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SCOX - Q4 2003 The SCO Group Earnings Conference Call

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SCOX - Q4 2003 The SCO Group Earnings Conference Call

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PRESENTATION

Operator

Good day, everyone, and welcome to the SCO Group's fourth-quarter 2003 conference call. At this time all participants are in a listen only mode. Later we will conduct a question-and-answer session. [Operator Instructions] Any reproduction of this call in whole or in part is not permitted without prior written authorization from the SCO Group. As a reminder, this call is being recorded today, Monday, December 22nd, year 2003.

Participating in today's call are Darl McBride -- President and CEO -- and Robert Bench, Chief Financial Officer.

Before we begin today's call, I'd like to inform you that our discussion may contain forward looking statements including without limitation statements relating to our future operations and financial performance. Such forward looking statements reflect management's current expectations and beliefs but they're not guarantees and are subject to risks and uncertainties that could cause results to differ materially from those contained in the forward looking statements.

These risks and uncertainties include but are not limited to those set forth in our earnings press release issued earlier today and in our filings with the SEC.

Now, ladies and gentlemen, I'll turn the call over to Darl McBride -- President and CEO of the SCO Group. Please go ahead, sir.

Darl McBride - SCO Group - President and CEO

Okay. Thank you and thank you all for joining us today. Fiscal 2003 was a year of tremendous progress for SCO on many fronts. First, we achieved record financial results in the fourth-quarter. Our revenue of \$24.3 million represents an increase of 57 percent over the fourth-quarter of last year.

These results are in line with our expectations.

Second, we achieved record financial results for our full fiscal year. We posted net income of \$5.3 million or 34 cents per diluted common share reversing a net loss of 24.9 million or \$1.93 per diluted common share in fiscal 2002.

This marks the first time that SCO has generated cash and been profitable on a full year basis.

Third, we ended up the year in a position of financial strength that represent a substantial turnaround from this time last year. Our positive financial results -- along with the \$50 million equity financing completed in October -- have given us the resources and flexibility we need to pursue our strategies.

At the close of the fiscal year, we had 64.4 million of cash on the balance sheet.

Overall, I would characterize 2003 as the year in which we created a strong platform for SCO -- a platform upon which we expect to generate long-term growth in 2004 and beyond.

We have taken important first steps over the last 12 months -- strengthening our management team, our financial footing, our core unit product offerings and our intellectual property positioning.

We are excited about our future at SCO and in fact, today, we're announcing two important new initiatives but before we get into those announcements I'd like to turn the call over to Bob to review last year's financial results.

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Robert Bench - SCO Group - Chief Financial Officer

Thanks, Darl. The fourth-quarter ended October 31, 2003, was our third consecutive quarter of strong revenue and cash contribution. Of the 24.3 million in fourth quarter revenue, 58 percent was related to our UNIX products and services business line and 42 percent was generated from our SCOSource licensing initiatives. The fourth-quarter revenue performance for our UNIX product line -- which is [indiscernible] quarterly performance this year, a breakdown of revenue for the fourth-quarter by geography was as follows -- 58 percent in the Americas, 31 percent in EMEA and 11 percent in Asia-Pac.

Our gross margin of 16.9 million or 70 percent was lower than prior quarters, primarily as a result of increased legal fees incurred with the connection with our SCOSource initiatives.

Operating costs this [indiscernible] for the fourth-quarter fiscal 2003 exclude (indiscernible) compensation charge to law firms were 12.1 million which is trending as expected and was consistent with our prior quarter.

Operating expenses in the fourth-quarter of fiscal 2003 were 2.8 million lower than operating expenses of 14.9 million in the fourth-quarter of the prior year.

Our full year revenue for fiscal 2003 increased 23 percent to 79.3 million from 64.2 million for 2002. And on a fiscal year basis, operating expenses declined 20 percent from 70.1 million to 55.9 million.

Additionally, our gross margin percentage increased from 71 percent to 75 percent compared to the prior year. These operating improvements were expected as we delivered and met our fiscal 2003 operating objectives. For fiscal year 2003, net income to common shareholders was 5.3 million or 34 cents for common diluted share.

That's compared to a net loss to common shareholders of 24.9 million or \$1.93 per share in the prior year. Fiscal 2003 results include revenue from our SCOSource initiatives of 25.8 million.

And as Darl noted earlier, the Company's 2003 net income of 5.3 million represents the first profitable year for the SCO group. As the Company had previously announced we raised net proceeds of 47.7 million in October. The accounting

treatment for this transaction was complex, although not uncommon for financial transactions such as this.

