should carefully consider the risks described below, in addition to the other information in this report and our other filings with the SEC. The risks and uncertainties described below are not the only ones facing our company. Additional risks and uncertainties not presently known to us or that we currently deem immaterial may also affect us. If any of these risks actually occur, our business, financial condition or results of operations could be seriously harmed. In that event, the market price of our common stock could decline and you may lose all or part of your investment.*

### *Risks Associated with our Operations*

#### **We cannot predict our success because our business model is unproven and changing.**

Juno began offering e-mail services in April 1996 and NetZero began offering Internet access services in October 1998. Each company has made significant changes to its business model to address changes in the market as well as other factors. We may make additional changes to each company's business model in the future. These factors make it difficult to evaluate or predict our performance. We cannot assure you that our current business model will be successful, that we will not make significant changes to our model or that any changes we make to our model will be successful.

#### **NetZero and Juno have a history of losses and we may incur additional losses. Our stock price could fall as a result of future losses and negative cash flow.**

We achieved profitability in the September 2002 quarter, and we were profitable in the December 2002 quarter as well. However, both

NetZero and Juno have a history of losses. NetZero incurred net losses of approximately \$334.5 million from its inception in July 1997 through September 2001. Juno incurred net losses of approximately \$191.3 million from its inception in June 1995 through September 2001. During the year ended June 30, 2002, United Online incurred a \$47.8 million net loss. Although our goal is to increase revenues and profitability, we cannot assure you that we will be successful in doing so, or that we will maintain profitability. We may never be successful in implementing our business strategies or in addressing the risks and uncertainties facing our company. We cannot assure you that we will be able to sustain or increase profitability on a quarterly or annual basis. If we fail to maintain or increase profitability, the market price for our common stock would suffer which may adversely affect our ability to raise capital and retain key employees.

**Our business is subject to fluctuations that may negatively impact the price of our common stock.**

Our revenues, expenses and operating results have varied in the past and may fluctuate significantly in the future due to a variety of factors including, without limitation, fluctuations in our pay and free user base, changes in the number of hours subscribers use our services, changes in our business model and service offerings, changes in the market for Internet advertising, the effect of significant contracts with advertisers and vendors, and fluctuations in marketing and telecommunications expenses. In addition, many of our operating expenses are based on our expectations of our future revenues and are relatively fixed in the short term. We cannot assure you that we will achieve the expectations or projections made by our management. Furthermore, we may be unable to adjust spending quickly enough to offset any revenue shortfall, which may cause our business and financial results to suffer. Future results of operations may also vary for other reasons discussed in Management's Discussion and Analysis of Financial Condition and Results of Operations.

Due to all of the above factors and the other risks discussed in this section, you should not rely on quarter-to-quarter or year-to-year comparisons of our results of operations as an indication of future performance. It is possible that in some future periods our results of operations may be below the

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projections of our management and expectations of public market analysts and investors. In this event, the price of our common stock is likely to fall.

**Our market share and revenues will suffer if we are unable to compete effectively with established and new providers of dial-up and broadband Internet access services.**

Competition for users of Internet access services is intense. We compete with established online service and content providers, such as AOL Time Warner, CompuServe and The Microsoft Network; independent national ISPs, such as EarthLink; companies combining their resources to offer Internet services in conjunction with other services such as the agreement between Yahoo! and SBC Internet Services and the arrangement between AOL Time Warner and Walmart.com; national communications companies and local exchange carriers such as AT&T WorldNet, Quest Software, Inc. and Verizon; and cable companies such as Comcast Corporation, Cox Communications, Inc. and Adelphia Communications Corporation. We also compete with local telephone companies and regional and local commercial ISPs.

While we believe our current product offerings compete primarily with other dial-up Internet access offerings, we also compete with broadband offerings. Our larger competitors offer both dial-up and broadband services. We offer broadband services on a limited basis pursuant to an agreement with Comcast Cable Communications, Inc. and we are uncertain whether we will offer broadband services on a more significant scale. We cannot assure you that we will be able to implement such a service successfully, that the service will be offered on other than a limited basis or that we will generate a significant number of subscribers to the service. Our failure to offer competitive broadband services on a significant scale will adversely impact our ability to compete for new users.

We expect competition to continue to intensify. Historically, there has been significant growth in the number of new users establishing Internet access accounts. It is estimated that approximately 88% of the homes in the United States with computers as of December 2001 had some form of Internet access. As such, the number of dial-up accounts being established by new users is decreasing. In addition, we expect that the aggregate number of dial-up accounts in the United States will decrease in the future due to the growth in broadband services. In addition to offering broadband services, many of our competitors have significantly greater resources and larger marketing budgets and more advanced features and services, and they may offer competing services at a lower price. While many of our competitors price their standard services above our standard offering price, there are other competitors with lower pricing and we cannot assure you that we will be price competitive.

We cannot assure you that we will be able to compete successfully. Our inability to effectively compete could require us to make significant revisions to our strategies and business model, and would likely result in increased costs, decreased revenues and the loss of users, all of which could materially and adversely impact our business, financial position and results of operations.

**Restrictions on our free services may result in significant reductions in our free user base.**

NetZero and Juno have, from time to time, implemented restrictions and limitations on their free services. As a result of these measures and other factors, we have experienced a decline in our free user base and a decrease in the number of new users registering for our free services. We also have focused our marketing efforts on marketing our pay services, not our free services. These measures may adversely impact our reputation as a provider of free services and make it more difficult to recruit new free users. Since a portion of our strategy is to increase our pay

user base by converting free users to pay users, reductions in our free user base may adversely impact this strategy. We cannot assure you that these measures will not adversely impact our business.

**If we are unable to grow our pay user base, we may not be able to grow revenues.**

Growth in our pay user base will be critical to our future success. Increasing our pay user base involves two components: converting our free service users to our pay service and gaining new pay users who have not previously used our free service. We have experienced, and may experience in the future, decreases in our free user base, which we believe will cause us to rely more heavily on signing up more pay users who have not previously used our free service. In addition, as our pay user base grows, we are required to obtain an increasing number of pay users to replace the users who cancel their service. We are competing directly with other pay service offerings and we cannot assure you we will achieve success in signing up new pay users. The average cost to acquire a pay user in our industry is significantly higher than we anticipate spending, and we cannot assure you that we will be able to acquire new pay users at a reasonable cost. If we experience decreases in our pay user base or increased costs in acquiring new pay users, our business, results of operations and financial position will be adversely impacted.

We are relying on the migration of free users to our pay services as a major source of our pay users. Since July 1998, Juno has advertised to its free users encouraging them to upgrade, and NetZero initiated a similar campaign in March 2001. There is a risk that repeated exposure to these advertisements may cause their effectiveness to decline. Furthermore, to the extent that our number of active free users declines, we will have a smaller pool of free users to solicit, further reducing the absolute number of potential migrations to our pay services. The rate at which users of the free service upgrade to our pay services has, from time to time, declined and may continue to decline, which would adversely impact our ability to retain or grow our pay user base.

