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**UNITED STATES  
SECURITIES AND EXCHANGE COMMISSION**

Washington, D.C. 20549

**FORM 10-Q**

(Mark one)

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

**For the Quarterly Period Ended September 30, 2004**

**O R**

**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**

(State or other jurisdiction of  
incorporation or organization)

**95-4803544**

(I.R.S. Employer Identification No.)

**3100 Ocean Park Boulevard, Santa Monica, CA**

(Address of principal executive offices)

**90405**

(Zip Code)

**(310) 255-2000**

(Registrant's telephone number, including area code)

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  No

Indicate by check mark whether the registrant is an accelerated filer (as defined in Rule 12b-2 of the Exchange Act). Yes  No

The number of shares of the registrant's Common Stock outstanding as of November 1, 2004 was 139,149,612.

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ACTIVISION, INC. AND SUBSIDIARIES

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**Part I. Financial Information.**  
**Item 1. Financial Statements.**

**ACTIVISION, INC. AND SUBSIDIARIES**  
**CONSOLIDATED BALANCE SHEETS**  
(In thousands, except share data)

|   | September 30,<br>2004<br>(Unaudited) | March 31,<br>2004 |
|---|--------------------------------------|-------------------|
| <b>Assets</b>   |                                      |                   |
| Current assets:   |                                      |                   |
| Cash and cash equivalents   | \$ 389,791                           | \$ 466,552        |
| Short-term investments  | 216,296                              | 121,097           |
| Accounts receivable, net of allowances of \$61,679 and \$47,028 at September 30, 2004 and March 31, 2004, respectively  | 138,586                              | 62,577            |
| Inventories   | 63,690                               | 26,427            |
| Software development  | 79,432                               | 58,320            |
| Intellectual property licenses  | 15,945                               | 32,115            |
| Deferred income taxes   | 21,203                               | 26,127            |
| Other current assets  | 29,930                               | 18,660            |
| <b>Total current assets</b>   | <b>954,873</b>                       | <b>811,875</b>    |
| Software development  | 21,023                               | 28,386            |
| Intellectual property licenses  | 19,885                               | 16,380            |
| Property and equipment, net   | 24,712                               | 25,539            |
| Deferred income taxes   | 5,056                                | 9,064             |
| Other assets  | 1,018                                | 1,080             |
| Goodwill  | 77,602                               | 76,493            |
| <b>Total assets</b>   | <b>\$ 1,104,169</b>                  | <b>\$ 968,817</b> |
| <b>Liabilities and Shareholders' Equity</b>   |                                      |                   |
| Current liabilities:  |                                      |                   |
| Accounts payable  | \$ 103,001                           | \$ 72,874         |
| Accrued expenses  | 113,341                              | 63,205            |
| <b>Total current liabilities</b>  | <b>216,342</b>                       | <b>136,079</b>    |
| Commitments and contingencies (Note 13)   |                                      |                   |
| Shareholders' equity:   |                                      |                   |
| Preferred stock, \$.000001 par value, 3,750,000 shares authorized, no shares issued at September 30, 2004 and March 31, 2004  | —                                    | —                 |
| Series A Junior Preferred stock, \$.000001 par value, 1,250,000 shares authorized, no shares issued at September 30, 2004 and March 31, 2004  | —                                    | —                 |
| Common stock, \$.000001 par value, 225,000,000 shares authorized, 168,443,592 and 166,876,567 shares issued and 138,898,268 and 137,331,242 shares outstanding at September 30, 2004 and March 31, 2004, respectively | —                                    | —                 |
| Additional paid-in capital  | 777,337                              | 758,626           |
| Retained earnings   | 245,779                              | 208,279           |
| Less: Treasury stock, at cost, 29,545,325 and 29,545,325 shares at September 30, 2004 and March 31, 2004, respectively  | (144,128)                            | (144,128)         |
| Accumulated other comprehensive income  | 8,839                                | 9,961             |
| <b>Total shareholders' equity</b>   | <b>887,827</b>                       | <b>832,738</b>    |
| <b>Total liabilities and shareholders' equity</b>   | <b>\$ 1,104,169</b>                  | <b>\$ 968,817</b> |

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

**ACTIVISION, INC. AND SUBSIDIARIES**  
**CONSOLIDATED STATEMENTS OF OPERATIONS**

(Unaudited)

(In thousands, except per share data)

|   | For the three months ended<br>September 30, |             | For the six months ended<br>September 30, |            |
|---|---|-------------|---|------------|
|   | 2004  | 2003        | 2004                                      | 2003       |
| Net revenues  | \$ 310,626                                  | \$ 117,523  | \$ 521,902                                | \$ 276,248 |
| Costs and expenses:   |   |             |   |            |
| Cost of sales — product costs                                   | 123,177                                     | 72,391      | 212,265                                   | 149,001    |
| Cost of sales — software royalties and amortization             | 46,363                                      | 11,397      | 58,646                                    | 26,895     |
| Cost of sales — intellectual property licenses                  | 17,551                                      | 7,401       | 35,199                                    | 17,544     |
| Product development   | 19,881                                      | 15,894      | 40,986                                    | 29,474     |
| Sales and marketing   | 53,234                                      | 17,237      | 94,968                                    | 43,522     |
| General and administrative                                      | 15,762                                      | 10,136      | 29,447                                    | 21,599     |
| Total costs and expenses  | 275,968                                     | 134,456     | 471,511                                   | 288,035    |
| Operating income (loss)   | 34,658                                      | (16,933)    | 50,391                                    | (11,787)   |
| Investment income, net  | 2,645                                       | 1,404       | 4,757                                     | 2,661      |
| Income (loss) before income tax provision (benefit)             | 37,303                                      | (15,529)    | 55,148                                    | (9,126)    |
| Income tax provision (benefit)                                  | 11,760                                      | (5,436)     | 17,648                                    | (3,196)    |
| Net income (loss)   | \$ 25,543                                   | \$ (10,093) | \$ 37,500                                 | \$ (5,930) |
| Basic earnings (loss) per share                                 | \$ 0.18                                     | \$ (0.08)   | \$ 0.27                                   | \$ (0.04)  |
| Weighted average common shares outstanding                      | 138,505                                     | 132,243     | 138,137                                   | 132,158    |
| Diluted earnings (loss) per share                               | \$ 0.17                                     | \$ (0.08)   | \$ 0.24                                   | \$ (0.04)  |
| Weighted average common shares outstanding<br>assuming dilution | 152,685                                     | 132,243     | 153,127                                   | 132,158    |

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

**ACTIVISION, INC. AND SUBSIDIARIES**  
**CONSOLIDATED STATEMENTS OF CASH FLOWS**  
(Unaudited)  
(In thousands)

|  | For the six months ended |                   |
|--|--------------------------|-------------------|
|  | September 30,            |                   |
|  | 2004                     | 2003              |
| Cash flows from operating activities:  |                          |                   |
| Net income (loss)  | \$ 37,500                | \$ (5,930)        |
| Adjustments to reconcile net income (loss) to net cash provided by (used in) operating activities:       |                          |                   |
| Deferred income taxes  | 8,932                    | (4,063)           |
| Realized gain on short term investments  | (471)                    | (16)              |
| Depreciation and amortization  | 5,132                    | 4,905             |
| Amortization and write-offs of capitalized software development costs and intellectual property licenses | 65,246                   | 32,364            |
| Tax benefit of stock options and warrants exercised  | 4,918                    | 958               |
| Changes in operating assets and liabilities:   |                          |                   |
| Accounts receivable  | (76,009)                 | (13,580)          |
| Inventories  | (37,263)                 | (1,586)           |
| Software development and intellectual property licenses  | (66,330)                 | (53,443)          |
| Other assets   | (11,208)                 | (9,430)           |
| Accounts payable   | 30,127                   | 3,413             |
| Accrued expenses and other liabilities   | 50,136                   | (5,681)           |
| Net cash provided by (used in) operating activities  | <u>10,710</u>            | <u>(52,089)</u>   |
| Cash flows from investing activities:  |                          |                   |
| Capital expenditures   | (4,443)                  | (8,215)           |
| Purchases of short-term investments  | (121,635)                | (77,311)          |
| Proceeds from sales and maturities of short-term investments   | 27,237                   | 100,691           |
| Net cash (used in) provided by investing activities  | <u>(98,841)</u>          | <u>15,165</u>     |
| Cash flows from financing activities:  |                          |                   |
| Proceeds from issuance of common stock to employees  | 12,602                   | 4,778             |
| Other borrowings, net  | -                        | (2,818)           |
| Purchase of structured stock repurchase transactions   | -                        | (42,621)          |
| Settlement of structured stock repurchase transactions   | -                        | 120,823           |
| Purchase of treasury stock   | -                        | (18,814)          |
| Net cash provided by financing activities  | <u>12,602</u>            | <u>61,348</u>     |
| Effect of exchange rate changes on cash  | <u>(1,232)</u>           | <u>3,468</u>      |
| Net (decrease) increase in cash and cash equivalents   | (76,761)                 | 27,892            |
| Cash and cash equivalents at beginning of period   | 466,552                  | 285,554           |
| Cash and cash equivalents at end of period   | <u>\$ 389,791</u>        | <u>\$ 313,446</u> |

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

**ACTIVISION, INC. AND SUBSIDIARIES**  
**CONSOLIDATED STATEMENT OF CHANGES IN SHAREHOLDERS' EQUITY**  
For the six months ended September 30, 2004  
(Unaudited)  
(In thousands)

|   | Common Stock   |             | Additional<br>Paid-In<br>Capital | Retained<br>Earnings | Treasury Stock  |                     | Accumulated Other<br>Comprehensive<br>Income (Loss) | Shareholders'<br>Equity |
|---|----------------|-------------|----------------------------------|----------------------|-----------------|---------------------|---|-------------------------|
|   | Shares         | Amount      |                                  |                      | Shares          | Amount              |   |                         |
| <b>Balance, March 31, 2004</b>  | <b>166,877</b> | <b>\$ —</b> | <b>\$ 758,626</b>                | <b>\$ 208,279</b>    | <b>(29,546)</b> | <b>\$ (144,128)</b> | <b>\$ 9,961</b>                                     | <b>\$ 832,738</b>       |
| Components of comprehensive income:   |                |             |                                  |                      |                 |                     |   |                         |
| Net Income  | —              | —           | —                                | 37,500               | —               | —                   | —   | 37,500                  |
| Unrealized gain on short-term investments   | —              | —           | —                                | —                    | —               | —                   | 330   | 330                     |
| Foreign currency translation adjustment   | —              | —           | —                                | —                    | —               | —                   | (1,452)   | (1,452)                 |
| Total comprehensive income  |                |             |                                  |                      |                 |                     |   | 36,378                  |
| Issuance of common stock pursuant to employee stock option and stock purchase plans and common stock warrants |                |             |                                  |                      |                 |                     |   |                         |
|   | 1,485          | —           | 12,602                           | —                    | —               | —                   | —   | 12,602                  |
| Tax benefit attributable to employee stock options and common stock warrants                                  |                |             |                                  |                      |                 |                     |   |                         |
|   | —              | —           | 4,918                            | —                    | —               | —                   | —   | 4,918                   |
| Issuance of stock to effect business combination  |                |             |                                  |                      |                 |                     |   |                         |
|   | 82             | —           | 1,191                            | —                    | —               | —                   | —   | 1,191                   |
| <b>Balance, September 30, 2004</b>  | <b>168,444</b> | <b>\$ —</b> | <b>\$ 777,337</b>                | <b>\$ 245,779</b>    | <b>(29,546)</b> | <b>\$ (144,128)</b> | <b>\$ 8,839</b>                                     | <b>\$ 887,827</b>       |

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

**ACTIVISION, INC. AND SUBSIDIARIES**  
Notes to Consolidated Financial Statements (Unaudited)  
For the three and six months ended September 30, 2004

**1. Summary of Significant Accounting Policies**

*Basis of Presentation*

The accompanying consolidated financial statements include the accounts of Activision, Inc. and its subsidiaries (“Activision” or “we”). The information furnished is unaudited and consists of only normal recurring adjustments that, in the opinion of management, are necessary to provide a fair statement of the results for the interim periods presented. Certain prior period amounts have been reclassified to conform with the current period presentation. The Consolidated Financial Statements should be read in conjunction with the Consolidated Financial Statements included in our Annual Report on Form 10-K for the year ended March 31, 2004 as filed with the Securities and Exchange Commission (“SEC”).

