

MOZILLA FOUNDATION AND SUBSIDIARY

DECEMBER 31, 2005

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INDEPENDENT AUDITORS' REPORT

AND

CONSOLIDATED FINANCIAL STATEMENTS

# Mozilla Foundation and Subsidiary

## Independent Auditors' Report and Consolidated Financial Statements

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## Independent Auditors' Report

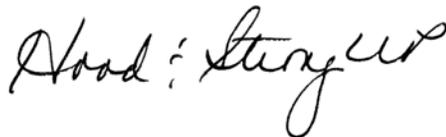
THE BOARD OF DIRECTORS  
MOZILLA FOUNDATION  
Mountain View, California

We have audited the accompanying consolidated statement of financial position of **MOZILLA FOUNDATION AND SUBSIDIARY (Mozilla)** as of December 31, 2005 and the related consolidated statements of activities and changes in net assets and cash flows for the year then ended. These financial statements are the responsibility of Mozilla's management. Our responsibility is to express an opinion on these financial statements based on our audit.

We conducted our audit in accordance with auditing standards generally accepted in the United States of America. Those standards require that we plan and perform the audit to obtain reasonable assurance about whether the financial statements are free of material misstatement. An audit includes examining, on a test basis, evidence supporting the amounts and disclosures in the financial statements. An audit also includes assessing the accounting principles used and significant estimates made by management, as well as evaluating the overall financial statement presentation. We believe that our audit provides a reasonable basis for our opinion.

In our opinion, the financial statements referred to above present fairly, in all material respects, the consolidated financial position of Mozilla Foundation and Subsidiary as of December 31, 2005, and the consolidated changes in their net assets and their cash flows for the year then ended in conformity with accounting principles generally accepted in the United States of America.

As discussed in Note 5, Mozilla adopted Financial Accounting Standards Interpretation No. 48 – *Accounting for Uncertainty in Income Taxes* for 2005.



November 3, 2006

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# Mozilla Foundation and Subsidiary

## Consolidated Statement of Financial Position

December 31, 2005

### Assets

<b>Cash and Cash Equivalents</b>	\$ 36,405,598
<b>Receivables</b>	5,318,714
<b>Prepays</b>	74,380
<b>Deferred Taxes</b>	509,190
<b>Investments</b>	9,125,732
<b>Furniture and Equipment, net</b>	898,773
<b>Deposits</b>	64,000
<b>Total assets</b>	<b>\$ 52,396,387</b>

### Liabilities and Net Assets

#### Liabilities:

Accounts payable and accrued liabilities	\$ 1,346,632
Income tax payable	7,774,040
Deferred revenue	137,500
Unrecognized income tax benefits	13,250,000
<b>Total liabilities</b>	<b>22,508,172</b>

#### Net Assets:

Unrestricted	29,888,215
<b>Total net assets</b>	<b>29,888,215</b>
<b>Total liabilities and net assets</b>	<b>\$ 52,396,387</b>

# Mozilla Foundation and Subsidiary

## Consolidated Statement of Activities and Changes in Net Assets

*Year Ended December 31, 2005*

<b>Revenues and Other Support:</b>	
Royalties - search	\$ 50,516,268
Royalties - product sales	171,329
Product revenues	841,138
Contracted services	356,500
Contributions	493,867
Interest income	577,351
Other income	12,593
Unrealized losses from investments	(62,444)
<b>Total revenue and support</b>	<b>52,906,602</b>
<b>Expenses:</b>	
Software development	6,075,474
Sales and marketing	768,701
General and administrative	1,328,353
<b>Total expenses</b>	<b>8,172,528</b>
<b>Change in Net Assets before Provision for Income Taxes</b>	<b>44,734,074</b>
Provision for income taxes	18,614,850
<b>Change in Net Assets</b>	<b>26,119,224</b>
<b>Net Assets:</b>	
Beginning of year, as previously reported	5,663,991
Cumulative effect of change in accounting principle - Note 5	(1,895,000)
<b>Beginning of year, as restated</b>	<b>3,768,991</b>
<b>Net Assets - end of year</b>	<b>\$ 29,888,215</b>