**If we are unable to retain users, our business and financial results will suffer.**

Our business and financial results are dependent on the number of users of our services. Our number of active users has a significant impact on our ability to attract advertisers, the number of advertising impressions we have available to sell, and on how many pay service users we can potentially acquire by soliciting users of our free service. Our number of pay service users is critical to our ability to generate revenues. Each month, an average of four to five percent of our pay service users cancel their accounts or have their accounts terminated. These percentages do not include those users who sign up for our pay service without previously using our free service and whose accounts are terminated within 30 days of registration. Each month, an even higher percentage of free users becomes inactive and the vast majority of registered free users are not actively using our services. This is due to competition, the imposition of limitations on our free services, changes in pricing plans and other factors. In addition, there may be significant overlap between NetZero's and Juno's active free user bases, so the actual combined active user base may be less than anticipated.

We anticipate further significant reductions in our free user base if we implement additional restrictions on our free services. We may also, in the future, make additional changes to the terms or prices of our pay services, which may result in additional pay user attrition. If these or other factors result in the loss of a significant number of users, our business and financial results will suffer. We cannot assure you that we will be able to effectively retain users or generate enough new users to make up for lost users.

**If we fail to generate significant revenues and derive a profit from our pay services, we may not be able to support our operations.**

Our ability to generate significant revenues from our pay services will be critical to our future success. Generating pay revenues includes increasing our pay user base as well as maintaining or increasing our pricing. Juno has offered a variety of pricing programs and has, in certain cases, increased the pricing to certain users based on their usage. Juno's monthly prices have ranged from

\$1.95 to \$29.95 per month. A significant number of users who have experienced price increases have discontinued their service, which adversely impacts revenues.

Our ability to offer a value-priced pay service will be adversely impacted if users of our pay service use the Internet excessively. We price our standard offering based on the expectation that users will access the Internet for only a moderate number of hours each month. If the average monthly usage for our pay users exceeds our expectations, or if our average hourly telecommunications cost increases, we may not be able to operate our value-priced pay services profitably. We may have to impose hourly limits on our pay services or increase our standard pricing, either of which could adversely impact our ability to attract and retain users to our pay services or compete effectively.

**We may be unable to maintain or grow our advertising revenues.**

Advertising revenues are intended to be an important component of our strategy and revenue base going forward. Our revenues from

advertising have, from time to time, decreased from quarter-to-quarter due to a variety of factors, including the deterioration of the online advertising market and the decrease in capital available to Internet companies. We have experienced a number of situations where our advertising arrangements are terminated early, are not renewed, are renewed at significantly lower rates or are repriced during the term of the arrangement. Our success may depend on our ability to effectively target users based on demographic and other information. We may encounter technical, legal and other limitations on this ability.

Competition for Internet-based advertising revenues is intense and the demand for advertising space has declined. These and other factors have caused Internet advertising rates to decline, and it is possible that rates will continue to decline in the future. Many of our advertising competitors have longer operating histories, greater name recognition, larger user bases, significantly greater financial, technical, sales, development and marketing resources and more established relationships with advertisers than we do. We must also compete with television, radio, cable and print media for a share of advertisers' total advertising budgets. Advertisers may be reluctant to devote a significant portion of their advertising budget to Internet advertising if they perceive the Internet to be a limited or ineffective advertising medium.

In light of these factors, we cannot assure you that we will be able to maintain or grow advertising revenues.

**Our business is highly dependent on our billing system, which is based on third-party software and internally developed software.**

We license from Portal the software necessary to operate our billing system. In addition, our billing system includes internally developed software. Customer billing is a highly complex process, and our billing system must efficiently interface with other third parties' systems such as the systems of credit card processing companies. Our ability to accurately and efficiently bill our subscribers is dependent on the successful operation of our billing system and third parties' systems, particularly our credit card processing vendor, upon which we rely. In addition, our ability to offer new pay services or alternative billing plans is dependent on our ability to customize our billing system. Issues associated with our billing system could cause a variety of problems including the failure to bill users on a timely basis, over-charging or under-charging users, inaccurate financial and customer data, credit card chargebacks, delays in new product or billing plan introductions and other billing-related errors. Such problems may lead to inaccurate reporting from time to time, which could adversely affect our business and financial results. We have experienced billing problems from time to time and may experience additional problems in the future. The failure of Portal to provide software upgrades and technical support, the failure of the Portal software or internally developed software to operate accurately, problems with our

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credit card processor or other billing vendors and any other failures or errors in our billing system could materially and adversely affect our business and financial results.

**If we are unable to successfully integrate acquisitions into our operations, then we may not realize the benefits associated with such acquisitions and our financial condition and results of operations may be adversely affected.**

In September 2001 we completed the Merger. While the majority of the integration has been completed, additional efforts are ongoing and we cannot assure you that all integration efforts will be completed successfully. In November, we acquired certain assets of BlueLight's value-priced Internet access and e-mail service, and integration efforts are ongoing. We may acquire other companies or undertake other business combinations that can complement our current or planned business activities. We are currently evaluating the possibility of acquiring and integrating additional ISPs offering pay services. Acquisitions may not be available at the times or on terms acceptable to us, or at all. In addition, acquiring a business involves many risks, including:

- disruption of our ongoing business and diversion of resources and management time;
- unforeseen obligations or liabilities;
- difficulty assimilating the acquired customer bases, technologies, operations and personnel;
- risks of entering markets in which we have little or no direct prior experience;
- potential impairment of relationships with employees or users as a result of changes in management; and
- potential dilutive issuances of equity, large and immediate write-offs, the incurrence of debt, and amortization of identifiable intangible assets.

We cannot assure you that we will make any further acquisitions, that we will be able to obtain additional financing for such acquisitions, if necessary, or that any acquisitions will be successful.

**We may not realize the benefits associated with our intangible assets.**

We also may not realize the benefits associated with our intangible assets, including those associated with acquisitions. During the quarter

ended March 31, 2001, we determined the carrying value of certain assets was impaired using the undiscounted cash flow method and the market comparison method. An impairment charge relating to goodwill, intangible assets and other assets totaling approximately \$48.6 million was recorded during the quarter, reflecting the amount by which the carrying amount of the assets exceeded their respective fair values. The impairment consisted of approximately \$33.5 million for goodwill and approximately \$15.1 million for other acquired intangible assets and other assets. We cannot assure you that we will not experience similar impairment losses related to the Merger or otherwise in the future. Any such loss could adversely and materially impact our results of operations and financial condition.

**The provision of Internet access for free creates substantial risks.**

We face numerous costs, operational and legal risks, and other uncertainties associated with our provision of free Internet access to consumers. These risks include risks that our pay users will cancel their subscription and switch to our free service and risks that the number of hours used by our free users, and the costs of providing the service, will not decrease, and may increase.