The financing was required to be split into two pieces -- temporary equity and a derivative financial instrument (ph). The temporary equity was [indiscernible] 9.7 million of the value of [indiscernible] preferred stock. The Company engaged an outside firm to assist in the evaluation of the derivative which was a reason for our delay in this earnings call.

As of October 31, 2003, the Company recorded a fair value of the derivative of 15.2 million as a current liability. And a change in that fair value of the derivative from October 16th to October 31 of 2.8 million has been recorded in the Company's fourth-quarter and fiscal year 2003 income statement as other income.

The accounting for the derivative will require the Company to mark to market its value at the end of each quarter and any difference in the carrying value will be included in the income statement as other income or expense. As was the case for the fourth-quarter this charge could be material.

Our positive financial results for fiscal 2003 and the 50 million funding completed in October have increased our cash balance to 64.4 million and our working capital to 37.2 million. The significant increase in cash and working capital -- coupled with the fact that we have no long-term debt -- puts the Company in a very strong financial position to pursue our strategic goals in fiscal 2004.

We believe our revenue outlook for 2004 will be enhanced by the strength of our financial position. Furthermore, management's intention can be directed for its [indiscernible] initiatives and revenue generating activities.

For fiscal 2004, the Company has three major business initiatives to drive increasing revenue.

Our UNIX operating systems (technical difficulties). Two, our SCOSource vendor licensing program that was successfully rolled out in fiscal 2003 and three, our recently introduced SCOSource intellectual property licensing program.

Revenues for the two SCOSource initiatives is expected to be minimal this first quarter of 2004 as the Company finalizes license agreements with its vendors and begins the implementation of its intellectual property licensing program.

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Our future revenue pipeline has strengthened this year along with our increased confidence in our intellectual property claims. We, therefore, anticipate significant revenue in subsequent quarters from both SCOsource licensing initiatives. However, the nature and predictability of these lines of revenue and the variability of revenue recognition does not allow for accurate near-term guidance.

In its first quarter ending January 31, 2004, the Company expects total revenues to be in the range of 10 to 15 million which is in line with first quarter revenue of last year.

The Company's UNIX line of products and services are expected to represent the majority of the consolidated revenue for this quarter. Operating expenses relating to our core business lines should remain consistent with recent quarters. Expense (technical difficulty) are expected to increase in fiscal 2004 as the Company expands and pursues its legal strategies.

With focused attention on our UNIX product development, our strong financial position and the increased size of our pipeline in licensing opportunities, we look forward to strong results from both our divisions in 2004. With that I'll turn it back to Darl.

Darl McBride - SCO Group - President and CEO

Okay, thanks, Bob. As Bob mentioned in his financial review our results demonstrated SCO's business in 2003 not only stabilized but thrived as we developed and emphasized new areas of our business, traded and strengthened relationships with key partners and worked to enforce and protect our intellectual property.

We've put together a strong foundation from which we will build our business in the new year. We've also introduced and built our SCOsource business unit to enforce our intellectual property rights. As we move into the digital age, intellectual property enforcement is a necessary and [indiscernible] of focus for companies around the world. Profitability will be sustained only to the extent intellectual property are identified, catalogued, and protected. We at SCO are pleased to be a leader in this important new area.

Before we move on to today's SCOsource announcements, I'd like to make a few comments on our core UNIX operating business.

In [indiscernible] product line we continue to see good uptake from existing customers while attracting new customers in our key vertical markets which encompass large as well as small to medium businesses. Let me just rattle off a few of the customer deals we completed transactions with during the previous quarter.

In North America, the list (indiscernible) include organization such as the Department of Justice, Lockheed Martin, U.S. Air Force, [indiscernible], Goodyear, AT&T, Avaya (ph), CSK Auto (ph) Pinkertons, 84, Lumber, Cracker Barrel restaurants, McDonalds, GE Aircraft Engines, DaimlerChrysler and Nasdaq (ph).

(technical difficulty) Europe, we're looking at organizations like Barcrest, Marconi, Dahls (ph) and Atchison, [indiscernible] and Argos (ph). In Germany -- BMW, out of Italy -- Ministry of Finance. Moving on to Asia-Pac area. Out of Japan we have companies like Toshiba, Matsui (ph) electronics and Image Partner. Out of Taiwan, LCC Taiwan Educational Training Group. In China, China Central Bank, People's Bank of China, Highway Administration and Shengdong (ph) profits. In India, India Overseas Bank, Bank of Pakistan, and Bank of India.

As you can see, we have a global business. We have large- and medium-sized customers that work with us and we're very pleased with the continued progress of our core business.

