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SCOX - Q3 2003 The SCO Group Earnings Conference Call

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SCOX - Q3 2003 The SCO Group Earnings Conference Call

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The SCO Group - President and CEO

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Dion Cornett

Decatur Jones - Analyst

Maureen O'Gara

Client Server News - Analyst

Robert McMillan

ING - Analyst

Matthew Haslet

Computer Wire - Analyst

statements are made as of the date of this conference call and the SCO Group, Inc. undertakes no obligation to update or revise the projections of revenues or earnings or other or forward-looking statements whether as a result of new information, future developments or otherwise. These risks and uncertainties may cause our actual results level of activity performance or achievements to be materially different from any projections or future results implied by the statements. In particular our results for the third quarter of 2003 and our projections of fourth-quarter revenues contain significant revenue from our SCOsource licensing initiative. This line of business was recently undertaken. We have had limited experience with it to date, and the underlying intellectual property is the subject of pending litigation, all of which makes the protection of these revenues particularly difficult and subject to both known and unforeseen risks. Accordingly you should not place undue reliance on these projections of future revenue and results or other forward-looking statements. For a full discussion of these and other risks, please see our Form 10k for the year ended October 31, 2002, and subsequent reports we have filed with the SEC available @www.SCO.com. I will now turn the call over to Darl McBride, President and Chief Executive Officer of The SCO Group Inc. Please go ahead, sir.

PRESENTATION

Operator

Good day everyone and welcome to The SCO Group third-quarter 2003 earnings conference call. At this time everyone is in a listen-only mode. Later a question-and-answer session will be open. Today's call is being recorded. Participating on the call today are Darl McBride, President and Chief Executive Officer; and Robert Bench, Chief Financial Officer. Each of you should have a copy of the press release issued this morning containing our third-quarter results for fiscal 2003 which we will be discussing further in this call. If you do not have a copy, please call at the Kathy Martins (ph) at 801-765-9999. Again that number 801-765-4999 so we can immediately send you a copy.

I wish to point out that the participants on today's conference call that the information provided during his call will include forward-looking statements within the meaning of the Private Securities Litigation Reform Act of 1995. Our performance is subject to significant risks and uncertainties known and unknown that could cause our actual results to differ materially from those that may be anticipated by the forward-looking statements. These forward-looking

Darl McBride - The SCO Group - President and CEO

Thanks to all of you for joining our call today. Our quarter that ended July 31, 2003, marks the second consecutive quarter of strong positive earnings. Revenue attributed to our SCOsource intellectual property licensing initiative has generated positive operating margins and has contributed to positive cash flow from operations. These activities during the past two quarters have nearly tripled our cash balance and thus strengthened our balance sheet. Over the past four quarters our market cap has gone from under \$10 million to over \$140 million, making SCOX one of the top performing stocks on the NASDAQ market. In a moment our Bob Bench, our CFO, will give a detailed analysis of the quarter, however before that analysis I would like to review the actions we have taken over the last year.

Since my joining SCO as the chief executive officer that have made these significant accomplishments possible and will continue to drive greater success in the future. We restructured the company to reduce expenses and better manage our assets. We reestablished the SCO brand. The SCO brand is 20 plus years old, known worldwide and strongly associated with UNIX. We formed SCOsource to monetize our

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UNIX intellectual property. We initiated an effort to vigorously protect our intellectual property and we are pleased to bring on David Boies and Boies, Schiller and Flexner to assist us. Over the last six months we have taken numerous steps in connection with our legal action against IBM and are fully prepared if necessary to see the litigation through to full conclusion.

We re-established SCO is a leader in the \$21 billion UNIX market. We initiated the new Web services strategy called SCOx that should provide the company with a platform for growth and revenue opportunities well into the future. We have strengthened industry partnerships and made strategic investments and acquisitions in key areas that will support SCO's future business opportunities. We have strengthened SCO's financial footing. For the first nine months of the fiscal year we have grown revenue year-over-year and generated positive net income of \$7.5 million or 47 cents per diluted share.

Some of the quarterly business highlights, we have continued to build and strengthen our legal case. We have stated that our UNIX IP is sound in the Linux 2.4 and the upcoming 2.6 kernel and have notified Fortune 1000 and Global 500 companies of our position. We terminated IBM's AIX software contract, we opened our doors and invited anyone who would like to view the infringing code to come to Lindon, Utah. To date over 100 parties have accepted our offer and have seen the code.