If the number of our users who remain on, or return to, the free service is significant, our business and financial results may suffer. As users of the service spend more time connected, the costs we incur

to provide the service increase. If aggregate hours of connection time associated with our free services increase, our business and financial results may suffer.

**We may not be able to grow or retain our user base if we are unsuccessful in maintaining our brands and marketing our services.**

If we are unsuccessful in maintaining and continuing to market our brands, we may not be able to grow or retain our user base. Promotion of our brands will depend on our success in providing high-quality Internet products and services. If our users and advertisers do not perceive our existing products and services as high quality, or if we introduce new products or services or enter into new business ventures that are not favorably received by our users and advertisers, then we may be unsuccessful in building brand recognition and brand loyalty in the marketplace.

Our marketing activities may be insufficient to increase or maintain the size of our subscriber base and may be insufficient to develop or maintain awareness of our services. We have relied on a variety of cash-intensive subscriber acquisition activities in the past, including the distribution of CD's, the acquisition of competitors, fee-based referral agreements and extensive advertising and promotions. While certain of these activities have been reduced, we could be required to incur significant marketing expenses to maintain or grow our user base, potentially resulting in increased user acquisition costs. If we incur costs in implementing marketing campaigns without generating sufficient new users, or if capital limitations or other factors prevent us from implementing marketing campaigns, or if marketing campaigns undertaken by competitors cause attrition in our user base, our business and financial results will suffer.

**Our advertising and commerce revenues would significantly decrease if we lose key marketing and advertising relationships.**

We have entered into a number of advertising agreements with third parties. The number of terminations or nonrenewals of various types of advertising contracts by our partners has increased. In particular, Internet companies have scaled back the resources devoted to advertising. In light of the concentration of our advertisers within the Internet industry, we expect that we will continue to experience a significant number of terminations or nonrenewals in the future.

A small number of customers have accounted for, and may in the future account for, a significant portion of our advertising and commerce revenues. Each of NetZero and Juno has previously experienced reductions in revenues from material customers. For example, LookSmart, GM and Cisco have been material customers of NetZero. The LookSmart agreement was terminated in January 2001 and the Cisco agreement was terminated in August 2001. NetZero was not able to replace either agreement with a comparable arrangement. During the three and six months ended December 31, 2002, GM represented approximately 36% of our advertising and commerce revenues. While we have had a long-term relationship with GM, our agreement with them expires in December 2003. We have provided them with reductions in their advertising obligations in the past and may do so in the future. We can give no assurance that we will continue to derive the amount of revenues from GM that we currently do during the remainder of the agreement. We do not anticipate that, following December 2003, the agreement will be replaced by other arrangements which will generate comparable revenues.

The termination or renegotiation of significant agreements, as well as the timing of orders under such agreements, has caused, and may in the future cause, significant fluctuations in our quarterly results. Our business, results of operations and financial condition will be materially and adversely affected if we are unable either to maintain or renew our significant agreements or to replace such agreements with similar agreements with new customers.

**Our business is dependent on a small number of telecommunications carriers and our inability to maintain agreements at attractive rates with such carriers may negatively impact our business.**

Our business substantially depends on the capacity, affordability, reliability and security of our telecommunications networks. Only a small number of telecommunications providers offer the network services we require, and the majority of our telecommunications services are currently purchased from Leve13 Communications LLC, ICG Telecom Group, Inc., and UUNET Technologies, Inc., a WorldCom company. Several vendors have ceased operations or ceased offering the services we require, causing us to switch vendors. In addition, several vendors are experiencing significant financial difficulties and may be unable to perform satisfactorily or to continue to offer their service. In particular, UUNET and StarNet, Inc. are in bankruptcy proceedings, and ICG Telecom Group recently emerged from bankruptcy proceedings. The loss of vendors has resulted, and may in the future result, in increased costs, decreased service quality and the loss of users. In particular, the failure of Leve13 Communications, ICG Telecom Group or UUNET Technologies to continue to provide the scope, quality and pricing of services currently provided could materially and adversely affect our business. Certain of our telecommunications services are provided pursuant to short-term agreements that the providers can terminate or elect not to renew. In addition, each of our telecommunications carriers provides network access to some of our competitors, and could choose to grant those competitors preferential network access or pricing. Many of our telecommunications providers compete, or have announced an intention to compete, with us in the market to provide consumer Internet access. As a result, any or all of our current telecommunications service providers could discontinue providing us with service at rates acceptable to us, or at all, which could materially and adversely affect our business, results of operations and financial condition.

Market rates for telecommunications services used in our business have declined significantly in recent years. We do not anticipate that such rates will continue to decline in the future. General market forces, the failure of providers, regulatory issues and other factors could result in increased rates. Any increase in market rates would increase the cost of providing our services and, if significant, could materially adversely affect our business, results of operations and financial condition.

**Our business will suffer if the scope or quality of service from our telecommunications carriers is inadequate.**

If our third-party telecommunications service providers deliver unacceptable service, the quality of our Internet access service would suffer. In this event, we would likely lose users who are dissatisfied with our service. Since we do not have direct control over our telecommunications carriers' network reliability and the quality of their service, we cannot assure you that we will be able to provide consistently reliable Internet access for our users.

We do not offer Internet access in all areas. Many potential users may be unable to access our services through a point of presence that is within their local calling area. These users may be particularly reluctant to use our services to access the Internet due to the telecommunications charges that they would incur. We cannot be sure if or when additional infrastructure developments by our telecommunications providers will establish points of presence that cover these areas at costs acceptable to us.

**If we fail to manage our telecommunications or our internal network capacities, our service levels may suffer or we may experience increased per-user costs.**

We will have to accurately anticipate our future telecommunications capacity needs within lead-time requirements. If we fail to procure sufficient quantities of telecommunications services, we may be unable to provide our users with acceptable service levels. We also run the risk of purchasing excessive amounts of telecommunications services. In that event, we would be required to bear the

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costs of excess telecommunications capacity without commensurate increases in revenues. We have experienced such overcapacity in the past, and we may experience overcapacity in the future. Our failure to effectively manage telecommunications costs would likely have a material adverse effect on our business, results of operations, financial position and cash flow.

In addition, we may from time to time experience increases in our telecommunications usage, which exceed our then-available telecommunications capacity and the capacity of our internal servers. As a result, users may be unable to register or log on to our service, may experience a general slow-down in their Internet access or may be disconnected from their sessions. Excessive user demand could also result in system failures of our internal server networks, which would prevent us from generating advertising revenues. Inaccessibility, interruptions or other limitations on the ability to access our service due to excessive user demand, or any failure of our servers to handle user traffic, could have a material adverse effect on our reputation and our revenues.