For the future of all concerning (ph) our UnixWare (technical difficulty) developing products and services that build on our historical strength in vertical markets which is a key partner of strategy. There are a lot of high-tech companies out there trying to align their offerings to vertical markets. SCO is already there today with a partner base of more than 4300 application providers selling into markets such as retail, health care and financial services.

At SCO Forum last August [indiscernible], we announced that we had begun work on new versions of the Company's flagship UnixWare and OpenServer UNIX operating systems. We also added to the Company's roadmap plans for a 64 bit UNIX product. We expect to deliver the upgrade to UnixWare and introduce the beta for OpenServer -- currently code-named Legend -- during 2004. So let's now move on to our SCOsource's initiative.

As most of you are probably aware by now, throughout the course of 2003, SCO has been actively engaged in protecting and enforcing our valuable intellectual property under our SCOsource business unit.

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We believe this is a model that many companies will adopt in one form or another as intellectual property protection becomes a key area of focus in our digital age. This coming year SCOsource will continue to focus on winning the IBM lawsuit and (technical difficulty) our focus is to enforce our UNIX intellectual property rights against other companies.

Let's talk for moment about the IBM litigation then. Our lawsuit with IBM is progressing to our satisfaction as we have been building our case through the discovery process. The case is (technical difficulty) trial on April 11, 2005. We are encouraged by the strength of our case there as reflected by the evidence that we have been able to discover thus far and we are absolutely prepared to see this case to its full conclusion.

Based on our claim that IBM's breached its software agreement with us we have terminated its ability to license any product based on UNIX System V. IBM's ongoing business related to AIX licensing is therefore operating outside its license grants in UNIX technology.

IBM does not have the right to currently license UNIX technology and customers do not have the right to license UNIX technology from IBM. This is a significant legal right that we will enforce in the coming year.

In addition, we will enforce and protect the Company's intellectual property rights against unauthorized use and distribution under the Digital Millennium Copyright Act. We are beginning with enforcement of certain copyrighted UNIX header files that are found in Linux which have been used in property in Linux with copyright attributions removed.

We've identified specific code that must be removed from Linux prior to any further use or distribution. Failure to remove this copyrighted code from any new distribution under [indiscernible] may subject the distributing company to liability under the Digital Millennium Copyright Act section 1202 for knowing distribution of copyrighted material with copyright management information improperly removed.

From today's press release, I'd like to call particular attention to the written notices we're sending to our UNIX Source Code licensees. And I'd really like to emphasize a couple of points here.

First, these source code agreements are the legal foundation upon which much of the industry's [indiscernible] operating systems are licensed. Second the list of UNIX Source Code's

licensees is substantial. Both in number and in scope. These [Indiscernible] licensees include 41 companies in the Fortune 100. They include leaders in numerous industries including pharmaceuticals, financial services, transportation energy, automotive, computer hardware and computer software. And there are thousands of them.

Third, under the terms of these agreements, SCO is requiring each of these licensees to certify in writing that they are utilizing the code in compliance with the terms of the agreement. This means that each company must certify to SCO that each of the following three points.

First. The company is not running Linux binary code that was compiled from any version of Linux including code that contains SCO's copyrighted applications binary interface code.

Second. The company, its employees and contractors have held that all times all parts of the UNIX product in confidence for SCO.

And third. No employees or contractors that have had access to UNIX have contributed any software code based on that product to Linux or any other UNIX-based product.

SCO has requested that such certification be provided by the end of January. Failure to respond or failure to certify full compliance gives SCO the right to terminate the agreement and require the licensee to discontinue use of UNIX software.

I'd like to add here, it's important to understand also that we're not talking about the previous product group. When we talk about SCO, UNIX, UnixWare [indiscernible] sold in as a product. These are the underlying source code agreements that emanated from AT&T that have been passed on and are still valid today.

The UNIX source code license agreements were put in place years ago to allow companies themselves to make source code changes to their versions of UNIX. That activity, alone, is fine if exercised within the terms and conditions of the agreement. However some of these same companies are using, modifying, and redistributing Linux to the extent any [indiscernible] method or context have been used by a company that such a company in making its Linux modifications, our source code agreements have been violated. We, therefore, will require that every SCO source code licensee verify its compliance with its UNIX software

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agreement with us as a condition of continued use of its UNIX technology.

If verification is not complete or violations are found inside any company we will terminate that company's right to use UNIX consistent with the terms of our source code agreement.

We will not allow any UNIX licensee to use UNIX technology to build Linux. UNIX source code licensees who are doing this will lose the right to use any version of UNIX. We expect that this will, also, become an area of focus for our enforcement initiatives in the near-term.