We established an end-user licensing program that just kicked off and was based on demand, people came in, saw the code, had a desire to get a license. We have made unavailable, kicked it off and companies are now signing up for that. We have built a partnership (indiscernible) for future deals and we hit our quarterly financial targets that we gave you 90 days ago on our quarterly call. So that is a high-level view of where we have been for the last year, but more specifically how things have gone for the last 90 days. What I would like to do now is turn the call over to Bob, and have him run with respect to a more detailed analysis on how the quarter went.

Unidentified Corporate Participant

The company has continued to adhere to a viable upgrading model that will create additional efficiencies in our worldwide operations. We increased the percent of revenue invested in product development this past quarter while slightly decreasing our other operating costs. Of the \$20.1 million in

revenue, \$12.8 million, or 64 percent was related to our core UNIX operating system platform. Of the \$12.8 million, \$10.8 million was product-related and \$2 million was from services. The other 36 percent of our \$20 million in revenue, or \$7.3 million in revenue was generated from our SCOsource initiatives.

Our gross margin of \$15.5 million or is 77 percent, was slightly higher than last quarter and in line with our operating model. Operating costs and expenses of \$12.1 million were slightly higher last quarter by \$800,000 or 7 percent. This is due in part by to nonrecurring restructuring costs of 600,000, and our increased investment in development relating to our SCOx productline. We have not yet seen a consistent uptrend in the worldwide IT spending, and as with any other technology companies, our revenues continue to be impacted by the slow economic recovery worldwide. Our SCOsource activities and initiatives and our recent announcements regarding Linux may also be causing customers to lengthen their purchase an implementation cycle as they contemplate the appropriate operating platform of the future and assess the current risks related to Linux.

Our products are continuing to be used in new businesses and our present customers are expanding their current operations. I would like to give a breakdown of our revenue by geography for our operating platform business. \$7 million or 55 percent was generated in the Americas. This is a slight increase from our prior quarter. \$4.7 million or 36 percent was generated in Amea (ph), again that is a slight increase from prior quarter. \$1.1 million or nine percent of our revenues was generated in Asia-Pac and that is a decrease from the prior quarter. Still reflective of the economy there.

May I mention at this time just a few of the customers this past quarter from around the world. People's Bank of China, China Telecom, in partnership with Hewlett-Packard, Taiwanese Government, with our partner Alliance Technology Corporation. Taiwan Bank, Interspace Planning in Japan. French Military, the Ministry of Defense in the UK, Pizza Hut, the German Railway, also one of the largest telecom providers in Europe, Johnson & Johnson, Walgreens, McDonald's, Daimler Chrysler, Warner Bros., and Lucent Technologies. These are just some of the customers to choose the SCO platform to run their business day to day this past quarter.

We expect that revenue for our fourth quarter ending October 31, 2003, will be in the range of 22 to \$25 million. Our optimism relates to our potential upside in SCOsource licensing revenue which is difficult to quantify or estimate at

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this time. With a number of SCOsource licensing opportunities for our fourth and subsequent quarters that are in various stages of negotiations and therefore difficult to predict the ultimate revenue opportunity and timing for revenue recognition. With our revenue growth over the past two quarters, operations that are generating positive cash flow and SCOsource initiatives gaining strength, acceptance and momentum, we are optimistic that the company is moving in the right financial direction. Our strength in balance sheet will provide additional leverage for investing in the future growth. We expect that SCOx, our Internet Web services strategy will begin generating new revenue opportunities for our resellers and become an exciting Web-based platform for our customers around the world. Back to you, Darl.

Darl McBride - The SCO Group - President and CEO

Clearly SCO's financial position has improved. Where does SCO go now? I would like to spend a few moments and just have a little bit of discussion on where we are going. We have talked about where things up on the last year, we have talked about this quarter, for those of you on this call that are contemplating investing in the company, the big question is always, where are you going. And I would like to talk about that. I like where SCO is positioned as we head into the future. I would like to go through some of the key points as to why I like our current positioning.