*Software Development Costs and Intellectual Property Licenses*

Software development costs include payments made to independent software developers under development agreements, as well as direct costs incurred for internally developed products.

We account for software development costs in accordance with SFAS No. 86, “Accounting for the Costs of Computer Software to Be Sold, Leased, or Otherwise Marketed.” Software development costs are capitalized once technological feasibility of a product is established and such costs are determined to be recoverable. Technological feasibility of a product encompasses both technical design documentation and game design documentation. For products where proven technology exists, this may occur early in the development cycle. Technological feasibility is evaluated on a product-by-product basis. Prior to a product’s release, we expense, as part of cost of sales — software royalties and amortization, capitalized costs when we believe such amounts are not recoverable. Capitalized costs for those products that are cancelled or abandoned are charged to product development expense in the period of cancellation. Amounts related to software development which are not capitalized are charged immediately to product development expense. We evaluate the future recoverability of capitalized amounts on a quarterly basis. The recoverability of capitalized software development costs is evaluated based on the expected performance of the specific products for which the costs relate. Criteria used to evaluate expected product performance include: historical performance of comparable products using comparable technology; orders for the product prior to its release; and estimated performance of a sequel product based on the performance of the product on which the sequel is based.

Commencing upon product release, capitalized software development costs are amortized to cost of sales — software royalties and amortization based on the ratio of current revenues to total projected revenues, generally resulting in an amortization period of six months or less. For products that have been released in prior periods, we evaluate the future recoverability of capitalized amounts on a quarterly basis. The primary evaluation criterion is actual title performance.

Significant management judgments and estimates are utilized in the assessment of when technological feasibility is established, as well as in the ongoing assessment of the recoverability of capitalized costs. In evaluating the recoverability of capitalized costs, the assessment of expected product performance utilizes forecasted sales amounts and estimates of additional development costs to be incurred. If revised forecasted or actual product sales are less than and/or revised forecasted or actual costs are greater than the original forecasted amounts utilized in the initial recoverability analysis, the actual impairment charge may be larger than originally estimated in any given quarter.

Intellectual property license costs represent license fees paid to intellectual property rights holders for use of their trademarks, copyrights, software, technology or other intellectual property or proprietary rights in the development of our products. Depending upon the agreement with the rights holder, we may obtain the rights to use acquired intellectual property in multiple products over multiple years, or alternatively, for a single product.

We evaluate the future recoverability of capitalized intellectual property licenses on a quarterly basis. The recoverability of capitalized intellectual property license costs is evaluated based on the expected performance of the specific products in which the licensed trademark or copyright is to be used. As many of our intellectual property licenses extend for multiple products over multiple years, we also assess the recoverability of capitalized intellectual property license costs based on certain qualitative factors such as the success of other

products and/or entertainment vehicles utilizing the intellectual property, whether there are any future planned theatrical releases or television series based on the intellectual property and the rights holder's continued promotion and exploitation of the intellectual property. Prior to the related product's release, we expense, as part of cost of sales — intellectual property licenses, capitalized intellectual property costs when we believe such amounts are not recoverable. Capitalized intellectual property costs for those products that are cancelled or abandoned are charged to product development expense in the period of cancellation. Criteria used to evaluate expected product performance include: historical performance of comparable products using comparable technology; orders for the product prior to its release; and estimated performance of a sequel product based on the performance of the product on which the sequel is based.

Commencing upon the related product's release, capitalized intellectual property license costs are amortized to cost of sales — intellectual property licenses based on the ratio of current revenues for the specific product to total projected revenues for all products in which the licensed property will be utilized. As intellectual property license contracts may extend for multiple years, the amortization of capitalized intellectual property license costs relating to such contracts may extend beyond one year. For intellectual property included in products that have been released, we evaluate the future recoverability of capitalized amounts on a quarterly basis. The primary evaluation criterion is actual title performance.

Significant management judgments and estimates are utilized in the assessment of the recoverability of capitalized costs. In evaluating the recoverability of capitalized costs, the assessment of expected product performance utilizes forecasted sales amounts and estimates of additional development costs to be incurred. If revised forecasted or actual product sales are less than, and/or revised forecasted or actual costs are greater than, the original forecasted amounts utilized in the initial recoverability analysis, the actual impairment charge may be larger than originally estimated in any given quarter. Additionally, as noted above, as many of our intellectual property licenses extend for multiple products over multiple years, we also assess the recoverability of capitalized intellectual property license costs based on certain qualitative factors such as the success of other products and/or entertainment vehicles utilizing the intellectual property, whether there are any future planned theatrical releases or television series based on the intellectual property and the rights holder's continued promotion and exploitation of the intellectual property. Material differences may result in the amount and timing of charges for any period if management makes different judgments or utilizes different estimates in evaluating these qualitative factors.

#### *Revenue Recognition*

We recognize revenue from the sale of our products upon the transfer of title and risk of loss to our customers. Certain products are sold to customers with a street date (the date that products are made widely available by retailers). For these products we recognize revenue on the street date. Revenue from product sales is recognized after deducting the estimated allowance for returns and price protection. With respect to license agreements that provide customers the right to make multiple copies in exchange for guaranteed amounts, revenue is recognized upon delivery of such copies. Per copy royalties on sales that exceed the guarantee are recognized as earned. In addition, in order to recognize revenue for both product sales and licensing transactions, persuasive evidence of an arrangement must exist and collection of the related receivable must be probable. Revenue recognition also determines the timing of certain expenses, including cost of sales — intellectual property licenses and cost of sales — software royalties and amortization.

Sales incentives or other consideration given by us to our customers is accounted for in accordance with the Financial Accounting Standards Board's Emerging Issues Task Force ("EITF") Issue 01-9, "Accounting for Consideration Given by a Vendor to a Customer (Including a Reseller of the Vendor's Products)." In accordance with EITF Issue 01-9, sales incentives and other consideration that are considered adjustments of the selling price of our products, such as rebates and product placement fees, are reflected as reductions of revenue. Sales incentives and other consideration that represent costs incurred by us for assets or services received, such as the appearance of our products in a customer's national circular ad, are reflected as sales and marketing expenses.



*Stock-Based Compensation and Pro Forma Information*

Under SFAS No. 123 "Accounting for Stock-Based Compensation," compensation expense is recorded for the issuance of stock options and other stock-based compensation based on the fair value of the stock options and other stock-based compensation on the date of grant or measurement date. Alternatively, SFAS No. 123 allows companies to continue to account for the issuance of stock options and other stock-based compensation in accordance with Accounting Principles Board ("APB") Opinion No. 25, "Accounting for Stock Issued to Employees." Under APB No. 25, compensation expense is recorded for the issuance of stock options and other stock-based compensation based on the intrinsic value of the stock options and other stock-based compensation on the date of grant or measurement date. Under the intrinsic value method, compensation expense is recorded on the date of grant or measurement date only if the current market price of the underlying stock exceeds the stock option or other stock-based compensation exercise price. At September 30, 2004, we had several stock-based employee compensation plans, which are described more fully in Note 15 to the Notes to Consolidated Financial Statements included in Item 8 of our Annual Report on Form 10-K for the year ended March 31, 2004 filed with the SEC. We account for those plans under the recognition and measurement principles of APB Opinion No. 25 and related Interpretations. The following table illustrates the effect on net income and earnings per share if we had applied the fair value recognition provisions of SFAS No. 123 to stock-based employee compensation (amounts in thousands, except per share data):

|   | Three months ended September 30, |             | Six months ended September 30, |             |
|---|----------------------------------|-------------|--------------------------------|-------------|
|   | 2004                             | 2003        | 2004                           | 2003        |
| Net income (loss), as reported  | \$ 25,543                        | \$ (10,093) | \$ 37,500                      | \$ (5,930)  |
| Deduct: Total stock-based employee compensation expense determined under fair value based method for all awards, net of related tax effects | (3,559)                          | (4,205)     | (8,498)                        | (9,740)     |
| Pro forma net income (loss)   | \$ 21,984                        | \$ (14,298) | \$ 29,002                      | \$ (15,670) |
| Earnings (loss) per share:  |                                  |             |                                |             |
| Basic — as reported   | \$ 0.18                          | \$ (0.08)   | \$ 0.27                        | \$ (0.04)   |
| Basic — pro forma   | \$ 0.16                          | \$ (0.11)   | \$ 0.21                        | \$ (0.12)   |
| Diluted — as reported   | \$ 0.17                          | \$ (0.08)   | \$ 0.24                        | \$ (0.04)   |
| Diluted — pro forma   | \$ 0.14                          | \$ (0.11)   | \$ 0.19                        | \$ (0.12)   |

The fair value of options granted is estimated at the date of grant using the Black-Scholes option pricing model. The Black-Scholes option pricing model requires the input of highly subjective assumptions, including the expected stock price volatility. We use the historical stock price volatility of our common stock over the most recent period that is generally commensurate with the expected option life as the basis for estimating expected stock price volatility. For options granted during the three months ended September 30, 2004 and 2003, the historical stock price volatility used was based on a weekly stock price observation, using an average of the high and low stock prices of our common stock, which resulted in an expected stock price volatility of approximately 45% and 52%, respectively. For purposes of the above pro forma disclosure, the fair value of options granted is amortized to stock-based employee compensation cost over the period(s) in which the related employee services are rendered. Accordingly, the pro forma stock-based compensation cost for any period will typically relate to options granted in both the current period and prior periods.

## 2. Stock Split

In February 2004, the Board of Directors approved a three-for-two split of our outstanding common shares effected in the form of a 50% stock dividend. The split was paid on March 15, 2004 to shareholders of record as of February 23, 2004. The par value of our common stock was maintained at the pre-split amount of \$.000001. The Consolidated Financial Statements and Notes thereto, including all share and per share data, have been restated as if the stock split had occurred as of the earliest period presented.

## 3. Cash, Cash Equivalents and Short-term Investments

Short-term investments generally mature between three months and two years. Investments with maturities beyond one year may be classified as short-term based on their liquid nature and because such securities represent the investment of cash that is available for current operations. All of our short-term investments are classified as available-for-sale and are carried at fair market value with unrealized appreciation (depreciation) reported as a separate component of accumulated other comprehensive income (loss) in shareholders' equity. The specific identification method is used to determine the cost of securities disposed with realized gains and losses reflected in investment income, net.