So to put a summary on all of this -- fiscal 2003 was a pivotal and successful year for SCO -- as the first profitable year in more than seven years for this company. We have no long-term debt, we have more than 64.4 million in cash on our balance sheet, and this strong financial basis will provide SCO with the resources and flexibility to focus on its strategy for the new year.

So to keep things going forward for us will be -- delivering new UNIX products and services which address customer demand for greater flexibility and interoperability. Pursuing our claims against IBM. Building awareness with Linux users and providing them with a path for continued Linux use which will build recurring revenue for SCO to a flexible licensing program and also building industry true relationships which support our UNIX business and our SCOsource initiatives.

We are encouraged by the positive momentum we have in these areas as we head into fiscal 2004 and we're looking forward to an outstanding year.

With that, why don't we turn it over to the operator to build a Q&A list?

QUESTIONS AND ANSWERS

Operator

[Operator Instructions]

Brian Skiba with Deutsche Bank.

Brian Skiba - Deutsche Bank - Analyst

Hi. Good morning and congratulations on the quarter. Question around the notices you're sending out, the letters to the Fortune 1000 Linux end-users. Darl, can you give us any kind of range about how many of those sort of letters have been sent out and whether this is more or less a first set of letters and if there's more to follow? And what kind of legal options as mentioned in the press release are available to them at that point?

Darl McBride - SCO Group - President and CEO

So, let's talk about the numbers first and then we'll go to the options. On the number side, we really have two letters that we started last week. We got a few days, we're down for Christmas this week and then following the Christmas break, we will jump back in. First, we expect we will have several thousand letters in the hands of the UNIX licensees to have a requirement to certify back to us that they are not using Linux in contradiction of our UNIX license agreements.

With respect to the Linux end-users, basically, we are starting with a list we have of 1500, we have a lot of intelligence there now, we know a number of those organizations are not using Linux but we also know of a number that are. So I would say that list is going to be in the hundreds but probably won't get to 1000. But it will be substantial in terms of those that receive the DMCA notice.

Those who receive the UNIX letters will also receive a copy of the DMCA letter, stating that use of Linux in their environment on top of the UNIX violations that they may face would be relevant for them as well from a copyright perspective.

Let's talk then about the options organizations have. I think there's really three. The first one is to cease and desist use of Linux. We absolutely see our copyrighted code inside there, we said that continually. This is a very clearcut set of violations. We have spelled those violations out in the letters. People have been asking for discrete disclosure of where these files are. We have over 40 files that are disclosed here and so, basically, discontinued use of Linux would be the option number one or removing those header files out of Linux I suppose would be a subset of that option. One challenge of trying to remove the header files is that when you get into the middle of this, you're going to see that the header files touch virtually every application that's been written in Linux so removal of the files themselves would tend to create an

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incompatibility of the application that's running inside the organization on Linux.

So option one then summarized is essentially stop using.

Option two would be -- if you keep using Linux but I want to straight with the legal side of things and we have provided the mechanism for licensing there, and in our price points (ph) 1399 per CPU we have extended for some creative time the (indiscernible) price to get going on that, and so that would be the option two.

Then the final one would be to continue using Linux and then at that point we would be pursuing all the legal options we have at our -- within our hands at that point in time. So I think those are the three remedies that I see or three options.

Brian Skiba - Deutsche Bank - Analyst

And the 699 is a one time fee and they have a source code rights to use Linux and everything at that point?

Darl McBride - SCO Group - President and CEO

They basically would have a right to use a binary version and continue to run Linux is the way that program works.

Brian Skiba - Deutsche Bank - Analyst

Okay. Very good. Thank you.

Operator

Nicholas Donovan with J.P. Morgan.

Nicholas Donovan - J.P. Morgan - Analyst

Congratulations on your quarter. My question to you is as it relates to the source code licensing, how will -- if you process on a per CPU on a multiple processor machine and what about distributing application programs?

Darl McBride - SCO Group - President and CEO

Well I think that the [indiscernible] it's important to recognize that the world is moving to larger and larger machine types and expanded environments here and our licensing program

on the source code side has always been listed as a CPU count. If you go back to the UNIX license agreement that were signed 20 years ago from 20 years ago going forward, what you'll see is the thousands of companies that are out there today that have these agreements have an obligation to report to us by CPU and if the source code that is licensed to us is exceeding the CPU count that they have licenses for, then they're out of bounds.

So, yes, I think it is important distinction to make and we're focused on CPU count here, not on the server count. When you get into these large expanded server farms, this is a key point to understand from a distributed application standpoint. It is a focus on the CPU side of things.