First, our IP ownership is extremely powerful. There are two major operating systems in play around the world, Windows and UNIX. Microsoft obviously owns Windows, SCO owns the UNIX operating system. This is a big deal. There has been a lot of companies around the world that are running on UNIX. We have a lot of licensees that are taking UNIX and expanding that in going to their marketplace. A lot of times, maybe a year ago when people would have said where is SCO with respect to the UNIX, people may have thought, they have a version of UNIX. No, we do not have a version, we own the UNIX operating system and we have licensees who are tied into that ownership tree. Now what we are talking about is basically having these contracts in place that are very powerful with respect to that UNIX intellectual property ownership.

The next point, we have great customer relationships with major corporations around the world. Some of the top 10 retailers run on SCO's version of UNIX. So we have a very strong tie in with major companies. Our financial position is strengthening. We have detractors that continue to come

out and say SCO (technical difficulty) but do they have an ability to see this litigation through to conclusion. One of our competitors came out last week and said this legal game is now a war of attrition, and we are going to out-lawyer them; we are going to pound room with legal filings; and thereby the unspoken part there was not so much what the merits of the legal case were; it was really, what their focus was, we are going to pound away. We have very strong capabilities to fight the legal fight to whatever level it has to go.

Our financial position has strengthened from a quarter by quarter standpoint. We have had two strong quarters now, a great performance. We have now given guidance for the third. We give the guidance to you because we already have visibility and to where this quarter is. There is upsides to the numbers that are there but we still very confident about the numbers that Bob has given.

Industry support from our partners is strengthening. We have great partners, we see these partnerships continuing to strengthen our financial performance. As we talked about some of the heat that we may be taking, what really is happening here from my view is that in the marketplace, this issue around intellectual property as it ties into the Linux operating system, is really starting to divide the industry into two camps; those that are trying to take the value of intellectual property and destroy it; and those who are lining up saying that intellectual property matters. Although there are a number of detractors that are very vocal, I would say that they are in the minority. I believe that the silent majority is actually behind SCO in this case. Basically if you take any company who has intellectual property that they want to protect, they are hoping that SCO is going to prevail in this case because at the end of the day that is going to give them the ability to monetize their software they have been able to develop over the years.

What else do we like? The legal position we have is rock solid, we have had over 100 people come and see the code. If there is anybody on the call who still questions where this is, you are more than welcome to come out. We have absolutely a session we are going to be having in Las Vegas next week, we had our annual conference, our SCO Forum conference, and we will in fact be going through and breaking down giving even more in-depth analysis of our legal position in the code to the point where we have so confidence in making the statements we have, that Linux is in fact infringing with our code. So anybody who would like to come out to Vegas next week, Monday is the day we will going through that in detail on the Monday session of our conference.

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What else is up? We have a very strong resolve to defend our intellectual property assets, we have pretty thick skin around here at this point. We have a lot of people throwing rocks at us, we expect that to continue. We have been called into a fight here, we are not the ones who started this fight, we are not the ones that misappropriated our technology. We're not the ones who are trying to destroy our company. We have been called into the fight and we are not backing down. So we do have a very strong resolve to continue to defend our extremely valuable intellectual property assets as we move forward.

The final point I would make as with respect to why I like our position currently is that we continue to gain in credibility. If you follow the case here, if you go back to when we filed this in February, when the view from the normal guy on the street was what are you guys doing? Are they crazy? Is this just a Hail Mary pass by a company going out of business? As people have dug deeper and deeper, they have come to the conclusion that we have a strong case here. We wouldn't be corporate and individual reputations on the line without a very strong knowledge of our case and the infringement that has happened here. Again as you move forward, the arguments that you see, there has been a major shift happen with respect to the arguments.

The arguments are now more around these SCO guys should just let us get the code and change it so we can get back to work. Okay, so we may have taken their stuff, let's just change it and let's all go back to work. I think that argument is missing a very important point here, which is we have had our program misappropriated, we do need to get compensation for that, and it is not as simple as just brushing and off and moving on. So the discussion really has shifted to what happens now. As we move forward, we expect that we are going to continue to gain support for our position and the credibility continues to rise as we go forward. Those are the main statements we have with respect to the how the quarter has gone, where we see things going forward. What I would like to do now is open up the phone lines for Q&A. We will let you all come on with a question you might have at this point.