The following table summarizes our investments in securities as of September 30, 2004 (amounts in thousands):

|   | Amortized<br>Cost | Gross<br>Unrealized<br>Gains | Gross<br>Unrealized<br>Losses | Fair<br>Value |
|---|-------------------|------------------------------|-------------------------------|---------------|
| Cash and cash equivalents:                        |                   |                              |                               |               |
| Cash and time deposits                            | \$ 135,668        | \$ —                         | \$ —                          | \$ 135,668    |
| Money market instruments                          | 131,023           | —                            | —                             | 131,023       |
| Auction rate notes                                | 123,100           | —                            | —                             | 123,100       |
| Cash and cash equivalents                         | 389,791           | —                            | —                             | 389,791       |
| Short-term investments:                           |                   |                              |                               |               |
| Corporate bonds                                   | 26,174            | —                            | (86)                          | 26,088        |
| Taxable senior debt                               | 27,042            | 1                            | —                             | 27,043        |
| U.S. agency issues                                | 148,768           | 2                            | (699)                         | 148,071       |
| Asset-backed securities                           | 12,714            | 14                           | (59)                          | 12,669        |
| Common stock                                      | 167               | 1,254                        | —                             | 1,421         |
| Municipal bonds                                   | 1,004             | —                            | —                             | 1,004         |
| Short-term investments                            | 215,869           | 1,271                        | (844)                         | 216,296       |
| Cash, cash equivalents and short-term investments | \$ 605,660        | \$ 1,271                     | \$ (844)                      | \$ 606,087    |

The following table summarizes the maturities of our investments in debt securities as of September 30, 2004 (amounts in thousands):

|                                      | Amortized<br>Cost | Fair<br>Value |
|--------------------------------------|-------------------|---------------|
| Due in one year or less              | \$ 273,000        | \$ 272,511    |
| Due after one year through two years | 53,088            | 52,795        |
|                                      | 326,088           | 325,306       |
| Asset-backed securities              | 12,714            | 12,669        |
| Total                                | \$ 338,802        | \$ 337,975    |

For the three months and six months ended September 30, 2004, net realized gains on short-term investments consisted of \$471,000 of gross realized gains and no gross realized losses. For the three months ended September 30, 2003, net realized gains on short-term investments consisted of \$20,000 of gross realized gains and no gross realized losses. For the six months ended September 30, 2003 net realized gains on short-term investments consisted of \$20,000 of gross realized gains and \$4,000 of gross realized losses.

#### 4. Inventories

Inventories are valued at the lower of cost (first-in, first-out) or market. Our inventories consist of the following (amounts in thousands):

|                                | September 30, 2004 | March 31, 2004   |
|--------------------------------|--------------------|------------------|
| Purchased parts and components | \$ 3,686           | \$ 392           |
| Finished goods                 | 60,004             | 26,035           |
|                                | <u>\$ 63,690</u>   | <u>\$ 26,427</u> |

#### 5. Goodwill and Other Intangible Assets

The changes in the carrying amount of goodwill for the six months ended September 30, 2004 are as follows (amounts in thousands):

|  | Publishing       | Distribution    | Total            |
|--|------------------|-----------------|------------------|
| Balance as of March 31, 2004               | \$ 70,898        | \$ 5,595        | \$ 76,493        |
| Adjustment to original purchase allocation | 1,191            | —               | 1,191            |
| Effect of foreign currency exchange rates  | —                | (82)            | (82)             |
| Balance as of September 30, 2004           | <u>\$ 72,089</u> | <u>\$ 5,513</u> | <u>\$ 77,602</u> |

#### 6. Income Taxes

The income tax provision of \$11.8 million and \$17.6 million for the three and six months ended September 30, 2004, respectively, reflects our effective income tax rate of 32%. The significant items that generated the variance between our effective rate and our statutory rate of 35% were research and development tax credits and the impact of foreign tax rate differentials, partially offset by state taxes. The income tax benefit of \$5.4 million and \$3.2 million for the three and six months ended September 30, 2003, respectively, reflects our effective income tax rate of approximately 35%. State taxes, offset by research and development tax credits and the impact of foreign tax rate differentials, resulted in an effective income tax rate equal to our statutory rate of 35% for the three and six months ended September 30, 2003.

#### 7. Software Development Costs and Intellectual Property Licenses

As of September 30, 2004, capitalized software development costs included \$40.1 million of internally developed software costs and \$60.3 million of payments made to third-party software developers. As of March 31, 2004, capitalized software development costs included \$35.3 million of internally developed software costs and \$51.5 million of payments made to third-party software developers. Capitalized intellectual property licenses were \$35.8 million and \$48.5 million as of September 30, 2004 and March 31, 2004, respectively. Amortization of capitalized software development costs and intellectual property licenses were \$65.2 million and \$32.4 million for the six months ended September 30, 2004 and 2003, respectively.

## 8. Comprehensive Income (Loss) and Accumulated Other Comprehensive Income (Loss)

### *Comprehensive Income (Loss)*

The components of comprehensive income (loss) for the three and six months ended September 30, 2004 and 2003 were as follows (amounts in thousands):

|  | <u>Three months ended September 30,</u> |                   | <u>Six months ended September 30,</u> |                   |
|--|---|-------------------|---------------------------------------|-------------------|
|  | <u>2004</u>                             | <u>2003</u>       | <u>2004</u>                           | <u>2003</u>       |
| Net income (loss)  | \$ 25,543                               | \$ (10,093)       | \$ 37,500                             | \$ (5,930)        |
| Other comprehensive income:                                      |   |                   |                                       |                   |
| Foreign currency translation adjustment                          | (92)                                    | 896               | (1,452)                               | 4,621             |
| Unrealized appreciation (depreciation) on short-term investments | <u>1,547</u>                            | <u>10</u>         | <u>330</u>                            | <u>(14)</u>       |
| Other comprehensive income                                       | <u>1,455</u>                            | <u>906</u>        | <u>(1,122)</u>                        | <u>4,607</u>      |
| Comprehensive income (loss)                                      | <u>\$ 26,998</u>                        | <u>\$ (9,187)</u> | <u>\$ 36,378</u>                      | <u>\$ (1,323)</u> |

### *Accumulated Other Comprehensive Income (Loss)*

The components of accumulated other comprehensive income (loss) were as follows (amounts in thousands):

|                                   | <u>Foreign<br/>Currency</u> | <u>Unrealized<br/>Appreciation<br/>(Depreciation)<br/>on Investments</u> | <u>Accumulated<br/>Other<br/>Comprehensive<br/>Income (Loss)</u> |
|-----------------------------------|-----------------------------|--|--|
| Balance, March 31, 2004           | \$ 9,864                    | \$ 97  | \$ 9,961   |
| Other comprehensive income (loss) | <u>(1,452)</u>              | <u>330</u>   | <u>(1,122)</u>   |
| Balance, September 30, 2004       | <u>\$ 8,412</u>             | <u>\$ 427</u>  | <u>\$ 8,839</u>  |

The income taxes related to unrealized appreciation (depreciation) on investments were not significant. Income taxes were not provided for foreign currency translation items as these are considered indefinite investments in non-U.S. subsidiaries.

## 9. Investment Income, Net

Investment income, net is comprised of the following (amounts in thousands):

|                                  | <u>Three months ended September 30,</u> |                 | <u>Six months ended September 30,</u> |                 |
|----------------------------------|---|-----------------|---------------------------------------|-----------------|
|                                  | <u>2004</u>                             | <u>2003</u>     | <u>2004</u>                           | <u>2003</u>     |
| Interest expense                 | \$ (58)                                 | \$ (88)         | \$ (146)                              | \$ (283)        |
| Interest income                  | 2,232                                   | 1,472           | 4,432                                 | 2,928           |
| Net realized gain on investments | 471                                     | 20              | 471                                   | 16              |
| Investment income, net           | <u>\$ 2,645</u>                         | <u>\$ 1,404</u> | <u>\$ 4,757</u>                       | <u>\$ 2,661</u> |

## 10 Supplemental Cash Flow Information

Non-cash investing and financing activities and supplemental cash flow information is as follows (amounts in thousands):

|   | <u>Six months ended September 30,</u> |             |
|---|---------------------------------------|-------------|
|   | <u>2004</u>                           | <u>2003</u> |
| Non-cash investing and financing activities:                                |                                       |             |
| Issuance of stock to effect business combination                            | \$ 1,191                              | -           |
| Change in unrealized (appreciation)/ depreciation on short-term investments | (330)                                 | 14          |
| Supplemental cash flow information:   |                                       |             |
| Cash paid for income taxes  | \$ 5,018                              | \$ 4,457    |
| Cash paid (received) for interest, net                                      | (4,231)                               | (2,844)     |

## 11 Operations by Reportable Segments and Geographic Area

Based upon our organizational structure, we operate two business segments: (i) publishing of interactive entertainment software and (ii) distribution of interactive entertainment software and hardware products.

Publishing refers to the development, marketing and sale of products, either directly, by license or through our affiliate label program with certain third-party publishers. In the United States, we primarily sell our products on a direct basis to mass-market retailers, consumer electronics stores, discount warehouses and game specialty stores. We conduct our international publishing activities through offices in the United Kingdom, Germany, France, Italy, Spain, Australia, Sweden, Canada and Japan. Our products are sold internationally on a direct-to-retail basis and through third-party distribution and licensing arrangements and through our wholly-owned distribution subsidiaries.

Distribution refers to our operations in the United Kingdom, the Netherlands and Germany that provide logistical and sales services to third-party publishers of interactive entertainment software, our own publishing operations and manufacturers of interactive entertainment hardware.

Resources are allocated to each of these segments using information on their respective net revenues and operating profits before interest and taxes.

The accounting policies of these segments are the same as those described in the Summary of Significant Accounting Policies in our Annual Report on Form 10-K for the year ended March 31, 2004. Revenue derived from sales between segments is eliminated in consolidation.

Information on the reportable segments for the three and six months ended September 30, 2004 and 2003 is as follows (amounts in thousands):

|                                      | Three months ended September 30, 2004 |              |              |
|--------------------------------------|---------------------------------------|--------------|--------------|
|                                      | Publishing                            | Distribution | Total        |
| Total segment revenues               | \$ 266,395                            | \$ 44,231    | \$ 310,626   |
| Revenues from sales between segments | (32,454)                              | 32,454       | -            |
| Revenues from external customers     | \$ 233,941                            | \$ 76,685    | \$ 310,626   |
| Operating income                     | \$ 31,609                             | \$ 3,049     | \$ 34,658    |
| Total assets                         | \$ 986,966                            | \$ 117,203   | \$ 1,104,169 |

|                                      | Three months ended September 30, 2003 |              |             |
|--------------------------------------|---------------------------------------|--------------|-------------|
|                                      | Publishing                            | Distribution | Total       |
| Total segment revenues               | \$ 71,796                             | \$ 45,727    | \$ 117,523  |
| Revenues from sales between segments | (4,534)                               | 4,534        | -           |
| Revenues from external customers     | \$ 67,262                             | \$ 50,261    | \$ 117,523  |
| Operating income (loss)              | \$ (16,894)                           | \$ (39)      | \$ (16,933) |
| Total assets                         | \$ 682,804                            | \$ 80,252    | \$ 763,056  |

|                                      | Six months ended September 30, 2004 |              |              |
|--------------------------------------|-------------------------------------|--------------|--------------|
|                                      | Publishing                          | Distribution | Total        |
| Total segment revenues               | \$ 428,047                          | \$ 93,855    | \$ 521,902   |
| Revenues from sales between segments | (40,778)                            | 40,778       | -            |
| Revenues from external customers     | \$ 387,269                          | \$ 134,633   | \$ 521,902   |
| Operating income                     | \$ 47,503                           | \$ 2,888     | \$ 50,391    |
| Total assets                         | \$ 986,966                          | \$ 117,203   | \$ 1,104,169 |

|                                      | Six months ended September 30, 2003 |              |             |
|--------------------------------------|-------------------------------------|--------------|-------------|
|                                      | Publishing                          | Distribution | Total       |
| Total segment revenues               | \$ 186,201                          | \$ 90,047    | \$ 276,248  |
| Revenues from sales between segments | (14,204)                            | 14,204       | -           |
| Revenues from external customers     | \$ 171,997                          | \$ 104,251   | \$ 276,248  |
| Operating income (loss)              | \$ (11,724)                         | \$ (63)      | \$ (11,787) |
| Total assets                         | \$ 682,804                          | \$ 80,252    | \$ 763,056  |

