

SECURITIES AND EXCHANGE COMMISSION  
WASHINGTON, D.C. 20549

FORM 10-K

(Mark one)

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

FOR THE FISCAL YEAR ENDED MARCH 31, 1997

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

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

Commission File Number 0-12699

ACTIVISION, INC.

(Exact name of registrant as specified in its charter)

DELAWARE

94-2606438

(State or other jurisdiction of (I.R.S. Employer Identification No.)  
incorporation or organization)

3100 OCEAN PARK BLVD., SANTA MONICA, CA  
(Address of principal executive offices)

90405  
(Zip Code)

REGISTRANT'S TELEPHONE NUMBER, INCLUDING AREA CODE: (310) 255-2000

SECURITIES REGISTERED PURSUANT TO SECTION 12(b) OF THE ACT: None

SECURITIES REGISTERED PURSUANT TO SECTION 12(g) OF THE ACT:

COMMON STOCK, PAR VALUE \$.000001 PER SHARE

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(Title of Class)

Indicate by check mark whether the registrant (1) has filed all reports required  
to be filed by Section 13 or 15(d) of the Securities Exchange Act of 1934 during  
the preceding 12 months (or for such shorter period that the registrant was  
required to file such reports), and (2) has been subject to such filing  
requirements for the past 90 days. Yes X No  
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Indicate by check mark if disclosure of delinquent filers pursuant to Item 405  
of Regulation S-K is not contained herein, and will not be contained, to the  
best of the registrant's knowledge, in definitive proxy or information  
statements incorporated by reference in Part III of this Form 10-K or any  
amendment to this Form 10-K. [ X ]

The aggregate market value of the Common Stock of the registrant held by  
non-affiliates of the registrant on June 10, 1997 was \$161,294,682.

Indicate by check mark whether the registrant has filed all documents and  
reports required to be filed by Section 12, 13, or 15(d) of the Securities  
Exchange Act of 1934 subsequent to the distribution of securities under a plan  
confirmed by a court. Yes X No  
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The number of shares of the registrant's Common Stock outstanding as of June 10,  
1997 was 14,193,620.

DOCUMENTS INCORPORATED BY REFERENCE

Portions of the registrant's definitive Proxy Statement, to be filed with the  
Securities and Exchange Commission within 120 days after the end of the fiscal  
year covered by this Form 10-K, with respect to the Annual Meeting of  
Shareholders to be held on September 24, 1997 are incorporated by reference into  
Part III of this Annual Report.

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PART I

Item 1. BUSINESS

(a) GENERAL

Activision, Inc. (together with its subsidiaries, the "Company") is a diversified international publisher and developer of interactive entertainment software in a wide variety of formats. The Company was incorporated in California in 1979. In December 1992, the Company reincorporated in Delaware.

(b) FINANCIAL INFORMATION ABOUT INDUSTRY SEGMENTS

The Company operates in one industry segment: publishing CD-based and, to a lesser extent, cartridge and floppy disk entertainment software. See the Consolidated Financial Statements and Notes thereto included in Item 8 of this Annual Report on Form 10-K for certain financial information required by Item 1.

(c) NARRATIVE DESCRIPTION OF BUSINESS

INDUSTRY BACKGROUND

The interactive entertainment software market is composed of two markets: the PC systems market -- software created for use on personal computers ("PCs"), including PCs utilizing the MS-DOS and Windows operating systems as well as Apple Macintosh computers; and the console systems market -- software created for dedicated game consoles that use the television as a display, including the Sony PlayStation, Sega Saturn and Nintendo N64 entertainment systems.

PC SYSTEMS. According to Access Media International ("AMI"), 35.5% of U.S. households had at least one multimedia PC ("MPC") at the end of 1996. AMI is projecting this installed base to grow to 37.5% by the end of 1997. This increase in PC ownership appears to be spurred by lower-cost Pentium-based MPCs which incorporate higher-speed CD-ROM drives, modems and increasingly sophisticated graphics capabilities, as well as by the continued growth and interest in the Internet. AMI reports that MPC shipments to the home reached 8.4 million units in 1996 and are expected to increase to 9.6 million units in 1997, bringing the total installed base of MPC units to 27.7 million by the end of 1997. The improved functionality and ease-of-use provided by Windows 95, the continued production of compelling entertainment and education applications, and increasingly favorable price to performance ratios for PCs also appear to be major contributing factors to the increased growth in this industry.

As a result of all these factors, demand appears to be growing for MPC-based entertainment software, as evidenced by increases in the sale of entertainment software titles. According to AMI, North American sales of PC entertainment software grew from \$750 million in 1995 to \$900 million in 1996. AMI further expects 1997 sales to increase to \$1.1 billion. The Company believes that the continued future growth of the PC interactive entertainment software market will be dependent upon the development of increasingly sophisticated software incorporating advanced graphics and sound, compelling story lines and rewarding game play.

CONSOLE SYSTEMS. The console systems market currently is finishing the transition from 16-bit systems to 32 and 64-bit systems ("next generation systems"). Next generation systems have experienced healthy growth following their introduction in 1995 and have begun to establish significant installed bases. Sony's PlayStation has been particularly strong, establishing an installed base of approximately 3 million units in North America at the end of 1996, according to AMI. The Company currently believes that the PlayStation will continue to enjoy major growth through 1997.

According to AMI, the U.S. installed base of all next generation systems at the end of 1996 was approximately 5.8 million units and will reach approximately 13.7 million units by the end of 1997. AMI projects further growth in the installed base of next generation systems to approximately 21.4 million units by the end of 1998. The Company believes that these systems will continue to be successful as hardware manufacturers recently have lowered prices to a level that will allow for mass market penetration. The Company believes that the specific level of future success also will be dependent on the ability of developers consistently to supply increasingly sophisticated software for the consumer.

DISTRIBUTION. The Company believes that the distribution channels for entertainment software have expanded in the last several years. During the 1980s, console entertainment software was sold primarily through mass merchants and toy stores, while PC entertainment software typically was sold through specialty software stores. The distribution of PC software is now expanding into traditional console channels such as



mass merchants, specialty retailers and warehouse stores, and console software has begun to penetrate specialty software stores and other traditional PC outlets. Although the number of distribution channels for entertainment software has increased overall, an abundance of new software titles has forced retailers to be highly selective when allocating shelf space. Competition for shelf space has intensified as retailers, especially mass merchants, continue to carry only a limited number of products that are expected to sell in high volumes. In addition, in the last year a few specialty retailers have either ceased business or consolidated their operations, resulting in even greater competition for shelf space.

To be successful in this more competitive distribution environment, companies must demonstrate to retailers that their products have broad appeal and can become best sellers. In order to achieve broad appeal, companies must utilize the enhanced capabilities of MPCs and next generation systems to create sophisticated products with high production values and appealing game play. Since this approach results in higher development budgets, companies that can institute disciplined development processes to lower cost overruns and innovative marketing campaigns that increase consumer awareness should be in the best position to maximize their return on product investments.

#### CERTAIN CAUTIONARY INFORMATION

In connection with the Private Securities Litigation Reform Act of 1995 (the "Litigation Reform Act"), the Company is hereby disclosing certain cautionary information to be used in connection with written materials (including this Annual Report on Form 10-K) and oral statements made by or on behalf of its employees and representatives that may contain "forward-looking statements" within the meaning of the Litigation Reform Act. Such statements consist of any statement other than a recitation of historical fact and can be identified by the use of forward-looking terminology such as "may," "expect," "anticipate," "estimate" or "continue" or the negative thereof or other variations thereon or comparable terminology. The listener or reader is cautioned that all forward-looking statements are necessarily speculative and there are numerous risks and uncertainties that could cause actual events or results to differ materially from those referred to in such forward-looking statements. The discussion below highlights some of the more important risks identified by management, but should not be assumed to be the only factors that could affect future performance. The reader or listener is cautioned that the Company does not have a policy of updating or revising forward-looking statements and thus he or she should not assume that silence by management over time means that actual events are bearing out as estimated in such forward-looking statements.

FLUCTUATIONS IN QUARTERLY RESULTS; FUTURE OPERATING RESULTS UNCERTAIN; SEASONALITY. The Company's quarterly operating results have in the past varied significantly and will likely in the future vary significantly depending on numerous factors, several of which are not under the Company's control. Such factors include, but are not limited to, demand for the Company's products and those of its competitors, the size and rate of growth of the interactive entertainment software market, development and promotional expenses relating to the introduction of new products, changes in computing platforms, product returns, the timing of orders from major customers, delays in shipment, the level of price competition, the timing of product introduction by the Company and its competitors, product life cycles, software defects and other product quality problems, the level of the Company's international revenues, and personnel changes. Products are generally shipped as orders are received, and consequently, the Company operates with little or no backlog. Net revenues in any quarter are, therefore, substantially dependent on orders booked and shipped in that quarter.

The Company's expenses are based in part on the Company's product development and marketing budgets. Product development and marketing costs generally are expensed as incurred, which is often long before a product ever is released. In addition, a large portion of the Company's expenses are fixed. As the Company increases its development and marketing activities, current expenses will increase and, if sales from previously released products are below expectations, net income is likely to be disproportionately affected.

Due to all of the foregoing, revenues and operating results for any future quarter are not predictable with any significant degree of accuracy. Accordingly, the Company believes that period-to-period comparisons of its operating results are not necessarily meaningful and should not be relied upon as indications of future performance.

The Company's business has experienced and is expected to continue to experience significant seasonality, in part due to consumer buying patterns. Net revenues typically are significantly higher during the fourth calendar quarter, due primarily to the increased demand for consumer software during the year-end holiday buying season. Net revenues in other quarters are generally lower and vary significantly as a result of new product introductions and other factors. For example, the Company's net revenues in its last five

quarters were \$21.6 million for the quarter ended March 31, 1996, \$7.0 million for the quarter ended June 30, 1996, \$19.2 million for the quarter ended September 30, 1996, \$31.4 million for the quarter ended

December 31, 1996 and \$28.9 million for the quarter ended March 31, 1997. The Company expects its net revenues and operating results to continue to reflect significant seasonality.

**DEPENDENCE ON NEW PRODUCT DEVELOPMENT; PRODUCT DELAYS.** The Company's future success depends on the timely introduction of successful new products to replace declining revenues from older products. If, for any reason, revenues from new products were to fail to replace declining revenues from older products, the Company's business, operating results and financial condition would be materially and adversely affected. In addition, the Company believes that the competitive factors in the interactive entertainment software marketplace create the need for higher quality, distinctive products that incorporate increasingly sophisticated effects and the need to support product releases with increased marketing, resulting in higher development, acquisition and marketing costs. The lack of market acceptance or significant delay in the introduction of, or the presence of a defect in, one or more products could have a material adverse effect on the Company's business, operating results and financial condition, particularly in view of the seasonality of the Company's business. Further, because a large portion of a product's revenue generally is associated with initial shipments, the delay of a product introduction expected near the end of a fiscal quarter may have a material adverse effect on operating results for that quarter.

The Company has, in the past, experienced significant delays in the introduction of certain new products. The timing and success of interactive entertainment products remain unpredictable due to the complexity of product development, including the uncertainty associated with technological developments. Although the Company has implemented substantial development controls, there likely will be delays in developing and introducing new products in the future. There can be no assurance that new products will be introduced on schedule, or at all, or that they will achieve market acceptance or generate significant revenues.

From time to time, the Company utilizes independent contractors for certain aspects of product development and production. The Company also has increased its acquisition of products developed entirely by independent third party developers. The Company has less control over the scheduling and the quality of work by independent contractors and third party developers than that of its own employees. A delay in the work performed by independent contractors and third party developers or a lack of quality in such work may result in product delays. Although the Company intends to continue to rely in part on internal product development, the Company's business and future operating results also will depend, in part, on the Company's continued ability to maintain relationships with skilled independent contractors and third party developers. There can be no assurance that the Company will be able to maintain such relationships.

**UNCERTAINTY OF MARKET ACCEPTANCE; SHORT PRODUCT LIFE CYCLES.** The market for entertainment systems and software has been characterized by shifts in consumer preferences and short product life cycles. Consumer preferences for entertainment software products are difficult to predict and few entertainment software products achieve sustained market acceptance. There can be no assurance that new products introduced by the Company will achieve any significant degree of market acceptance, that such acceptance will be sustained for any significant period, or that product life cycles will be sufficient to permit the Company to recoup development, marketing and other associated costs. In addition, if market acceptance is not achieved, the Company could be forced to accept substantial product returns to maintain its relationships with retailers and its access to distribution channels. Failure of new products to achieve or sustain market acceptance or product returns in excess of the Company's expectations would have a material adverse effect on the Company's business, operating results and financial condition.

**PRODUCT CONCENTRATION; DEPENDENCE ON HIT PRODUCTS.** A key aspect of the Company's strategy is to focus its development and acquisition efforts on selected, high quality entertainment software products. The Company derives a significant portion of its revenues from a select number of high quality entertainment software products released each year, and many of these products have substantial production or acquisition costs and marketing budgets. Due to this dependence on a limited number of products, the Company may be adversely effected if one or more principal entertainment software products fail to achieve anticipated results. During fiscal 1996 and 1997, one title accounted for approximately 49% and 23%, respectively, of the Company's consolidated net revenues. In addition, during fiscal 1997, one other title accounted for approximately 16% of the Company's consolidated net revenues.

The Company's strategy also includes as a key component developing and releasing products that have franchise value, such that sequels, enhancements and add-on products can be released over time, thereby extending the life of the property in the market. While the focus on franchise properties, if successful, results in extending product life cycles, it also results in the Company depending on a limited number of titles for its revenues. There can be no assurance

that the Company's existing franchise titles can continue to be exploited as successfully as in the past. In addition, new products that the Company believes will have potential value as franchise properties may not achieve market acceptance and therefore may not be a basis for future releases.



**INDUSTRY COMPETITION; COMPETITION FOR SHELF SPACE.** The interactive entertainment software industry is intensely competitive. Competition in the industry is principally based on product quality and features, the compatibility of products with popular platforms, company or product line brand name recognition, access to distribution channels, marketing effectiveness, reliability and ease of use, price and technical support. Significant financial resources also have become a competitive factor in the entertainment software industry, principally due to the substantial cost of product development and marketing that is required to support best-selling titles. In addition, competitors with broad product lines and popular titles typically have greater leverage with distributors and other customers who may be willing to promote titles with less consumer appeal in return for access to such competitor's most popular titles.

The Company's competitors range from small companies with limited resources to large companies with substantially greater financial, technical and marketing resources than those of the Company. The Company's competitors currently include Electronic Arts, Inc., Lucas Arts Entertainment Company, Microsoft Corporation ("Microsoft"), Sega, Nintendo, Sony, Sierra On-Line, Inc., Good Times Interactive, Inc. and Spectrum HoloByte, Inc., among many others.

As competition increases, significant price competition, increased production costs and reduced profit margins may result. Prolonged price competition or reduced demand would have a material adverse effect on the Company's business, operating results and financial condition. There can be no assurance that the Company will be able to compete successfully against current or future competitors or that competitive pressures faced by the Company will not have a material adverse effect on its business, operating results and financial condition.

Retailers typically have a limited amount of shelf space, and there is intense competition among entertainment software producers for adequate levels of shelf space and promotional support from retailers. As the number of entertainment software products increase, the competition for shelf space has intensified, resulting in greater leverage for retailers and distributors in negotiating terms of sale, including price discounts and product return policies. The Company's products constitute a relatively small percentage of a retailer's sales volume, and there can be no assurance that retailers will continue to purchase the Company's products or promote the Company's products with adequate levels of shelf space and promotional support.

**CHANGES IN TECHNOLOGY AND INDUSTRY STANDARDS.** The consumer software industry is undergoing rapid changes, including evolving industry standards, frequent new platform introductions and changes in consumer requirements and preferences. The introduction of new technologies, including operating systems such as Microsoft's Windows 95, technologies that support multi-player games, and new media formats such as on-line delivery and digital video disks ("DVD"), could render the Company's previously released products obsolete or unmarketable. The development cycle for products utilizing new operating systems, microprocessors or formats may be significantly longer than the Company's current development cycle for products on existing operating systems, microprocessors and formats and may require the Company to invest resources in products that may not become profitable. There can be no assurance that the mix of the Company's future product offerings will keep pace with technological changes or satisfy evolving consumer preferences, or that the Company will be successful in developing and marketing products for any future operating system or format. Failure to develop and introduce new products and product enhancements in a timely fashion could result in significant product returns and inventory obsolescence and could have a material adverse effect on the Company's business, operating results and financial condition.

**LIMITED PROTECTION OF INTELLECTUAL PROPERTY AND PROPRIETARY RIGHTS; RISK OF LITIGATION.** The Company holds copyrights on its products, manuals, advertising and other materials and maintains trademark rights in the Company name, the ACTIVISION logo, and the names of products owned by the Company. The Company regards its software as proprietary and relies primarily on a combination of trademark, copyright and trade secret laws, employee and third-party nondisclosure agreements, and other methods to protect its proprietary rights. Unauthorized copying is common within the software industry, and if a significant amount of unauthorized copying of the Company's products were to occur, the Company's business, operating results and financial condition could be adversely effected. There can be no assurance that third parties will not assert infringement claims against the Company in the future with respect to current or future products. As is common in the industry, from time to time the Company receives notices from third parties claiming infringement of intellectual property rights of such parties. The Company investigates these claims and responds as it deems appropriate. Any claims or litigation, with or without merit, could be costly and could result in a diversion of management's attention, which could have a material adverse effect on the Company's business, operating results and financial condition. Adverse determinations in such claims or litigation could also have a material adverse effect on the Company's

business, operating results and financial condition.