**We may not successfully develop and market new products in a timely or cost-effective manner; consumers or advertisers may not accept our new products.**

We may not be able to compete effectively if we are not able to adapt to changes in technology and industry standards, and to develop and introduce new and enhanced products and service offerings. New products may be dependent on our obtaining needed technology or services from third parties. We also believe that our ability to compete successfully will also depend upon the continued compatibility of our services with products offered by various vendors.

We have expended, and may in the future expend, significant resources developing and implementing new products. Product development involves a number of uncertainties, including unanticipated delays and expenses. New products may have technological problems or may not be accepted by our users or advertisers. Several of the new products we have offered, or intend to offer, are intended to generate additional revenues for us. We cannot assure you that such products will provide us with any meaningful revenue. In particular, the expansion of a broadband service offering, including a cable offering, could result in significant expenses without a commensurate increase in revenues.

**We may not be able to compete effectively if we are not able to protect our proprietary rights.**

If we are not able to protect our proprietary rights, we may not be able to compete effectively. We principally rely upon patent, copyright, trade secret and contract laws to protect our proprietary technology. We cannot be certain that we have taken adequate steps to prevent misappropriation of our technology or that our competitors will not independently develop technologies that are substantially equivalent or superior to our technologies. In addition, since we provide our Internet access software for free, we are extremely susceptible to various forms of unauthorized use of our software. These actions could adversely affect our brand names.

In addition, both Juno and NetZero have engaged in lawsuits and expended significant resources attempting to enforce their proprietary rights. We may attempt to enforce our proprietary rights in the future, which could result in significant costs without a corresponding economic or competitive benefit.

**We may incur substantial costs and diversion of management resources if we are accused of infringing upon the proprietary rights of others.**

Third parties may assert claims against us for infringement of their proprietary rights and these claims may be successful. In addition, a number of third-party owners of patents have claimed to hold patents that cover various forms of online transactions or online technology. As with other online service providers, patent claims could be asserted against us based upon our services or technologies.

We have had claims asserted against us in the past although we do not believe that any claims are material to our business.

We could incur substantial costs and diversion of management resources in the defense of any claims relating to proprietary rights. Parties making these claims could secure a judgment awarding substantial damages as well as injunctive or other equitable relief that could effectively block our ability to use our products in the United States or abroad. If a third party asserts a claim relating to proprietary technology or information against us, we may seek licenses to the intellectual property from the third party. We cannot be certain, however, that third parties will extend licenses to us on commercially reasonable terms, or at all. If we fail to obtain the necessary licenses or other rights, it could materially and adversely affect our ability to operate our business.

**A security breach, virus or inappropriate use by Internet users could disrupt our service.**

The future success of our business will depend on the security of our network and, in part, on the security of the network infrastructures of our third-party telecommunications service providers, providers of customer support services and other vendors. In addition, the sending of "spam" through our network could result in third parties asserting claims against us. Unauthorized or inappropriate access to our computer systems, including by current or former employees, could potentially jeopardize the security of confidential information, including credit card information, and that could cause losses to our users or us. Users or third parties may also potentially expose us to liability by "identity theft." Users or others may assert claims of liability against us as a result of any failure by us to prevent these network malfunctions and security breaches. Although we intend to use industry-standard security measures, such measures have been circumvented in the past, and we cannot assure you that these measures will not be circumvented in the future. We also cannot assure you that the security measures of our third-party network providers, providers of customer support services or other vendors will be adequate. In addition to potential legal liability as a result of computer viruses or other inappropriate uses or security breaches, we may have to interrupt, delay, or temporarily cease service to our users, which could have a material adverse effect on our revenues and could also result in increased user turnover.

**If our software or hardware contains errors, or if we encounter difficulties integrating our systems and technologies, our business could be seriously harmed.**

The software and hardware used to operate and provide our services is complex and may contain undetected errors or failures. We have in the past encountered, and may in the future encounter, errors in the software or hardware used to operate our business and provide our services. This has resulted in, and may in the future result in, a number of adverse consequences, which have included or may include:

- users being disconnected from our services or being unable to access our services;
- loss of data or revenue;
- injury to reputation; and

- diversion of development resources.

We have experienced some technical and customer support issues associated with our products and software releases. These issues have resulted in users discontinuing our service and have adversely impacted our revenues. A number of our material technologies and systems, including the software client systems and ad-serving technologies for NetZero, Juno and BlueLight Internet, are based on different platforms. To the extent we attempt to integrate these technologies and systems, we may experience a number of difficulties, errors, failures and unanticipated costs. In addition, our internal operations are dependent upon software provided by Oracle. Any significant failure of this software

could materially and adversely affect our business. We cannot assure you that we will not experience significant problems in the future.

**We are dependent on third parties for technical support and customer service and our business may suffer if they are unable to provide these services, cannot expand to meet our needs or terminate their relationships with us.**

Our business and financial results depend, in part, on the availability and quality of live technical and customer support services. We outsource most of these functions to ClientLogic Corporation pursuant to an agreement that terminates in June 2003. As a result, we maintain only a small number of internal customer service personnel. We are not equipped to provide the necessary range of customer service functions in the event that ClientLogic becomes unable or unwilling to offer these services to us. At times, users have experienced lengthy waiting periods to reach representatives trained to provide the technical or customer support they require. ClientLogic has also experienced outages in the past where they were unable to service our users. Maintaining desired customer support levels may require significantly more support personnel than are currently available to us, or significantly greater expense than we feel it is appropriate, or than we are able, to incur. If our relationship with ClientLogic terminates and we are unable to enter into a comparable arrangement with a replacement vendor, if our current vendor is unable to provide the quality and quantity of service required, or if we are unable to develop internally the additional customer service and technical support capacity we expect to need, our business and financial results will suffer. We use technical support staff in India in part for supporting our customers via e-mail. If technical problems are encountered with communication to India, it may impair our ability to provide e-mail support.

**We cannot predict our future capital needs and we may not be able to secure additional financing.**

We may need to raise substantial additional funds in the future to fund our operations, for acquisitions of businesses or technologies or for other purposes. Additional financing may not be available on terms favorable to us, or at all. If adequate funds are not available or not available when required in sufficient amounts or on acceptable terms, we may not be able to devote sufficient cash resources to continue to provide our services in their current form, acquire additional users, enhance or expand our services, respond to competitive pressures or take advantage of perceived opportunities, and our business and financial results may suffer, or we could be forced to cease our operations entirely.

**If we are unable to successfully defend against legal actions against us, we could face substantial liabilities.**

We are currently parties to various legal actions. Defending against these lawsuits may involve significant expense and diversion of management's attention and resources from other matters. Due to the inherent uncertainties of litigation, we may not prevail in these actions. In addition, our ongoing operations may continue to subject us to significant litigation and costs in the future. Both the costs of defending lawsuits and any settlements or judgments against us could materially and adversely affect our financial position and results of operations.