Geographic information for the three and six months ended September 30, 2004 and 2003 is based on the location of the selling entity. Revenues from external customers by geographic region were as follows (amounts in thousands):

|               | Three months ended September 30, |            | Six months ended September 30, |            |
|---------------|----------------------------------|------------|--------------------------------|------------|
|               | 2004                             | 2003       | 2004                           | 2003       |
| United States | \$ 157,705                       | \$ 46,450  | \$ 282,896                     | \$ 129,189 |
| Europe        | 141,019                          | 66,292     | 219,120                        | 139,033    |
| Other         | 11,902                           | 4,781      | 19,886                         | 8,026      |
| Total         | \$ 310,626                       | \$ 117,523 | \$ 521,902                     | \$ 276,248 |

Revenues by platform were as follows (amounts in thousands):

|           | Three months ended September 30, |            | Six months ended September 30, |            |
|-----------|----------------------------------|------------|--------------------------------|------------|
|           | 2004                             | 2003       | 2004                           | 2003       |
| Console   | \$ 175,471                       | \$ 79,207  | \$ 333,792                     | \$ 203,033 |
| Hand-held | 27,225                           | 8,917      | 49,310                         | 16,425     |
| PC        | 107,930                          | 29,399     | \$ 138,800                     | \$ 56,790  |
| Total     | \$ 310,626                       | \$ 117,523 | \$ 521,902                     | \$ 276,248 |

As of and for the three and six months ended September 30, 2004, we had one customer that accounted for 19% and 22% of consolidated net revenues, respectively, and 27% of consolidated accounts receivable, net at September 30, 2004. As of and for the three and six months ended September 30, 2003, we had one customer that accounted for 18% and 17%, respectively, of consolidated net revenues and 38% of consolidated accounts receivable, net at September 30, 2003. This customer was the same customer in all periods and was a customer of both our publishing and distribution businesses.

## 12 Computation of Earnings Per Share

The following table sets forth the computations of basic and diluted earnings (loss) per share (amounts in thousands, except per share data):

|  | Three months ended<br>September 30, |             | Six months ended<br>September 30, |            |
|--|-------------------------------------|-------------|-----------------------------------|------------|
|  | 2004                                | 2003        | 2004                              | 2003       |
| Numerator:   |                                     |             |                                   |            |
| Numerator for basic and diluted earnings per share –<br>income (loss) available to common shareholders                 | \$ 25,543                           | \$ (10,093) | \$ 37,500                         | \$ (5,930) |
| Denominator:   |                                     |             |                                   |            |
| Denominator for basic earnings per share- weighted average<br>common shares outstanding                                | 138,505                             | 132,243     | 138,137                           | 132,158    |
| Effect of dilutive securities:   |                                     |             |                                   |            |
| Employee stock options and stock purchase plan   | 13,559                              | -           | 14,327                            | -          |
| Warrants to purchase common stock  | 621                                 | -           | 663                               | -          |
| Potential dilutive common shares   | 14,180                              | -           | 14,990                            | -          |
| Denominator for diluted earnings per share – weighted<br>average common shares outstanding plus assumed<br>conversions | 152,685                             | 132,243     | 153,127                           | 132,158    |
| Basic earnings (loss) per share  | \$ 0.18                             | \$ (0.08)   | \$ 0.27                           | \$ (0.04)  |
| Diluted earnings (loss) per share  | \$ 0.17                             | \$ (0.08)   | \$ 0.24                           | \$ (0.04)  |

Options to purchase 2,050,357 shares of common stock at exercise prices ranging from \$13.47 to \$16.66 and options to purchase 1,462,784 shares of common stock at exercise prices ranging from \$13.47 to \$16.66 were outstanding for the three and six months ended September 30, 2004, respectively, but were not included in the calculation of diluted earnings per share because their effect would be antidilutive.

Options to purchase 20,187,822 shares of common stock at exercise prices ranging from \$1.41 to \$14.77 and options to purchase 20,230,385 shares of common stock at exercise prices ranging from \$1.41 to \$14.77 were outstanding for the three and six months ended September 30, 2003, respectively, but were not included in the calculation of diluted earnings (loss) per share because their effect would be antidilutive.

## 13 Commitments and Contingencies

### *Credit Facilities*

We have revolving credit facilities with our Centresoft subsidiary located in the United Kingdom (the “UK Facility”) and our NBG subsidiary located in Germany (the “German Facility”). The UK Facility provides Centresoft with the ability to borrow up to Great Britain Pounds (“GBP”) 8.0 million (\$14.3 million), including issuing letters of credit, on a revolving basis as of September 30, 2004. In addition, under the UK Facility, Centresoft provided a GBP 0.6 million (\$1.1 million) guarantee for the benefit of our CD Contact subsidiary as of September 30, 2004. The UK Facility bore interest at LIBOR plus 2.0% as of September 30, 2004, is collateralized by substantially all of the assets of the subsidiary and expires in November 2005. The UK Facility also contains various covenants that require the subsidiary to maintain specified financial ratios related



to, among other things, fixed charges. As of September 30, 2004, we were in compliance with these covenants. No borrowings were outstanding against the UK Facility as of September 30, 2004. The German Facility provided for revolving loans up to EUR 0.5 million (\$0.6 million) as of September 30, 2004, bore interest at a Eurocurrency rate plus 2.5%, is collateralized by certain of the subsidiary's property and equipment and has no expiration date. No borrowings were outstanding under the German Facility as of September 30, 2004.

#### *Developer and Intellectual Property Contracts*

In the normal course of business, we enter into contractual arrangements with third parties for the development of products, as well as for the rights to intellectual property. Under these agreements, we commit to provide specified payments to a developer or intellectual property holder based upon contractual arrangements. Assuming all contractual provisions are met, the total future minimum contract commitment for contracts in place as of September 30, 2004 is approximately \$70.4 million and is scheduled to be paid as follows (amounts in thousands):

| <b>Fiscal year ending March 31,</b> |                  |
|-------------------------------------|------------------|
| 2005                                | \$ 35,750        |
| 2006                                | 21,451           |
| 2007                                | 8,475            |
| 2008                                | 1,775            |
| 2009 and thereafter                 | 2,900            |
| <b>Total</b>                        | <b>\$ 70,351</b> |

The commitment schedule above excludes approximately \$9.3 million of commitments originally scheduled to be paid from fiscal 2004 through fiscal 2007 relating to an intellectual property rights agreement with a third party. Effective June 30, 2003, we terminated the agreement and filed a breach of contract suit against the third party.

#### *Marketing Commitments*

In connection with certain intellectual property right acquisitions and development agreements, we will commit to spend specified amounts for marketing support for the related game(s) which is to be developed or in which the intellectual property will be utilized. Assuming all contractual provisions are met, the total future minimum marketing commitment for contracts in place as of September 30, 2004 is approximately \$41.4 million, which is scheduled to be paid as follows (amounts in thousands):

| <b>Fiscal Year ending March 31,</b> |                  |
|-------------------------------------|------------------|
| 2005                                | \$ 14,872        |
| 2006                                | 11,500           |
| 2007                                | 10,000           |
| 2008                                | 5,000            |
| <b>Total</b>                        | <b>\$ 41,372</b> |

### *Lease Obligations*

We lease certain of our facilities under non-cancelable operating lease agreements. Total future minimum lease commitments as of September 30, 2004 are as follows (amounts in thousands):

| <b>Fiscal Year ending March 31,</b> |                  |
|-------------------------------------|------------------|
| 2005                                | \$ 4,930         |
| 2006                                | 9,058            |
| 2007                                | 8,175            |
| 2008                                | 5,341            |
| 2009                                | 4,476            |
| Thereafter                          | 18,914           |
| <b>Total</b>                        | <b>\$ 50,894</b> |

### *Legal and Regulatory Proceedings*

On March 5, 2004, a class action lawsuit was filed against us and certain of our current and former officers and directors. The complaint, which asserts claims under Sections 10(b) and 20(a) of the Securities Exchange Act of 1934 based on allegations that our revenues and assets were overstated during the period between February 1, 2001 and December 17, 2002, was filed in the United States District Court, Central District of California by the Construction Industry and Carpenters Joint Pension Trust for Southern Nevada purporting to represent a class of purchasers of Activision stock. Five additional purported class actions have subsequently been filed by Gianni Angeloni, Christopher Hinton, Stephen Anish, the Alaska Electrical Pension Fund, and Joseph A. Romans asserting similar claims. Five of the six actions have been transferred to the same court where the first-filed complaint was pending. In addition, on March 12, 2004, a shareholder derivative lawsuit was filed which asserts the same claims set forth in the federal class action lawsuit. That complaint was filed in Superior Court for the County of Los Angeles. We strongly deny these allegations and will vigorously defend these cases.

On July 11, 2003, we were informed by the staff of the Securities and Exchange Commission that the Securities and Exchange Commission has commenced a non-public formal investigation captioned "In the Matter of Certain Video Game Manufacturers and Distributors." The investigation appears to be focused on certain accounting practices common to the interactive entertainment industry, with specific emphasis on revenue recognition. In connection with this inquiry, the Securities and Exchange Commission submitted to us a request for information. We responded to this inquiry on September 2, 2003. To date, we have not received a request from the Securities and Exchange Commission for any additional information. The Securities and Exchange Commission staff also informed us that other companies in the video game industry received similar requests for information. The Securities and Exchange Commission has advised us that this request for information should not be construed as an indication from the Securities and Exchange Commission or its staff that any violation of the law has occurred, nor should it reflect negatively on any person, entity or security. We have cooperated and intend to continue to cooperate fully with the Securities and Exchange Commission in the conduct of this inquiry.

On June 30, 2003, we terminated our Star Trek Merchandising License Agreement with Viacom Consumer Products, Inc. and filed a complaint in the Superior Court of the State of California for breach of contract and constructive trust against Viacom Consumer Products and Viacom International, Inc. ("Viacom"). On August 15, 2003, Viacom filed its response to our complaint as well as a cross-complaint alleging, among other matters, a breach of contract by Activision and seeking claimed damages in excess of \$50 million. We strongly dispute the claims by Viacom, consider the damages alleged by Viacom to be speculative and without merit, and intend to defend vigorously and aggressively against the cross-complaint.

In addition, we are party to other routine claims and suits brought by us and against us in the ordinary course of business, including disputes arising over the ownership of intellectual property rights, contractual claims and collection matters. In the opinion of management, after consultation with legal counsel, the outcome of such routine claims will not have a material adverse effect on our business, financial condition, results of operations or liquidity.

**14. Capital Transactions**

During fiscal 2003, our Board of Directors authorized a buyback program under which we can repurchase up to \$350.0 million of our common stock of which \$123.5 million has been repurchased to date. Under the program, shares may be purchased as determined by management and within certain guidelines, from time to time, in the open market or in privately negotiated transactions, including privately negotiated structured option transactions, and through transactions in the options markets. Depending on market conditions and other factors, these purchases may be commenced or suspended at any time or from time to time without prior notice.

During the three months ended September 30, 2004, we did not repurchase any of our common stock or enter into any structured stock repurchase transactions. As of September 30, 2004, we had no outstanding structured stock repurchase transactions.

**15. Related Parties**

In August 2001, we elected to our Board of Directors an individual who is a partner in a law firm that has provided legal services to Activision for more than ten years. For the three and six months ended September 30, 2004 and 2003, the fees we paid to the law firm were an insignificant portion of the firm's total revenues. We believe that the fees charged to us by the law firm are competitive with the fees charged by other law firms.