Policing unauthorized use of the Company's products is difficult, and while the Company is unable to determine the extent to which piracy of its software products exists, software piracy can be expected to be a persistent problem. In selling its products, the Company relies primarily on "shrink wrap" licenses that are

not signed by licensees and, therefore, may be unenforceable under the laws of certain jurisdictions. Further, the Company enters into transactions in countries where intellectual property laws are not well developed or are poorly enforced. Legal protections of the Company's rights may be ineffective in such countries.

**DEPENDENCE ON KEY PERSONNEL.** The Company's success depends to a significant extent on the performance and continued service of its senior management and certain key employees. Competition for highly skilled employees with technical, management, marketing, sales, product development and other specialized training is intense, and there can be no assurance that the Company will be successful in attracting and retaining such personnel. Specifically, the Company may experience increased costs in order to attract and retain skilled employees. Although the Company generally enters into term employment agreements with its skilled employees and other key personnel, there can be no assurance that such employees will not leave the Company or compete against the Company. The Company's failure to attract or retain qualified employees could have a material adverse effect on the Company's business, operating results and financial condition.

**DEPENDENCE ON DISTRIBUTORS; RISK OF CUSTOMER BUSINESS FAILURE; PRODUCT RETURNS.** Certain mass market retailers have established exclusive buying relationships under which such retailers will buy consumer software only from one intermediary. In such instances, the price or other terms on which the Company sells to such retailers may be adversely effected by the terms imposed by such intermediary, or the Company may be unable to sell to such retailers on terms which the Company deems acceptable. The loss of, or significant reduction in sales attributable to, any of the Company's principal distributors or retailers could materially adversely effect the Company's business, operating results and financial condition. Distributors and retailers in the computer industry have from time to time experienced significant fluctuations in their businesses and there have been a number of business failures among these entities. The insolvency or business failure of any significant distributor or retailer of the Company's products could have a material adverse effect on the Company's business, operating results and financial condition. Sales are typically made on credit, with terms that vary depending upon the customer and the nature of the product. The Company does not hold collateral to secure payment. Although the Company has obtained insolvency risk insurance to protect against any bankruptcy filings that may be made by its customers, such insurance contains a significant deductible as well as a co-payment obligation, and the policy does not cover all instances of non-payment. In addition, the Company maintains a reserve for uncollectible receivables that it believes to be adequate, but the actual reserve which is maintained may not be sufficient in every circumstance. As a result of the foregoing, a payment default by a significant customer could have a material adverse effect on the Company's business, operating results and financial condition.

The Company also is exposed to the risk of product returns from distributors and retailers. Although the Company provides reserves for returns that it believes are adequate, and although the Company's agreements with certain of its customers place certain limits on product returns, the Company could be forced to accept substantial product returns to maintain its relationships with retailers and its access to distribution channels. Product returns that exceed the Company's reserves could have a material adverse effect on the Company's business, operating results and financial condition.

**RISKS ASSOCIATED WITH INTERNATIONAL OPERATIONS.** International sales and licensing accounted for 28%, 23% and 26% of the Company's total revenues in the fiscal years 1995, 1996 and 1997, respectively. The Company intends to continue to expand its direct and indirect sales and marketing activities worldwide. Such expansion will require significant management time and attention and financial resources in order to develop adequate international sales and support channels. There can be no assurance, however, that the Company will be able to maintain or increase international market demand for its products. International sales are subject to inherent risks, including the impact of possible recessionary environments in economies outside the United States, the costs of transferring and localizing products for foreign markets, longer receivable collection periods and greater difficulty in accounts receivable collection, unexpected changes in regulatory requirements, difficulties and costs of staffing and managing foreign operations, and political and economic instability. There can be no assurance that the Company will be able to sustain or increase international revenues or that the foregoing factors will not have a material adverse effect on the Company's future international revenues and, consequently, on the Company's business, operating results and financial condition. The Company currently does not engage in currency hedging activities. Although exposure to currency fluctuations to date has been insignificant, there can be no assurance that fluctuations in currency exchange rates in the future will not have a material adverse impact on revenues from international sales and licensing and thus the Company's business, operating results and financial condition.

RISK OF SOFTWARE DEFECTS. Software products such as those offered by the Company frequently contain errors or defects. Despite extensive product testing, in the past the Company has released products with defects and has discovered software errors in certain of its product offerings after their introduction. In particular, the PC hardware environment is characterized by a wide variety of non-standard peripherals (such as sound cards and graphics cards) and configurations that make pre-release testing for programming or compatibility errors very difficult and time-consuming. There can be no assurance that, despite testing by

the Company, errors will not be found in new products or releases after commencement of commercial shipments, resulting in a loss of or delay in market acceptance, which could have a material adverse effect on the Company's business, operating results and financial condition.

## STRATEGY

The Company's objective is to be a worldwide leader in the development and delivery of exceptional and innovative interactive entertainment software designed for a range of platforms, appealing to existing and new audiences for entertainment software products, and incorporating sophisticated graphics, sound and video, and compelling story lines and game experiences. The Company's strategy includes the following elements:

**PUBLISH BEST-SELLING TITLES.** The Company believes that competitive factors in the interactive entertainment software marketplace create the need for very high quality, distinctive products that provide superior gaming experiences. Accordingly, the Company intends to focus its publishing efforts on a select number of major new titles each year. Several of these titles will be based on existing franchises, while others will be based on new concepts. The Company intends to support the development, production, acquisition and marketing of these titles with the resources necessary to create best selling products. In order to reduce the financial risks associated with the higher budgets required for this strategy, the Company may from time to time pre-sell various rights, including ancillary rights and rights with respect to hardware platforms which the Company does not intend to support itself, in selected geographical territories.

**LEVERAGE AND ENHANCE FRANCHISE PROPERTIES.** The Company seeks to develop and acquire distribution rights to product franchises that have sustainable consumer appeal and brand recognition. Through its long history in personal computer and video gaming, the Company has accumulated an extensive backlist of titles, some of which were best-sellers when originally released. The Company has converted certain of these popular titles into franchise product lines, including its ZORK, SHANGHAI and PITFALL series. For example, the Company has released six additional versions of ZORK since the introduction in 1982 of the original ZORK title, including RETURN TO ZORK, which has shipped over one million copies since its introduction in 1993, and the recently released ZORK NEMESIS. The Company intends to create additional franchises from its library and from new, original concepts.

**ENFORCE DISCIPLINED PRODUCT DEVELOPMENT AND PRODUCTION PROCESSES.** The Company has implemented product development and production processes that are designed to limit cost and schedule overruns within an environment that fosters creativity. Such processes often enable the Company to identify and address the majority of the technical and creative risks before the Company commences production of the title. The Company also has implemented a series of defined, measurable milestones throughout development and production in order to help increase its ability to maintain control over these processes. The Company develops and produces products using a studio model, in which a core group of creative, production, technical, marketing and financial professionals at the Company have overall responsibility for the entire development and production processes and for the supervision and coordination of internal and external resources. The Company believes that this studio model allows the Company to supplement internal expertise with top quality external resources on an as needed basis.

**ACQUIRE PUBLISHING RIGHTS TO ADDITIONAL PRODUCTS CREATED BY ESTABLISHED OUTSIDE DEVELOPERS.** In order to continue to grow its business and leverage its existing marketing and sales infrastructures, the Company has significantly increased its acquisition of publishing and distribution rights to entertainment software products that are developed and produced by independent third party developers. The Company's strategy is to develop relationships with a limited number of third party developers that have proven track records within the industry and that produce products in game genres in which the Company's studio may not have comparable expertise. For example, the Company has entered into a series of agreements with id Software, Inc., ("id") a premier developer of first-person perspective shooting games, pursuant to which the Company has been granted the right to publish id's products entitled QUAKE MISSION PACK NO. 1: SCOURGE OF ARMAGON, QUAKE MISSION PACK NO. 2: DISSOLUTION OF ETERNITY, HEXEN II and QUAKE II.

**FOCUS ON CD BASED SYSTEMS.** The Company seeks to capitalize on the popularity of platforms as they are adopted by consumers. The Company's current primary focus is on CD-based products to be used with MPCs and/or Sony PlayStation consoles. During the fiscal year ended March 31, 1997, approximately 80% of the Company's revenues were from CD-based products to be used with MPCs and approximately 20% of the Company's revenues were from Sony PlayStation products.

**DEVELOP AND UTILIZE PROPRIETARY TECHNOLOGIES.** The Company has developed proprietary development tools which enable its producers,

directors, artists and programmers to achieve visual and creative effects that differentiate the Company's products. For example, the Company's MECHWARRIOR 2 and MECHWARRIOR 2: MERCENARIES products utilized specialized real-time 3-D texture mapping and sophisticated artificial intelligence. ZORK NEMESIS utilized technology allowing for 360 degree movement within an

environment. All of these tools were developed by the Company's technology teams. The Company intends to continue to develop and utilize proprietary technologies to create products that provide innovative interactive experiences.

**EXPAND DISTRIBUTION CHANNELS.** The Company's strategy is to continue to expand its independent, direct distribution of its products. Through its internal sales force, the Company sells its software products directly to major computer and software retailing organizations, consumer electronic stores, discount warehouses and mail order companies in North America. For the fiscal year ended March 31, 1997, 75% of the Company's North America publishing revenues were direct to these retail organizations. The Company believes that a direct relationship with retail accounts results in more effective inventory management, merchandising and communications than would be possible through indirect relationships. The Company seeks to continue to increase the number of retail outlets reached directly through its sales force and also is enhancing its current distribution relationships by expanding real-time ordering and invoicing links to its major distribution partners. In addition, the Company intends to pursue further direct international sales and distribution activities.

## PRODUCTS

The Company is best known for its action, adventure and action/simulation products. However, the Company recently has expanded the line of products it distributes into new categories such as flight simulation, role playing and strategy products, and it expects to continue such expansion efforts.

The Company's platform strategy is to capitalize on the popularity of hardware platforms as they are adopted by consumers. Several of the Company's products are released in multiple formats for use on more than one MPC or console systems. The Company has developed interactive entertainment software for a variety of platforms since its founding in 1979. Throughout the 1980s, the Company developed over 100 titles for the Apple Macintosh, MS-DOS compatible, Amiga and Commodore platforms as well as the Atari 2600 and Sega and Nintendo 8-bit and 16-bit console systems. The majority of the Company's current titles are being developed for MPCs using the Windows 95 operating system. The majority of the Company's current console titles are being developed for the Sony PlayStation.

One of the Company's objectives is to create or acquire product franchises owned and controlled by the Company which have sustainable consumer appeal and brand recognition. The Company believes it has created or acquired certain product franchises by expanding upon the success of an original best selling title through the release of sequels, enhancements and add-on packs. The Company will attempt to create and acquire additional product franchises by introducing new titles based on original characters and concepts.

From time to time, the Company will selectively license from third parties intellectual property or other character or story rights for the purpose of developing titles based on such rights. For example, the Company recently obtained a long term license to be the exclusive developer and publisher of interactive entertainment software products based on the HEAVY GEAR role playing games created by an independent board game creator. Activision's HEAVY GEAR products are intended to replace the BATTLETECH/MECHWARRIOR 2 product line which was developed and published by the Company under license. In developing products based on licensed intellectual property rights, the Company generally seeks to capitalize on the name recognition, marketing efforts and goodwill associated with the underlying property.

The Company also selectively enters into arrangements with celebrities in order to enhance the gaming experience of certain of its products. For example, the Company currently is developing a product for the Sony PlayStation entitled APOCALYPSE, in which well-known film actor Bruce Willis is expected to act as the player's "virtual" partner in their battle against the Four Horsemen of the Apocalypse.

In addition to its own internally developed products, the Company publishes and distributes software products for other independent developers. As the Company seeks to associate the "ACTIVISION" mark only with the highest quality interactive entertainment products, the Company attempts to be selective in acquiring publishing and distribution rights from third party developers. All of such products are marketed under the Company's name as well as the name of the original developer. The Company believes that these efforts enable the Company to leverage its investment in its marketing and sales forces and add a new source of products without incurring all of the risks inherent in original product development and production. This activity also allows the Company to enter new product genres and provide consumers with a wider variety of products.

## PRODUCT DEVELOPMENT AND ACQUISITION

### ACTIVISION STUDIOS

Activision Studios, the Company's development and production group, generally is responsible for the selection, design, development and production of the interactive entertainment software products owned by the Company. Activision Studios also provides quality assurance and customer support services for almost all products published or distributed by the Company. The Company's creative development and production staff selects and develops new products, adapts existing products for additional hardware platforms and manages the external development of products or their components by independent contractors.

**PRODUCTION.** The Company develops and produces products using a studio model, in which a core group of creative, production, technical, marketing and financial professionals on staff at the Company have overall responsibility for the entire development and production process and for the supervision and coordination of internal and external resources. Each project team, which is led by a game producer and game director and includes one or more associate producers, game designers, production coordinators, a creative executive, a technology executive and a quality assurance manager, all of whom are on the Company's staff, assembles the necessary creative elements, using where appropriate outside programmers, graphic and other artists, animators, musicians and songwriters, sound effects and special effects experts, and sound and video studios. The Company believes that this model allows the Company to supplement internal expertise with top quality external resources on an as needed basis.

The Company has adopted and implemented a rigorous internal procedure for the selection, development, production and quality assurance of its entertainment software titles. The process involves one or more pre-development phases, development phases and production phases, each of which includes various measurable performance milestones. This procedure is designed to enable the Company to manage and control production and development budgets and timetables, to identify and address production and technical issues at the earliest opportunity, and to coordinate marketing and quality control strategies throughout the production and development phases, all in an environment that fosters creativity. Checks and balances are intended to be provided through the structured interaction of the project team with the Company's creative, technical, marketing and quality assurance/customer support personnel, as well as the legal, accounting and finance departments.

**QUALITY ASSURANCE AND CUSTOMER SUPPORT.** The Company's quality assurance personnel are involved throughout the development and production processes for each title, and products are subjected to extensive testing before release. To support its products after release, the Company provides on-line support on a 24-hour basis and operator help lines during regular business hours. The customer support group tracks customer inquiries and this data is used to improve the development and production processes.

### ACTIVISION BUSINESS DEVELOPMENT

The Company's Business Development division licenses or acquires software products from independent developers for publishing or distribution by the Company. Acquired titles are marketed under the Company's name as well as the name of the original developer. The agreements with affiliated developers provide for the grant to the Company of exclusive publishing and distribution rights for a specific period of time for specified platforms and territories.

The Company acquires titles from affiliated developers during various phases of the development and production processes for such titles. To the extent the Company acquires rights early in the development process, the Company generally will cause the independent developer to comply with the requirements of the pre-development, development and production processes applicable to titles internally produced by Activision Studios. The Business Development division will assign to a title a game producer who will serve as the principal liaison to the independent developer to help insure that performance milestones are met timely. The Company generally has the right to cease making payments to an independent developer if such developer fails to timely complete its performance milestones.

In connection with its acquisition of product publishing and distribution, the Company may make an investment and hold a minority equity interest in the third party developer in order to create a closer relationship between the Company and the developer. In fiscal 1997, the Company acquired a minority interest in Titanic Entertainment, Inc. in connection with the acquisition by the Company of the entertainment software product entitled NETSTORM, which currently is being developed by Titanic. There can be no assurance that the Company will realize long term benefits from this investment or that it will continue to carry such investment at its current value.





## PUBLISHING ACTIVITIES

### MARKETING

The Company's marketing efforts include on-line activities (such as the creation of World Wide Web pages to promote specific Company titles), public relations, print and broadcast advertising, coordinated in-store and industry promotions including merchandising and point of purchase displays, participation in cooperative advertising programs, direct response vehicles, and product sampling through demonstration software distributed through the Internet or on compact discs. In addition, the Company's recent products contain software that enables customers to "electronically register" their purchases with the Company via modem. Through this process, the Company captures electronic mail addresses for its customers as well as a variety of additional market research data. The Company intends to increase its on-line marketing activities using these electronic mail addresses for direct response promotions, and making its titles and upgrades available for sale through on-line services when appropriate.

The Company believes that certain of its franchise properties (such as the ZORK series) have loyal and devoted audiences who purchase the Company's sequels as a result of dedication to the property and satisfaction from previous product purchases. Marketing of these sequels is therefore directed both toward the established market as well as broader audiences. In marketing titles based on licensed properties, the Company believes that it derives marketing synergies and related benefits from the marketing and promotional activities of the property owners. In marketing affiliated label titles, the Company believes that it derives marketing synergies and related benefits from the previously established reputation of the independent developer and the properties owned by it.

### SALES AND DISTRIBUTION

**DOMESTIC SALES AND DISTRIBUTION.** The Company's products are domestically available for sale or rental in thousands of retail outlets ranging from consumer electronics and computer specialty stores to department stores, discount chains, video rental stores and toy stores. The Company's customers in these categories include Best Buy, CompUSA, Computer City, Electronic Boutique, Babbages, etc., WalMart, K-Mart, Target and Toys "R" Us. During fiscal 1997, no single customer accounted for more than 10% of consolidated net revenues. The majority of the Company's North American sales are made directly to the retailers. The Company believes that a direct relationship with retail accounts results in more effective inventory management, merchandising and communications than would be possible through indirect relationships. The Company has implemented electronic data interchange ("EDI") linkage with several retailers to facilitate the placing and shipment of orders. The Company seeks to continue to increase the number of retail outlets reached directly through its internal sales force. To a lesser extent, the Company sells its products through wholesale distributors, such as Ingram Micro, Handelman and Merisel.