**Our business could be shut down or severely impacted if a natural disaster occurs.**

Our computer equipment and the telecommunications infrastructure of our third-party network providers are vulnerable to damage from fire, earthquakes, power loss, telecommunications failures, and similar events. We have experienced situations where power loss and telecommunications failures have adversely impacted service, although to date such failures have not been material to our operations. A significant portion of our computer equipment, including critical equipment dedicated to

our Internet access services, is located at our headquarters in Westlake Village, California and at facilities in Los Angeles, California; San Jose, California; and New York City, New York. A natural disaster or other unanticipated problems at our headquarters or at a network hub, or within a third-party network provider's network, could cause interruptions in the services that we provide. Our systems are not fully redundant. Any prolonged disruption of our services due to system failures could result in user turnover and decreased revenues.

**Our business could be severely impacted due to political instability in India.**

Approximately 28% of our employees are located in Hyderabad, India. Due to the current political instability between India and Pakistan, it is possible that our India operations could be disrupted. We rely on our employees in India for product development, quality assurance, and customer support. If communications or personnel are disrupted, it could affect our ability to enhance our products or provide certain types of support to our users.

**Our ability to operate our business could be seriously harmed if we lose members of our senior management team and other key employees.**

Our business is largely dependent on the personal efforts and abilities of our senior management, particularly Mark Goldston, our chairman, chief executive officer and president, and other key personnel. Any of our officers or employees can terminate his or her employment relationship at any time. The loss of these key employees or our inability to attract or retain other qualified employees could seriously harm our business and prospects. We do not carry key man life insurance on any of our employees.

**We will not be able to grow our business if we are not able to retain or hire additional personnel.**

Our future success also depends on our ability to attract, retain and motivate highly skilled technical, managerial, editorial, merchandising, sales, marketing and customer service personnel. Competition for such personnel is intense, particularly in the Internet and high technology industry. As a result, we may be unable to successfully attract, assimilate or retain qualified personnel.

Any staff attrition we experience, whether initiated by the departing employees or by us, could place a significant strain on our managerial, operational, financial and other resources. We cannot assure you that we will be able to identify and hire adequate replacement staff promptly, or at all. Our subsidiaries have engaged in significant staffing reductions in the past and additional staffing reductions may take place. These reductions may make it more difficult for us to integrate their businesses, manage existing, or establish new, relationships with advertisers, vendors and other parties, or to integrate, expand and improve our service offerings. Our business and financial results could suffer as a result of the staff reductions undertaken to date and from any future staff reductions and attrition that might occur.

**Government regulation of the provision of Internet access services could decrease our revenues and increase our costs.**

Changes in the regulatory environment regarding the Internet could decrease our revenues and increase our costs. As a provider of Internet access services, we are not currently subject to direct regulation by the FCC. However, some telecommunications carriers have sought to have communications over the Internet regulated by the FCC in the same manner as other more traditional telecommunications services. Local telephone carriers have also petitioned the FCC to regulate ISPs in a manner similar to long distance telephone carriers and to impose access fees on these providers, and some developments suggest that they may be successful in obtaining the treatment they seek. In addition, we operate our services throughout the United States, and regulatory authorities at the state

level may seek to regulate aspects of our activities as telecommunications services. As a result, we could become subject to FCC and state regulation as Internet access services and telecommunications services converge.

**Changes in, or interpretations of, laws regarding consumer protection could subject us to liability or cause us to change our practices.**

Consumer protection laws and enforcement actions regarding advertising and user privacy, especially relating to children, are becoming more prevalent. The FTC has conducted investigations into the privacy practices of companies that collect information about individuals on the Internet. The FTC has also investigated us and other ISPs in connection with marketing, billing and disclosure practices. Juno and the FTC entered into a consent agreement, which was approved by the FTC on June 29, 2001, that provides for redress payments and specific disclosures or notices regarding, among other things, the cost of its Internet access services, its cancellation terms and local versus long-distance charges, as well as the requirement to provide adequate customer support to process cancellations.

Various state agencies as well as individuals have also asserted claims against, or instituted inquiries into, ISPs, including Juno and NetZero, in connection with marketing, billing and disclosure practices. We cannot assure you that our services and business practices, or changes to our services and business practices, will not subject us to claims and liability by private parties, the FTC or other governmental agencies. The enactment of any additional laws or regulations in this area, increased enforcement activity of existing laws and regulations, or claims by individuals could significantly impact our costs or the manner in which we conduct business, all of which could cause our business to suffer and adversely impact our results of operations.

**We could be exposed to liability for defamation, negligence and infringement.**

Because users download and redistribute materials that are cached or replicated by us in connection with our Internet services, claims could be made against us for defamation, negligence, copyright or trademark infringement, or other theories based on the nature and content of such materials. While we have attempted to obtain safe harbor protection against claims of copyright infringement under the Digital Millennium Copyright Act of 1998, we cannot assure you that we will prevail in any such claims. We also could be exposed to liability because of third-party

content that may be accessible through our services, including links to Web sites maintained by our users or other third parties, or posted directly to our Web site and subsequently retrieved by a third party through our services.

**Seasonal trends in Internet usage and advertising sales may cause fluctuations in our business.**

Seasonal trends could affect our advertising revenues, user sign ups and our telecommunication costs. Decreased usage during seasonal periods could decrease advertising inventory and adversely impact advertising revenue. While increased usage due to seasonality may positively impact advertising revenue, it would also result in increased telecommunication costs for such period. In addition, the rate at which new users sign up for our services may vary during certain seasons and holiday periods. Because our operating history is so limited, it is difficult for us to accurately predict these trends and plan accordingly. It is possible that seasonality could result in significant fluctuations in our operating results.

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*Risks Related to the Market for Our Common Stock*

**NetZero's and Juno's stock prices were highly volatile; our stock price has been highly volatile since the Merger and may cause limitations on the trading market for our stock.**

The market price of NetZero's and Juno's common stock fluctuated significantly prior to the Merger. The market price of our common stock has fluctuated significantly since our stock began trading on the Nasdaq National Market in September 2001 and it is likely to continue to be volatile with extreme volume fluctuations. The Nasdaq National Market, where most publicly held Internet companies are traded, has experienced substantial price and volume fluctuations. These broad market and industry factors may harm the market price of our common stock, regardless of our actual operating performance, and for this or other reasons we could suffer significant declines in the market price of our common stock.

**Future sales of our common stock may negatively affect our stock price.**

At December 31, 2002, approximately 42 million shares were outstanding and available for resale, subject to volume and manner of sale limitations applicable to affiliates under Rule 144. The market price of our common stock could decline as a result of sales of a large number of shares of our common stock in the market, or the perception that such sales could occur. These sales also might make it more difficult for us to sell equity securities in the future at a price that we think is appropriate, or at all.