## Item 2. Management's Discussion and Analysis of Financial Condition and Results of Operations

### Overview

#### *Our Business*

We are a leading international publisher of interactive entertainment software products. We have built a company with a diverse portfolio of products that spans a wide range of categories and target markets and that is used on a variety of game hardware platforms and operating systems. We have created, licensed and acquired a group of highly recognizable brands, which we market to a variety of consumer demographics.

Our products cover game categories such as action/adventure, action sports, racing, role-playing, simulation, first-person action and strategy. Our target customer base ranges from game enthusiasts and children to mass-market consumers and "value" buyers. We currently offer our products primarily in versions that operate on the Sony PlayStation 2 ("PS2"), Nintendo GameCube ("GameCube") and Microsoft Xbox ("Xbox") console systems, Nintendo Game Boy Advance ("GBA") hand-held device and the personal computer ("PC"). The installed base for this current-generation of hardware platforms is significant and growing. We believe recent price cuts in calendar 2004 on the Xbox, PS2, GameCube, and GBA hardware and a redesign of the PS2 should continue to drive the growth of the installed base of the current-generation platforms. In addition, Sony has announced that it would be entering the hand-held hardware market with the introduction of its hand-held gaming device, PlayStation Portable ("PSP"). We are currently developing titles based on the Spider-Man and Tony Hawk franchises for the PSP with the objective of having both ready for release at the launch of the PSP. Nintendo has also announced that it plans to launch a new dual-screened, portable game system, Nintendo Dual Screen ("NDS"), before the end of calendar 2004. For the launch of the NDS, we will release *Spider-Man 2* with other titles to follow. We are developing titles for the next-generation console systems being developed by Sony, Microsoft and Nintendo for release within the next one to two years. Though there are still many unknowns relating to these new platforms, our aim is to have a meaningful launch presence for all new hardware systems with a goal of gaining market share on each platform while continuing to exploit our products on the current-generation platforms given their large and growing installed base.

Our publishing business involves the development, marketing and sale of products directly by us, by license or through our affiliate label program with certain third-party publishers. In the United States, we primarily sell our products on a direct basis to mass-market retailers, consumer electronics stores, discount warehouses and game specialty stores. We conduct our international publishing activities through offices in the United Kingdom ("UK"), Germany, France, Italy, Spain, Australia, Sweden, Canada and Japan. Our products are sold internationally on a direct-to-retail basis, through third-party distribution and licensing arrangements and through our wholly-owned European distribution subsidiaries. Our distribution business consists of operations located in the UK, the Netherlands and Germany that provide logistical and sales services to third-party publishers of interactive entertainment software, our own publishing operations and manufacturers of interactive entertainment hardware.

Our profitability is directly affected by the mix of revenues from our publishing and distribution businesses. Operating margins realized from our publishing business are substantially higher than margins realized from our distribution business. Operating margins in our publishing business are affected by our ability to release highly successful or "hit" titles. Though many of these titles have substantial production or acquisition costs and marketing budgets, once a title recoups these costs, incremental net revenues directly and positively impact our operating margin. Operating margins in our distribution business are affected by the mix of hardware and software sales, with software producing higher margins than hardware.

#### *Our Focus*

With respect to future game development, we will continue to focus on our "big proposition" titles that are backed by strong brands and high quality development, for which we will provide significant marketing support.

A number of our fiscal 2005 "big proposition" titles include well-established brands, which are backed by high profile intellectual property and/or highly anticipated motion picture releases. Examples of these brands are our superheroes and skateboarding brands. We have a long-term relationship with Marvel Enterprises through an exclusive licensing agreement that expires in 2009. This agreement grants us the

exclusive rights to develop and publish video games based on Marvel's comic book franchises Spider-Man, X-Men, Fantastic Four and Iron Man. Through our long-term relationship with Spider-Man Merchandising, LLP, in the first quarter of fiscal 2005 we released the video game *Spider-Man 2*, the sequel to the highly successful *Spider-Man: The Movie*. The video game release of *Spider-Man 2* coincided with the "Spider-Man 2" theatrical release in June 2004. Also, under our licensing agreement with Spider-Man Merchandising, LLP, we will be developing and publishing video games based on Columbia Pictures/Marvel Enterprises, Inc.'s upcoming feature film "Spider-Man 3," which is expected to be released in May 2007. We also have an exclusive licensing agreement with professional skateboarder Tony Hawk that continues until 2015. The agreement grants us exclusive rights to develop and publish video games using Tony Hawk's name and his likeness. Through fiscal 2005, we released five successful titles in the Tony Hawk franchise with cumulative net revenues of over \$820 million, including the most recent, *Tony Hawk's Underground*, which was released in the third quarter of fiscal 2004. We have continued to promote our skateboarding franchise with the release of *Tony Hawk's Underground 2* in early October 2004.

We also continue to develop original intellectual properties such as *True Crime: Streets of L.A.* and *Call of Duty*, which were released in the third quarter of fiscal 2004. These highly successful titles were both ranked by third-party sales tracking agencies, such as NPD, as among the top-five selling games for the 2003 holiday season. We expect to develop a variety of games on multiple platforms based on these two original properties and hope to establish them as a source of recurring revenues. In the third quarter of fiscal 2005, we are scheduled to release *Call of Duty: Finest Hour*, which will be released on multiple console platforms.

We will also continue to evaluate and exploit emerging brands that we believe have potential to become successful game franchises. For example, we have a multi-year, multi-property, publishing agreement with DreamWorks SKG that grants us the exclusive rights to publish video games based on DreamWorks SKG's theatrical release "Shrek 2," which was released in the first quarter of fiscal 2005, "Shrek 2: The Game," which was released in the second quarter of fiscal 2005, as well as upcoming computer-animated films, "Madagascar" and "Over the Hedge," and their sequels. We also have an exclusive licensing agreement to develop and publish video games for the best-selling children's book series, "Lemony Snicket's A Series of Unfortunate Events" which is being developed as a feature film by Paramount Pictures, Nickelodeon Movies and DreamWorks SKG and will be released in the third quarter of the current fiscal year.

In addition to acquiring or creating high profile intellectual property, we have also continued our focus on establishing and maintaining relationships with talented and experienced software development teams. We have strengthened our internal development capabilities through the acquisition in prior fiscal years of a number of development companies with talented and experienced teams. We have development agreements with other top-level, third-party developers such as id Software, Spark Unlimited, Lionhead Studios and The Creative Assembly.

We are utilizing these developer relationships, new intellectual property acquisitions, new original intellectual property creations and our existing library of intellectual property to further focus our game development on product lines that will deliver significant, lasting and recurring revenues and operating profits.

#### **Critical Accounting Policies**

We have identified the policies below as critical to our business operations and the understanding of our financial results. The impact and any associated risks related to these policies on our business operations is discussed throughout Management's Discussion and Analysis of Financial Condition and Results of Operations where such policies affect our reported and expected financial results. For a detailed discussion on the application of these and other accounting policies, see Note 1 to the Notes to the Consolidated Financial Statements included in Item 8 of our Annual Report on Form 10-K for the year ended March 31, 2004 filed with the SEC. 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.

*Revenue Recognition.* We recognize revenue from the sale of our products upon the transfer of title and risk of loss to our customers. Certain products are sold to customers with a street date (the date that products are

made widely available for sale by retailers). For these products we recognize revenue on the street date. Revenue from product sales is recognized after deducting the estimated allowance for returns and price protection. With respect to license agreements that provide customers the right to make multiple copies in exchange for guaranteed amounts, revenue is recognized upon delivery of such copies. Per copy royalties on sales that exceed the guarantee are recognized as earned. In addition, in order to recognize revenue for both product sales and licensing transactions, persuasive evidence of an arrangement must exist and collection of the related receivable must be probable. Revenue recognition also determines the timing of certain expenses, including cost of sales — intellectual property licenses and cost of sales — software royalties and amortization.

*Allowances for Returns, Price Protection, Doubtful Accounts and Inventory Obsolescence.* In determining the appropriate unit shipments to our customers, we benchmark our titles using historical and industry data. We closely monitor and analyze the historical performance of our various titles, the performance of products released by other publishers and the anticipated timing of other releases in order to assess future demands of current and upcoming titles. Initial volumes shipped upon title launch and subsequent reorders are evaluated to ensure that quantities are sufficient to meet the demands from the retail markets but at the same time, are controlled to prevent excess inventory in the channel.

We may permit product returns from, or grant price protection to, our customers under certain conditions. In general, price protection refers to the circumstances when we elect to decrease the wholesale price of a product by a certain amount and, when granted and applicable, allows customers a credit against amounts owed by such customers to Activision with respect to open and/or future invoices. The conditions our customers must meet to be granted the right to return products or price protection are, among other things, compliance with applicable payment terms, delivery to us of weekly inventory and sell-through reports, and consistent participation in the launches of our premium title releases. We may also consider other factors, including the facilitation of slow-moving inventory and other market factors. Management must make estimates of potential future product returns and price protection related to current period product revenue. We estimate the amount of future returns and price protection for current period product revenue utilizing historical experience and information regarding inventory levels and the demand and acceptance of our products by the end consumer. The following factors are used to estimate the amount of future returns and price protection for a particular title: historical performance of titles in similar genres, historical performance of the hardware platform, historical performance of the brand, console hardware life cycle, Activision sales force and retail customer feedback, industry pricing, weeks of on-hand retail channel inventory, absolute quantity of on-hand retail channel inventory, Activision warehouse on-hand inventory levels, the title's recent sell-through history (if available), marketing trade programs and competing titles. The relative importance of these factors varies among titles depending upon, among other items, genre, platform, seasonality and sales strategy. Significant management judgments and estimates must be made and used in connection with establishing the allowance for returns and price protection in any accounting period. Based upon historical experience we believe our estimates are reasonable. However, actual returns and price protection could vary materially from our allowance estimates due to a number of reasons including, among others, a lack of consumer acceptance of a title, the release in the same period of a similarly themed title by a competitor, or technological obsolescence due to the emergence of new hardware platforms. Material differences may result in the amount and timing of our revenue for any period if management makes different judgments or utilizes different estimates in determining the allowances for returns and price protection.

Similarly, management must make estimates of the uncollectibility of our accounts receivable. In estimating the allowance for doubtful accounts, we analyze the age of current outstanding account balances, historical bad debts, customer concentrations, customer creditworthiness, current economic trends and changes in our customers' payment terms and their economic condition, as well as whether we can obtain sufficient credit insurance. Any significant changes in any of these criteria would impact management's estimates in establishing our allowance for doubtful accounts.

We value inventory at the lower of cost or market. We regularly review inventory quantities on hand and in the retail channel and record a provision for excess or obsolete inventory based on the future expected demand for our products. Significant changes in demand for our products would impact management's estimates in establishing our inventory provision.

*Software Development Costs.* Software development costs include payments made to independent software developers under development agreements, as well as direct costs incurred for internally developed products.

We account for software development costs in accordance with Statement of Financial Accounting Standard (“SFAS”) No. 86, “Accounting for the Costs of Computer Software to Be Sold, Leased, or Otherwise Marketed.” Software development costs are capitalized once technological feasibility of a product is established and such costs are determined to be recoverable. Technological feasibility of a product encompasses both technical design documentation and game design documentation. For products where proven technology exists, this may occur early in the development cycle. Technological feasibility is evaluated on a product-by-product basis. Prior to a product’s release, we expense, as part of cost of sales — software royalties and amortization, capitalized costs when we believe such amounts are not recoverable. Capitalized costs for those products that are cancelled or abandoned are charged to product development expense in the period of cancellation. Amounts related to software development which are not capitalized are charged immediately to product development expense. We evaluate the future recoverability of capitalized amounts on a quarterly basis. The recoverability of capitalized software development costs is evaluated based on the expected performance of the specific products for which the costs relate. Criteria used to evaluate expected product performance include: historical performance of comparable products using comparable technology; orders for the product prior to its release; and estimated performance of a sequel product based on the performance of the product on which the sequel is based.