**INTERNATIONAL SALES AND DISTRIBUTION.** The Company conducts a substantial portion of its international sales, licensing and distribution activities through its offices in Japan, England and Australia. At present, the Company's office in Australia handles the Company's distribution and marketing efforts in Australia, New Zealand, Singapore, and certain other Asian and South Pacific Rim markets. Through its office in Japan, the Company facilitates the licensing and distribution of its products in the Japanese and certain other Asian markets. The licensing and distribution of the Company's products in Europe is performed through the Company's London office. The Company recently established a sales office in Miami to oversee the Company's distribution and marketing efforts in Latin America. The Company seeks to broaden the distribution of its products in international markets by translating and localizing certain of its products into foreign languages. The Company currently intends to increase its staff in Europe in order to increase the percentage of its European sales that can be made directly to retailers. In furtherance of these objectives, the Company recently acquired Take Us! Marketing & Consulting GmbH, an eight-person company located in Germany which specializes in marketing and translation activities for German-speaking territories. The Company also currently intends to increase its staff in Japan so that new titles can be developed and published directly by the Company for the Japanese market. To this end, the Company may seek new development partners in Japan.

**OEM SALES AND DISTRIBUTION.** The Company seeks to enhance the distribution of its products through licensing arrangements with original equipment manufacturers ("OEM"s). Under these arrangements, one or more of the Company's titles are "bundled" with hardware or peripheral devices sold and distributed by the OEM so that the purchaser of the hardware or device obtains the Company's software as part of the purchase or on a discounted basis. Although it is customary for the Company to receive a lower per unit price on sales through OEM bundle arrangements, the OEM customer makes a high unit

volume commitment to the Company and there are no associated marketing costs. In addition, the Company from time to time receives substantial advance payments from the OEM customer. The Company also believes that such arrangements can substantially expand the distribution of its titles to a broader audience. Recent OEM partners include Microsoft, IBM, Sony, Apple, NEC and Toshiba.

## LICENSING AND MERCHANDISING

The Company believes that a number of its products have the potential to be exploited in ancillary markets and media, such as product merchandising and traditional entertainment media. Directly and through third party agents, the Company seeks opportunities for the exploitation of these ancillary rights. Potential opportunities include the publication of strategy guides for selected titles, the adaptation of titles into comic books, novels, television or motion pictures, and the licensing of product merchandising rights. The Company believes that these types of licensing activities can provide additional sources of revenue and increase the visibility of the title, thereby leading to additional unit sales and greater potential for additional sequels. There can be no assurance that the Company will be successful in exploiting its properties in ancillary markets or media.

Similarly, the Company believes that there are opportunities for further exploitation of its titles through the Internet, on-line services such as America Online and the Microsoft Network, and through recently created on-line gaming services such as TEN, Dwango, and MPath. The Company has established "900" telephone numbers as hint lines for certain of its titles, and has realized revenues from the calls made to these numbers. The Company also is actively exploring the establishment of on-line game playing opportunities, on-line hint sites, and Internet services as a method for realizing additional revenues from its products. There can be no assurance that the Company will be successful in exploiting these opportunities.

## HARDWARE LICENSES

The Company's console products currently are being developed or published for one or more systems owned by Sony or Sega. Each of the console systems owned by these companies has unique and proprietary configurations. In order to gain access to the console systems that the Company currently is supporting, the Company has obtained licenses for each of the PlayStation, Genesis, Sega CD, Saturn and SNES systems. Each license allows the Company to create one or more products for the applicable system, subject to certain approval rights as to quality which are reserved by each licensor. Each license also requires that the Company pay the licensor a per unit license fee from product sales.

In contrast, the Company currently is not required to obtain any license for the development and production of PC products. Accordingly, the Company's per unit manufacturing cost for PC products is less than the per unit manufacturing cost for console products.

## MANUFACTURING

The Company prepares a set of master program copies, documentation and packaging materials for its products for each respective hardware platform on which the product will be released. Except with respect to products for use on the Sony, Sega and Nintendo systems, the Company's disk duplication, packaging, printing, manufacturing, warehousing, assembly and shipping are performed by third party subcontractors.

In the case of products for the Sony, Sega and Nintendo systems, in order to maintain protection over their hardware technologies, such hardware producers generally specify and/or control the manufacturing and assembly of finished products. The Company delivers the master materials to the licensor or its approved replicator which then manufactures finished goods and delivers them to the Company for distribution under the Company's label. At the time the Company's product unit orders are filled by the manufacturer, the Company becomes responsible for the costs of manufacturing and the applicable per unit royalty on such units, even if the units do not ultimately sell.

To date, the Company has not experienced any material difficulties or delays in the manufacture and assembly of its products or material returns due to product defects.

## EMPLOYEES

As of March 31, 1997, the Company had 366 employees, including 227 in Activision Studios and business development, 53 in North American sales and marketing, 53 in finance, operations and administration, and 33 in its offices in Japan, the United Kingdom and Australia.

As of March 31, 1997, 98 of the Company's full-time employees were subject to term employment agreements with the Company. These agreements commit such employees to employment terms of between one and three years from the commencement of their respective agreements. Most of the employees subject to such agreements are senior executives of the Company or members of Activision Studios or the Company's business development, sales or marketing divisions, and such individuals perform services to the Company as executives, directors, producers, associate producers, computer programmers, game designers,



sales directors and marketing product managers. The execution by the Company of employment agreements with such employees, in the Company's experience, significantly reduces the Company's turnover during the development and production of its entertainment software products and allows the Company to plan more effectively for future development activities.

None of the Company's employees are subject to a collective bargaining agreement, and the Company has experienced no labor-related work stoppages.

(d) FINANCIAL INFORMATION ABOUT FOREIGN AND DOMESTIC OPERATIONS AND EXPORT SALES

See Item 7 "Management's Discussion and Analysis of Financial Condition and Results of Operations" and Note 5 of Notes to Consolidated Financial Statements included in Item 8.

Item 2. PROPERTIES

The Company's principal corporate, administrative, and product development offices are located in approximately 98,000 square feet of leased space in a building located at 3100 Ocean Park Boulevard, Santa Monica, California 90405. The lease in Santa Monica commenced on May 1, 1997. Prior to such date, the Company's principal corporate, administrative and product development offices were located in approximately 57,000 square feet of leased space located in Los Angeles, California. The following is a listing of the principal offices maintained by the Company at May 1, 1997:

| Location of<br>Principal Facilities | Square Feet | Lease Expiration Date |
|-------------------------------------|-------------|-----------------------|
| -----                               | -----       | -----                 |
| Santa Monica, California            | 98,000      | April 30, 2007        |
| London, United Kingdom              | 10,625      | July 23, 2005         |
| Tokyo, Japan                        | 450         | July 31, 1997         |
| Sydney, Australia                   | 400         | Month-to-Month        |

Item 3. LEGAL PROCEEDINGS

The Company is party to routine claims and suits brought against it in the ordinary course of business including disputes arising over the ownership of intellectual property rights and collection matters. In the opinion of management, the outcome of such routine claims will not have a material adverse effect on the Company's business, financial condition, results of operations or liquidity.

Item 4. SUBMISSION OF MATTERS TO A VOTE OF SECURITY HOLDERS

Not applicable.

## PART II

### Item 5. MARKET FOR REGISTRANT'S COMMON EQUITY AND RELATED STOCKHOLDER MATTERS

The Company's Common Stock is quoted on the NASDAQ National Market under the symbol "ATVI."

The following table sets forth for the periods indicated the high and low reported closing sale prices for the Company's Common Stock.

|   | High<br>----- | Low<br>----- |
|---|---------------|--------------|
| <b>Fiscal 1996</b><br>-----             |               |              |
| First Quarter ended June 30, 1995       | \$ 7.18       | \$ 5.75      |
| Second Quarter ended September 30, 1995 | \$19.75       | \$ 6.75      |
| Third Quarter ended December 31, 1995   | \$18.50       | \$ 8.13      |
| Fourth Quarter ended March 31, 1996     | \$15.13       | \$ 8.63      |
| <b>Fiscal 1997</b><br>-----             |               |              |
| First Quarter ended June 30, 1996       | \$15.00       | \$ 11.63     |
| Second Quarter ended September 30, 1996 | \$14.38       | \$ 9.50      |
| Third Quarter ended December 31, 1996   | \$14.00       | \$ 10.56     |
| Fourth Quarter ended March 31, 1997     | \$16.25       | \$ 10.00     |
| <b>Fiscal 1998</b><br>-----             |               |              |
| First Quarter through June 10, 1997     | \$14.50       | \$ 10.25     |

On June 10, 1997, the reported last sales price for the Common Stock was \$13.875. As of March 31, 1997, the Company had approximately 5,000 stockholders of record, excluding banks, brokers and depository companies that are the stockholders of record for the account of beneficial owners.

The Company has never paid cash dividends on its capital stock and does not intend to pay cash dividends at any time in the foreseeable future. The Company expects that earnings will be retained for the continued growth and development of the Company's business. Future dividends, if any, will depend upon the Company's earnings, financial condition, cash requirements, future prospects and other factors deemed relevant by the Company's Board of Directors.

During the period from December 11, 1995 to December 14, 1995, the Company purchased in open market transactions 500,000 of its shares of common stock, at prices ranging from \$10.25 to \$10.875, aggregating approximately \$5.3 million. These purchases were made pursuant to the Company's announced share repurchase program. The company may from time to time in the future make additional open market purchases of its common stock.

During the fiscal year ended March 31, 1997, the Company granted warrants to purchase Common Stock to two of its outside directors in connection with their election to the Board. Neither these warrants nor the shares of Common Stock for which they are exercisable have been registered under the Securities Act of 1933, as amended (the "Securities Act"), by reason of the exemption under Section 4(2) of the Act. On November 1, 1996, the Company granted warrants to purchase 16,667 shares to Harold Brown. The warrants have an exercise price of \$12.25 per share and become exercisable at the rate of 25% on November 1, 1997 and 12.5% each six months thereafter. The Company granted Mr. Brown warrants to purchase an additional 3,333 shares on February 27, 1997, which warrants have an exercise price of \$11.80 per share and become exercisable at the rate of 20% per year, beginning on February 27, 1998. On February 27, 1997, the Company granted to Robert Morgado warrants to purchase 20,000 shares of Common Stock. Warrants to purchase 16,667 of the shares have an exercise price of \$13.88 per share and become exercisable at the rate of 25% on February 27, 1998 and 12.5% each six months thereafter; the warrants to purchase the remaining 3,333 shares have an exercise price of \$11.80 per share and become exercisable at the rate of 20% per year, beginning on February 27, 1998. All of the warrants granted to Messrs. Brown and Morgado expire ten years after the date of grant.





Item 6. SELECTED CONSOLIDATED FINANCIAL DATA

The following table summarizes certain selected consolidated financial data, which should be read in conjunction with the Company's Consolidated Financial Statements and Notes thereto and with Management's Discussion and Analysis of Financial Condition and Results of Operations included elsewhere herein. The selected consolidated financial data presented below as of and for each of the fiscal years in the five-year period ended March 31, 1997 are derived from the audited consolidated financial statements of the Company. The Consolidated Financial Statements as of March 31, 1997 and 1996 and for each of the fiscal years in the three-year period ended March 31, 1997, and the reports thereon, are included elsewhere in this Form 10-K.

(IN THOUSANDS, EXCEPT PER SHARE DATA, RATIOS AND EMPLOYEE DATA)

|  | Fiscal Years ended March 31, |          |          |          |          |
|--|------------------------------|----------|----------|----------|----------|
|  | 1997                         | 1996     | 1995     | 1994     | 1993     |
|  | -----                        | -----    | -----    | -----    | -----    |
| STATEMENT OF OPERATIONS DATA:  |                              |          |          |          |          |
| Net revenues   | \$86,483                     | \$61,393 | \$40,669 | \$26,604 | \$21,069 |
| Gross profit   | 56,661                       | 39,644   | 19,376   | 11,293   | 9,535    |
| Operating income (loss)  | 9,807                        | 2,532    | (2,957)  | (2,031)  | (208)    |
| Income (loss) before provision for income taxes  | 10,731                       | 4,239    | (1,365)  | (1,853)  | (217)    |
| Net income (loss) from continuing operations   | 7,107                        | 5,530    | (1,520)  | (1,987)  | (279)    |
| Loss from discontinued operations  | -                            | -        | -        | -        | (1,100)  |
| Net income (loss)  | 7,107                        | 5,530    | (1,520)  | (1,987)  | (1,379)  |
| Accumulated, unpaid preferred dividends  | -                            | -        | -        | (3,296)  | (3,163)  |
| Net income (loss) per common share from continuing operations (1)                          | \$0.49                       | \$0.37   | \$(0.11) | \$(0.97) | \$(1.01) |
| Net income (loss) per common share (1)   | 0.49                         | 0.37     | (0.11)   | (0.97)   | (1.33)   |
| Weighted average number of shares used in computing net income (loss) per common share (1) | 14,619                       | 14,950   | 13,944   | 5,432    | 3,412    |
| OTHER OPERATING DATA:  |                              |          |          |          |          |
| Average number of employees  | 342                          | 234      | 93       | 62       | 60       |
| Net revenues per employee (in thousands)   | \$253                        | \$262    | \$437    | \$429    | \$351    |
|  | As of March 31,              |          |          |          |          |
|  | 1997                         | 1996     | 1995     | 1994     | 1993     |
|  | ----                         | ----     | ----     | ----     | ----     |
| BALANCE SHEET DATA:  |                              |          |          |          |          |
| Cash and cash equivalents  | \$ 17,639                    | \$25,288 | \$37,355 | \$38,093 | \$1,851  |
| Working capital  | 52,938                       | 40,227   | 40,648   | 41,218   | 5,261    |
| Intangible assets  | 18,313                       | 19,580   | 20,863   | 22,146   | 23,429   |
| Total assets   | 95,670                       | 77,613   | 68,883   | 68,677   | 34,580   |
| Redeemable preferred stock (2)   | -                            | -        | -        | -        | 25,200   |
| Preferred shareholders' equity (3)   | -                            | -        | -        | -        | 4,603    |
| Common shareholders' equity  | 80,808                       | 62,999   | 62,704   | 63,985   | (792)    |

(1) Reflects the Company's 1-for-3 reverse stock split effective October 20, 1993. Accordingly, previously reported net income (loss) per share and common share amount have been retroactively restated.

(2) Does not include accrued dividends of \$3,163 as of March 31, 1993.

(3) Represents \$5,000 of gross proceeds received from the sale of Series AA Preferred Stock, less offering expenses and the amount allocated to warrants sold at the time.

Item 7. MANAGEMENT'S DISCUSSION AND ANALYSIS OF FINANCIAL CONDITION AND RESULTS OF OPERATIONS

RESULTS OF OPERATIONS - FISCAL YEARS ENDED MARCH 31, 1997 AND 1996

NET REVENUES

Net revenues by territory were as follows (amounts in thousands):

|                           | Fiscal Years Ended March 31, |                   |          |                   |          |
|---------------------------|------------------------------|-------------------|----------|-------------------|----------|
|                           | 1997                         |                   | 1996     |                   | % Change |
|                           | Amount                       | % of Net Revenues | Amount   | % of Net Revenues |          |
| North America             | \$65,049                     | 75.2%             | \$47,176 | 76.8%             | 38.0%    |
| Europe                    | 12,211                       | 14.1%             | 6,501    | 10.6%             | 87.8%    |
| Japan                     | 4,504                        | 5.2%              | 4,768    | 7.8%              | -5.5%    |
| Australia and Pacific Rim | 4,719                        | 5.5%              | 2,948    | 4.8%              | 60.1%    |
|                           | \$86,483                     | 100.0%            | \$61,393 | 100.0%            | 40.9%    |

Net revenues by platform were as follows (amounts in thousands):

|         | Fiscal Years Ended March 31, |                   |          |                   |          |
|---------|------------------------------|-------------------|----------|-------------------|----------|
|         | 1997                         |                   | 1996     |                   | % Change |
|         | Amount                       | % of Net Revenues | Amount   | % of Net Revenues |          |
| Console | \$17,367                     | 20.1%             | \$5,161  | 8.4%              | 236.5%   |
| PC      | 69,116                       | 79.9%             | 56,232   | 91.6%             | 22.9%    |
|         | \$86,483                     | 100.0%            | \$61,393 | 100.0%            | 40.9%    |

Net revenues by distribution channel were as follows (amounts in thousands):

|                              | Fiscal Years Ended March 31, |                   |          |                   |          |
|------------------------------|------------------------------|-------------------|----------|-------------------|----------|
|                              | 1997                         |                   | 1996     |                   | % Change |
|                              | Amount                       | % of Net Revenues | Amount   | % of Net Revenues |          |
| Retailer/reseller            | \$68,478                     | 79.2%             | \$46,192 | 75.2%             | 48.2%    |
| OEM                          | 13,935                       | 16.1%             | 10,728   | 17.5%             | 29.9%    |
| On-line, licensing and other | 4,070                        | 4.7%              | 4,473    | 7.3%              | -9.0%    |
|                              | \$86,483                     | 100.0%            | \$61,393 | 100.0%            | 40.9%    |

Total net revenues and retailer/reseller net revenues for the fiscal year ended March 31, 1997 increased 40.9% and 48.2%, respectively, over the prior year, primarily as a result of an increase in the number of new console and PC title releases. Console net revenues increased 236.5% over the prior year as a result of the initial release of BLOOD OMEN: LEGACY OF KAIN (PlayStation), MECHWARRIOR 2 (PlayStation and Saturn), POWER MOVE PRO WRESTLING (PlayStation) and TIME COMMANDO (PlayStation). PC net revenues increased by 22.9% over the prior year primarily as a result of the initial release of MECHWARRIOR 2: MERCENARIES (Windows 95), INTERSTATE 76 (Windows 95), TIME COMMANDO (Windows 95), QUAKE MISSION PACK NO. 1: SCOURGE OF ARMAGON (MS-DOS/Windows 95), QUAKE MISSION PACK NO. 2: DISSOLUTION OF ETERNITY (MS-DOS/Windows 95) and continued sales of MECHWARRIOR 2 (Windows 95/Macintosh).