Does that address your question, Nicholas?

Nicholas Donovan - J.P. Morgan - Analyst

Yes -- thank you.

Operator

[Operator Instructions].

Herbert Jackson with Renaissance.

Herbert Jackson - Renaissance - Analyst

Good morning and great quarter. Couple of questions -- one's been answered but -- Fortune 1000 UNIX IP licensees that you referenced in some prior press interviews. Do those begin to book in subsequent quarters? Have those been finalized?

Darl McBride - SCO Group - President and CEO

Yes -- you're talking about the UNIX side of things?

Herbert Jackson - Renaissance - Analyst

Yes.

Darl McBride - SCO Group - President and CEO

Yes -- we see a very healthy pipeline right now in a handful of different areas as we forward here. We have, basically, very strong contractual rights flowing down to these end use

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customers that hold UNIX source licenses they came down through the AT&T side. As we go out and go through this process we just initiated last week we think that as we move primarily into Q2 and beyond, that that is going to be a very healthy pipeline. I mean, the point is, someone who is out there who has (indiscernible) source licenses is either going to -- and they have a lot of Linux inside their shop and there's going to be a lot of companies that fit that bill, they're really going to be forcing the situation of discontinuing use of Linux or paying a fee here and it's one going to be one or the other.

There's no doubt that Linux is popular out there. It's popular in large part because it's free but we do see a healthy pipeline coming from the site. The second pipeline that we see that is healthy heading into the new fiscal year is that on the vendor side. We see our vendor pipeline healthy -- obviously we did some deals last year. As we head into this new year quite frankly one of the biggest issues that is basically between us and some deals here has been our coming out and putting on the table some things on the legal side that relate not through IBM.

A lot of folks have become a little bit conditioned and saying, well let's wait until the IBM thing turns out and go from there.

Let's be 100 percent crystal clear on what we announced this morning. The DMCA copyright violations that were announced this morning are independent of the IBM legal case. The contract case that's been moving since March with IBM we like where that's going. The case that came out this morning is the first time we've come out definitively saying here is our set of issues, here are our problems that we have, here [indiscernible] set of files and we're going to go out and pursue that.

It's not the only set of files. It's -- think of this again as the tip of the iceberg. We rolled out a small set of code in the summertime frame -- 80 lines or so -- Linux community came out and said, we've removed that. Well, by removing that essentially there's a few million servers out there that don't have it removed on so on that basis alone Linux is tainted.

What we're talking about right now is much more than 80 lines of code. We're talking about 43 or so header files that touch virtually all the applications that have been written in Linux. So as those come together now, the -- that's what a lot of the vendors as well as end-users quite honestly have been looking for before they move forward on the licensing program.

Herbert Jackson - Renaissance - Analyst

Great. Thanks. If you'll take one more question -- totally unrelated -- but any visibility for your Web services platform sell through? In subsequent quarters?

Darl McBride - SCO Group - President and CEO

Yes. We -- On the Web services sell through we had said in the summertime frame that we thought in 2004 we would see some traction there. And we're starting 2004 right now. We are basically putting together this program to go to the 4300 applications that are in a vertical environment and we have some interesting partnerships that we are in the middle of right now that we think will really drive that in a positive way.

We're well-positioned there. I don't see the uptake on that hitting in Q1 but I do see some positive momentum that comes out of that in this fiscal year.

Operator

Dion Cornett with Decatur Jones.

Dion Cornett - Decatur Jones - Analyst

Congratulations on a strong quarter. Couple of quick questions about the guidance coming forward and trying to model that out. Now, obviously, it's complicated and unusual for a software company to migrate to some things you're having to with these end user agreements. But I had a number of 2.5 million for January -- looks like if I am reading the guidance right [indiscernible]. Trying to figure out how I'd get a handle on what the April number should look like? Could you sort of -- maybe easiest way to do this -- when you look at the last initiative [indiscernible] 1500 letters and you talked about this a little bit with Brian's question, can you sort of break down best you can to nearest hundred, nearest 10 percent [indiscernible] responded to you of the people that responded, how many did you meet with win in general ballpark, how many said yes and it's just a matter of some administrative stuff to get the licensing fees in, how many [indiscernible] know?

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Darl McBride - SCO Group - President and CEO

All good questions, Dion. Yeah. When we rolled this thing out initially last summer there was a lot of stuff flying around out there. We were going to send out invoices, we were going to do this, we were going to do that [indiscernible]. What we're trying to do, what we did do during the last quarter was spent a lot of one on one time meeting with large end-users of Linux. Probably had 12 to 15 percent or so direct one-on-one meetings and we learned a lot through that process -- I'd really look at Q4 as more of a modeling that is almost like a testing time that we went through here to tell everybody where we were and we listened to where everybody else was.