Commencing upon product release, capitalized software development costs are amortized to cost of sales — software royalties and amortization based on the ratio of current revenues to total projected revenues, generally resulting in an amortization period of six months or less. For products that have been released in prior periods, we evaluate the future recoverability of capitalized amounts on a quarterly basis. The primary evaluation criterion is actual title performance.

Significant management judgments and estimates are utilized in the assessment of when technological feasibility is established, as well as in the ongoing assessment of the recoverability of capitalized costs. In evaluating the recoverability of capitalized costs, the assessment of expected product performance utilizes forecasted sales amounts and estimates of additional development costs to be incurred. If revised forecasted or actual product sales are less than and/or revised forecasted or actual costs are greater than the original forecasted amounts utilized in the initial recoverability analysis, the actual impairment charge may be larger than originally estimated in any given quarter. Based upon historical experience we believe our estimates are reasonable.

*Intellectual Property Licenses.* Intellectual property license costs represent license fees paid to intellectual property rights holders for use of their trademarks, copyrights, software, technology or other intellectual property or proprietary rights in the development of our products. Depending upon the agreement with the rights holder, we may obtain the rights to use acquired intellectual property in multiple products over multiple years, or alternatively, for a single product.

We evaluate the future recoverability of capitalized intellectual property licenses on a quarterly basis. The recoverability of capitalized intellectual property license costs is evaluated based on the expected performance of the specific products in which the licensed trademark or copyright is to be used. As many of our intellectual property licenses extend for multiple products over multiple years, we also assess the recoverability of capitalized intellectual property license costs based on certain qualitative factors such as the success of other products and/or entertainment vehicles utilizing the intellectual property, whether there are any future planned theatrical releases or television series based on the intellectual property and the rights holder’s continued promotion and exploitation of the intellectual property. Prior to the related product’s release, we expense, as part of cost of sales — intellectual property licenses, capitalized intellectual property costs when we believe such amounts are not recoverable. Capitalized intellectual property costs for those products that are cancelled or abandoned are charged to product development expense in the period of cancellation. Criteria used to evaluate expected product performance include: historical performance of comparable products using comparable technology; orders for the product prior to its release; and estimated performance of a sequel product based on the performance of the product on which the sequel is based.

Commencing upon the related product's release, capitalized intellectual property license costs are amortized to cost of sales — intellectual property licenses based on the ratio of current revenues for the specific product to total projected revenues for all products in which the licensed property will be utilized. As intellectual property license contracts may extend for multiple years, the amortization of capitalized intellectual property license costs relating to such contracts may extend beyond one year. For intellectual property included in products that have been released and unreleased products, we evaluate the future recoverability of capitalized amounts on a quarterly basis. The primary evaluation criterion is actual title performance.

Significant management judgments and estimates are utilized in the assessment of the recoverability of capitalized costs. In evaluating the recoverability of capitalized costs, the assessment of expected product performance utilizes forecasted sales amounts and estimates of additional development costs to be incurred. If revised forecasted or actual product sales are less than and/or revised forecasted or actual costs are greater than the original forecasted amounts utilized in the initial recoverability analysis, the actual impairment charge may be larger than originally estimated in any given quarter. Additionally, as noted above, as many of our intellectual property licenses extend for multiple products over multiple years, we also assess the recoverability of capitalized intellectual property license costs based on certain qualitative factors such as the success of other products and/or entertainment vehicles utilizing the intellectual property, whether there are any future planned theatrical releases or television series based on the intellectual property and the rights holder's continued promotion and exploitation of the intellectual property. Material differences may result in the amount and timing of charges for any period if management makes different judgments or utilizes different estimates in evaluating these qualitative factors. Based upon historical experience we believe our estimates are reasonable.



The following table sets forth certain consolidated statements of operations data for the periods indicated as a percentage of total net revenues and also breaks down net revenues by territory, business segment and platform, as well as operating income (loss) by business segment (amounts in thousands):

|   | Three months ended September 30, |      |             |       | Six months ended September 30, |      |             |      |
|---|----------------------------------|------|-------------|-------|--------------------------------|------|-------------|------|
|   | 2004                             |      | 2003        |       | 2004                           |      | 2003        |      |
| Net revenues  | \$ 310,626                       | 100% | \$ 117,523  | 100%  | \$ 521,902                     | 100% | \$ 276,248  | 100% |
| Costs and expenses:                                 |                                  |      |             |       |                                |      |             |      |
| Cost of sales — product costs                       | 123,177                          | 40   | 72,391      | 61    | 212,265                        | 41   | 149,001     | 54   |
| Cost of sales — software royalties and amortization | 46,363                           | 15   | 11,397      | 10    | 58,646                         | 11   | 26,895      | 10   |
| Cost of sales — intellectual property licenses      | 17,551                           | 6    | 7,401       | 6     | 35,199                         | 7    | 17,544      | 6    |
| Product development                                 | 19,881                           | 6    | 15,894      | 13    | 40,986                         | 8    | 29,474      | 10   |
| Sales and marketing                                 | 53,234                           | 17   | 17,237      | 15    | 94,968                         | 18   | 43,522      | 16   |
| General and administrative                          | 15,762                           | 5    | 10,136      | 9     | 29,447                         | 5    | 21,599      | 8    |
| Total costs and expenses                            | 275,968                          | 89   | 134,456     | 114   | 471,511                        | 90   | 288,035     | 104  |
| Operating income (loss)                             | 34,658                           | 11   | (16,933)    | (14)  | 50,391                         | 10   | (11,787)    | (4)  |
| Investment income, net                              | 2,645                            | 1    | 1,404       | 1     | 4,757                          | 1    | 2,661       | 1    |
| Income (loss) before income tax provision (benefit) | 37,303                           | 12   | (15,529)    | (13)  | 55,148                         | 11   | (9,126)     | (3)  |
| Income tax provision (benefit)                      | 11,760                           | 4    | (5,436)     | (4)   | 17,648                         | 4    | (3,196)     | (1)  |
| Net income (loss)                                   | \$ 25,543                        | 8%   | \$ (10,093) | (9)%  | \$ 37,500                      | 7%   | \$ (5,930)  | (2)% |
| Net Revenues by Territory:                          |                                  |      |             |       |                                |      |             |      |
| United States                                       | \$ 157,705                       | 51%  | \$ 46,450   | 40%   | \$ 282,896                     | 54%  | \$ 129,189  | 47%  |
| Europe  | 141,019                          | 45   | 66,292      | 56    | 219,120                        | 42   | 139,033     | 50   |
| Other   | 11,902                           | 4    | 4,781       | 4     | 19,886                         | 4    | 8,026       | 3    |
| Total net revenues                                  | \$ 310,626                       | 100% | \$ 117,523  | 100%  | \$ 521,902                     | 100% | \$ 276,248  | 100% |
| Net Revenues by Segment/Platform Mix                |                                  |      |             |       |                                |      |             |      |
| Publishing:   |                                  |      |             |       |                                |      |             |      |
| Console   | \$ 145,542                       | 47%  | \$ 46,019   | 39%   | \$ 264,669                     | 51%  | \$ 134,503  | 49%  |
| Hand-held   | 23,669                           | 8    | 4,187       | 4     | 42,099                         | 8    | 8,783       | 3    |
| PC  | 97,184                           | 31   | 21,590      | 18    | 121,279                        | 23   | 42,915      | 15   |
| Total publishing net revenues                       | 266,395                          | 86   | 71,796      | 61    | 428,047                        | 82   | 186,201     | 67   |
| Distribution:                                       |                                  |      |             |       |                                |      |             |      |
| Console   | 29,929                           | 10   | 33,188      | 28    | 69,123                         | 13   | 68,530      | 25   |
| Hand-held   | 3,556                            | 1    | 4,730       | 4     | 7,211                          | 1    | 7,642       | 3    |
| PC  | 10,746                           | 3    | 7,809       | 7     | 17,521                         | 4    | 13,875      | 5    |
| Total distribution net revenues                     | 44,231                           | 14   | 45,727      | 39    | 93,855                         | 18   | 90,047      | 33   |
| Total net revenues                                  | \$ 310,626                       | 100% | \$ 117,523  | 100%  | \$ 521,902                     | 100% | \$ 276,248  | 100% |
| Operating Income (Loss) by Segment:                 |                                  |      |             |       |                                |      |             |      |
| Publishing  | \$ 31,609                        | 10%  | \$ (16,894) | (14)% | \$ 47,503                      | 9%   | \$ (11,724) | (4)% |
| Distribution  | 3,049                            | 1    | (39)        | —     | 2,888                          | 1    | (63)        | —    |
| Total operating income (loss)                       | \$ 34,658                        | 11%  | \$ (16,933) | (14)% | \$ 50,391                      | 10%  | \$ (11,787) | (4)% |

## Results of Operations — Three and Six Months Ended September 30, 2004 and 2003

Net income for the three months ended September 30, 2004 was \$25.5 million or \$0.17 per diluted share, as compared to a net loss of \$(10.1) million or \$(0.08) per share for the three months ended September 30, 2003.

Net income for the six months ended September 30, 2004 was \$37.5 million or \$0.24 per diluted share, as compared to a net loss of \$(5.9) million or \$(0.04) per share for the six months ended September 30, 2003.

### Net Revenues

We primarily derive revenue from sales of packaged interactive software games designed for play on video game consoles (such as the PS2, Xbox and GameCube), PCs and hand-held game devices (such as the GBA). We also derive revenue from our distribution business in Europe that provides logistical and sales services to third-party publishers of interactive entertainment software, our own publishing operations and third-party manufacturers of interactive entertainment hardware.

The following table details our consolidated net revenues by business segment and our publishing net revenues by territory for the three months ended September 30, 2004 and 2003 (in thousands):

|                               | Three Months ended September 30, |            | Increase/<br>(Decrease) | Percent<br>Change |
|-------------------------------|----------------------------------|------------|-------------------------|-------------------|
|                               | 2004                             | 2003       |                         |                   |
| Publishing Net Revenues       |                                  |            |                         |                   |
| North America                 | \$ 157,705                       | \$ 46,450  | \$ 111,255              | 240%              |
| Europe                        | 96,788                           | 20,565     | 76,223                  | 371%              |
| Other                         | 11,902                           | 4,781      | 7,121                   | 149%              |
| Total International           | 108,690                          | 25,346     | 83,344                  | 329%              |
| Total Publishing Net Revenues | 266,395                          | 71,796     | 194,599                 | 271%              |
| Distribution Net Revenues     | 44,231                           | 45,727     | (1,496)                 | (3)%              |
| Consolidated Net Revenues     | \$ 310,626                       | \$ 117,523 | \$ 193,103              | 164%              |

Consolidated net revenues increased 164% from \$117.5 million for the three months ended September 30, 2003 to \$310.6 million for the three months ended September 30, 2004. This increase was driven by our publishing business both in North America and internationally. The increase in consolidated net revenues was driven by the following:

- In the second quarter of fiscal 2005, we released several “big proposition” titles including the worldwide release of *Doom 3*, and *Call of Duty: United Offensive*; the North American release of *Rome: Total War*, *X-Men Legends*, and *Dreamworks' Shark Tale*; and the international release of *Spiderman 2*. This compares to three titles released in the second quarter of fiscal 2004: *Disney's Extreme Skate Adventure*, *Jedi Knight: Jedi Academy*, and *Cabela's Deer Hunt 2004 Season*.
- Continued strong performance of our catalog titles, which are titles released prior to the current quarter, particularly *Spider-Man 2*, *Shrek 2*, and our Tony Hawk franchise. *Spider-Man 2* was the number one selling game in the U.S. and the U.K for the month of July.
- Publishing console net revenues increased by 216% from \$46.0 million for the three months ended September 30, 2003 to \$145.5 million for the three months ended September 30, 2004. The increase was driven by strong sales of *Spider-Man 2* and three new console releases, *Dreamworks' Shark Tale*, *X-Men Legends*, and *Cabela's Deer Hunt 2005 Season*.