# Mozilla Foundation and Subsidiary

## Consolidated Statement of Cash Flows

*Year Ended December 31, 2005*

<b>Cash Flows from Operating Activities:</b>	
Change in net assets	\$ 26,119,224
Adjustments to reconcile change in net assets to net cash provided by operations:	
Depreciation	162,876
Unrealized loss on investments	62,444
Change in deferred taxes	(509,190)
Changes in assets and liabilities:	
Receivables	(1,344,747)
Prepays and other assets	(74,380)
Deposits	(64,000)
Accounts payable and accrued expenses	1,188,147
Income tax payable	7,774,040
Deferred revenue	137,500
Unrecognized income tax benefits	11,355,000
Due to/from related parties	(6,696)
Net cash provided by operating activities	44,800,218
<b>Cash Flows from Investing Activities:</b>	
Purchases of furniture and equipment	(962,729)
Purchases of investments	(10,188,176)
Proceeds from sale of investments	1,000,000
Net cash used by investing activities	(10,150,905)
<b>Net Increase in Cash and Cash Equivalents</b>	<b>34,649,313</b>
<b>Cash and Equivalents - Beginning of year</b>	<b>1,756,285</b>
<b>Cash and Equivalents - End of year</b>	<b>\$ 36,405,598</b>

# Mozilla Foundation and Subsidiary

## Notes to Financial Statements

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### Note 1 - Nature of the Organization:

Established in July 2003, the Mozilla Foundation (the Foundation) is a California not-for-profit corporation that exists to provide organizational, legal, and financial support for the Mozilla open-source software project. The Foundation's purpose is to develop open source, standards compliant, free Internet applications that will be useable free of charge to tens of millions of users. In addition, its purpose is to develop foundational technologies that will be used by content and software developers to develop standards compliant online content and open source internet software.

In August 2005, the Foundation launched a wholly owned subsidiary, the Mozilla Corporation (the Corporation.) The Corporation is a taxable subsidiary that serves the non-profit, public benefit goals of its parent, the Foundation, and is responsible for product development, marketing and distribution of Mozilla products. The activities of the Foundation related to sponsorship contracts, contracted services and the affiliate program were assigned to the new corporation. The employees were also transferred to the new corporation. The Foundation retained the product royalty contract and continues to receive contributions.

### Note 2 - Summary of Significant Accounting Policies:

#### a. Principles of Consolidation

The consolidated financial statements include the accounts of the Foundation and the Corporation (collectively Mozilla.) All significant intercompany transactions have been eliminated.

#### b. Basis of Presentation

Net assets, revenues, expenses, gains and losses are classified based on the existence or absence of donor imposed restrictions. Since no donor restrictions exist on the Foundation's net assets, all of the net assets are classified as unrestricted.

#### c. Cash and Cash Equivalents

For purposes of the statement of cash flows, Mozilla considers its operating checking accounts to be cash and cash equivalents.

# Mozilla Foundation and Subsidiary

## Notes to Financial Statements

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d. Receivables

Receivables consist primarily of amounts due from contracts with the search engine providers and the Amazon affiliates program. An allowance for uncollectible receivables is provided based upon prior history and management's assessment of collectibility. No allowance has been deemed necessary for any receivables.

e. Investments

Investments, which consist of money funds and institutional short–intermediate bond fund are stated at market value, based upon quoted market prices. Changes in market value are recognized on a current basis in the statement of activities.

f. Furniture and Equipment

Furniture and equipment are stated at cost. Contributed equipment is recorded at fair value at the date of donation. Depreciation is calculated over the estimated useful lives of the related assets using the straight-line method. Leasehold improvements are amortized over the useful life or the term of the lease, whichever is shorter.

g. Recognition of Revenue

*Royalties:* Mozilla receives income from contracts with various search engine providers. Revenue from these contracts is determined by the search engine provider based upon its activity. In addition, Mozilla receives royalties from the sale of various products on its website. Mozilla records revenue based upon the amounts received, with the revenue recorded on the accrual basis.