**We may issue common stock resulting in dilution to our stockholders, and the dilutive effect of these issuances would increase to the extent that our stock price declines.**

Juno entered into a number of relationships in which it could use its common stock to compensate third parties for services, including subscriber referral services, and we may enter into additional such relationships in the future. If the price of our common stock should decline, our electing to pay with common stock would entail issuing a relatively larger number of shares, increasing the dilutive effect on our stockholders, and potentially impairing our ability to execute financing transactions. Additionally, the third parties to whom we issue common stock will generally have registration rights that require us to register these shares of common stock for resale in the public markets. The market price of our common stock could decline as a result of sales of these shares in the market, or the perception that such sales could occur. If we raise additional funds, acquire assets, or obtain goods or services through the issuance of equity securities, stockholders may experience significant dilution of their ownership interest and the newly issued securities may have rights superior to those of our common stock. The dilutive effect of these issuances will be increased to the extent our share price declines.

**Our directors will have the ability to exercise significant influence over us.**

Our executive officers, directors, and persons and entities affiliated with our executive officers or directors, own in the aggregate approximately 20% of our outstanding common stock. As a result of this concentration of ownership, our executive officers and directors may be able to exercise significant influence over matters requiring approval by our stockholders, including the election of directors and approval of significant corporate transactions. This concentration of ownership could also have the effect of delaying or preventing a change in control of United Online that may adversely impact stockholders by preventing them from realizing a premium price for their stock in connection with a sale of United Online.

**We have anti-takeover provisions that may make it difficult for a third party to acquire us.**

Provisions of our certificate of incorporation, our bylaws and Delaware law could make it more difficult for a third party to acquire us, even if doing so might be beneficial to our stockholders because

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of a premium price offered by a potential acquiror. In addition, our board of directors adopted a stockholder rights plan on November 15, 2001, which is an anti-takeover measure that will cause substantial dilution to a person who attempts to acquire the company on terms not approved by our board of directors.

**We do not plan to pay dividends in the foreseeable future and, as a result, you will need to sell your shares in order to realize a near-term return on your investment.**

We intend to retain any future earnings to finance the operation and expansion of our business and do not anticipate paying any cash dividends in the foreseeable future. Consequently, stockholders will need to sell shares of common stock in order to realize a return on their investment, if any.

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

We maintain a short-term investment portfolio consisting of U.S. commercial paper, U.S. Government or U.S. Government Agency obligations and money market funds. The minimum long-term rating is A and if a long-term rating is not available we require a short-term credit rating of A1 and P1. Increases and decreases in short-term interest rates could have a material impact on interest income from our investment portfolio.

### **ITEM 4. CONTROLS AND PROCEDURES**

Based on their evaluation, as of a date within 90 days of the filing of this Form 10-Q, the Company's Chief Executive Officer and Chief Financial Officer have concluded the Company's disclosure controls and procedures (as defined in Rules 13a-14(c) and 15d-14(c) under the Securities Exchange Act of 1934) are effective to ensure that all material information required to be disclosed in this quarterly report has been made known to them in a timely fashion.

There have been no significant changes in the Company's internal controls, or in other factors that could significantly affect the Company's internal controls, subsequent to the date of their evaluation.

## **PART II. OTHER INFORMATION**

### **ITEM 1. LEGAL PROCEEDINGS**

There have been no material developments in the legal proceedings discussed in our Annual Report on Form 10-K filed with the SEC on September 30, 2002 and, as of the date of this Report, there are no new material legal proceedings to report.

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

The annual meeting of our stockholders was held on November 12, 2002. Two nominees to the Board of Directors, James T. Armstrong and Dennis Holt, were elected to serve for terms expiring at the 2005 annual meeting and the appointment of PricewaterhouseCoopers LLP as our independent accountants for the fiscal year ending June 30, 2003 was ratified at the meeting.

The results of voting for the election of Mr. Armstrong were as follows: 33,949,402 votes for and 301,967 votes withheld. The results of voting for the election of Mr. Holt were as follows: 33,756,212 votes for and 495,157 votes withheld. The remaining members of the Board of Directors who continued in office after the meeting and the year in which their terms expire are: (1) Robert Berglass and Kenneth L. Coleman, whose terms expire in 2003; and (2) Mark R. Goldston and Jennifer S. Fonstad, whose terms expire in 2004.

The results of the voting for the ratification of the appointment of PricewaterhouseCoopers LLP as our independent accountants were as follows: 23,850,636 votes for, 5,778,668 votes against and 4,622,065 abstentions.

### **ITEM 6. EXHIBITS AND REPORTS ON FORM 8-K**

- (a) Exhibits.

Exhibit No.	Description
3.1*	Amended and Restated Certificate of Incorporation
3.2*	Amended and Restated Bylaws
3.3**	Certificate of Designation for Series A Junior Participating Preferred Stock (included in exhibit 4.1 below).
4.1**	Rights Agreement, dated as of November 15, 2001, between the Company and U.S. Stock Transfer Corporation, which includes the form of Certificate of Designation for the Series A junior participating preferred stock as Exhibit A, and the form of Rights Certificate as Exhibit B
10.1+	Amended and Restated Registration Rights Agreement
10.2+	Lease Agreement between Westlake Gardens and Registrant
10.3+	2001 Employee Stock Purchase Plan
10.4+	2001 Stock Incentive Plan
10.5+	2001 Supplemental Stock Incentive Plan
10.6+	Employment Agreement between the Registrant and Mark R. Goldston
10.7+	Amendment to Employment Agreement between the Registrant and Mark R. Goldston
10.8+	Stock Pledge Agreement between Registrant and Mark R. Goldston
10.9+	Note Secured by Stock Pledge Agreement made by Mark R. Goldston in favor of Registrant
10.10+	Employment Agreement between the Registrant and Charles S. Hilliard
10.11+	Amendment to Employment Agreement between the Registrant and Charles S. Hilliard
10.12+	Stock Pledge Agreement between Registrant and Charles S. Hilliard
10.13+	Note Secured by Stock Pledge Agreement made by Charles S. Hilliard in favor of Registrant

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10.14+	Employment Agreement between the Registrant and Frederic A. Randall, Jr.
10.15+	Amendment to Employment Agreement between the Registrant and Frederic A. Randall, Jr.
10.16+	Employment Agreement between the Registrant and Brian Woods
10.17+	Amendment to Employment Agreement between the Registrant and Brian Woods
10.18++	Form of Note Secured by Stock Pledge Agreement made by certain officers of the Company in favor of Registrant
10.19++	Form of Stock Pledge Agreement between Registrant and certain officers of the Company
10.20++	Form of Restricted Stock Purchase Agreement between Registrant and certain officers of the Company
10.21	United Online, Inc. Fiscal Year 2003 Management Bonus Plan
99.1	Certification of the Chief Executive Officer pursuant to 18 U.S.C. Section 1350 as adopted pursuant to Section 906 of the Sarbanes-Oxley Act of 2002.
99.2	Certification of the Chief Financial Officer pursuant to 18 U.S.C. Section 1350 as adopted pursuant to Section 906 of the Sarbanes-Oxley Act of 2002.