QUESTIONS AND ANSWERS

Operator

(OPERATOR INSTRUCTIONS) Andy Shopeck (ph) from Nutmeg Securities (ph).

Andy Shopeck - Nutmeg Securities - Analyst

Can you give us any kind of guidance at this time in terms of what the budgeted legal expenses are? Really how they are likely to track in the coming quarters in terms of a rough framework?

Darl McBride - The SCO Group - President and CEO

Sure. From a budget standpoint, I can tell you that we have spent less than half of what we have budgeted so far. We had anticipated costs that could be in \$1 million per quarter range. We are now almost six months into the litigation and I think our legal expenses are what Bob, 6 to 700,000 so far, so we are well -- the amount that we have reserved in we continue to allocate for this, we still have a huge buffer in terms of the budgeted that has gone in versus the expenses that have gone out. We have a couple of cases out there now, if you look as the nature of the cases that are there, in both cases with Red Hat and IBM, there is a lot more words in there than actual hard-core positions, you have to go actually defend. The patent part of the IBM case we expecting, in fact we have been prepared on that. So as we go forward, as we see some of those expenses trending up, possibly but in terms of hitting even the budget of what we have for it, we feel very good about where we are on the allocation expenses and the expenditure thereof.

Andy Shopeck - Nutmeg Securities - Analyst

So included in G&A expenses in this quarter was what about half a million or so of legal-related expenses.

Unidentified Corporate Participant

We had less than half a million, but those are included in costs of sales.

Andy Shopeck - Nutmeg Securities - Analyst

They are in costs of sales.

Unidentified Corporate Participant

Yes, we have chosen to include all costs directly associated with those SCOsource licenses right now in costs of sales.

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Andy Shopeck - *Nutmeg Securities - Analyst*

Okay, thank you.

Operator

Jonathan Cowen (ph) from J. H. C. Capitol.

Jonathan Cowen - *J. H. C. Capitol - Analyst*

I know you haven't given any bottom-line guidance for the next quarter or any guidance for any quarters beyond this coming quarter, but could you give any sense that all the just trending, how we are looking at the bottom-line versus is this past quarter and the previous quarter and what sort of steady top and bottom line we might be looking to within a couple of quarters?

Unidentified Corporate Participant

I think as we look forward, the last two or three quarters would give you a good idea of our overall worldwide operating costs, and they are not only stabilizing but we have continue to become more efficient and decrease those quarter over quarter. This past quarter, as I mentioned, we had about \$600,000 in non-recurring restructure costs which should lower our future operating costs, so those are fairly stable and should be for the next several quarters. Two or three factors that are a little more difficult to determine and that is as Andy brought up, our legal costs associated as we go forward. Those we don't expect to be out of line but they could increase a little. That will increase our costs of sales of course. Our normal operating costs really are pretty well fixed at this point and any increases would relate to our launch of SCOx over the next two to three quarters, some sales and marketing related to that but we may increase a little. R&D, we still maintain a pretty strong approach there. But for the most part I think you could get a pretty good sense of what they are going to be in the future by looking at our last three quarters.

Jonathan Cowen - *J. H. C. Capitol - Analyst*

Thanks very much.

Operator

Peter Richards from Empire Capitol.

Peter Richards - *Empire Capitol - Analyst*

I was just hoping to get some financial understanding or better financial understanding regarding the first intellectual property compliance license that you guys signed a couple of days ago. In the press release there was not financial terms discussed to the extent that you have the liberty to do that I would appreciate some guidance on that.

Darl McBride - *The SCO Group - President and CEO*

Let me give a general comment about the first concerning licensing. And then maybe we can talk generally. We kicked off the licensing program last week but then the first four business days of a program we had hundreds of companies contact us about the program and during that same period of time, we also signed our first licensee. The identity in terms of the agreement on this first contract are confidential. What I can tell you is that the licensee is a Fortune 500 company and the license was purchased for each of the Linux servers running in their business. My view is that the deal is significant and that it is a very positive sign for the future of the licensing program and the economic that will flow from that. We have said publicly that we signed this first deal at a slight discount over the introductory price since we basically came out and said the pricing on this is 699 per server, based on some factors with this company we discounted that only slightly. The introductory pricing goes from 699 to double as we get into October. As we move forward we think that the pricing on this potentially multiplied against the 2.5 million servers in a marketplace, creates a very significant opportunity. We have always said we feel like SCO needs to be compensated for the infringement that has gone on with Linux and we are willing to get there if not down the legal path we started with IBM, we are willing to get there other directions. There have been a lot of customer that have come in and know that they have said, is there somewhere I can get straight with you guys and is there a license I can sign up for. So that is what we have put in place here.