*Product revenues:* Mozilla has a contract with Amazon under the Amazon's affiliates program. Mozilla records revenue based upon amounts received, with revenue recorded on the accrual basis.

*Contracted services:* Revenues under service agreements are recognized over the contracted service period if a term agreement or as earned if under specific services agreement.

# Mozilla Foundation and Subsidiary

## Notes to Financial Statements

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### h. Contributions

Contributions are recorded at fair value when the donor makes an unconditional promise to give. Contributions collected by third parties are recorded as revenue when received by the third party. Donor-restricted contributions are reported as an increase in temporarily or permanently restricted net assets, depending on the nature of the restriction. When a restriction expires, temporarily restricted net assets are reclassified to unrestricted net assets and reported in the Statement of Activities as net assets released from restrictions. Contributions that are restricted by the donor are reported as increases in unrestricted net assets if the restrictions expire in the same year in which the contributions are recognized.

Dues for the Tech Advisory Group have been recorded as contributions.

### i. Software development costs

Mozilla develops open source software which is available free of charge to users. In addition, due to the open source nature of the development, there is generally no passage of time between achievement of technological feasibility and the availability for general release. Therefore, Mozilla expenses the cost of software development as incurred.

### j. Advertising costs

Mozilla expenses advertising costs as incurred.

### k. Income Taxes

In July 2004 the Foundation received its advance ruling as a public benefit charitable organization exempt from income taxes on related income under Section 501(c)(3) of the Internal Revenue Code and applicable sections of the California Revenue and Taxation Code.

The Foundation provides for tax on its unrelated business income which consists of revenue from the Amazon affiliates program.

For 2005, the Foundation elected early implementation of Financial Accounting Standards Interpretation No. 48 (FIN 48) *Accounting for Uncertainty in Income Taxes*. See note 5.

The Corporation is a C corporation. Income taxes are accounted for using an asset and liability approach, which requires the recognition of deferred tax liabilities and assets for the expected future tax consequences of temporary differences between the financial statement and tax basis of assets and liabilities at the applicable enacted tax rates. The differences relate primarily to state taxes.

# Mozilla Foundation and Subsidiary

## Notes to Financial Statements

### l. Use of Estimates

The preparation of financial statements in conformity with generally accepted accounting principles requires management to make estimates and assumptions. Actual results could differ from those estimates.

### m. Functional Expenses

Expenses are allocated to functional areas based on management's estimates. There were no direct fundraising expenses incurred and the incidental expenses, such as the website, were immaterial.

### Note 3 – Investments

At December 31, 2005 investments consist of the following:

Institutional Diversified Assets (money fund)	\$ 4,094,338
Institutional Short/Intermediate bond fund	5,031,394
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	\$ 9,125,732

### Note 4 - Furniture and Equipment:

Furniture and equipment as of December 31, 2005 is as follows:

		Useful Life (Years)
Computer equipment	\$ 884,299	3
Furniture and office equipment	132,862	7
Leasehold improvements	43,030	4
Software	30,120	3
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	1,090,311	
Less accumulated depreciation	(191,538)	
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Net furniture and equipment	\$ 898,773	

# Mozilla Foundation and Subsidiary

## Notes to Financial Statements

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### Note 5 - Income Taxes:

The Mozilla Foundation received revenue from various search engine providers in exchange for being included in Mozilla's Firefox web browser. These contracts were transferred to the Mozilla Corporation in August 2005. Management, having received a tax opinion from its legal counsel with respect to the contract that is the source of most of the revenue, believes that the revenue constitutes royalties as defined in the Internal Revenue Code. Therefore, it would not be unrelated business taxable income, subject to income taxes. However, there is no direct authority involving similar payments for such e-commerce activities for not-for-profit organizations.