And, essentially, what comes out of that, then, is we had several people sign up for the license and these are people we don't have other deals going with in the technology (indiscernible). These are Fortune 500, Fortune 1000 level accounts that have signed up. We have another group of those people we met with that have basically said, Fine, I am not going to use Linux. (indiscernible) CIOs in meetings and said, Fine we're not going to do it.

And then we have another group that essentially we're looking for something -- we're either going to wait for the IBM litigation is done or we're looking for something on your copyright (indiscernible) and if you show us something there then we will step up and move.

So if you take those and you say, the greatest group of those again, there were some of them that said I'm not going to use any, but the greatest group either likes this or said they would upon seeing something that legally they felt like they should be moving on now as opposed to waiting for the IBM case.

The other thing to recognize is that Q4 we only had two people involved in this. One coming from more of the legal side and one from for the marketplace present perspective, account perspective. We intentionally kept this thing very tight, very controlled because we wanted to not let this thing get out ahead of us.

We feel now from where we sit that we are in a mode to move this out. We announced this today. And we're going to be moving very aggressively whereas last quarter we had two people working on this. Starting next week -- when we come back from the holidays -- we're going to be moving essentially dozens of resources onto this project. And as we move forward with those resources internally backed by the Boies

(ph) externally, we think that, again, we might see some uptake here in Q1 as relates to this but as we get into Q2 and beyond --

It's hard to give guidance exactly, Dion. What I can tell you if that people are meeting with have thousands and thousands of UNIX up of Linux inside their shop. Your take some of these that have anywhere from 5 to 10,000 units going, you can model out the 699 to 1399 price point that (indiscernible) lower end of that right now 'cause we still have that as an option.

As we move into the legal side of this, it's important for people to understand that under copyright law, people who are violating copyright law can pay statutory damages as high as \$30,000 for not willful infringement on a (indiscernible) basis per server per CPU basis and as high as \$150,000 for instance for willful violation.

So people are going to be staring at these letters that say we're going to be considering you a willful violator if you continue to copy our IP going forward.

So I think that the options are really clear. You go down the legal path it's going to be where it is with the legal remedies, the licensing paths and other, the third would be to just not use it at all.

But I think the realistic path probably is going to be the licensing path for many companies.

Dion Cornett - Decatur Jones - Analyst

So, one of the earlier points you made, you have signed up several and I can understand why these customers would want anonymity (ph) but how, for these 340 signed up in the ballpark what dollars are associated with the deal?

Darl McBride - SCO Group - President and CEO

We haven't signed up any yet that are in the thousands of users. So we have -- Saying exact number on that but I would say we haven't signed up any of the large users yet. I can say we have large users north of 5,000 bosses in their enterprise that are on the bubble, waiting to see where they go on this.

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Dion Cornett - Decatur Jones - Analyst

And just one final thing on this morning's initiative if Linux community were to come back and say all right, fine, you got to -- we have got to take header files out that are largely definition files then you've got to take [indiscernible] and some of our stuff out of your software -- what would be your response? Would you remove those [indiscernible] components or do you believe there's a valid license out there that allows you to ship [indiscernible]?

Darl McBride - SCO Group - President and CEO

Again we're not taking a shot at the whole open source community. We're saying we see there's a flaw in the process out there where our stuff is seeping in there. So we're not -- this is not the case of SCO vs. open source. This is a case very clearly where our IP has been misappropriated. As a matter of fact, we're seeing those violations there is what's giving us the basis to step up and make those claims.

Operator

Gary Dean (ph) with Jetstream Capital.

Gary Dean - Jetstream Capital - Analyst

Couple of questions -- I am newer to the story. What was the revenue in last year's fourth quarter from the UNIX product segment?

Darl McBride - SCO Group - President and CEO

Bob you have that on the tip of your tongue? [indiscernible] [indiscernible]

Robert Bench - SCO Group - Chief Financial Officer

Yes, that was about 15 million, Gary. Just a little over about 15.5 million -- almost all of last year. Since we did not have the SCO source initiative at that time, all the revenues we reported were really from the UNIX related business line.

Gary Dean - Jetstream Capital - Analyst

Thank you. My second question was related to Darl's comment earlier about the action and I notice it's being sent out to the Linux customers being an independent faction (ph). Assuming

the customers receive the notices I think Darl laid out two choices -- they can either stop using Linux or they could remove the code. If they decide to wit and say, we want to see what the outcome of the IBM action is -- we can see the base argument being made here is valid -- can you decide to pursue them? Would you pursue customers individually, collectively? What is the strategy for pursuit if they decide not to move on your letter?