Based on those 2.5 million servers and growing, and the price point that we have there, obviously the opportunity is in the multi billions of dollars and then you factor down how much of that we collect, where do we go with our price as we go

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forward. Those are the factors that we will look at as we continue the program.

Peter Richards - Empire Capital - Analyst

It is that kind of deal SCOSource being upside to this next quarter?

Darl McBride - The SCO Group - President and CEO

Yes, the guidance we have given has not factored in the SCOSource licensing part in any significant way. As we get traction with that program, we think that that is thing that will carry on into subsequent quarters, depending on how fast the traction comes in this quarter. We would view that as more upside for the current quarter revenues that we are in.

Peter Richards - Empire Capital - Analyst

Based on the amount of interest you have had in the limited time that you have been out in the marketplace, you are confidence that some of those license revenues will be flowing through?

Darl McBride - The SCO Group - President and CEO

We are cautiously optimistic. Again, we have chosen not to put guidance, we have done a lot of modeling on this, and the models get pretty exciting about what a positive impacts it has on the financials, but as a rule there, we don't generally give guidance on things that we don't have firmly locked in, so as we start to get traction with this yes, it would be nice to multiply out the first deal signed by the next 100 or thousands and say let's give guidance on that. We prefer to have this thing run for some period of months and be able to come back to you and say this is what we will go to the bank on for the subsequent quarters. But yes, the signs are positive. We are cautiously optimistic and we are encouraged about the kickoff of this program.

Peter Richards - Empire Capital - Analyst

If I can just for a second follow-up on the previous question. With a revenue guidance up 10 percent to 20 percent sequentially from 20 million to 22 to \$25 million, as I model this through, you have dropped a good amount of money to the bottom-line in the last two quarters, and I am just trying

to get a sense of how much of that increase in revenue will drop to the bottom-line as I model out the bottom-line going forward.

Unidentified Corporate Participant

Peter, I think we have chosen to record the direct cost related to the SCOSource activity as cost of sales and we have modeled that at about 70 percent gross margin. We have very little operating overhead other than that so I think as a model probably about 65 percent of that would drop to the operating margin level. So that is kind of modeling that we had done as we mentioned earlier, it is somewhat difficult to judge that, but that is kind of where we are if that helps to answer your question. So if you took our three lines of revenue that we publish, that being our heritage UNIX operating system and platform revenue, our services and then our SCOSource, this past quarter we should be pretty close in operations as we have been the last couple of three quarters with our heritage productline and then if you use the assumptions I just gave you that is about as close to the modeling as we have done at this point.

Peter Richards - Empire Capital - Analyst

So I'm clear, on the 2 extra million dollars in revenue and 65 percent operating margin drops about a million three down?

Unidentified Corporate Participant

That is pretty close to what we are modeling right now, Peter.

Peter Richards - Empire Capital - Analyst

Great, thank you.

Operator

Bart Davies from First Western Advisers.

Bart Davies - Western Advisers - Analyst

The last two days, articles in the Wall Street Journal, the first one was the David and Goliath wasn't real favorable, the one today about the GPO copyright trademark deal. I wondered if you would like to characterize those articles, if you would like to make some comments about maybe some facts that

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you find are missing in those articles or things that you would dispute?

Darl McBride - The SCO Group - President and CEO

Sure. On a general level, it is interesting to see the press reaction in the early phases of this case. The press you can almost draw a line and you would see the Linux fanatical press types that are out there against us and the more general business press that were coming in with the sort of David, Goliath, here is the little company, the mouse is roaring against IBM and the business press is very positive towards us. Linux press was very negative. I would say it is a little bit of a coming-of-age of the company when a respected publication like the Wall Street Journal steps up and starts swinging away at us, it is a sign that I would say we are in the big league now and there is more storyline there than just the David, Goliath twist. The twist they are doing on David and Goliath is kind of taking some shots at us. The shots that they took were interesting in the story that came out of earlier this week.