OEM net revenues increased 29.9% over the prior year primarily due to revenues related to enhanced 3-D versions of MECHWARRIOR 2 (Windows 95) and MECHWARRIOR 2: MERCENARIES (Windows 95/D3D). OEM net revenues also included net revenues from INTERSTATE '76 (Windows 95), TIME COMMANDO (Windows 95) and DVD versions of SPYCRAFT (Windows 95) and MUPPET TREASURE ISLAND (Windows 95).

North America, Europe and Australia net revenues increased as a result of the increase in PC and console revenues discussed above. The Company expects revenues in each of these territories to increase in fiscal 1998, but at a more moderate rate than fiscal 1997 growth. Japan net revenues decreased primarily due to a decrease in licensing net revenues, which was partially offset by an increase in direct publishing net revenues. The Company expects Japan revenues to increase in fiscal 1998 due to an increase in the number of products to be localized for this territory.

#### COST OF GOODS SOLD; GROSS PROFIT

Cost of goods sold related to console, PC and OEM net revenues represents the manufacturing and related costs of computer software and console games. Manufacturers of the Company's computer software are located in the United States and Europe and are readily available. Console CDs and cartridges are manufactured by the respective video game console manufacturers, Sony, Sega and Nintendo, who often require significant lead time to fulfill the Company's orders. Also included in cost of goods sold is the royalty expense related to amounts due developers, product owners and other royalty participants as a result of product sales. Various contracts are maintained with developers, product owners or other royalty participants which state a royalty rate, territory and term of agreement, among other items.

Cost of goods sold as a percentage of net revenues decreased to 34.5% for the fiscal year ended March 31, 1997 compared to 35.4% for fiscal 1996. As a result, gross profit as a percentage of net revenues increased to 65.5% for the fiscal year ended March 31, 1997, from 64.6% for fiscal 1996. The increase in gross profit as a percentage of net revenues is the result of increased efficiencies in the manufacturing and distribution processes, partially offset by an increase in net revenues attributable to console products. Future determinations of gross profit as a percentage of net revenues will be driven primarily by the mix of new PC and console products released by the Company during the applicable period, as well as the mix of internal versus external product development, the latter in each case resulting in lower gross profit margins.

#### OPERATING EXPENSES

| (Amounts in thousands)            |          |                   |          |                   |          |
|-----------------------------------|----------|-------------------|----------|-------------------|----------|
| Fiscal Years Ended March 31,      |          |                   |          |                   |          |
|                                   | 1997     |                   | 1996     |                   |          |
|                                   | Amount   | % of Net Revenues | Amount   | % of Net Revenues | % Change |
| Product development               | \$18,195 | 21.0%             | \$17,505 | 28.5%             | 3.9%     |
| Sales and marketing               | 22,351   | 25.9%             | 13,920   | 22.7%             | 60.6%    |
| General and administrative        | 5,041    | 5.8%              | 4,404    | 7.2%              | 14.4%    |
| Amortization of intangible assets | 1,267    | 1.5%              | 1,283    | 2.1%              | -1.2%    |
| Total operating expenses          | \$46,854 | 54.2%             | \$37,112 | 60.5%             | 26.3%    |

Total operating expenses for the 1997 fiscal year decreased as a percentage of net revenues from the prior fiscal year as a result of the Company's ability to increase net revenues without incurring comparable increases in product development and general and administrative expenses. This decrease was partially offset, however, by an increase in sales and marketing expenses as a percentage of net revenues. Product development expenses in fiscal 1997 increased 3.9% from fiscal 1996 due to the continued growth of Activision Studios, the increased number of new products in development, and the increased costs associated with the enhanced production content and new technologies incorporated into such products. The impact of these increases, however, was partially offset by a decrease in the number of products in development that contain live action video, which generally have higher production costs. In addition, operating expenses as a percentage of net revenues decreased due in part to the change in mix of internally developed and externally developed products. The costs of internal product development are generally expensed as incurred prior to the product's release and are therefore reflected in operating expenses; the costs of acquired products are generally amortized against product unit sales or revenues following the release of the product and are identified as royalty expenses and are included in the cost of goods sold. During the 1997 fiscal year, products developed internally by Activision Studios accounted for a smaller portion of the overall number of new products released by the Company as compared to the 1996 fiscal year.

Sales and marketing costs in fiscal 1997 increased in amount and as a percentage of net revenues from fiscal 1996 due to increased marketing and promotional activities necessary to release new titles in an increasingly competitive environment and the Company's expansion of its European and Japanese

sales and marketing infrastructures. General and administrative expenses increased 14.4% during the 1997 fiscal year due to an increase in worldwide administrative support needs and headcount related expenses.

## OTHER INCOME (EXPENSE)

Interest income decreased to \$924,000 for the fiscal year ended March 31, 1997, from \$1,707,000 for the fiscal year ended March 31, 1996, as a result of lower average cash and cash equivalent balances. See "Liquidity and Capital Resources."

## PROVISION FOR INCOME TAXES

The Company's effective tax rate was 33.8% for the fiscal year ended March 31, 1997. During the fiscal year ended March 31, 1996, the Company recognized a tax benefit of \$1.5 million due to a reduction in the Company's deferred tax asset valuation allowance. The reduction reflected the remaining portion of the Company's net operating loss carryforwards, the benefit from which could be recognized in the Company's provision for income taxes. During the fiscal year ended March 31, 1997, the Company recognized an additional \$6.6 million reduction to the Company's deferred tax asset valuation allowance, relating to net operating loss carryforwards arising prior to the Company's reorganization, which were credited to additional paid-in capital in shareholders' equity and did not affect net income. The reductions in the valuation allowance during the years ended March 31, 1997 and 1996 resulted principally from the Company's assessment of the realizability of its deferred tax assets, based on recent operating history, as well as an assessment that operations will continue to generate taxable income. Realization of the deferred tax assets depends on the continued generation of sufficient taxable income prior to expiration of tax credits and loss carryforwards. Although realization is not assured, management believes it is more likely than not that the deferred tax asset of \$5.7 million will be realized. The amount of deferred tax assets considered realizable, however, could be reduced in the future if estimates of future taxable income during the carryforward period are reduced. The provision for income taxes for the year ended March 31, 1995 represents foreign taxes withheld.

## RESULTS OF OPERATIONS - FISCAL YEARS ENDED MARCH 31, 1996 AND 1995

### NET REVENUES

Net revenues by territory were as follows (amounts in thousands):

|                           | Fiscal Years Ended March 31, |                   |          |                   |          |
|---------------------------|------------------------------|-------------------|----------|-------------------|----------|
|                           | 1996                         |                   | 1995     |                   | % Change |
|                           | Amount                       | % of Net Revenues | Amount   | % of Net Revenues |          |
| North America             | \$47,176                     | 76.8%             | \$29,492 | 72.5%             | 60.0%    |
| Europe                    | 6,501                        | 10.6%             | 7,574    | 18.6%             | -14.2%   |
| Japan                     | 4,768                        | 7.8%              | 2,194    | 5.4%              | 117.3%   |
| Australia and Pacific Rim | 2,948                        | 4.8%              | 1,409    | 3.5%              | 109.2%   |
|                           | \$61,393                     | 100.0%            | \$40,669 | 100.0%            | 51.0%    |

Net revenues by platform were as follows (amounts in thousands):

|         | Fiscal Years Ended March 31, |                   |          |                   |          |
|---------|------------------------------|-------------------|----------|-------------------|----------|
|         | 1996                         |                   | 1995     |                   | % Change |
|         | Amount                       | % of Net Revenues | Amount   | % of Net Revenues |          |
| Console | \$ 5,161                     | 8.4%              | \$26,069 | 64.1%             | -80.2%   |
| PC      | 56,232                       | 91.6%             | 14,600   | 35.9%             | 285.2%   |
|         | \$ 61,393                    | 100.0%            | \$40,669 | 100.0%            | 51.0%    |

Net revenues by distribution channel were as follows (amounts in thousands):

|                              | Fiscal Years Ended March 31, |                   |           |                   |          |
|------------------------------|------------------------------|-------------------|-----------|-------------------|----------|
|                              | 1996                         |                   | 1995      |                   | % Change |
|                              | Amount                       | % of Net Revenues | Amount    | % of Net Revenues |          |
| Retailer/reseller            | \$ 46,192                    | 75.2%             | \$ 34,706 | 85.3%             | 33.1%    |
| OEM                          | 10,728                       | 17.5%             | 2,637     | 6.5%              | 306.8%   |
| On-line, licensing and other | 4,473                        | 7.3%              | 3,326     | 8.2%              | 34.5%    |
|                              | \$ 61,393                    | 100.0%            | \$ 40,669 | 100.0%            | 51.0%    |

Net revenues for the fiscal year ended March 31, 1996 increased by 51% over the prior year, primarily as a result of an increase in the release of new PC titles. PC net revenues increased by 285% over the prior year as a result of the initial release of MECHWARRIOR 2 (MS-DOS and Windows 95), MECHWARRIOR 2 EXPANSION PACK: GHOST BEAR'S LEGACY (MS-DOS), ZORK NEMESIS (MS-DOS/Windows 95), SPYCRAFT: THE GREAT GAME (MS-DOS/Windows 95 and Macintosh), PITFALL: THE MAYAN ADVENTURE (Windows 95), EARTHWORM JIM (Windows 95) and five MIGHTY MORPHIN POWER RANGER titles (MS-DOS and Mac). The decrease in console net revenues during the fiscal year was due to the Company's strategic change in its business emphasis from cartridge-based console systems to CD-based PC and console systems.

On-line, OEM, licensing and other revenues increased over the prior year due to the Company's increased commitment to generating additional OEM revenues and the availability of several additional titles for the OEM market. OEM and licensing revenues during the 1996 fiscal year primarily were derived from sales and licenses of MECHWARRIOR 2 (MS-DOS, Windows 95 and an enhanced 3-D ATI version), EARTHWORM JIM (Windows 95), PITFALL: THE MAYAN ADVENTURE (Windows 95) and SHANGHAI: GREAT MOMENTS (MS-DOS and Windows 95).

North America, Japan and Australia net revenues increased as a result of the increase in PC, OEM and licensing revenues discussed above. The decrease in Europe net revenues was attributable to a change from the publishing by the Company of its products under an exclusive guaranteed distribution agreement in fiscal 1995 to the publishing by the Company of its products directly to retailers and resellers in fiscal 1996, combined with the change of the Company's business emphasis from cartridge-based console systems to CD-based PC systems.

#### COST OF GOODS SOLD

Cost of goods sold related to console, PC and OEM revenues represents the manufacturing and related costs of computer software and video games. Manufacturers of the Company's computer software are located in the United States and Europe and are readily available. Console cartridges and CDs are manufactured by the respective video game console manufacturers, Sony, Nintendo and Sega, who require significant lead time to fulfill the Company's orders.

Also included in cost of goods sold is royalty expense related to amounts due to developers, title owners or other royalty participants based on product sales. Various contracts are maintained with developers, product title owners or other royalty participants which state a royalty rate, territory and term of agreement, among other items. The increase in total cost of goods sold is related to the increase in PC and OEM net revenues.

#### GROSS PROFIT

Gross profit as a percentage of net revenues increased to 64.6% for the fiscal year ended March 31, 1996, from 47.6% for fiscal 1995, as a result of an increase in PC CD-based net revenues. Net revenues from CD-based PC products generally yield a higher gross profit margin than net revenues from console products as a result of the lower costs of goods sold attributable to such PC products. The increase in gross profit also was due to the increase in on-line, OEM, licensing and other revenues, which also yield higher gross profit margins.

## OPERATING EXPENSES

(Amounts in thousands)  
Fiscal Years Ended March 31,

|                                   | 1996      |                   | 1995      |                   |          |
|-----------------------------------|-----------|-------------------|-----------|-------------------|----------|
|                                   | Amount    | % of Net Revenues | Amount    | % of Net Revenues | % Change |
| Product development               | \$ 17,505 | 28.5%             | \$ 7,274  | 17.9%             | 140.7%   |
| Sales and marketing               | 13,920    | 22.7%             | 10,410    | 25.6%             | 33.7%    |
| General and administrative        | 4,404     | 7.2%              | 3,366     | 8.3%              | 30.8%    |
| Amortization of intangible assets | 1,283     | 2.1%              | 1,283     | 3.2%              | -        |
| Total operating expenses          | \$ 37,112 | 60.5%             | \$ 22,333 | 55.0%             | 66.2%    |

Total operating expenses increased as a percentage of net revenues as a result of a substantial increase in product development expenses. This increase was partially offset, however, by a decrease in sales and marketing expenses and general and administrative expenses as a percentage of net revenues. Product development expenses increased both in amount and as a percentage of net revenues due to the continued growth of the Company's product development departments, the increased number of products in product development, and the increased costs associated with enhanced production content and new technologies incorporated into such products. Sales and marketing expenses increased in actual amount, but not as a percentage of net revenues, as a result of the marketing and promotional activity related to newly released titles. General and administrative expenses increased in actual amount, but not as a percentage of net revenues, due to an increase in headcount related expenses.

## OTHER INCOME (EXPENSE)

Interest income increased to \$1,707,000 for the fiscal year ended March 31, 1996, from \$1,592,000 for the fiscal year ended March 31, 1995, as a result of higher yields earned on cash and cash equivalents. See "Liquidity and Capital Resources."

## QUARTERLY OPERATING RESULTS

The Company's quarterly operating results have in the past varied significantly and will likely in the future vary significantly depending on numerous factors, several of which are not under the Company's control. See Item 1. Business - "Certain Cautionary Information." Accordingly, the Company believes that period-to-period comparisons of its operating results are not necessarily meaningful and should not be relied upon as indications of future performance.

The following table is a comparative breakdown of the Company's quarterly results for the immediately preceding eight quarters (amounts in thousands, except per share data):

|                             | Quarter ended  |               |                |               |                |               |                |               |
|-----------------------------|----------------|---------------|----------------|---------------|----------------|---------------|----------------|---------------|
|                             | March 31, 1997 | Dec. 31, 1996 | Sept. 30, 1996 | June 30, 1996 | March 31, 1996 | Dec. 31, 1995 | Sept. 30, 1995 | June 30, 1995 |
| Net revenues                | \$28,926       | \$31,361      | \$19,175       | \$ 7,021      | \$21,648       | \$17,578      | \$18,848       | \$ 3,319      |
| Gross profit                | 18,203         | 19,483        | 13,463         | 5,512         | 15,327         | 10,447        | 12,105         | 1,765         |
| Operating income (loss)     | 6,054          | 6,210         | 1,769          | (4,226)       | 4,607          | 1,573         | 2,366          | (6,014)       |
| Net income (loss)           | 4,282          | 4,120         | 1,336          | (2,631)       | 6,345          | 1,948         | 2,765          | (5,528)       |
| Net income (loss) per share | 0.29           | 0.28          | 0.09           | (0.19)        | 0.43           | 0.13          | 0.18           | (0.39)        |

## LIQUIDITY AND CAPITAL RESOURCES

On January 31, 1994, the Company completed a private placement of approximately 5,000,000 shares of its Common Stock. The net proceeds from this private placement, approximately \$39.5 million, together with funds from operations, have been the Company's primary sources of liquidity for the fiscal years ended March 31, 1997 and 1996. At March 31, 1997, the Company had

approximately \$17.6 million of cash and cash equivalents.



The Company uses its working capital to finance ongoing operations, including the acquisition of inventory, the development, marketing and distribution of new products, and the acquisition of products and intellectual property rights from third parties.

Cash flows used in operating activities of \$6.3 million primarily resulted from the increase in accounts receivable of approximately \$16.5 million to \$36.4 million as of March 31, 1997. The increase in accounts receivable was due to the overall increase in net revenues during the quarter and year ended March 31, 1997 as compared to the same periods in the prior fiscal year.

The Company's working capital increased approximately \$12.7 million from March 31, 1996 to \$52.9 million as of March 31, 1997. The increase in working capital primarily was attributable to the increase in accounts receivable and prepaid software and license royalties.

Net cash used in investing activities primarily was attributable to capital expenditures incurred by the Company as a result of the increase in headcount and the number of products in development during the fiscal year. During fiscal 1998, the Company expects to incur additional capital expenditures relating to the development of its products, the acquisition of new products and related intellectual property rights, the general operation of its business and the relocation of its Los Angeles headquarters to a new leased facility in Santa Monica, California in May 1997.

Management currently believes that the Company's existing capital resources are sufficient to meet its requirements for at least the next fiscal year. Previous common stock and preferred stock private placements have provided, and will continue to provide, the Company with resources to enable it to acquire properties for development, engage in more extensive product development and expand marketing activities, and increase working capital for operations.

Management also currently believes that inflation has not had, and will not have in the foreseeable future, a material impact on continuing operations.