Darl McBride - SCO Group - President and CEO

That is going to be a decision for David Boies (ph) voids in terms of the ultimate strategy. On our call a month ago, he did say within 90 days you should expect to see end users lawsuits showing up during that period of time that would basically give us a basis to go in and establish claims we have here on the copyright side. What we're announcing here today, with these violations notices, will eventually tie in to that litigation. So do you go after one, do you go after a set? Those are going to be calls for David.

With respect to some of the concerns that have come up from various folks saying it's crazy to be going after end-users. I know some folks in the industry have been on record, coming out of the free software environment, saying, this is as crazy as going out and finding someone who bought a book at Barnes & Noble and chasing them down at home and while they're in their living room suing them for reading a book.

But I would point out two major differences with the free software examples that they're floating around out there. The first one is that when you look at the GPL, you realize that you don't actually buy this. In other words, this would be like going into Barnes & Noble and not buying the book but Barnes & Noble bookseller gives you a book for free. And then they point you to the GPL language that says by the way since this is free there's no warranty and essentially this is as is, if somebody comes after you you're on your own. So that's one significant difference.

The second difference is even bigger. The book readers who went home and is sitting by his fireplace and reading the book when he got through it he didn't tend to get up and [indiscernible] 500 copies and give it to his closest friends and neighbors,

That's what's happening with Linux. There's huge amounts of copying. So this would be like getting a book, you read the

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book and then you make 500 copies and send them around the neighborhood.

That is the whole point here.

Copyrights are to protect people from making copies. At the end user level is where the substantial amount of copying is going on. And that is, thus, the target area for the litigation that will be coming up with respect to Linux related lawsuits.

I just mentioned the GPL forces that issue. Pushes everything down to the level -- when I met with IBM earlier this year they said you can't sue us, we don't do distribution.

If you look at Linux distributors, everybody can point to some out clause where they don't have liability and, technically, whether they have [indiscernible] or lawyers (indiscernible) but clearly what's happening here, they are pushing the liability down to the end users -- so go ahead.

Operator

Andy Chopic (ph) with Nutmeg Securities.

Andy Chopic - Nutmeg Securities - Analyst

Couple of questions I hope you can clarify. In connection with the IBM litigation, can you give us any sense of what the general expected litigation costs will be in the upcoming fiscal year? And what they actually were in the fiscal year you just reported?

Darl McBride - SCO Group - President and CEO
(technical difficulty)

Robert Bench - SCO Group - Chief Financial Officer

Yes, Andy, this past year, we spent about \$9 million in total cost. That's including the cost for internal expenses and probably spent about \$7 million on legal fees last year. So about \$2.5 to \$3 million for quarter. We are expecting that will increase -- our activity has increased dramatically. And we would expect an additional million to \$2 million for quarter as we move forward in this year, compared to last year's cost.

Andy Chopic - Nutmeg Securities - Analyst

Of just the legal cost?

Robert Bench - SCO Group - Chief Financial Officer

Legal, expert advice, all the relevant cost associated with pursuing these claims.

Andy Chopic - Nutmeg Securities - Analyst

So it's an extra 1 to 2 million a quarter above the rate of spending that we have seen this past year.

Robert Bench - SCO Group - Chief Financial Officer

That's right.

Darl McBride - SCO Group - President and CEO

And what you should factor in there also is we're stepping up our enforcement activities. And there's a level of almost variability here that when you talk about going after the end user campaign very clearly we fully expect to see some pretty big returns coming back to us due to the licensing or due to the litigation program. And so it's not just a dial up against the IBM related expenses. It's also against things that we expect are going to generate revenues during this fiscal year.

Andy Chopic - Nutmeg Securities - Analyst

On the revenue side, secondarily, in connection with having terminated IBM's right to UNIX 5.0, what were the license revenues associated with that in the most recent fiscal year? I assume those will go to zero now.

Darl McBride - SCO Group - President and CEO

Yeah, it's a little bit quirky. The thing that as you go back and look at the IBM agreement, IBM had actually bought out their royalty streams so they actually didn't have obligation to pay ongoing royalties. I think that's a little bit of the confusion of how we got to where we were. On their side they sort of probably felt like hey, we already bought this thing out. What we owned, though, was the underlying intellectual property rights that essentially said you can go ahead and sell your product but what you can't do is disclose [indiscernible] in

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an unconfidential manner. And certainly you can't give the source code away in violation of our contract rights.