They went to some points that the whole thing that we don't have any code, which is part of the monitor from the Linux community. Anybody who has come in and visited Lindon and taken the time to look at what we have, has almost universally walked away with the same conclusive which is this is a big problem for Linux. And in fact, the number of people who are taking shots at us, Red Hat for example, we invited Red Hat to come in and look at the code, they chose not to and instead they filed a lawsuit saying they won't show the code. In the case of the Wall Street Journal writer, we offered to show them the code, they chose not to but wrote the story saying we won't show the code. It is a strange situation where we continue to offer it up and they continue to say they won't so the code. Essentially for a reputable magazine newspaper like the journal to be taking that kind of approach.

The article that came out this morning was obviously much more positive towards us. The point that they bring out with respect to the GPO we felt from day one in this case that the GPL building your company on a GPL-based license is like building your enterprise software on quicksand. It is very suspect, it has major problems with it and the world is now coming as in this article, to the same conclusion we have seen for a long time this is a major problem. Behind closed doors as we have talked to major companies that are even pro Linux in the pro Linux camp, they also have problems with the GPL.

Everybody is scared to death that their own intellectual property is going to get sucked in to this GPL machine and get destroyed.

So although it is kind of (indiscernible) to get one part of the industry commoditized, as long as it is not the part that you are in. And so I think that the article that is out there today was very strongly sided toward the view that we have. So anyway, we believe that we do have a strong case there. We believe as we go forward you are going to continue to see press way in on both sides of this industry. This is a big issue, (indiscernible) industry executives have thoughts on this, because this is one of the biggest intellectual property issues that they have seen in their career. It is going to continue to be a big issue until it gets resolved, we recognize that. But as we go forward we expect that we will continue to see people weighing in on both sides of the argument.

Bart Davies - Western Advisers - Analyst

The other question I had was about the firm that you have hired. The article today maybe it was the other day, mentioned that he was on a split basis for you working that. Could you detail what kind of a split you are working with him on? I got the impression today that you're actually spending legal fees on a retainer basis, hourly basis as opposed to a contingency basis.

Darl McBride - The SCO Group - President and CEO

We have a good contract in place with our legal firm. We have a modified situation where we have C (ph) coverage for them at a discounted rate, but then they do have some upside on the monies that come in. We feel very good about the modeling on there with our contract and I think we are in good shape with that.

Bart Davies - Western Advisers - Analyst

Okay, thanks.

Operator

Dion Cornett from Decatur Jones.

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Dion Cornett - *Decatur Jones - Analyst*

Do buyers of SCO Linux need to buy the UNIXWare primary license?

Darl McBride - *The SCO Group - President and CEO*

Do buyers of SCO Linux have to buy --?

Dion Cornett - *Decatur Jones - Analyst*

(inaudible) a company that purchased Linux from SCO, am I free --? my.

Darl McBride - *The SCO Group - President and CEO*

The answer to that is, yes.

Dion Cornett - *Decatur Jones - Analyst*

Okay they do need to buy the binary license.

Darl McBride - *The SCO Group - President and CEO*

No, no they don't buy the binary license. It is actually, it is available to them with no charge is the way that works. But that is a state that they are in.

Dion Cornett - *Decatur Jones - Analyst*

If I buy that (indiscernible) Linux then I don't have to worry about the company coming after me?

Darl McBride - *The SCO Group - President and CEO*

That is correct, that is the main thing need to understand.

Dion Cornett - *Decatur Jones - Analyst*

Your guidance for next quarter doesn't necessarily factor in the SCO source potential, and maybe Bob this is a question for you, does this imply that the Heritage business is going to go from 11 to 13 to 15 million? I just want to make sure I am understanding guidance properly.

Unidentified Corporate Participant

I think the upside what we are saying is we have not done enough quarters and we're not far enough along on the pipeline of opportunities in the SCOsource, so that is the upside that we are optimistic about as we begin to get closure on many of the negotiations and contracts that we are working on right now. That would come through the SCOsource line and not necessarily the Heritage product line. The Heritage product line as you can see from the past several quarters has leveled out and as we said we had a slight increase in the Americas and in Europe this past quarter. But that was very slight. And we would expect that the economic recovery is going to have more impact on our Heritage business so it should be about where it has been the last several quarters. So if with inside of SCOsource we had multiple line items, I guess what I was referring to is that we have not put a heavy emphasis on the customer end use customer licensing programs yet. On our guidance.