\* Incorporated by reference from the exhibits to the Current Report on Form 8-K filed by Registrant with the SEC on October 1, 2001 (File No. 333-63704).

\*\* Incorporated by reference from the exhibits to the Current Report on Form 8-K filed by Registrant with the SEC on November 23, 2001 (File No. 333-63704).

+ Incorporated by reference from the exhibits to the Quarterly Report on Form 10-Q filed by Registrant with the SEC on November 14, 2001 (File No. 333-63704).

++ Incorporated by reference from the exhibits to the Quarterly Report on Form 10-Q filed by Registrant with the SEC on February 14, 2002 (File No. 333-63704).

(b) Reports on Form 8-K.

None.

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## 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.

UNITED ONLINE, INC.

(REGISTRANT)

Dated: February 10, 2003

By: /s/ CHARLES S. HILLIARD

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Charles S. Hilliard  
*Executive Vice President, Finance and Chief  
Financial Officer*

Dated: February 10, 2003

By: /s/ NEIL P. EDWARDS

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Neil P. Edwards  
*Senior Vice President, Finance, Treasurer and  
Chief Accounting Officer*

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**Certification of Chief Executive Officer Pursuant to  
Securities Exchange Act Rules 13a-14 and 15d-14  
as Adopted Pursuant to  
Section 302 of the Sarbanes-Oxley Act of 2002**

I, Mark R. Goldston, Chairman, Chief Executive Officer and President of United Online, Inc., certify that:

1. I have reviewed this quarterly report on Form 10-Q of United Online, Inc.;
2. Based on my knowledge, this quarterly 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 quarterly report;
3. Based on my knowledge, the financial statements, and other financial information included in this quarterly 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 quarterly report;
4. The registrant's other certifying officers and I are responsible for establishing and maintaining disclosure controls and procedures (as defined in Exchange Act Rules 13a-14 and 15d-14) for the registrant and we have:
  - a. designed such disclosure controls and procedures 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 quarterly report is being prepared;
  - b. evaluated the effectiveness of the registrant's disclosure controls and procedures as of a date within 90 days prior to the filing date of this quarterly report (the "Evaluation Date"); and
  - c. presented in this quarterly report our conclusions about the effectiveness of the disclosure controls and procedures based on our evaluation as of the Evaluation Date;
5. The registrant's other certifying officers and I have disclosed, based on our most recent evaluation, to the registrant's auditors and the audit committee of registrant's board of directors (or persons performing the equivalent function):
  - a. all significant deficiencies in the design or operation of internal controls which could adversely affect the registrant's ability to record, process, summarize and report financial data and have identified for the registrant's auditors any material weaknesses in internal controls; and
  - b. any fraud, whether material or not material, that involves management or other employees who have a significant role in the registrant's internal controls; and
6. The registrant's other certifying officers and I have indicated in this quarterly report whether or not there were significant changes in internal controls or in other factors that could significantly affect internal controls subsequent to the date of our most recent evaluation, including any corrective actions with regard to significant deficiencies and material weaknesses.

Dated: February 10, 2003

/s/ MARK R. GOLDSTON

**Certification of Chief Financial Officer Pursuant to  
Securities Exchange Act Rules 13a-14 and 15d-14  
as Adopted Pursuant to  
Section 302 of the Sarbanes-Oxley Act of 2002**

I, Charles S. Hilliard, Executive Vice President, Finance and Chief Financial Officer of United Online, Inc., certify that:

1. I have reviewed this quarterly report on Form 10-Q of United Online, Inc.;
2. Based on my knowledge, this quarterly 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 quarterly report;
3. Based on my knowledge, the financial statements, and other financial information included in this quarterly 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 quarterly report;
4. The registrant's other certifying officers and I are responsible for establishing and maintaining disclosure controls and procedures (as defined in Exchange Act Rules 13a-14 and 15d-14) for the registrant and we have:
  - a. designed such disclosure controls and procedures 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 quarterly report is being prepared;
  - b. evaluated the effectiveness of the registrant's disclosure controls and procedures as of a date within 90 days prior to the filing date of this quarterly report (the "Evaluation Date"); and
  - c. presented in this quarterly report our conclusions about the effectiveness of the disclosure controls and procedures based on our evaluation as of the Evaluation Date;
5. The registrant's other certifying officers and I have disclosed, based on our most recent evaluation, to the registrant's auditors and the audit committee of registrant's board of directors (or persons performing the equivalent function):
  - a. all significant deficiencies in the design or operation of internal controls which could adversely affect the registrant's ability to record, process, summarize and report financial data and have identified for the registrant's auditors any material weaknesses in internal controls; and
  - b. any fraud, whether material or not material, that involves management or other employees who have a significant role in the registrant's internal controls; and
6. The registrant's other certifying officers and I have indicated in this quarterly report whether or not there were significant changes in internal controls or in other factors that could significantly affect internal controls subsequent to the date of our most recent evaluation, including any corrective actions with regard to significant deficiencies and material weaknesses.

Dated: February 10, 2003

/s/ CHARLES S. HILLIARD

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Charles S. Hilliard  
*Executive Vice President, Finance and Chief Financial Officer*

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**UNITED ONLINE, INC.  
FISCAL 2003 MANAGEMENT BONUS PLAN**

**I. PURPOSES OF THE PLAN**

1.01 The United Online, Inc. ("Company") Fiscal 2003 Management Bonus Plan ("Plan") is established to promote the interests of the Company by creating an incentive program to (i) attract and retain employees who will strive for excellence, and (ii) motivate those individuals to set and achieve above-average objectives by providing them with rewards for contributions to the financial performance of the Company.

**II. ADMINISTRATION OF THE PLAN**

2.01 The Plan is hereby adopted by the Company's Compensation Committee of the Board of Directors (the "Committee"), and shall be administered by the Committee pursuant to the powers provided to the Committee by the Board of Directors of the Company.

2.02 The interpretation and construction of the Plan and the adoption of rules and regulations for administering the Plan shall be made by the Committee. Decisions of the Committee shall be final and binding on all parties who have an interest in the Plan.

**III. DETERMINATION OF PARTICIPANTS**

3.01 The following individuals will participate in the Plan: Mark R. Goldston, Charles Hilliard, Frederic A. Randall, Jr., Brian Woods, Jerry Popek, Jon Fetveit and Rusty Taragan. An individual shall be eligible to participate in the Plan if employed by the Company or any of its participating subsidiaries on June 30, 2003. If an individual is not employed by the Company or a participating subsidiary on such date, he will not be eligible to receive a bonus under the Plan. However, an individual who is on a leave of absence or whose employment terminates and is then re-hired in the same fiscal year may remain eligible at the discretion of the Committee, and the Committee may provide a pro rata bonus. In the event of termination of an individual's employment as a result of death or disability, the Committee shall provide the individual or the individual's estate with a pro rata bonus.