So what it -- what we've been in the middle of here is that you think of it as a dumping case. What happens when you have a dumping case? You basically take the value of the market and you take it down. Well Linux is the ultimate dumping case. The price is 0. You can't destroy marketing more than that.

So our claims are against the destruction of our marketplace as the owners of the Linux operating system and as they're taking that and destroying the value and trying to take that value down to 0, we are losing a lot of ability to monetize our assets along the way.

Andy Chopic - *Nutmeg Securities - Analyst*

So, there is no real additional revenue impact from having outright terminated IBM's rights.

Darl McBride - *SCO Group - President and CEO*

Yes that's correct. Even when you go to the -- when we talk about thousands of UNIX licensees, the people we're out meeting with on this are not really our customers per se on the OpenServer and the UNIXWare site. Both guys are already buying products from us, most of those are not using Linux. (indiscernible) independent -- they're really separate from this. We're talking about a lot of folks out there who have the requirement to keep UNIX safeguarded and protected and they may fall under an HP camp and may follow under an IBM camp or (indiscernible) one of the other big vendors out there.

Operator

Peter Richards with Empire Capital.

Operator

Robert Phillips with RLP (ph) Capital.

Robert Phillips - *RLP Capital - Analyst*

I think I'm (indiscernible) earlier, is there a web site I can go to that have the list of [indiscernible] files in question so I can get an idea how good this is going to work out?

Darl McBride - *SCO Group - President and CEO*

Where we have that out, I think there's a lot of requests coming in from the press today so we will probably put up on a web site here today. So I would go to [indiscernible] Blake and ask him what time and where that is going to be, we will have it up on the web site and you should be able to take a look at that. I would go to sco.com/SCOsource and they should have it out there somewhere. [indiscernible] just gave me high sign, said it's be out there in about two hours.

Robert Phillips - *RLP Capital - Analyst*

Two hours -- thank you very much.

Operator

This concludes the portion of our question-and-answer session. At this time, I'd like to turn the back over to Mr. Darl McBride.

Darl McBride - *SCO Group - President and CEO*

I would like to pass one more question that is on the mind of some people go out there. I know because they called in separately and I didn't come up here now so I will take that one head-on. That is the question about Novell and the recent actions they have taken.

We found out over the last couple of weeks that [indiscernible] Novell snuck into the copyright office and tried to file some copyrights that would be basically on top of the claims the copyright registrations that we have made. The acts that Novell is going through here seem to be desperate. I know they're tied in very closely with IBM and I know IBM and those guys are working very closely to try and win this battle against us.

As we found out two quarters ago, on the day of earnings release when Novell came out and said we own the copyrights and then we produced the amendment to which basically said well no, actually those copyrights have now been transferred over to us. We find it very interesting behavior on their part that they're still trying to play some games here. Let me be real clear with anybody that has any questions about some of the legal rights that SCO acquired in this transaction with Novell.

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In the contract that we received from them on the included assets it says we have all rights and ownership of UNIX and UnixWare. That was later amended an amendment to include all copyrights. For UNIX and UnixWare.

Turn the page, we have the right to all claims that arise after the closing date. So if there's any claim with respect to copyright violation it says in our contract those claims are all owned by SCO. So that's another key point there to understand.

If you go look at the press release that was issued the day that SCO and Novell did their deal very clearly said that the intellectual property rights to UNIX were transferring over to SCO. I found that -- I've heard that Novell has actually pulled that press release off from their web site -- I guess they don't like that floating around out there. I think in Novell's case very clearly they're getting [indiscernible] to them from IBM right now.

We get a lot of communications that come from Novell where they see [indiscernible] IBM and these guys are obviously working very closely together. If you turn the clock back exactly a year ago to when I first brought the issues up around our intellectual property rights being violated with IBM they came back and said, well, we've looked at the asset purchase agreement and you didn't appear to get any [indiscernible] intellectual property rights so that's been the defense they used all they way up until May 28th when we produced amendment two. When that happened it was a bad day on that side, we see them taking desperate steps at this point to try and grasp for something that doesn't appear to be there.

So they're trying to force some kind of issue here. We will be glad to take the necessary legal steps to remedy that. We see this as a fraudulent filing of copyright notices on their side and we will take the appropriate measures as necessary with our legal team.

In summary, I see the Novell case as being one of tall hats and no cattle.

With that, we'd like to thank you all for joining our call here today and have a good holiday season. We look forward to talking to you in the New Year.

Operator

And this does conclude today's conference call. At this time, you may disconnect.

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