- PC net revenues increased 350% from \$21.6 million for the three months ended September 30, 2003 compared to \$97.2 million for the three months ended September 30, 2004. This was mainly due to the release of *Doom 3*, which to date is the number one selling PC title in the United States for the calendar year, *Rome: Total War*, which is the highest rated PC game in our history, and *Call of Duty: United Offensive*, an expansion pack to last year's #1 PC title, *Call of Duty*.
- International Publishing and Distribution net revenues benefited from the strong year-over-year strengthening of the Euro ("EUR") and Great Britain Pound ("GBP") in relation to the U.S. dollar. We estimate that foreign exchange rates increased reported net revenue by approximately \$16.2 million. Excluding the impact of changing foreign currency rates, our International Publishing and Distribution net revenue increased 92% year-over-year.

The following table details our consolidated net revenues by business segment and our publishing net revenues by territory for the six months ended September 30, 2004 and 2003 (in thousands):

|                                  | Six Months ended<br>September 30, |                   | Increase/ (Decrease) | Percent<br>Change |
|----------------------------------|-----------------------------------|-------------------|----------------------|-------------------|
|                                  | 2004                              | 2003              |                      |                   |
| <b>Publishing Net Revenues</b>   |                                   |                   |                      |                   |
| North America                    | \$ 282,896                        | \$ 129,189        | \$ 153,707           | 119%              |
| Europe                           | 125,265                           | 48,986            | 76,279               | 156%              |
| Other                            | 19,886                            | 8,026             | 11,860               | 148%              |
| <b>Total International</b>       | <b>145,151</b>                    | <b>57,012</b>     | <b>88,139</b>        | <b>155%</b>       |
| Total Publishing Net Revenues    | 428,047                           | 186,201           | 241,846              | 130%              |
| Distribution Net Revenues        | 93,855                            | 90,047            | 3,808                | 4%                |
| <b>Consolidated Net Revenues</b> | <b>\$ 521,902</b>                 | <b>\$ 276,248</b> | <b>\$ 245,654</b>    | <b>89%</b>        |

Consolidated net revenues increased 89% from \$276.2 million for the six months ended September 30, 2003 to \$521.9 million for the six months ended September 30, 2004. This increase was driven almost entirely by our publishing business. The increase in consolidated net revenue was driven by the following:

- In the first half of fiscal 2005, we released *Spider-Man 2*, *Shrek 2*, *Doom 3*, *Call of Duty: United Offensive*, and *Cabela's Deer Hunt 2005 Season* worldwide and, in North America, we released *Rome: Total War*, *X-Men Legends*, and *Dreamworks' Shark Tale*. Overall sales of these titles significantly outperformed titles released in the first half of fiscal 2004.
- International Publishing and Distribution net revenues benefited from the strong year-over-year strengthening of the EUR and GBP in relation to the U.S. dollar. We estimate that foreign exchange rates increased reported net revenue by approximately \$23.3 million for the six-months ended September 30, 2004. Excluding the impact of changing foreign currency rates, our international net revenue increased 47% year-over-year.

North America Publishing Net Revenue (in thousands)

|                    | September 30,<br>2004 | % of Consolidated<br>Net Revenue | September 30,<br>2003 | % of<br>Consolidated Net<br>Revenue | Increase/<br>(Decrease) | Percent<br>Change |
|--------------------|-----------------------|----------------------------------|-----------------------|-------------------------------------|-------------------------|-------------------|
| Three Months Ended | \$ 157,705            | 51%                              | \$ 46,450             | 40%                                 | \$ 111,255              | 240%              |
| Six Month Ended    | 282,896               | 54%                              | \$ 129,189            | 47%                                 | \$ 153,707              | 119%              |

Domestic publishing net revenues increased 240% from \$46.5 million for the three months ended September 30, 2003, to \$157.7 million for the three months ended September 30, 2004. The increase reflects the strong performance of our fiscal 2005 second quarter releases of *Dreamworks' Shark Tale*, *X-Men Legends*, *Cabela's Deer Hunt 2005 Season*, *Doom 3*, *Rome: Total War*, and *Call of Duty: United Offensive* in comparison to a low volume of new titles released in the second quarter of fiscal 2004. We also had solid catalog sales from a number of our franchises, including *Spider-Man 2*, *Shrek 2*, and our Tony Hawk franchise.

For the six months ended September 30, 2004, domestic publishing net revenues increased 119% from \$129.2 million at September 30, 2003 to \$282.9 million. The increase reflects the strong performance of our fiscal 2005 releases of *Spider-Man 2*, *Shrek 2*, *Dreamworks' Shark Tale*, *X-Men Legends*, *Cabela's Deer Hunt 2005 Season*, *Doom 3*, *Rome: Total War*, and *Call of Duty: United Offensive*.

International Publishing Net Revenue (in thousands)

|                    | September 30,<br>2004 | % of Consolidated<br>Net Revenue | September 30,<br>2003 | % of Consolidated<br>Net Revenue | Increase/<br>(Decrease) | Percent<br>Change |
|--------------------|-----------------------|----------------------------------|-----------------------|----------------------------------|-------------------------|-------------------|
| Three Months Ended | \$ 108,690            | 35%                              | \$ 25,346             | 22%                              | \$ 83,344               | 329%              |
| Six Months Ended   | 145,151               | 28%                              | 57,012                | 21%                              | \$ 88,139               | 155%              |

International publishing net revenues increased by 329% from \$25.3 million for the three months ended September 30, 2003, to \$108.7 million for the three months ended September 30, 2004. International publishing saw strong results from our fiscal 2005 second quarter releases of *Doom 3* and *Spider-Man 2*, which was released in all international territories after only a limited international territorial release in the first quarter of fiscal 2005. In addition, net revenues were improved due to the expansion of our European operations into Spain and Italy. There also was a positive strengthening of the EUR and the GBP in relation to the U.S. dollar of approximately \$11.5 million. Excluding the impact of changing foreign currency rates, our international publishing net revenue increased 284% year-over-year.

International publishing net revenues increased by 155% from \$57.0 million for the six months ended September 30, 2003, to \$145.2 million for the six months ended September 30, 2004. International publishing saw strong results from our fiscal 2005 second quarter releases as mentioned above and the release of *Shrek 2* in the first quarter of fiscal 2005. In addition, net revenues were improved due to the expansion of our European operations into Spain and Italy. There also was a positive strengthening of the EUR and the GBP in relation to the U.S. dollar of approximately \$13.9 for the six months ended September 30, 2004 compared to the six-months ended September 30, 2003. Excluding the impact of changing foreign currency rates, our international publishing net revenue increased 130% year-over-year.

*Publishing Net Revenue by Platform*

Publishing net revenues increased 271% from \$71.8 million for the three months ended September 30, 2003 to \$266.4 million for the three months ended September 30, 2004. The following table details our publishing net revenues by platform and as a percentage of total publishing net revenues for the three months ended September 30, 2004 and 2003 (in thousands):

|                                      | Quarter Ended<br>September 30,<br>2004 | % of Publishing<br>Net Revs. | Quarter Ended<br>September 30,<br>2003 | % of Publishing<br>Net Revs. | Increase/<br>(Decrease) | Percent<br>Change |
|--------------------------------------|--|------------------------------|--|------------------------------|-------------------------|-------------------|
| <b>Publishing Net Revenues</b>       |  |                              |  |                              |                         |                   |
| PC                                   | \$ 97,184                              | 36%                          | \$ 21,590                              | 30%                          | \$ 75,594               | 350%              |
| <b>Console</b>                       |  |                              |  |                              |                         |                   |
| PlayStation 2                        | 87,762                                 | 33%                          | 23,201                                 | 32%                          | 64,561                  | 278%              |
| Microsoft Xbox                       | 36,763                                 | 14%                          | 12,939                                 | 18%                          | 23,824                  | 184%              |
| Nintendo GameCube                    | 20,717                                 | 8%                           | 2,856                                  | 4%                           | 17,861                  | 625%              |
| Other                                | 300                                    | -                            | 7,023                                  | 10%                          | (6,723)                 | (96)%             |
| Total Console                        | 145,542                                | 55%                          | 46,019                                 | 64%                          | 99,523                  | 216%              |
| <b>Hand-held</b>                     |  |                              |  |                              |                         |                   |
| Game Boy Advance                     | 23,669                                 | 9%                           | 4,187                                  | 6%                           | 19,482                  | 465%              |
| <b>Total Publishing Net Revenues</b> | <b>\$ 266,395</b>                      | <b>100%</b>                  | <b>\$ 71,796</b>                       | <b>100%</b>                  | <b>\$ 194,599</b>       | <b>271%</b>       |

Publishing net revenues increased 130% from \$186.2 million for the six months ended September 30, 2003 to \$428.0 million for the six months ended September 30, 2004. The following table details our publishing net revenues by platform and as a percentage of total publishing net revenues for the six months ended September 30, 2004 and 2003 (in thousands):

|                                | Six Months<br>Ended<br>September 30,<br>2004 | % of Publishing<br>Net Revs. | Six Months<br>Ended<br>September 30,<br>2003 | % of Publishing<br>Net Revs. | Increase/<br>(Decrease) | Percent<br>Change |
|--------------------------------|--|------------------------------|--|------------------------------|-------------------------|-------------------|
| <b>Publishing Net Revenues</b> |  |                              |  |                              |                         |                   |
| PC                             | \$ 121,279                                   | 28%                          | \$ 42,915                                    | 23%                          | \$ 78,364               | 183%              |
| <b>Console</b>                 |  |                              |  |                              |                         |                   |
| PlayStation 2                  | 156,466                                      | 37%                          | 65,654                                       | 35%                          | 90,812                  | 138%              |
| Microsoft Xbox                 | 62,599                                       | 15%                          | 48,087                                       | 26%                          | 14,512                  | 30%               |
| Nintendo GameCube              | 44,469                                       | 10%                          | 9,082  | 5%                           | 35,387                  | 390%              |
| Other                          | 1,135  | -%                           | 11,680                                       | 6%                           | (10,545)                | (90)%             |
| Total Console                  | 264,669                                      | 62%                          | 134,503                                      | 72%                          | 130,166                 | 97%               |
| <b>Hand-held</b>               |  |                              |  |                              |                         |                   |
| Game Boy Advance               | 42,099                                       | 10%                          | 8,783  | 5%                           | 33,316                  | 379%              |
| Total Publishing Net Revenues  | \$ 428,047                                   | 100%                         | \$ 186,201                                   | 100%                         | \$ 241,846              | 130%              |

Personal Computer Net Revenue (in thousands)

|                    | September 30,<br>2004 | % of Publishing<br>Net Revenue | September 30,<br>2003 | % of Publishing<br>Net Revenue | Increase/<br>(Decrease) | Percent<br>Change |
|--------------------|-----------------------|--------------------------------|-----------------------|--------------------------------|-------------------------|-------------------|
| Three Months Ended | \$ 97,184             | 36%                            | \$ 21,590             | 30%                            | \$ 75,594               | 350%              |
| Six Months Ended   | 121,279               | 28%                            | 42,915                | 23%                            | 78,364                  | 183%              |

Net revenue from sales of titles for the PC increased 350% from \$21.6 million for the three months ended September 30, 2003 to \$97.2 million for the three months ended September 30, 2004. Our new release titles, specifically *Doom 3*, performed very well in both the domestic and international markets. In addition, the number of premium PC titles released in the second quarter of fiscal 2005 increased to three titles from one title, which was only released internationally, in the second quarter of fiscal 2004.