Operator

Maureen O'Gara from Client Server News.

Maureen O'Gara - *Client Server News - Analyst*

I'm still having trouble with these projections. Are we to understand that about 10 or \$12 million of this 22 to 25 million in Q4 is going to come from SCOsource?

Unidentified Corporate Participant

Yes, that is right. We would expect our Heritage business that came in a little over 12 million this quarter, to be fairly level over the next several quarters.

Maureen O'Gara - *Client Server News - Analyst*

But you think that it could go even higher because you are saying it hasn't been factored in.

Darl McBride - *The SCO Group - President and CEO*

No, it hasn't been factored in is when we announced the licensing program for the SCOsource end use, the one where we announced this week we had a Fortune 500 company sign up. We have not factored in any significant way yet the multiple company signing up for that program. We think that

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there is a lot of upside there. We are going to see how that plays out quarter over quarter before we start giving guidance on that.

Unidentified Corporate Participant

What we have factored in is the SCOSource license line of revenues. Not the right to use revenues because that is a little too early. We are only into that about a week and we really have not factored any of that into our future revenue projections.

Operator

Robert McMillan from ING.

Robert McMillan - ING - Analyst

Actually my question was pretty much what Maureen just asked you. Could you maybe you could tell me a little bit more about the SCOSource revenue, could you tell me where is that going to be coming from? I mean do you have new licensing technology, licensing the UNIX source code or how are you going to get 10 to \$12 million from SCOSource?

Darl McBride - The SCO Group - President and CEO

As we said on our last call about a quarter ago we modeled this thing out and we wanted to go out and sign up big industry partnerships, and we would choose to model that in a way that we would have more revenue coming in, in bigger blocks over multiple quarter periods of time. As a mechanism to shore up our balance sheet. And then as we got into more of the end-use licensing part we would put in the more of the blocking and tackling per unit royalty licensing that we would roll out. That is really on track with where we are.

We continue to go down the path of having big deals that are done with big companies that provides more of an upfront sort of cash payment to come in over multiple quarters, and then this licensing program we just kicked off here over the last couple of weeks is something that we expect to ramp up and the first part of the revenue line item there with the big blocks coming in is not something that goes on forever. But you get multiple quarter coverage out of that and then over time we see the ramp really coming significant run-up over

time coming from more of this end-use type of the licensing program.

Robert McMillan - ING - Analyst

So are you saying there are new licensees or not?

Darl McBride - The SCO Group - President and CEO

Yes.

Robert McMillan - ING - Analyst

You are saying there are new licensees?

Darl McBride - The SCO Group - President and CEO

In terms of what we are projecting going into the next quarter, yes.

Robert McMillan - ING - Analyst

Okay.

Operator

Matthew Haslet (ph) Computer Wire.

Matthew Haslet - Computer Wire - Analyst

The second one which I suspect will be the longer answer, I wonder if you could explain more of the thinking about some of the trading that has been done by executives in terms of recommending or encouraging (inaudible) executives to continue with what they have been doing. The first question is -- you said earlier that building your company on a GOP outbased license is like building your headquarters on quicksand. I wonder if you could expand on that, given that that is precisely what Caldera did which enabled it to buy the UNIXWare intellectual property?

Darl McBride - The SCO Group - President and CEO

Let's take both of those. With respect to the GPL license, there are clearly a lot of problems that come from a GPL. The fact that you (indiscernible) intellectual property, you are trying

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to protect it, I can tell you, we -- let's go back to the days when we were involved more heavily with Linux. A lot of the customers or partnership deals that we were involved in, a lot of companies were coming in trying to understand how do you get involved with this piece without getting your (indiscernible) property destroyed. How you do this? The answer is it is very difficult. It is a very challenging situation. We find it very interesting that in IBM's lawsuit, counter against us, that they are using to the card of using the GPL as a defense. We feel very comfortable in being able to go out and defend ourselves against that.