#### EFFECT OF RECENT ACCOUNTING CHANGES

In February 1997, the Financial Standards Board issued SFAS No. 128, "Earnings Per Share." SFAS No. 128 specifies new standards designated to improve the earnings per share ("EPS") information provided in financial statements by simplifying the existing computational guidelines, revising the disclosure requirements and increasing the comparability of EPS data on an international basis. Some of the changes made to simplify the EPS computational include: (a) eliminating the presentation of primary EPS and replacing it with basic EPS, with the principal difference being that common stock equivalents are not considered in computing basic EPS, (b) eliminating the modified treasury stock method and the three percent materiality provision, and (c) revising the contingent share provision and the supplemental EPS data requirements. SFAS No. 128 also makes a number of changes to existing disclosure requirements. SFAS No. 128 is effective for financial statements issued for periods ending after December 15, 1997, including interim periods. The Company has determined the following impact of the implementation of SFAS No. 128:

|  | Fiscal Year ended March 31, |         |           |
|--|-----------------------------|---------|-----------|
|  | 1997                        | 1996    | 1995      |
| Earnings (loss) per share as originally reported | \$ 0.49                     | \$ 0.37 | \$ (0.11) |
| Pro forma basic earnings per share               | 0.51                        | 0.39    | (0.11)    |
| Pro forma diluted earnings per share             | 0.49                        | 0.37    | (0.11)    |

#### Item 7A. QUANTITATIVE AND QUALITATIVE DISCLOSURES ABOUT MARKET RISK

Not applicable.

Item 8. CONSOLIDATED FINANCIAL STATEMENTS AND SUPPLEMENTARY DATA

Page

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| Independent Auditor's Report  | F-1  |
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| Consolidated Balance Sheets as of March 31, 1997 and 1996   | F-3  |
| Consolidated Statements of Operations for the Years ended<br>March 31, 1997, 1996 and 1995                      | F-4  |
| Consolidated Statements of Changes in Shareholders' Equity<br>for the Years Ended March 31, 1997, 1996 and 1995 | F-5  |
| Consolidated Statements of Cash Flows for the Years Ended<br>March 31, 1997, 1996 and 1995                      | F-6  |
| Notes to Consolidated Financial Statements  | F-7  |
| Schedule II-Valuation and Qualifying Accounts and Reserves<br>as of March 31, 1997, 1996 and 1995               | F-17 |

All other schedules of the Registrant are omitted because of the absence of conditions under which they are required or because the required information is included elsewhere in the financial statements or in the notes thereto.

Item 9. CHANGES IN AND DISAGREEMENTS WITH ACCOUNTANTS ON ACCOUNTING AND FINANCIAL DISCLOSURE

The Company replaced Coopers & Lybrand, LLP ("Coopers & Lybrand") as its principal accountants, effective January 17, 1997. The action was recommended by the Audit Committee of the Board of Directors and was approved by the Company's Board of Directors. Coopers & Lybrand's reports on the Company's financial statements for the fiscal years ended March 31, 1996 and 1995 did not contain an adverse opinion or a disclaimer of opinion and were not qualified or modified as to uncertainty, audit scope or accounting principles. During the two fiscal years ended March 31, 1996 and 1995 and all interim periods through January 17, 1997, (i) there were no disagreements with Coopers & Lybrand on any matter of accounting principles or practices, financial statement disclosure, or auditing scope or procedure, which disagreements, if not resolved to the satisfaction of Coopers & Lybrand, would have caused Coopers & Lybrand to make a reference to the subject matter of the disagreements in connection with its reports in the financial statements for such years, and (ii) there were no reportable events as described in Item 304 of Regulation S-K.

The Company engaged KPMG Peat Marwick, LLP ("Peat Marwick") as the Company's principal accountants to audit the Company's financial statements, effective January 17, 1997. The action was recommended by the Audit Committee of the Board of Directors and was approved by the Company's Board of Directors.

PART III

Item 10. DIRECTORS AND EXECUTIVE OFFICERS OF THE REGISTRANT

The information required by this Item is incorporated by reference to the sections of the Company's definitive Proxy Statement for the Annual Meeting of Shareholders to be held on September 24, 1997, entitled "Election of Directors" and "Executive Officers and Key Employees" to be filed with the Securities and Exchange Commission within 120 days after the end of the fiscal year covered by this Form 10-K.

Item 11. EXECUTIVE COMPENSATION

The information required by this Item is incorporated by reference to the sections of the Company's definitive Proxy Statement for the Annual Meeting of Shareholders to be held on September 24, 1997, entitled "Executive Compensation" and "Indebtedness of Management" to be filed with the Securities and Exchange Commission within 120 days after the end of the fiscal year covered by this Form 10-K.

Item 12. SECURITY OWNERSHIP OF CERTAIN BENEFICIAL OWNERS AND MANAGEMENT

The information required by this Item is incorporated by reference to the sections of the Company's definitive Proxy Statement for the Annual Meeting of Shareholders to be held on September 24, 1997, entitled "Security Ownership of Certain Beneficial Owners and Management" to be filed with the Securities and Exchange Commission within 120 days after the end of the fiscal year covered by this Form 10-K.

Item 13. CERTAIN RELATIONSHIPS AND RELATED TRANSACTIONS

The information required by this Item is incorporated by reference to the sections of the Company's definitive Proxy Statement for the Annual Meeting of Shareholders to be held on September 24, 1997, entitled "Certain Relationships and Related Transactions" to be filed with the Securities and Exchange Commission within 120 days after the end of the fiscal year covered by this Form 10-K.

PART IV

Item 14. EXHIBITS, FINANCIAL STATEMENT SCHEDULES AND REPORTS ON FORM 8-K

- (a) 1. FINANCIAL STATEMENTS See Item 8. - Consolidated Financial Statements and Supplementary Data Index for Financial Statements and Schedule on page 26 herein.
2. FINANCIAL STATEMENT SCHEDULES See Item 8. - Consolidated Financial Statements and Supplementary Data Index for Financial Statements and Schedule on page 26 herein.
3. EXHIBITS REQUIRED BY ITEM 601 OF REGULATION S-K

| Exhibit<br>Number<br>----- | Exhibit<br>-----   |
|----------------------------|--|
| 2.1                        | Plan of Reorganization of the Company, as confirmed by the United States Bankruptcy Court for the Northern District of California on November 25, 1991 (incorporated by reference to Exhibit 28.2 of the Company's Current Report on Form 8-K dated October 4, 1991).  |
| 2.2                        | Plan and Agreement of Merger, dated March 30, 1992, among the Company, Disc Company, Inc. and International Consumer Technologies Corporation (incorporated by reference to Exhibit 28.1 of the Company's Current Report on Form 8-K dated March 31, 1992).  |
| 2.3                        | Agreement and Plan of Merger between Activision, Inc., a California corporation, and Activision, Inc., a Delaware corporation, as filed with the Secretary of State of the State of Delaware (incorporated by reference to Exhibit 4.7 of Amendment No. 1 to the Company's Form S-8, Registration No. 33-48411 filed on June 1, 1993). |
| 2.4                        | Plan and Agreement of Merger, dated October 28, 1994, among the Company, ACTV Acquisition, Inc. and International Consumer Technologies Corporation (incorporated by reference to Exhibit 2.4 of the Company's Quarterly Report on Form 10-Q for the period ended December 31, 1994).  |
| 3.1                        | Amended and Restated Articles of Incorporation of Activision, Inc., dated October 15, 1992 (incorporated by reference to Exhibit 4.5 of Amendment No. 1 to the Company's Form S-8, Registration No. 33-48411 filed on June 1, 1993).   |
| 3.2                        | Bylaws of Activision, Inc. (incorporated by reference to Exhibit 4.6 of Amendment No. 1 to the Company's Form S-8, Registration No. 33-48411 filed on June 1, 1993).   |
| 10.7                       | Mediagenic 1991 Stock Option and Stock Award Plan, as amended (incorporated by reference to Exhibit 4.1 to the Company's Registration Statement on Form S-8, Registration No. 33-63638, filed on December 8, 1995).  |
| 10.8                       | Mediagenic 1991 Director Warrant Plan as amended (incorporated by reference to Exhibit 28.2 to the Company's Registration Statement on Form S-8, Registration No. 33-63638, filed on June 1, 1993).  |
| 10.9                       | Purchase Agreement, dated as of January 24, 1994, among the Company and each purchaser who is a signatory thereto (incorporated by reference to Exhibit 28.1 of the Company's Form 8-K filed February 9, 1994).  |
| 10.10                      | Registration Rights Agreement, dated as of January 31, 1994, among the Company and each purchaser who is a signatory thereto   |

(incorporated by reference to Exhibit 28.2 of the Company's Form 8-K filed February 9, 1994).

- 10.11 Share Exchange and Recapitalization Agreement, dated as of January 14, 1994, among the Company, International Consumer Technologies Corporation, Steven Wynn, J.F. Shea Co., Inc. as Nominee 1993-6 and ESL Partners, L.P. (incorporated by reference to Exhibit 28.3 of the Company's Form 8-K filed February 9, 1994).
- 10.12 Registration Rights Agreement, dated as of January 31, 1994, among the Company, International Consumer Technologies Corporation, Steven Wynn, J.F. Shea Co., Inc. as Nominee 1993-6 and ESL Partners, L.P. (incorporated by reference to Exhibit 28.4 of the Company's Form 8-K filed February 9, 1994).
- 10.14 Lease Agreement dated as of December 20, 1996, between the Company and Barclay Curci Investment Company (incorporated by reference to Exhibit 10.14 of the Company's Form 10-Q for the quarter ended December 31, 1996).
- 11. Statement regarding computation of per share earnings.
- 16. Letter from Coopers & Lybrand, LLP pursuant to Item 304 (a) (3) of Regulation S-K (incorporated by reference to exhibit 16 of the Company's Form 8-K filed January 17, 1997.)
- 21. Principal subsidiaries of the Company.
- 23.1 Independent Auditor Consents.
- 23.2 Independent Auditor Consents.
- 27. Financial Data Schedule.

(b) REPORTS ON FORM 8-K

The Company filed a Form 8-K on January 17, 1997 reporting a change in the Company's certifying accountant from Coopers & Lybrand, LLP to KPMG Peat Marwick, LLP, effective January 17, 1997.

SIGNATURES

Pursuant to the requirements of Section 13 or 15(d) of the Securities Exchange Act of 1934, the Registrant has duly caused this report to be signed on its behalf by the undersigned, thereunto duly authorized.

Date: June 13, 1997

ACTIVISION, INC.

By: /s/ ROBERT A. KOTICK

-----  
(Robert A. Kotick)  
Chairman and Chief  
Executive Officer

Pursuant to the requirements of the Securities Exchange Act of 1934, this report has been signed below by the following persons on behalf of the Registrant and in the capacities and on the dates indicated.

|                          |                                  |               |
|--------------------------|----------------------------------|---------------|
| By: /s/ ROBERT A. KOTICK | Chairman, Chief Executive        | June 13, 1997 |
| -----                    | Officer (Principal Executive     |               |
| (Robert A. Kotick)       | Officer), President and Director |               |

|                         |                          |               |
|-------------------------|--------------------------|---------------|
| By: /s/ HOWARD E. MARKS | Executive Vice President | June 13, 1997 |
| -----                   | and Director             |               |
| (Howard E. Marks)       |                          |               |

|                        |                               |               |
|------------------------|-------------------------------|---------------|
| By: /s/ BRIAN G. KELLY | Chief Financial and Operating | June 13, 1997 |
| -----                  | Officer and Director          |               |
| (Brian G. Kelly)       | (Principal Financial Officer) |               |

|                        |                                |               |
|------------------------|--------------------------------|---------------|
| By: /s/ BARRY J. PLAGA | Chief Accounting Officer       | June 13, 1997 |
| -----                  | (Principal Accounting Officer) |               |
| (Barry J. Plaga)       |                                |               |

|                         |          |               |
|-------------------------|----------|---------------|
| By: /s/ HAROLD A. BROWN | Director | June 13, 1997 |
| -----                   |          |               |
| (Harold A. Brown)       |          |               |

|                          |          |               |
|--------------------------|----------|---------------|
| By: /s/ BARBARA S. ISGUR | Director | June 13, 1997 |
| -----                    |          |               |
| (Barbara S. Isgur)       |          |               |

|                         |          |               |
|-------------------------|----------|---------------|
| By: /s/ STEVEN T. MAYER | Director | June 13, 1997 |
| -----                   |          |               |
| (Steven T. Mayer)       |          |               |

|                           |          |               |
|---------------------------|----------|---------------|
| By: /s/ ROBERT J. MORGADO | Director | June 13, 1997 |
| -----                     |          |               |
| (Robert J. Morgado)       |          |               |

## INDEPENDENT AUDITORS' REPORT

The Board of Directors and Shareholders

We have audited the accompanying consolidated balance sheet of ACTIVISION, INC. and subsidiaries as of March 31, 1997 and the related consolidated statements of operations, changes in shareholders' equity and cash flows for the year then ended. In connection with our audit of the consolidated financial statements, we also have audited financial statement schedule II for the year ended March 31, 1997. These financial statements and financial statement schedule are the responsibility of the Company's management. Our responsibility is to express an opinion on these financial statements and financial statement schedule based on our audit.

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

In our opinion, the consolidated financial statements referred to above present fairly, in all material respects, the consolidated financial position of ACTIVISION, INC. and subsidiaries as of March 31, 1997, and the consolidated results of their operations and their cash flows for the year the ended, in conformity with generally accepted accounting principles. In addition, in our opinion, the related financial statement schedule for the year ended March 31, 1997, when considered in relation to the basic financial statements taken as a whole, presents fairly, in all material respects, the information set forth therein.

KPMG PEAT MARWICK, LLP

Los Angeles, California  
May 8, 1997

REPORT OF INDEPENDENT ACCOUNTANTS

To the Shareholders of ACTIVISION, INC. and Subsidiaries.

We have audited the accompanying consolidated balance sheet of ACTIVISION, INC. and subsidiaries as of March 31, 1996 and the related consolidated statements of operations, changes in shareholders' equity and cash flows for the years ended March 31, 1996 and 1995. In connection with our audits of the consolidated financial statements, we have also audited the financial statement schedule listed under item 14(a)2 of this Annual Report on 10K for each of the two years in the period ended March 31, 1996. These financial statements and financial statement schedule are the responsibility of the Company's management. Our responsibility is to express an opinion on these financial statements and financial statement schedule based on our audits.

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

In our opinion, the consolidated financial statements referred to above present fairly, in all material respects, the consolidated financial position of ACTIVISION, INC. and subsidiaries as of March 31, 1996, and the consolidated results of their operations and their cash flows for each of the two years then ended, in conformity with generally accepted accounting principles. In addition, in our opinion, the related financial statement schedule referred to above, when considered in relation to the basic financial statements taken as a whole, presents fairly, in all material respects, the information set forth therein.

COOPERS & LYBRAND, LLP

Los Angeles, California  
May 15, 1996, except for Note 9,  
as to which the date is June 10, 1997.



ACTIVISION, INC. AND SUBSIDIARIES  
CONSOLIDATED BALANCE SHEETS

(In thousands except share data)

|  | March 31,<br>1997 | March 31,<br>1996 |
|--|-------------------|-------------------|
|  | -----             | -----             |
| ASSETS   |                   |                   |
| Current assets:  |                   |                   |
| Cash and cash equivalents  | \$ 17,639         | \$ 25,288         |
| Accounts receivable, net of allowances of \$6,468 and \$7,005, respectively  | 36,367            | 19,909            |
| Inventories, net   | 4,520             | 2,975             |
| Prepaid software and license royalties   | 6,559             | 3,652             |
| Prepaid expenses and other current assets  | 1,222             | 1,183             |
| Deferred income taxes  | 1,493             | 1,500             |
|  | -----             | -----             |
| Total current assets   | 67,800            | 54,507            |
| Property and equipment, net  | 5,090             | 3,326             |
| Deferred income taxes  | 4,212             | -                 |
| Other assets   | 255               | 200               |
| Excess purchase price over identifiable assets acquired, net   | 18,313            | 19,580            |
|  | -----             | -----             |
| Total assets   | \$ 95,670         | \$ 77,613         |
|  | -----             | -----             |
| LIABILITIES AND SHAREHOLDERS' EQUITY   |                   |                   |
| Current liabilities:   |                   |                   |
| Accounts payable   | \$ 7,054          | \$ 4,592          |
| Accrued expenses   | 7,808             | 9,688             |
|  | -----             | -----             |
| Total current liabilities  | 14,862            | 14,280            |
| Other liabilities  | -                 | 334               |
|  | -----             | -----             |
| Total liabilities  | 14,862            | 14,614            |
|  | -----             | -----             |
| Commitments and contingencies  |                   |                   |
| Shareholders' equity:  |                   |                   |
| Common stock, \$.000001 par value, 50,000,000 shares<br>authorized, 14,644,895 and 14,250,180 shares issued<br>and 14,144,895 and 13,750,180 outstanding, respectively | -                 | -                 |
| Additional paid-in capital   | 78,484            | 67,904            |
| Retained earnings  | 7,815             | 708               |
| Cumulative foreign currency translation  | (213)             | (335)             |
| Less: Treasury stock, cost of 500,000 shares   | (5,278)           | (5,278)           |
|  | -----             | -----             |
| Total shareholders' equity   | 80,808            | 62,999            |
|  | -----             | -----             |
| Total liabilities and shareholders' equity   | \$ 95,670         | \$ 77,613         |
|  | -----             | -----             |