3.02 For purposes of the Plan:

A. An individual shall be considered an employee for so long as such individual remains employed by the Company or one or more subsidiary corporations.

B. Each corporation (other than the Company) in an unbroken chain of corporations beginning with the Company shall be considered to be a subsidiary of the Company, provided each such corporation (other than the last corporation in the unbroken chain) owns, at the time of determination, stock possessing more than fifty percent of the total combined voting power of all classes of stock in one of the other corporations in such chain.

**IV. BONUS AWARDS**

4.01 No eligible employee shall earn any portion of a bonus award made hereunder for any fiscal year until June 30, 2003.

4.02 The individual bonus awards payable to the participants in the Plan for the 2003 Fiscal Year shall be based upon the Company's success in achieving a specified EBITDA target (that is, a target tied to the Company's earnings before interest expense, taxes, depreciation and amortization expenses)

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determined by the Committee for that fiscal year ("EBITDA Target"). In determining whether the Company has achieved the EBITDA Target, EBITDA will be determined consistent with the Company's historical methodology for calculating EBITDA for financial reporting purposes; provided, however, (1) EBITDA shall be calculated before restructuring and merger related expenses, (2) in determining whether the Company has achieved in excess of 100% of the EBITDA Target, any bonus amounts to be accrued under this Plan shall be excluded from EBITDA, (3) any adjustments to EBITDA attributable to a change in accounting principles shall be excluded and (4) all items of gain, loss or expense for such fiscal year determined to be extraordinary or unusual in nature or infrequent in occurrence, or related to the disposal of a segment of a business, shall be excluded from EBITDA. In the event the Company acquires other companies or businesses during the 2003 fiscal year, the Committee shall use its discretion to determine the impact, if any, such acquisitions should have on the EBITDA Target (it being hereby

determined that the proposed acquisition of assets from BlueLight will not have an impact on the EBITDA Target). While the bonuses shall be granted if the Company achieves the EBITDA Target, the Committee may use its discretion to award bonuses based on criteria other than the EBITDA Target if the Committee determines it to be appropriate based on executive performance and other facts and circumstances, with the goal being to reward performance based upon the Company's objectives.

4.03 The bonuses shall be based on a percentage of each individual's base salary for fiscal 2003. For Mark Goldston, he will receive a bonus equal to 40%, 50%, 60%, 75% or 100% of base if the Company achieves, respectively, 80%, 90%, 100%, 110% or greater than 120% of the EBITDA Target. For the other eligible participants, each will receive 30%, 40%, 50%, 60% or 75% of his base if the Company achieves, respectively, 80%, 90%, 100%, 110% or greater than 120% of the EBITDA Target.

4.04 Following completion of the bonus calculation referenced above, the Committee shall issue a written report containing the final calculation.

## **V. PAYMENT OF BONUS AWARDS**

5.01 Bonuses shall be paid no later than September 15, 2003. All payments under the Plan shall be subject to the Company's collection of all applicable federal, state and local income and employment withholding taxes.

## **VI. GENERAL PROVISIONS**

6.01 The Plan shall become effective when adopted by the Compensation Committee. The Committee may at any time amend, suspend or terminate the Plan, provided such action is effected by written resolution and does not adversely affect rights and interests of Plan participants.

6.03 No amounts awarded or accrued under this Plan shall actually be funded, set aside or otherwise segregated prior to payment. The obligation to pay the bonuses awarded hereunder shall at all times be an unfunded and unsecured obligation of the Company. Plan participants shall have the status of general creditors and shall look solely to the general assets of the Company for the payment of their bonus awards.

6.04 No Plan participant shall have the right to alienate, pledge or encumber his/her interest in this Plan, and such interest shall not (to the extent permitted by law) be subject in any way to the claims of the employee's creditors or to attachment, execution or other process of law.

6.05 Neither the action of the Company in establishing the Plan, nor any action taken under the Plan by the Committee, nor any provision of the Plan, shall be construed so as to grant any person the right to remain in the employ of the Company or its subsidiaries for any period of specific duration. Rather, each employee will be employed "at-will," which means that either such employee or the

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Company may terminate the employment relationship at any time for any reason, with or without cause, subject in each case to any employment agreement between such person and the Company.

6.06 This is the full and complete agreement between the eligible employees and the Company with respect to incentive bonus compensation for the 2003 fiscal year. This Plan does not supersede, but is supplemental to, any provisions of any employment agreement to which any of the employees eligible under this Plan may be party. With respect to references to Annual Bonuses in the Employment Agreements for Msrs. Goldston, Hilliard, Randall and Woods, for the purposes of such Agreements the references to Annual Bonuses shall be deemed to be the bonus each of such executives would be entitled to receive hereunder assuming the Company achieves 100% of the EBITDA Target.

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

I, Mark R. Goldston, Chairman, Chief Executive Officer and President of United Online, Inc. (the "Company"), do hereby certify, pursuant to 18 U.S.C. Section 1350, as adopted pursuant to Section 906 of the Sarbanes-Oxley Act of 2002, that, to my knowledge:

(a) the Quarterly Report on Form 10-Q of the Company for the quarterly period ended December 31, 2002, as filed with the Securities and Exchange Commission (the "Report"), fully complies with the requirements of Section 13(a) or 15(d) of the Securities Exchange Act of 1934; and

(b) the information contained in the Report fairly presents, in all material respects, the financial condition and results of operations of the Company.

Dated: February 10, 2003

/s/ MARK R. GOLDSTON

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Mark R. Goldston  
*Chairman, Chief Executive Officer and President*

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[QuickLinks](#)

[CERTIFICATION OF CHIEF EXECUTIVE OFFICER](#)

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

I, Charles S. Hilliard, Executive Vice President, Finance and Chief Financial Officer of United Online, Inc. (the "Company"), do hereby certify, pursuant to 18 U.S.C. Section 1350, as adopted pursuant to Section 906 of the Sarbanes-Oxley Act of 2002, that, to my knowledge:

(a) the Quarterly Report on Form 10-Q of the Company for the quarterly period ended December 31, 2002, as filed with the Securities and Exchange Commission (the "Report"), fully complies with the requirements of Section 13(a) or 15(d) of the Securities Exchange Act of 1934; and

(b) the information contained in the Report fairly presents, in all material respects, the financial condition and results of operations of the Company.

Dated: February 10, 2003

/s/ CHARLES S. HILLIARD

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Charles S. Hilliard  
*Executive Vice President, Finance and Chief Financial Officer*

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