The bottom line is this, our UNIX IP is in Linux. If you look at the GPL, we think that one of the big problems with the GPL license when you look inside of it, you see in big, bold letters there is no warranty that is associated with this license. It is one of the hot issues in the industry right now, is are companies going to be indemnified for the use of a product or not, so the GPL licenses is have you got this product for free, don't expect any warranties with it. We think that is very problematic for companies moving forward who are looking for , it is also problematic for companies who are trying to give indemnification. Many companies are now coming to IBM and Red Hat and others and saying give us indemnification. Very difficult for them to do because they cannot indemnify where the property has come from. They can't indemnify in fact that there have not been intellectual property violations. So in any case, as we move forward, we look forward to the ability to go into a court room and take on these big time legal issues the general public license.

With respect to the trading side of this, I would like to make one statement on the whole issue around the insider shares that are being sold and that is that I have been a shareholder in the companies since early 2000. I have a lot of shares that are available for selling right now. I haven't been sold a single share. Okay? I don't have any plans in place to sell any stock right now. The point here that we have a selling going on -- there is an article out there today I thought did a good job of explaining why some of the selling has happened, Bob, maybe you could step through some of those issues.

Unidentified Corporate Participant

Matthew, a very good question and as I think our directors and also the executive officers feel a lot of stewardship to shareholders, and so we appreciate shareholders who question what is going on. Just a little background as part of the company's drive to profitability over the past two years,

all the executives have taken substantial cuts in salary. When Darl came on board a year ago as part of these executive remuneration plans, he wanted to make sure that executive's objectives were very much aligned to the interests of the shareholders. So several of these executives were awarded restricted stock that vests periodically over several years.

And each time that stock vests and the award vests, it triggers a tax event for these individuals and there is really no other way for them to pay those taxes without selling a portion of those vested shares. That is what is happening. As you can see from our press release this morning, the amount of insider sales are very, very small in relationship to the stock owned by insiders. I think it is less than 1 1/2 percent, so a total of 117,000 shares last quarter, just to put in perspective, that is a very small percent of the 8 million shares owned. So it certainly isn't going to be considered unloading stock. We appreciate that and what these plans are Matthew, they are put in place for a long period of time, in fact to give the public a good view of what management is doing, and that is why we issued this press release this morning and we will do this each quarter or so that you as public and the shareholders can see exactly what is happening with the executives. But if you look at these executives holdings you will see it is a very small portion of their holdings that they are selling and for the most part it is to take care of the liabilities that they have to pay.

Matthew Haslet - Computer Wire - Analyst

Okay, thanks.

Unidentified Corporate Participant

I believe that wraps it up or us. We appreciate you joining our call today. I guess as a final statement that I would give here is when I joined the company a year ago, we did an analysis, spent 30 days looking at operations, and came out with a shareholder letter that said here is where we are going to try and go with the company over the coming year, and the focus was very strongly around taking our UNIX intellectual property, our UNIX capabilities, our UNIX brand which is this SCO and we were going to rally around that and take those as some of our key assets that we owe to the company and get leverage value out of those in the marketplace. We have gone out, we have executed on that, and the last share stage has gone well for us obviously from a shareholder perspective, and from an industry perspective we are definitely back on the main stage with respect to our UNIX business.

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As we move forward, we think we have great opportunities too monetized this and we think we have great opportunities to go in and really lead this charge and take a leadership position in this fight over intellectual property and to help that stand up not only for us but for other companies around the world who want to defend their intellectual property. We are going to as we go forward over the coming year, make a concerted effort to be a leadership, a leader in that category. The other thing that I had mentioned a year ago is that my goal as CEO of this company was to get a return on my investment in the initial shares I made in the company back in the year 2000. We have a lot more to go to get there after the reverse split. The stock price on those shares is now \$56 a share, but that is still what my goal is. And that is still what is driving me. We look forward to going out this coming quarter. We like the prospects as we see them right now. We are encouraged after the last two very strong quarters of performance and another one in our sight going forward, that we are on the right path. So we are going to go out swinging away hard and continue with our, continue to make the progress that we have and look forward to it. We appreciate your joining our call today and look forward to talking to you again in 90 days. Thank you for attending.

Operator

Ladies and gentlemen that does conclude our conference today. Thank you for your participation and you may disconnect at this time.

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