Management has elected to apply the provisions of *FAS Interpretation No.48 (FIN 48) Accounting for Uncertainty in Income Taxes* for 2005. Under FIN 48, an entity must determine whether it is more likely than not that a tax position will be sustained upon examination, including resolution of any appeals or litigation processes, based upon the technical merits of the position. Due to the lack of directly related case law, management cannot conclude that it is more likely than not that the Internal Revenue Service would concur with the Foundation's position. Therefore, in accordance with FIN 48, the Foundation has accrued a liability for unrecognized tax benefits related to the revenue received by the Foundation from the search providers.

In accordance with the provisions of FIN 48, management has recorded the cumulative effect of applying the provisions of FIN 48 as an adjustment to net assets as of January 1, 2005. This amount totaled \$1,895,000 and represents the potential tax on the revenues received by the Foundation prior to 2005.

A reconciliation of unrecognized tax benefits as of the beginning and end of the year is as follows:

Balance at January 1, 2005:	\$ 1,895,000
Additions based on tax positions related to the current year	11,281,000
Additions for interest due on liabilities from the prior year	74,000
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Balance at December 31, 2005	\$ 13,250,000

The Foundation accrues interest related to unrecognized tax benefits due from the prior year as part of the tax expense. However, due to the fact that the Foundation believes it has substantial authority for its position, it has not accrued for any penalties.

The Foundation received the royalty revenue in 2004 and 2005. These years are open to examination. It is not expected that there will be any significant increase or decrease in the unrecognized tax benefits in the next year unless there is an examination of the issue.

# Mozilla Foundation and Subsidiary

## Notes to Financial Statements

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The Foundation also receives revenue from its affiliate program which is considered to be unrelated business taxable income. The Foundation has accrued \$ 147,000 for taxes on this source of revenue.

The provision for income taxes for 2005 is comprised of the following:

Currently payable:	
Corporation income taxes	\$ 7,622,040
Foundation taxes on the affiliate program	147,000
Deferred:	
Corporation – related to state taxes	(509,190)
Unrecognized tax benefits, including interest	11,355,000
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Total provision for income taxes	\$ 18,614,850

### Note 6 - Related Party Transactions:

#### a. Shared Expenses

During part of 2005, the Foundation contracted with a for-profit company to provide back-office support and services. The sole owner of this company is the Chairman of the Foundation. For 2005, the total amount charged for such services was \$50,659. All amounts reimbursed were based upon the cost to the for-profit company and allocated based upon estimates of time or usage. These transactions were reviewed in advance by the Board of Directors to insure that the costs were fair and reasonable and did not exceed market rates.

#### b. Contributions

Contributions include \$150,000 for the Tech Advisory Group from an entity related to a Board member.

### Note 7 - Retirement Plan:

The Foundation and the Corporation have defined contribution plans covering substantially all employees. The Foundation and the Corporation contribute an amount equal to 3% of the employee's qualified salary plus an additional discretionary percent of their qualified salary. Contributions to the plans totaled \$199,700 for 2005.

# Mozilla Foundation and Subsidiary

## Notes to Financial Statements

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### Note 8 - Concentrations of Risk:

Mozilla has a contract with a search engine provider for royalties. The contract originally expired in November 2006 but was renewed for two years and expires in November 2008. Approximately 95% of Mozilla's revenue for 2005 was derived from this contract.

Mozilla has defined its financial instruments which are potentially subject to credit risk as cash and investments. At December 31, 2005, essentially all of the cash and investments are in excess of the federally insured limits.

### Note 9 - Commitments and Contingencies:

#### *Commitments*

The Corporation leases office space under a lease which expires in August 2009. The corporation provides space to the Foundation at no charge. Rent expense for 2005 totaled \$112,000. Future minimum lease commitments are as follows:

<u>Year Ended</u>	
2006	\$ 335,000
2007	353,000
2008	371,000
2009	289,000
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	\$ 1,348,000

#### *Contingencies*

The Foundation has not accrued for any potential penalties related to unrecognized income tax benefits as described in Note 5.

The Foundation is in its advance ruling period as a public benefit corporation. The ruling period ends December 31, 2007 at which time it will be required to submit information for its public support test. If it does not pass the public support test, the Foundation would be ruled to be a private foundation subject to excise tax at 2% on its net investment income.