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

ACTIVISION, INC. AND SUBSIDIARIES  
CONSOLIDATED STATEMENTS OF OPERATIONS  
(in thousands except per share data)

|  | For the years ended March 31, |           |            |
|--|-------------------------------|-----------|------------|
|  | 1997                          | 1996      | 1995       |
| Net revenues   | \$ 86,483                     | \$ 61,393 | \$ 40,669  |
| Cost of goods sold   | 29,822                        | 21,749    | 21,293     |
| Gross profit   | 56,661                        | 39,644    | 19,376     |
| Operating expenses:  |                               |           |            |
| Product development  | 18,195                        | 17,505    | 7,274      |
| Sales and marketing  | 22,351                        | 13,920    | 10,410     |
| General and administrative   | 5,041                         | 4,404     | 3,366      |
| Amortization of intangible assets  | 1,267                         | 1,283     | 1,283      |
| Total operating expenses   | 46,854                        | 37,112    | 22,333     |
| Operating income (loss)  | 9,807                         | 2,532     | (2,957)    |
| Other income:  |                               |           |            |
| Interest income  | 924                           | 1,707     | 1,592      |
| Income (loss) before income taxes  | 10,731                        | 4,239     | (1,365)    |
| Income tax provision (benefit)   | 3,624                         | (1,291)   | 155        |
| Net income (loss)  | \$ 7,107                      | 5,530     | \$ (1,520) |
| Net income (loss) per common share                                       | \$ 0.49                       | \$ 0.37   | \$ (0.11)  |
| Number of shares used in computing<br>net income (loss) per common share | 14,619                        | 14,950    | 13,944     |

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

ACTIVISION, INC. AND SUBSIDIARIES  
CONSOLIDATED STATEMENTS OF CHANGES IN SHAREHOLDERS' EQUITY

(In thousands)

|  | Common Stock |        | Common Stock Warrants |        | Additional<br>Paid-in Capital |
|--|--------------|--------|-----------------------|--------|-------------------------------|
|  | Shares       | Amount | Shares                | Amount |                               |
| Balances March 31, 1994  | 13,849       | -      | 267                   | \$ 120 | \$ 67,356                     |
| Exercise of common stock warrants                                    | 267          | -      | (267)                 | (120)  | 200                           |
| Issuance of common stock pursuant to employee stock option plan      | 59           | -      | -                     | -      | 99                            |
| Issuance of common stock pursuant to directors stock warrant plan    | 8            | -      | -                     | -      | 12                            |
| Net loss for the year  | -            | -      | -                     | -      | -                             |
| Foreign currency translation adjustment                              | -            | -      | -                     | -      | -                             |
| Balances March 31, 1995  | 14,183       | -      | -                     | -      | \$ 67,667                     |
| Issuance of common stock pursuant to employee stock option plan      | 50           | -      | -                     | -      | 224                           |
| Issuance of common stock pursuant to directors stock warrant plan    | 17           | -      | -                     | -      | 13                            |
| Purchase of treasury stock   | -            | -      | -                     | -      | -                             |
| Net income for the year  | -            | -      | -                     | -      | -                             |
| Foreign currency translation adjustment                              | -            | -      | -                     | -      | -                             |
| Balances March 31, 1996  | 14,250       | -      | -                     | -      | \$ 67,904                     |
| Issuance of common stock   | 63           | -      | -                     | -      | 822                           |
| Issuance of common stock pursuant to employee stock option plan      | 313          | -      | -                     | -      | 2,209                         |
| Issuance of common stock pursuant to employee stock purchase plan    | 19           | -      | -                     | -      | 179                           |
| Tax benefit attributable to employee stock option plan               | -            | -      | -                     | -      | 736                           |
| Tax benefit derived from net operating loss carryforward utilization | -            | -      | -                     | -      | 6,634                         |
| Net income for the year  | -            | -      | -                     | -      | -                             |
| Foreign currency translation adjustment                              | -            | -      | -                     | -      | -                             |
| Balances March 31, 1997  | 14,645       | \$ -   | -                     | \$ -   | \$ 78,484                     |

|   | Retained Earnings (Deficit) | Cumulative Foreign Currency Translation | Treasury Stock |        | Shareholders' Equity |
|---|-----------------------------|---|----------------|--------|----------------------|
|   |                             |   | Shares         | Amount |                      |
| Balances March 31, 1994   | \$ (3,302)                  | \$ (189)                                | -              | -      | \$ 63,985            |
| Exercise of common stock warrants                                 | -                           | -                                       | -              | -      | 80                   |
| Issuance of common stock pursuant to employee stock option plan   | -                           | -                                       | -              | -      | 99                   |
| Issuance of common stock pursuant to directors stock warrant plan | -                           | -                                       | -              | -      | 12                   |
| Net loss for the year   | (1,520)                     | -                                       | -              | -      | (1,520)              |
| Foreign currency translation adjustment                           | -                           | 48                                      | -              | -      | 48                   |
| Balances March 31, 1995   | \$ (4,822)                  | \$ (141)                                | -              | -      | \$ 62,704            |
| Issuance of common stock pursuant to employee stock option plan   | -                           | -                                       | -              | -      | 224                  |
| Issuance of common stock pursuant to directors stock warrant plan | -                           | -                                       | -              | -      | 13                   |

|   |          |          |       |            |           |
|---|----------|----------|-------|------------|-----------|
| Purchase of treasury stock  | -        | -        | 500   | (5,278)    | (5,278)   |
| Net income for the year   | 5,530    | -        | -     | -          | 5,530     |
| Foreign currency translation adjustment                                 | -        | (194)    | -     | -          | (194)     |
|   | -----    | -----    | ----- | -----      | -----     |
| Balances March 31, 1996   | \$ 708   | \$ (335) | 500   | \$ (5,278) | \$ 62,999 |
| Issuance of common stock  | -        | -        | -     | -          | 822       |
| Issuance of common stock pursuant to<br>employee stock option plan      | -        | -        | -     | -          | 2,209     |
| Issuance of common stock pursuant to<br>employee stock purchase plan    | -        | -        | -     | -          | 179       |
| Tax benefit attributable to employee<br>stock option plan               | -        | -        | -     | -          | 736       |
| Tax benefit derived from net operating<br>loss carryforward utilization | -        | -        | -     | -          | 6,634     |
| Net income for the year   | 7,107    | -        | -     | -          | 7,107     |
| Foreign currency translation adjustment                                 | -        | 122      | -     | -          | 122       |
|   | -----    | -----    | ----- | -----      | -----     |
| Balances March 31, 1997   | \$ 7,815 | \$ (213) | 500   | \$ (5,278) | \$ 80,808 |
|   | -----    | -----    | ----- | -----      | -----     |

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

ACTIVISION, INC. AND SUBSIDIARIES  
CONSOLIDATED STATEMENTS OF CASH FLOWS

(In thousands)

|  | For the years ended March 31, |           |            |
|--|-------------------------------|-----------|------------|
|  | 1997                          | 1996      | 1995       |
| Cash flows from operating activities:  |                               |           |            |
| Net income (loss)  | \$ 7,107                      | \$ 5,530  | \$ (1,520) |
| Adjustments to reconcile net income (loss) to net cash used in operating activities: |                               |           |            |
| Deferred income taxes  | 3,165                         | (1,500)   | -          |
| Depreciation and amortization  | 3,335                         | 2,646     | 1,942      |
| Change in assets and liabilities:  |                               |           |            |
| Accounts receivable  | (16,458)                      | (14,343)  | (3,641)    |
| Inventories  | (1,545)                       | (1,003)   | 551        |
| Prepaid software and license royalties   | (2,085)                       | (2,570)   | (202)      |
| Prepaid expenses and other current assets  | (39)                          | (841)     | 126        |
| Other assets   | (55)                          | (140)     | 37         |
| Accounts payable   | 2,462                         | 2,076     | 587        |
| Accrued liabilities  | (1,880)                       | 6,535     | 911        |
| Other liabilities  | (334)                         | (176)     | (11)       |
| Net cash used in operating activities  | (6,327)                       | (3,786)   | (1,220)    |
| Cash flows from investing activities:  |                               |           |            |
| Capital expenditures   | (3,832)                       | (3,045)   | (1,256)    |
| Restricted cash  | -                             | -         | 1,500      |
| Net cash provided by (used in) investing activities                                  | (3,832)                       | (3,045)   | 244        |
| Cash flows from financing activities:  |                               |           |            |
| Proceeds from issuance and exercise of common stock options and warrants             | 2,209                         | 237       | 191        |
| Proceeds from employee stock purchase plan   | 179                           | -         | -          |
| Payments under line-of-credit agreements   | -                             | -         | (4,695)    |
| Borrowings under line-of-credit agreements   | -                             | -         | 4,695      |
| Other  | -                             | -         | (1)        |
| Purchase of treasury stock   | -                             | (5,278)   | -          |
| Net cash provided by (used in) financing activities                                  | 2,388                         | (5,041)   | 190        |
| Effect of exchange rate changes on cash  | 122                           | (195)     | 48         |
| Net decrease in cash and cash equivalents  | (7,649)                       | (12,067)  | (738)      |
| Cash and cash equivalents at beginning of year                                       | 25,288                        | 37,355    | 38,093     |
| Cash and cash equivalents at end of year   | \$ 17,639                     | \$ 25,288 | \$ 37,355  |
| Non-cash investing activities:   |                               |           |            |
| Stock issued in exchange for licensing rights  | \$ 822                        | \$ -      | \$ -       |
| Tax benefit derived from stock option exercises                                      | 736                           | -         | -          |
| Tax benefit derived from net operating loss carryforward utilization                 | 6,634                         | -         | -          |
| Supplemental cash flow information:  |                               |           |            |
| Cash paid for income taxes   | \$ 291                        | \$ 124    | \$ 193     |
| Cash paid for interest   | -                             | 20        | 18         |

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

ACTIVISION, INC. AND SUBSIDIARIES  
NOTES TO CONSOLIDATED FINANCIAL STATEMENTS  
MARCH 31, 1997, 1996 AND 1995

1. SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES

BUSINESS

The Company is a diversified international publisher of interactive entertainment software. The Company develops and publishes entertainment software for a variety of platforms, including both personal computer CD-ROM systems, including the Windows 95 operating system, and video game console hardware systems such as the Sony Playstation ("Playstation") and Sega Saturn ("Saturn"). The Company distributes its products worldwide primarily through its direct sales force and, to a lesser extent through third party distributors and licensees.

PRINCIPLES OF CONSOLIDATION

The consolidated financial statements include the accounts of Activision, Inc., a Delaware corporation, and its wholly-owned subsidiaries (the Company.) All intercompany accounts and transactions have been eliminated in consolidation.

CASH AND CASH EQUIVALENTS

Cash and cash equivalents include cash and short-term investments with original maturities of not more than 90 days.

CONCENTRATION OF CREDIT RISK

Financial instruments which potentially subject the Company to concentration of credit risk consist principally of temporary cash investments and accounts receivable. The Company places its temporary cash investments with quality financial institutions. At various times during the fiscal years ended March 31, 1997, 1996 and 1995, the Company had deposits in excess of the \$100,000 Federal Deposit Insurance Corporation ("FDIC") limit at these financial institutions. At March 31, 1997, the Company had approximately \$13.4 million invested in short-term United States government backed securities. The Company's customer base includes retail outlets and distributors including consumer electronics and computer specialty stores, discount chains, video rental stores and toy stores in the United States and countries worldwide. The Company performs ongoing credit evaluations of its customers and maintains allowances for potential credit losses. The Company generally does not require collateral or other security from its customers.

FAIR VALUE OF FINANCIAL INSTRUMENTS

The fair values of the Company's cash and cash equivalents, accounts receivable, accounts payable, and accrued liabilities approximate their carrying values due to the relatively short maturities of these instruments. Trade receivables are primarily due from retailers and OEM's.

CAPITALIZED SOFTWARE DEVELOPMENT COSTS

Statement of Financial Accounting Standards No. 86, "Accounting for the Costs of Computer Software to be Sold, Leased, or Otherwise Marketed," provides for the capitalization of certain software development costs once technological feasibility is established. The capitalized costs are then amortized on a straight-line basis over the estimated product life, or on the ratio of current revenues to total projected revenues, whichever is greater. The software development costs that have been capitalized to date have been immaterial.

PREPAID SOFTWARE AND LICENSED PROPERTY ROYALTIES

Prepaid royalties represent prepayments made to independent software developers under development agreements. Prepaid royalties are expensed at the contractual royalty rate as cost of goods sold based on actual net product sales. Management evaluates the future realization of prepaid royalties quarterly, and charges to cost of goods sold any amounts that management deems unlikely to be amortized at the contract royalty rate through product sales.

REVENUE RECOGNITION

Product Sales: The Company recognizes revenue from the sale of its products upon shipment. Subject to certain limitations, the Company permits customers to obtain exchanges within certain specified periods, and provides price protection on certain unsold merchandise. Revenue from product sales is reflected net of the allowance for returns and price protection.

Software Licenses: For those license agreements which provide the customers the right to multiple copies in exchange for guaranteed amounts, revenue is recognized at delivery of the product master or the first copy. Per copy royalties on sales which exceed the guarantee are recognized as earned.

#### ADVERTISING EXPENSES

The Company expenses advertising and the related costs as incurred. Advertising expenses for the years ended March 31, 1997, 1996 and 1995 were approximately \$3,144,000, \$1,940,000 and \$3,564,000, respectively, and are included in sales and marketing expense in the statement of operations.

#### AMORTIZATION OF INTANGIBLE ASSETS

The Company's merger with The Disc Company, Inc. effective April 1, 1992 was accounted for by the purchase method of accounting, resulting in an intangible asset of approximately \$24,417,000. This intangible asset is being amortized on a straight-line basis over a 20 year period. Amortization for each of the years ended March 31, 1997, 1996 and 1995 was approximately \$1,221,000. The company adopted the provisions of SFAS No. 121, "Accounting for Impairment of Long-Lived Assets and Long-Lived Assets to Be Disposed Of," on April 1, 1996. This Statement requires that long-lived assets and certain identifiable intangibles be reviewed for impairment whenever events of changes in circumstances indicate that the carrying amount of an asset may not be recoverable. Recoverability of assets to be held and used is measured by a comparison of the carrying amount of the asset to undiscounted cash flows expected to be generated by the asset. If such assets are considered to be impaired, the impairment to be recognized is measured by the amount by which the carrying amount exceeds the fair value of the assets. Adoption of this Statement did not have a material impact on the Company's financial position, results of operations, or liquidity.

#### INCOME TAXES

The Company accounts for income taxes using Statement of Financial Accounting Standards No. 109 (SFAS No. 109), "Accounting for Income Taxes." Under SFAS No. 109 income taxes are accounted for under the asset and liability method. Deferred tax assets and liabilities are recognized for the future tax consequences attributable to differences between the financial statement carrying amounts of existing assets and liabilities and their respective tax bases and operating loss and tax credit carryforwards. Deferred tax assets and liabilities are measured using enacted tax rates expected to apply to taxable income in the years in which those temporary differences are expected to be recovered or settled. The effect on deferred tax assets and liabilities of a change in tax rates is recognized in income in the period that includes the enactment date.

#### FOREIGN CURRENCY TRANSLATION

The Company's foreign subsidiaries maintain their accounting records in their local currency. The currencies are then converted to United States dollars and the effect of the foreign currency translation is reflected as a component of shareholders' equity in accordance with Statement of Financial Accounting Standards No. 52, "Foreign Currency Translation."

#### NET INCOME (LOSS) PER COMMON SHARE

Net income (loss) per common share is computed using the weighted average number of common and, when dilutive, common equivalent shares outstanding during the period.

#### ESTIMATES

The preparation of financial statements in conformity with generally accepted accounting principles requires management to make estimates and assumptions that affect the reported amounts of assets and liabilities at the date of the financial statements and the reported amounts of revenues and expenses during the reporting period. Actual results could differ from those estimates.

#### STOCK OPTION PLAN

Prior to April 1, 1996, the Company accounted for its stock option plan in accordance with the provisions of Accounting Principles Board ("APB") Opinion No. 25, Accounting for Stock Issued to Employees, and related

interpretations. As such, compensation expense would be recorded on the date of the grant only if the current market price of the underlying stock exceeded the exercise price. On April 1, 1996 the Company adopted SFAS No. 123, Accounting for Stock-Based Compensation, which permits entities to recognize as expense over the vesting period the fair value of all stock-based awards on the date of the grant. Alternatively, SFAS No. 123 also allows entities to continue to apply the provisions of APB Opinion No. 25 and provide pro forma net income and pro forma earnings per share disclosures for employee stock option grants made in 1995 and future years as if the fair-value-based method defined in SFAS No. 123 had been applied. The Company has elected to continue to apply the provisions of APB No. 25 and provide the pro forma disclosure provisions of SFAS No. 123.

#### RECLASSIFICATIONS

Certain amounts in the consolidated financial statements have been reclassified to conform with the current year's presentation.

#### 2. INVENTORIES

Inventories are valued at the lower of cost (first-in, first-out) or market. Inventories at March 31, 1997 and 1996 reflect an adjustment to net realizable value of approximately \$135,000 and \$145,000, respectively. The provisions for net realizable value for the years ended March 31, 1997, 1996 and 1995 were approximately \$142,000, \$532,000 and \$134,000, respectively. Inventories, net of reserves consisted of (amounts in thousands):

|                                | March 31, 1997 | March 31, 1996 |
|--------------------------------|----------------|----------------|
|                                | -----          | -----          |
| Purchased parts and components | \$ 1,162       | \$ 876         |
| Finished goods                 | 3,358          | 2,099          |
|                                | -----          | -----          |
|                                | \$ 4,520       | \$ 2,975       |
|                                | -----          | -----          |

Included in finished goods at March 31, 1997 and 1996 are expected inventory returns at a net realizable value of \$837,000 and \$427,000, respectively.

#### 3. PROPERTY AND EQUIPMENT

Equipment, furniture and leasehold improvements are recorded at cost. Depreciation and amortization are provided using the straight-line method over the shorter of the estimated useful lives or the lease term generally ranging from three to ten years. Property and equipment, stated at cost, was as follows (amounts in thousands):

|  | March 31, 1997 | March 31, 1996 |
|--|----------------|----------------|
|  | -----          | -----          |
| Computer equipment                             | \$ 6,910       | \$ 4,360       |
| Office furniture and other equipment           | 1,885          | 1,338          |
| Leasehold improvements                         | 1,029          | 310            |
|  | -----          | -----          |
|  | 9,824          | 6,008          |
| Less accumulated depreciation and amortization | (4,734)        | (2,682)        |
|  | -----          | -----          |
|  | \$ 5,090       | \$ 3,326       |
|  | -----          | -----          |

Depreciation expense for the years ended March 31, 1997, 1996 and 1995 was \$2,068,000, \$1,362,000 and \$658,000, respectively.



#### 4. ACCRUED EXPENSES

Accrued expenses were as follows (amounts in thousands):

|                                     | March 31, 1997 | March 31, 1996 |
|-------------------------------------|----------------|----------------|
|                                     | -----          | -----          |
| Accrued royalties                   | \$ 4,173       | \$ 3,104       |
| Accrued selling and marketing costs | 1,680          | 1,759          |
| Deferred revenue                    | -              | 2,242          |
| Other                               | 1,955          | 2,583          |
|                                     | -----          | -----          |
|                                     | \$ 7,808       | \$ 9,688       |
|                                     | -----          | -----          |

#### 5. OPERATIONS BY GEOGRAPHIC AREA

The following table summarizes the geographic operations of the Company (amounts in thousands):

|                               | Year ended March 31, |              |             |
|-------------------------------|----------------------|--------------|-------------|
|                               | -----                | -----        | -----       |
|                               | 1997                 | 1996         | 1995        |
|                               | ----                 | ----         | ----        |
| Net revenues:                 |                      |              |             |
| North America                 | \$ 65,049            | \$ 47,176    | \$ 29,492   |
| Europe                        | 12,211               | 6,501        | 7,574       |
| Japan                         | 4,504                | 4,768        | 2,194       |
| Australia and Pacific         | 4,719                | 2,948        | 1,409       |
|                               | -----                | -----        | -----       |
| Total net revenues            | \$ 86,483            | \$ 61,393    | \$ 40,669   |
|                               | -----                | -----        | -----       |
| Operating income (loss):      |                      |              |             |
| North America                 | \$ 2,306             | \$(5,110)    | \$(5,114)   |
| Europe                        | 3,466                | 2,547        | 77          |
| Japan                         | 2,022                | 3,814        | 1,655       |
| Australia and Pacific         | 2,013                | 1,281        | 425         |
|                               | -----                | -----        | -----       |
| Total operating income (loss) | \$ 9,807             | \$2,532      | \$(2,957)   |
|                               | -----                | -----        | -----       |
|                               | At March 31,         | At March 31, | At March 31 |
|                               | 1997                 | 1996         | 1995        |
|                               | ----                 | ----         | ----        |
| Assets:                       |                      |              |             |
| United States                 | \$ 81,833            | \$ 73,377    | \$ 68,226   |
| Foreign                       | 13,837               | 4,236        | 657         |
|                               | -----                | -----        | -----       |
| Total assets                  | \$ 95,670            | \$ 77,613    | \$ 68,883   |
|                               | -----                | -----        | -----       |

Operating income (loss) by geographic territory is reflected without any allocation for product development and general and administrative expenses to the geographic territories other than North America. These expenses are incurred primarily in North America.

#### 6. SIGNIFICANT CUSTOMERS

The Company had no sales to any one customer in excess of 10% of total net revenues for the years ended March 31, 1997 and 1996. For the fiscal year ended March 31, 1995, the Company had sales to one customer which represented 14.9% of total net revenues.

## 7. INCOME TAXES

Domestic and foreign income (loss) before income taxes and details of the income tax provision (benefit) are as follows (amounts in thousands):

|   | Year ended March 31, |            |            |
|---|----------------------|------------|------------|
|   | 1997                 | 1996       | 1995       |
| Income (loss) before income taxes:  |                      |            |            |
| Domestic  | \$ 5,896             | \$ 3,681   | \$ (3,096) |
| Foreign   | 4,835                | 558        | 1,731      |
|   | \$ 10,731            | \$ 4,239   | \$ (1,365) |
| Income tax provision:   |                      |            |            |
| Current:  |                      |            |            |
| Federal   | \$ 383               | \$ 106     | \$ -       |
| State   | 31                   | 25         | -          |
| Foreign   | 45                   | 78         | 155        |
| Total current   | 459                  | 209        | 155        |
| Deferred:   |                      |            |            |
| Federal   | (2,961)              | (1,369)    | -          |
| State   | (1,244)              | (131)      | -          |
| Total deferred  | (4,205)              | (1,500)    | -          |
| Add back benefit credited to additional paid-in capital:                              |                      |            |            |
| Tax benefit related to stock option exercises   | 736                  | -          | -          |
| Tax benefit related to utilization of pre-bankruptcy net operating loss carryforwards | 6,634                | -          | -          |
|   | 7,370                | -          | -          |
|   | \$ 3,624             | \$ (1,291) | \$ 155     |

The items accounting for the difference between income taxes computed at the U.S. federal statutory income tax rate and the income tax provision for each of the years are as follows:

|  | Year ended March 31, |         |         |
|--|----------------------|---------|---------|
|  | 1997                 | 1996    | 1995    |
| Federal income tax provision at statutory rate | 35.0%                | 34.0%   | (34.0%) |
| State taxes, net of federal benefit            | 3.4%                 | -       | -       |
| Benefit of net operating loss carryforward     | -                    | (25.7%) | -       |
| Nondeductible amortization                     | 3.9%                 | 10.3%   | 30.4%   |
| Future (current) deductible reserves           | -                    | (4.9%)  | 39.3%   |
| Research and development credits               | (8.4)%               | (8.7%)  | (41.9%) |
| Incremental effect of foreign tax rates        | (4.1)%               | (0.5%)  | 22.2%   |
| Increase (reduction) of valuation allowance    | 4.0%                 | (35.4%) | -       |
| Other  | -                    | 0.4%    | (4.5)%  |
|  | 33.8%                | (30.5%) | 11.5%   |

The components of the net deferred tax asset and liability were as follows (amounts in thousands):

|                                  | March 31, 1997 | March 31, 1996 |
|----------------------------------|----------------|----------------|
|                                  | -----          | -----          |
| Deferred asset:                  |                |                |
| Allowance for bad debts          | \$ 272         | \$ 211         |
| Allowance for sales returns      | 441            | 785            |
| Miscellaneous                    | 99             | 49             |
| Tax credit carryforwards         | 2,553          | 1,450          |
| Net operating loss carryforwards | 10,447         | 13,310         |
|                                  | -----          | -----          |
| Deferred tax asset               | 13,812         | 15,805         |
| Valuation allowance              | (8,107)        | (14,305)       |
|                                  | -----          | -----          |
| Net deferred tax asset           | 5,705          | 1,500          |
|                                  | -----          | -----          |

During the year ended March 31, 1996, the Company recognized a tax benefit of \$1.5 million through a reduction in the Company's deferred tax asset valuation allowance. The reduction reflected the remaining portion of the Company's net operating loss carryforwards, the benefit from which could be recorded in the Company's provision for income taxes. In accordance with Statement of Position 90-7, "Financial Reporting by Entities in Reorganization Under the Bankruptcy Code," issued by the American Institute of Certified Public Accountants, benefits from loss carryforwards arising prior to the Company's reorganization are recorded as additional paid-in capital. During the year ended March 31, 1997, \$6.6 million of such benefit have been recognized through a reduction in the valuation allowance. The reductions in the valuation allowance during the years ended March 31, 1997 and 1996 were determined based on the Company's assessment of the realizability of its deferred tax assets, based on recent operating history, and the Company's expectation that operations will continue to generate taxable income, as well as other factors. Realization of the deferred tax assets is dependent upon the continued generation of sufficient taxable income prior to expiration of tax credits and loss carryforwards. Although realization is not assured, management believes it is more likely than not that the deferred tax asset of \$5.7 million will be realized. The amount of deferred tax assets considered realizable, however, could be reduced in the future if estimates of future taxable income are reduced. The provision for Income taxes for the year ended March 31, 1995 represents foreign taxes withheld.

The Company's available net operating loss carryforward for federal tax reporting purposes approximates \$28.3 million and is subject to certain limitations as defined under Section 382 of the Internal Revenue Code. The net operating loss carryforwards expire from 1999 to 2009. At March 31, 1997, the Company had a net operating loss carryforward for California tax reporting purposes of approximately \$10.7 million. The California net operating loss carryforwards expire from 1998 to 2003.

## 8. COMMITMENTS AND CONTINGENCIES

### LEASE OBLIGATIONS

The Company leases its facilities under non-cancelable operating lease agreements. Total future minimum lease commitments as of March 31, 1997 are as follows (amounts in thousands):

|                       |           |
|-----------------------|-----------|
| Year ending March 31, |           |
| 1998                  | \$ 2,379  |
| 1999                  | 2,116     |
| 2000                  | 2,218     |
| 2001                  | 2,223     |
| 2002                  | 2,223     |
| Thereafter            | 11,070    |
|                       | -----     |
|                       | \$ 22,229 |
|                       | -----     |
|                       | -----     |

Rent expense for the years ended March 31, 1997, 1996 and 1995 was approximately \$1,777,000, \$1,348,000 and \$811,000, respectively.

### EMPLOYMENT AGREEMENTS

As of March 31, 1997, the Company has entered into employment agreements with various personnel which have obligated the Company to make total minimum payments of \$3,102,000 and \$67,000 during the years ending March 31, 1998 and 1999, respectively.

## LEGAL PROCEEDINGS

The Company is party to routine claims and suits brought against it in the ordinary course of business including disputes arising over the ownership of intellectual property rights and collection matters. In the opinion of management, the outcome of such routine claims will not have a material adverse effect on the Company's business, financial condition, results of operations or liquidity.

## 9. EMPLOYEE BENEFIT PLANS

### STOCK OPTION PLAN

The Company has a stock option plan (the "Stock Option Plan") for the benefit of officers, employees, consultants and others. The Stock Option Plan permits the granting of non-qualified stock options, incentive stock options ("ISOs"), stock appreciation rights ("SARs"), restricted stock awards, deferred stock awards and other Common Stock-based awards. The total number of shares of Common Stock available for distribution under the Stock Option Plan is 6,066,667. The plan requires available shares to consist in whole or in part of authorized and unissued shares or treasury shares. There were 326,000 remaining shares available for grant under the Stock Option Plan as of March 31, 1997.

The stock option exercise price is determined at the discretion of the Board of Directors, and for ISOs, is not to be less than the fair market value at the date of grant, or in the case of non-qualified options, must exceed or be equal to 85% of fair market value at date of grant. Options typically become exercisable in equal installments over a period not to exceed five years and must be exercised within 10 years of date of grant. Historically, stock options have been granted with exercise prices equal to or greater than the fair market value at the date of grant.

Stock Option Plan activity was as follows (amounts in thousands, except weighted average exercise price amounts):

|                                  | 1997            |                     | 1996            |                     | 1995            |                     |
|----------------------------------|-----------------|---------------------|-----------------|---------------------|-----------------|---------------------|
|                                  | Shares<br>(000) | Wtd Avg<br>Ex Price | Shares<br>(000) | Wtd Avg<br>Ex Price | Shares<br>(000) | Wtd Avg<br>Ex Price |
| Outstanding at beginning of year | 3,725           | \$11.37             | 1,190           | \$ 5.20             | 398             | \$ 2.98             |
| Granted                          | 1,947           | 11.28               | 2,805           | 13.61               | 1,073           | 5.61                |
| Exercised                        | (313)           | 7.05                | (50)            | 4.54                | (59)            | 1.67                |
| Forfeited                        | (181)           | 9.24                | (220)           | 6.07                | (222)           | 4.13                |
| Expired                          | -               | -                   | -               | -                   | -               | -                   |
| Outstanding at end of year       | 5,178           | \$11.69             | 3,725           | \$ 11.37            | 1,190           | \$ 5.20             |
| Exercisable at end of year       | 3,242           | \$12.62             | 334             | \$ 4.55             | 176             | \$ 3.82             |

The range of exercise prices for options outstanding as of March 31, 1997 was \$1.50 to \$21.18. The range of exercise prices for options is wide due to increases in the Company's stock price over the period of the grants. For the year ended March 31, 1997, 1,227,000 options were granted at an exercise price equal to the fair market value on the date of grant, and 720,000 options were granted at an exercise price greater than fair market value on the date of grant.

The following tables summarize information about options outstanding at March 31, 1997:

| Outstanding Options |  |                              |
|---------------------|--|------------------------------|
| Shares<br>(000)     | Remaining<br>Weighted Avg<br>Contractual<br>Life<br>(in years) | Wtd Avg<br>Exercise<br>Price |

|                           |       |       |         |
|---------------------------|-------|-------|---------|
| Range of exercise prices: |       |       |         |
| \$1.50 to \$9.75          | 1,728 | 7.9   | \$ 6.53 |
| \$9.78 to \$13.00         | 1,557 | 9.4   | 11.34   |
| \$13.13 to \$21.18        | 1,893 | 8.3   | 16.69   |
|                           | ----- | ----- | -----   |
| Total                     | 5,178 | 8.5   | \$11.69 |
|                           | ----- | ----- | -----   |
|                           | ----- | ----- | -----   |

#### Exercisable Options

|                           | Shares<br>(000) | Wtd Avg<br>Exercise<br>Price |
|---------------------------|-----------------|------------------------------|
|                           | -----           | -----                        |
| Range of exercise prices: |                 |                              |
| \$1.50 to \$9.75          | 829             | \$ 5.92                      |
| \$9.78 to \$13.00         | 789             | 10.34                        |
| \$13.13 to \$21.18        | 1,624           | 17.16                        |
|                           | -----           | -----                        |
| Total                     | 3,242           | \$12.62                      |
|                           | -----           | -----                        |
|                           | -----           | -----                        |

These options will expire if not exercised at specific dates ranging from January 2002 to March 2007. Prices for options exercised during the three year period ended March 31, 1997 ranged from \$0.75 to \$11.05.

#### EMPLOYEE STOCK PURCHASE PLAN

The Company has an employee stock purchase plan for all eligible employees (the "Purchase Plan"). Under the Purchase Plan, shares of the Company's common stock may be purchased at six-month intervals at 85% of the lower of the fair market value on the first or last day of each six-month period (the "Offering Period"). Employees may purchase shares having a value not exceeding 10% of their gross compensation during an Offering Period. During the Purchase Plan's first Offering Period ended March 31, 1997, employees purchased 19,000 shares at a price of \$9.56 per share. As of March 31, 1997, 181,000 shares were reserved for future issuance under the Purchase Plan.

#### EMPLOYEE RETIREMENT PLAN

The Company has a retirement plan covering substantially all of its eligible employees. The retirement plan is qualified in accordance with Section 401(k) of the Internal Revenue Code. Under the plan, employees may defer up to 15% of their pre-tax salary, but not more than statutory limits. The Company contributes 5% of each dollar a participant contributes. The Company's matching contributions to the plan were \$25,000 and \$10,000 during the years ended March 31, 1997 and March 31, 1996; the Company made no matching contributions in the year ended March 31, 1995.

#### DIRECTOR WARRANT PLAN

The Director Warrant Plan provides for the automatic granting of warrants ("Director Warrants") to purchase 16,667 shares of the Common Stock to each director of the Company who is not an officer or employee of the Company or any of its subsidiaries. The total number of shares of Common Stock available for distribution under the Director Warrant Plan was 100,000. Director Warrants granted under the Director Warrant Plan vest 25% on the first anniversary of the date of grant, and 12.5% each six months thereafter. The Director Warrant Plan expired on December 19, 1996. The expiration had no effect on the outstanding Warrants.

Director Warrant activity was as follows (amounts in thousands, except weighted average exercise price amounts):

|                                  | 1997            |                     | 1996            |                     | 1995            |                     |
|----------------------------------|-----------------|---------------------|-----------------|---------------------|-----------------|---------------------|
|                                  | Shares<br>(000) | Wtd Avg<br>Ex Price | Shares<br>(000) | Wtd Avg<br>Ex Price | Shares<br>(000) | Wtd Avg<br>Ex Price |
|                                  | -----           | -----               | -----           | -----               | -----           | -----               |
| Outstanding at beginning of year | 73              | \$4.43              | 50              | \$ 0.75             | 67              | \$ 0.94             |
| Granted                          | -               | -                   | 60              | 7.50                | -               | -                   |
| Exercised                        | -               | -                   | (17)            | 0.75                | (8)             | 1.50                |
| Forfeited                        | -               | -                   | (20)            | 7.50                | (9)             | 1.50                |

|                            |       |        |       |         |       |         |
|----------------------------|-------|--------|-------|---------|-------|---------|
| Expired                    | -     | -      | -     | -       | -     | -       |
|                            | ----- | -----  | ----- | -----   | ----- | -----   |
| Outstanding at end of year | 73    | \$4.43 | 73    | \$ 4.43 | 50    | \$ 0.75 |
|                            | ----- | -----  | ----- | -----   | ----- | -----   |
| Exercisable at end of year | 73    | \$4.43 | 39    | \$ 2.47 | 38    | \$ 0.75 |

During the fiscal year ended March 31, 1997, 40,000 Director Warrants were granted to new directors outside of the Director Warrant Plan with an average exercise price of \$12.85 and vesting consistent with other outstanding Director Warrants.

The range of exercise prices for director warrants outstanding as of March 31, 1997 was \$0.75 to \$8.50. The range of exercise prices for options is wide due to increases in the Company's stock price over the period of the grants. As of March 31, 1997, 33,000 of the outstanding and vested director warrants have a weighted average remaining contractual life of 4.8 years and a weighted average exercise price of \$0.75, 20,000 of the outstanding and vested director warrants have a weighted average remaining contractual life of 7.8 years and a weighted average exercise price of \$6.50 and 20,000 of the outstanding and vested director warrants have a weighted average remaining contractual life of 7.8 years and a weighted average exercise price of \$8.50.

#### PRO FORMA INFORMATION

The Company has elected to follow APB Opinion No. 25, "Accounting for Stock Issued to Employees," in accounting for its employee stock options. Under APB No. 25, if the exercise price of the Company's employee stock options equals the market price of the underlying stock on the date of grant, no compensation expense is recognized in the Company's financial statements.

Pro forma information regarding net income and earnings per share is required by SFAS No. 123. This information is required to be determined as if the Company had accounted for its employee stock options (including shares issued under the Purchase Plan and Director Warrant Plan collectively called "options") granted during fiscal 1996 and 1997 under the fair value method of that statement. The fair value of options granted in the years ended March 31, 1997 and 1996 reported below has been estimated at the date of grant using a Black-Scholes option pricing model with the following weighted average assumptions:

|                          | Stock Option Plan |       | Purchase Plan |      | Director Warrant Plan |       |
|--------------------------|-------------------|-------|---------------|------|-----------------------|-------|
|                          | 1997              | 1996  | 1997          | 1996 | 1997                  | 1996  |
| Expected life (in years) | 2.2               | 3.7   | 0.5           | -    | -                     | 2.0   |
| Risk free interest rate  | 6.45%             | 6.45% | 6.45%         | -    | -                     | 6.45% |
| Volatility               | .60               | .60   | .60           | -    | -                     | .60   |
| Dividend yield           | -                 | -     | -             | -    | -                     | -     |

The Black-Scholes option valuation model was developed for use in estimating the fair value of traded options that have no vesting restrictions and are fully transferable. In addition, option valuation models require the input of highly subjective assumptions, including the expected stock price volatility. Because the Company's options have characteristics significantly different from those of trade options, and because changes in the subjective input assumptions can materially affect the fair value estimate, in the opinion of management, the existing models do not necessarily provide a reliable single measure of the fair value of its options. The weighted average estimated fair value of Stock Option Plan shares granted during the years ended March 31, 1997 and 1996 was \$4.04 and \$3.74 per share, respectively. The weighted average estimated fair value of Employee Purchase Plan shares granted during the year ended March 31, 1997 was \$2.89. The weighted average estimated fair value of Director Warrants granted during the year ended March 31, 1997 was \$2.27.

For purposes of pro forma disclosures, the estimated fair value of the options is amortized to expense over the options' vesting period. The Company's pro forma information follows (amounts in thousands except for earnings per share information):

| Year ended March 31, |      |
|----------------------|------|
| 1997                 | 1996 |

|                              |          |          |
|------------------------------|----------|----------|
| Pro forma net income         | \$ 3,828 | \$ 2,302 |
| Pro forma earnings per share | \$ .26   | \$ .15   |

The effects on pro forma disclosures of applying SFAS No. 123 are not likely to be representative of the effects on pro forma disclosures of future years. Because SFAS No. 123 is applicable only to options granted during fiscal 1996 and 1997, the pro forma effect will not be fully reflected until the fiscal year ended March 31, 2000.

#### 10. RELATED PARTY TRANSACTIONS

##### PROMISSORY NOTES RECEIVABLE

As of March 31, 1997, accounts receivable includes \$177,000 in promissory notes receivable from Robert A. Kotick, a director, officer and shareholder of the Company. The promissory notes are dated December 28, 1994 and April 28, 1995, have maturity dates, as amended, of December 31, 1997 and bear interest at 9.0% per annum.

##### MERGER WITH INTERNATIONAL CONSUMER TECHNOLOGIES CORPORATION (ICT)

Effective January 1, 1995, ICT was merged with and into a wholly owned subsidiary of the Company, with ICT as the surviving corporation. ICT's sole asset at the time of the merger was 5,429,600 shares of the Company's Common Stock. As a result of the merger, the shares of the Company's Common Stock previously held by ICT were distributed to the shareholders of ICT in exchange for their shares of ICT common stock. No other assets or liabilities were acquired or assumed by the Company as a result of the merger.

#### 11. QUARTERLY FINANCIAL AND MARKET INFORMATION (UNAUDITED)

| (Dollars in thousands, except per share data) | Quarter Ended |           |           |           | Year<br>Ended |
|---|---------------|-----------|-----------|-----------|---------------|
|   | June 30       | Sept 30   | Dec 31    | Mar 31    |               |
|   | -----         | -----     | -----     | -----     |               |
| Fiscal 1997:                                  |               |           |           |           |               |
| Net revenues                                  | \$ 7,021      | \$ 19,175 | \$ 31,361 | \$ 28,926 | \$ 86,483     |
| Operating income (loss)                       | (4,226)       | 1,769     | 6,210     | 6,054     | 9,807         |
| Net income (loss)                             | (2,631)       | 1,336     | 4,120     | 4,282     | 7,107         |
| Net income (loss) per common share            | (0.19)        | 0.09      | 0.28      | 0.29      | 0.49          |
| Common stock price per share                  |               |           |           |           |               |
| High  | \$ 15.00      | \$ 14.38  | \$ 14.00  | \$ 16.25  | \$ 16.25      |
| Low   | 11.63         | 9.50      | 10.56     | 10.00     | 9.50          |
| Fiscal 1996:                                  |               |           |           |           |               |
| Net revenues                                  | \$ 3,319      | \$ 18,848 | \$ 17,578 | \$ 21,648 | 61,393        |
| Operating income (loss)                       | (6,014)       | 2,366     | 1,573     | 4,607     | 2,532         |
| Net income (loss)                             | (5,528)       | 2,765     | 1,948     | 6,345     | 5,530         |
| Net income (loss) per common share            | (0.39)        | 0.18      | 0.13      | 0.43      | 0.37          |
| Common stock price per share                  |               |           |           |           |               |
| High  | \$ 7.125      | \$ 19.75  | \$ 18.50  | \$ 15.125 | \$ 19.75      |
| Low   | 5.75          | 6.75      | 8.125     | 8.625     | 5.75          |



## SCHEDULE II

ACTIVISION, INC. AND SUBSIDIARIES  
VALUATION AND QUALIFYING ACCOUNTS AND RESERVES  
(Amounts in thousands)

| Col. A<br>-----<br>Description                                      | Col. B<br>-----<br>Balance at<br>Beginning<br>of Period | Col. C<br>-----<br>Additions | Col. D<br>-----<br>Deductions<br>(Describe) | Col. E<br>-----<br>Balance at<br>End of<br>Period |
|---|---|------------------------------|---|---|
| Year ended March 31, 1997:  |   |                              |   |   |
| Allowance for sales returns, price protection and doubtful accounts | \$ 7,005  | \$ 13,249                    | \$13,768 (A)                                | \$ 6,468  |
| Inventory valuation   | \$ 145  | \$ 142                       | \$ 152 (B)                                  | \$ 135  |
| Deferred tax valuation allowance                                    | \$14,305  | \$ 436                       | \$ 6,634                                    | \$ 8,107  |
| Year ended March 31, 1996:  |   |                              |   |   |
| Allowance for sales returns, price protection and doubtful accounts | \$ 4,469  | \$ 12,402                    | \$ 9,866                                    | \$ 7,005  |
| Inventory valuation   | \$ 357  | \$ 532                       | \$ 744 (B)                                  | \$ 145  |
| Deferred tax valuation allowance                                    | \$16,500  | \$ (695)                     | \$ 1,500                                    | \$14,305  |
| Year ended March 31, 1995:  |   |                              |   |   |
| Allowance for sales returns, price protection and doubtful accounts | \$ 3,266  | \$ 3,795                     | \$ 3,592 (A)                                | \$ 4,469  |
| Inventory valuation   | \$ 493  | \$ 134                       | \$ 270 (B)                                  | \$ 357  |
| Deferred tax valuation allowance                                    | \$15,531  | \$ 969                       | \$ -  | \$16,500  |

(A) Actual write-offs of uncollectible accounts receivable or sales returns and price protection.

(B) Actual write-offs of obsolete inventory, scrap and reduction in carrying value of certain portions of inventory.

# EXHIBIT INDEX

| Exhibit<br>Number<br>----- | Exhibit<br>-----   | Sequential Page<br>Number<br>----- |
|----------------------------|--|------------------------------------|
| 2.1                        | Plan of Reorganization of the Company, as confirmed by the United States Bankruptcy Court for the Northern District of California on November 25, 1991 (incorporated by reference to Exhibit 28.2 of the Company's Current Report on Form 8-K dated October 4, 1991).  |                                    |
| 2.2                        | Plan and Agreement of Merger, dated March 30, 1992, among the Company, Disc Company, Inc. and International Consumer Technologies Corporation (incorporated by reference to Exhibit 28.1 of the Company's Current Report on Form 8-K dated March 31, 1992).  |                                    |
| 2.3                        | Agreement and Plan of Merger between Activision, Inc., a California corporation, and Activision, Inc., a Delaware corporation, as filed with the Secretary of State of the State of Delaware (incorporated by reference to Exhibit 4.7 of Amendment No. 1 to the Company's Form S-8, Registration No. 33-48411 filed on June 1, 1993). |                                    |
| 2.4                        | Plan and Agreement of Merger, dated October 28, 1994, among the Company, ACTV Acquisition, Inc. and International Consumer Technologies Corporation (incorporated by reference to Exhibit 2.4 of the Company's Quarterly Report on Form 10-Q for the period ended December 31, 1994).  |                                    |
| 3.1                        | Amended and Restated Articles of Incorporation of Activision, Inc., dated October 15, 1992 (incorporated by reference to Exhibit 4.5 of Amendment No. 1 to the Company's Form S-8, Registration No. 33-48411 filed on June 1, 1993).   |                                    |
| 3.2                        | Bylaws of Activision, Inc. (incorporated by reference to Exhibit 4.6 of Amendment No. 1 to the Company's Form S-8, Registration No. 33-48411 filed on June 1, 1993).   |                                    |
| 10.7                       | Mediagenic 1991 Stock Option and Stock Award Plan, as amended (incorporated by reference to Exhibit 4.1 to the Company's Registration Statement on Form S-8, Registration No. 33-63638, filed on December 8, 1995).  |                                    |
| 10.8                       | Mediagenic 1991 Director Warrant Plan as amended (incorporated by reference to Exhibit 28.2 to the Company's Registration Statement on Form S-8, Registration No. 33-63638, filed on June 1, 1993).  |                                    |
| 10.9                       | Purchase Agreement, dated as of January 24, 1994, among the Company and each purchaser who is a signatory thereto (incorporated by reference to Exhibit 28.1 of the Company's Form 8-K filed February 9, 1994).  |                                    |
| 10.10                      | Registration Rights Agreement, dated as of January 31, 1994, among the Company and each purchaser who is a signatory thereto (incorporated by reference to Exhibit 28.2 of the Company's Form 8-K filed February 9, 1994).   |                                    |
| 10.11                      | Share Exchange and Recapitalization Agreement, dated as of January 14, 1994, among the Company, International Consumer Technologies Corporation, Steven Wynn, J.F. Shea Co., Inc. as Nominee 1993-6 and ESL Partners, L.P. (incorporated by reference to Exhibit 28.3 of the Company's Form 8-K filed February 9, 1994).               |                                    |
| 10.12                      | Registration Rights Agreement, dated as of January 31, 1994, among the Company, International Consumer Technologies Corporation, Steven Wynn, J.F. Shea Co., Inc. as Nominee 1993-6 and ESL Partners, L.P. (incorporated by reference to Exhibit 28.4 of the Company's Form 8-K filed February 9, 1994).                               |                                    |

| Exhibit<br>Number<br>----- | Exhibit<br>-----   | Sequential Page<br>Number<br>----- |
|----------------------------|--|------------------------------------|
| 10.14                      | Lease Agreement dated as of December 20, 1996,<br>between the Company and Barclay Curci Investment<br>Company (incorporated by reference to<br>Exhibit 10.14 of the Company's Form 10-Q for<br>the quarter ended December 31, 1996). |                                    |
| 11.                        | Statement regarding computation of per share earnings.   | 46                                 |
| 16.                        | Letter from Coopers & Lybrand, LLP pursuant to<br>Item 304 (a) (3) of Regulation S-K (incorporated by<br>reference to Exhibit 16 of the Company's Form 8-K<br>filed January 17, 1997.)   |                                    |
| 21.                        | Principal subsidiaries of the Company.   | 47                                 |
| 23.1                       | Consent of Independent Accountants.  | 48                                 |
| 23.2                       | Consent of Independent Accountants.  | 49                                 |
| 27.                        | Financial Data Schedule.   |                                    |

## ACTIVISION AND SUBSIDIARIES

COMPUTATION OF NET INCOME (LOSS) PER SHARE  
(In thousands, except per share amounts)

|   | Year ended<br>March 31, 1997<br>----- | Year ended<br>March 31, 1996<br>----- | Year ended<br>March 31, 1995<br>----- |
|---|---------------------------------------|---------------------------------------|---------------------------------------|
| PRIMARY SHARES CALCULATION  |                                       |                                       |                                       |
| Reconciliation of weighted average number of<br>shares outstanding to amount used in primary<br>earnings per share computation:       |                                       |                                       |                                       |
| Weighted average shares outstanding   | 13,930                                | 14,011                                | 13,944                                |
| Add-shares issuable from assumed exercise of<br>options and warrants  | 689                                   | 939                                   | -                                     |
|   | -----                                 | -----                                 | -----                                 |
| Weighted average number of shares outstanding<br>as adjusted  | 14,619                                | 14,950                                | 13,944                                |
|   | -----                                 | -----                                 | -----                                 |
| FULLY DILUTED SHARES CALCULATION  |                                       |                                       |                                       |
| Reconciliation of weighted average number of<br>shares outstanding to amount used in fully<br>diluted earnings per share computation: |                                       |                                       |                                       |
| Weighted average shares outstanding   | 13,930                                | 14,011                                | 13,944                                |
| Add-shares issuable from assumed exercise<br>of options and warrants  | 689                                   | 939                                   | -                                     |
|   | -----                                 | -----                                 | -----                                 |
| Weighted average number of shares<br>outstanding as adjusted  | 14,619                                | 14,950                                | 13,944                                |
|   | -----                                 | -----                                 | -----                                 |
| NET INCOME (LOSS)   | \$ 7,107                              | \$ 5,530                              | \$ (1,520)                            |
|   | -----                                 | -----                                 | -----                                 |
| PRIMARY EARNINGS PER SHARE  | \$ 0.49                               | \$ 0.37                               | \$ (0.11)                             |
|   | -----                                 | -----                                 | -----                                 |
| FULLY DILUTED EARNINGS PER SHARE (1)  | \$ 0.49                               | \$ 0.37                               | \$ (0.11)                             |
|   | -----                                 | -----                                 | -----                                 |

(1) Net income (loss) per common share presented on the face of the income statement represents primary earnings per share. Dual presentation of primary and fully diluted earnings per share has not been made on the face of the income statement because there are no differences. This exhibit is presented because the common stock equivalents represent more than 3% of weighted average common shares outstanding.

## PRINCIPAL SUBSIDIARIES OF THE REGISTRANT

| Name of subsidiary            | State or Other Jurisdiction<br>of Incorporation or<br>Organization |
|-------------------------------|--|
| -----                         | -----  |
| Activision Japan Co., Ltd.    | Japan  |
| Activision (U.K.) Ltd.        | United Kingdom   |
| Activision Europe SARL        | France   |
| Activision Australia Pty Ltd. | Australia  |
| TDC Group, Inc.               | Delaware   |
| Activision Productions, Inc.  | Delaware   |
| Activision Texas, Inc.        | Delaware   |
| Activision Illinois, Inc.     | Delaware   |

## INDEPENDENT AUDITORS' CONSENT

We consent to the incorporation by reference in the registration statement (Nos. 33-48411, 33-63638, 33-91074, 333-06130, 333-12621 and 333-06054) on Form S-8 and (Nos. 33-68144 and 33-75878) on Form S-3 of Activision, Inc. of our report dated May 18, 1997, relating to the consolidated balance sheet of ACTIVISION, INC. and Subsidiaries as of March 31, 1997 and the related consolidated statement of operations, changes in shareholders equity, and cash flows for the year then ended, and the related financial statement schedule for the year ended March 31, 1997, which report appears in the March 31, 1997 annual report on Form 10-K of ACTIVISION, INC.

KPMG Peat Marwick, LLP

Los Angeles, California  
June 13, 1997

CONSENT OF INDEPENDENT ACCOUNTANTS

We consent to the incorporation by reference in the registration statement of Activision, Inc. on Forms S-8 (File Nos. 33-48411, 33-63638, 33-91074, 333-06130, 333-12621 and 333-06054) and Forms S-3 (File Nos. 33-68144 and 33-75878) of our report dated May 15, 1996 except for Note 9, as to which the date is June 10, 1997, on our audits of the consolidated financial statements and financial statement schedules of Activision, Inc. and Subsidiaries as of March 31, 1996 and for the years ended March 31, 1996 and 1995, which report is included in this Annual Report on Form 10-K.

COOPERS & LYBRAND, LLP

Los Angeles, California  
June 13, 1997





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