Net revenue from sales of titles for the PC increased 183% from \$42.9 million for the six months ended September 30, 2003 to \$121.3 million for the six months ended September 30, 2004. The increase was driven mainly by the releases of numerous "big proposition" titles including the releases of *Spider-Man 2* and *Shrek 2* in the first quarter of fiscal 2005 and *Doom 3*, *Rome: Total War*, and *Call of Duty: United Offensive* in the second quarter of fiscal 2005. This compares to the releases of three new PC titles in the six months ended

September 30, 2003, *X2: Wolverine's Revenge*, *Medieval Total War: Viking Invasion*, and *Jedi Knight: Jedi Academy*, which was released in international markets.

We expect fiscal 2005 PC publishing net revenues to continue to increase over fiscal 2004 due to continued catalog sales of *Doom 3*, *Call of Duty: United Offensive*, and *Rome: Total War* and the releases of *Vampires: The Masquerade Bloodlines* in the third quarter of fiscal 2005 and *Doom 3: Resurrection of Evil* in late fiscal 2005.

PlayStation 2 Net Revenue (in thousands)

|                    | September 30,<br>2004 | % of Publishing<br>Net Revenue | September 30,<br>2003 | % of Publishing<br>Net Revenue | Increase/<br>(Decrease) | Percent<br>Change |
|--------------------|-----------------------|--------------------------------|-----------------------|--------------------------------|-------------------------|-------------------|
| Three Months Ended | \$ 87,762             | 33%                            | \$ 23,201             | 32%                            | \$ 64,561               | 278%              |
| Six Months Ended   | 156,466               | 37%                            | 65,654                | 35%                            | 90,812                  | 138%              |

Net revenue from sales of titles for the PS2 increased 278% from \$23.2 million for the three months ended September 30, 2003 to \$87.8 million for the three months ended September 30, 2004. This was driven by an increase in the number of new PS2 titles in the second quarter of fiscal 2005 to four from two in fiscal 2004 and continued strong sales of our catalog titles including *Shrek 2* and *Spider-Man 2*. In the second quarter of fiscal 2005 we released *X-Men Legends*, *Dreamworks' Shark Tale*, *Cabela's Deer Hunt 2005*, and *Rapala's Pro Fishing* for the PS2.

Net revenue from sales of titles for the PS2 increased 138% from \$65.7 million for the six months ended September 30, 2003 to \$156.5 million for the six months ended September 30, 2004. This was driven by the second quarter releases discussed above and the first quarter releases and continued strong sales of *Spider-Man 2* and *Shrek 2*.

We expect the overall installed base of the PS2 to continue to increase for the remainder of the fiscal year due to recent price cuts and a redesigned PS2 console. As the installed base increases we expect our overall net revenues from PS2 sales to continue to increase over prior periods.

Microsoft Xbox Net Revenue (in thousands)

|                    | September 30, 2004 | % of Publishing<br>Net Revenue | September 30,<br>2003 | % of Publishing<br>Net Revenue | Increase/<br>(Decrease) | Percent<br>Change |
|--------------------|--------------------|--------------------------------|-----------------------|--------------------------------|-------------------------|-------------------|
| Three Months Ended | \$ 36,763          | 14%                            | \$ 12,939             | 18%                            | \$ 23,824               | 184%              |
| Six Months Ended   | 62,599             | 15%                            | 48,087                | 26%                            | 14,512                  | 30%               |

Net revenue from sales of titles for the Xbox increased 184% from \$12.9 million for the three months ended September 30, 2003 to \$36.8 million for the three months ended September 30, 2004. The increase is due to an increase in the number of Xbox titles released in the second quarter of fiscal 2005 to four from two in the second quarter of fiscal 2004. In the second quarter of fiscal 2005 we released *X-Men Legends*, *Dreamworks' Shark Tale*, *Cabela's Deer Hunt 2005*, and *Rapala's Pro Fishing* for the Xbox.

Net revenue from sales of titles for the Xbox increased 30% from \$48.1 million for the six months ended September 30, 2003 to \$62.6 million for the six months ended September 30, 2004. The increase is due to the strength of the second quarter releases mentioned above. This was partially offset by the first quarter

fiscal 2005 releases on Xbox of *Spider-Man 2* and *Shrek 2*, which reflected solid sales both in the domestic and international markets, but did not perform as well on the Xbox as they did on other platforms as these titles were not as focused toward the demographic of the Xbox audience as compared to the titles released in the first quarter of fiscal 2004, *X2: Wolverine's Revenge*, *Return to Castle Wolfenstein*, *Wakeboarding Unleashed* and *Soldier of Fortune II: Double Helix*.

We expect the overall installed base of the Xbox, which has been the fastest selling console this year, to continue to increase for the remainder of the fiscal year. As the installed base increases we also expect our overall net revenues from Xbox sales to continue to increase over prior periods.

Nintendo GameCube Net Revenue (in thousands)

|                    | September 30, 2004 | % of Publishing<br>Net Revenue | September 30, 2003 | % of Publishing<br>Net Revenue | Increase/<br>(Decrease) | Percent<br>Change |
|--------------------|--------------------|--------------------------------|--------------------|--------------------------------|-------------------------|-------------------|
| Three Months Ended | \$ 20,717          | 8%                             | \$ 2,856           | 4%                             | \$ 17,861               | 625%              |
| Six Months Ended   | 44,469             | 10%                            | 9,082              | 5%                             | 35,387                  | 390%              |

Net revenue from sales of titles for the Nintendo GameCube increased 625% from \$2.9 million for the three months ended September 30, 2003 to \$20.7 million for the three months ended September 30, 2004. The increase is mainly due to continued strong catalog sales of *Spider-Man 2* and new North American releases of *Dreamworks' Shark Tale* and *X-Men Legends*. These titles performed very well as they were targeted toward the demographic of the GameCube audience. This compares to one new GameCube release in the second quarter of fiscal 2004, *Disney's Extreme Skate Adventure*.

Net revenue from sales of titles for the Nintendo GameCube increased 390% from \$9.1 million for the six months ended September 30, 2003 to \$44.5 million for the six months ended September 30, 2004. Although the number of GameCube titles released in the first six months of fiscal 2005 remained relatively consistent with the first six months of fiscal 2004, performance of our first quarter fiscal 2005 releases of *Spider-Man 2* and *Shrek 2* and our second quarter North American releases of *Dreamworks' Shark Tale* and *X-Men Legends* were stronger as these titles were targeted toward the demographic of the GameCube audience.

We expect the overall installed base of the GameCube to increase marginally for the remainder of the fiscal year.

Game Boy Advance Net Revenue (in thousands)

|                    | September 30,<br>2004 | % of Publishing<br>Net Revenue | September 30,<br>2003 | % of Publishing<br>Net Revenue | Increase/<br>(Decrease) | Percent<br>Change |
|--------------------|-----------------------|--------------------------------|-----------------------|--------------------------------|-------------------------|-------------------|
| Three Months Ended | \$ 23,669             | 9%                             | \$ 4,187              | 6%                             | \$ 19,482               | 465%              |
| Six Months Ended   | 42,099                | 10%                            | 8,783                 | 5%                             | 33,316                  | 379%              |

Net revenue from sales of titles for the GBA for the three months ended September 30, 2004 increased 465% from the prior fiscal year, from \$4.2 million to \$23.7 million. *Dreamworks' Shark Tale* in the second quarter of fiscal 2005, which performed very well in the North American market, combined with the continued strong performance of the two titles released in the first quarter of fiscal 2005, *Spider-Man 2* and *Shrek 2*. These titles were targeted toward the demographic of the GBA audience and performed in line with expectations.



Net revenue from sales of titles for the GBA for the six months ended September 30, 2004 increased 379% from the prior fiscal year, from \$8.8 million to \$42.1 million. The increase is due to three strong releases, *Dreamworks' Shark Tale*, *Spider-Man 2* and *Shrek 2* which were targeted toward the demographic of the GBA audience. By contrast, there were two releases in the six months ended September 30, 2003, *Disney's Extreme Skate Adventure* and *X2: Wolverine's Revenge*.

We expect the hand-held installed base to grow with the recent price cut of the GBA and the release of the NDS and PSP which are expected to launch in late calendar year 2004 and early calendar year 2005, respectively. In addition, in fiscal 2005, as the GBA hardware approaches the peak of its life cycle, we expect to increase our focus on developing GBA games for mass-market consumers.

The platform mix of our future publishing net revenues will likely be impacted by a number of factors, including the ability of hardware manufacturers to continue to increase their installed hardware base and the introduction of new hardware platforms, as well as the timing of key product releases from our product release schedule. We expect that net revenues from console titles will continue to represent the largest component of our publishing net revenues with PS2 having the largest percentage of that business due to its larger installed hardware base. We expect net revenues from hand-held titles to remain the smallest component of our publishing net revenues. However, when the PSP and/or the NDS hand-held devices are introduced, we may see an increase in our hand-held business in comparison to prior periods. Our net revenues from PC titles will be primarily driven by our product release schedule.

A significant portion of our revenues and profits are derived from a relatively small number of popular titles and brands each year as revenues and profits are significantly affected by our ability to release highly successful titles. For example, for the three months ended September 30, 2004, 42% of our consolidated net revenues and 49% of worldwide publishing net revenues were derived from net revenues from our *Spider-Man 2* and *Doom 3* titles. For the six months ended September 30, 2004, 39% of our consolidated net revenues and 47% of worldwide publishing net revenues were derived from net revenues from our *Spider-Man 2* and *Doom 3* titles. Though many of these titles have substantial production or acquisition costs and marketing budgets, once a title recoups these costs, incremental net revenues directly and positively impact operating profits resulting in a disproportionate amount of operating income being derived from these select titles. We expect that a limited number of titles and brands will continue to produce a disproportionately large amount of our net revenues and profits.

Two factors that could affect future publishing and distribution net revenue performance are console hardware pricing and software pricing. As console hardware moves through its life cycle, hardware manufacturers typically enact price reductions. Reductions in the price of console hardware typically result in an increase in the installed base of hardware owned by consumers. Price cuts on Xbox, PS2, and GBA hardware were announced in March, May, and September 2004, respectively. Historically, we have also seen that lower console hardware prices put downward pressure on software pricing. While we expect console software launch pricing at retail for most genres to hold at \$49.99 through the calendar 2004 holidays, we believe we could see software price declines thereafter.

*Distribution Net Revenue (in thousands)*

|                    | September 30,<br>2004 | % of<br>Consolidated<br>Net Revenue | September 30,<br>2003 | % of<br>Consolidated<br>Net Revenue | Increase/<br>(Decrease) | Percent<br>Change |
|--------------------|-----------------------|-------------------------------------|-----------------------|-------------------------------------|-------------------------|-------------------|
| Three Months Ended | \$ 44,231             | 14%                                 | \$ 45,727             | 39%                                 | \$ (1,496)              | (3)%              |
| Six Months Ended   | 93,855                | 18%                                 | 90,047                | 33%                                 | 3,808                   | 4%                |

Distribution net revenues for the three months ended September 30, 2004 decreased 3% from the prior fiscal year, from \$45.7 million to \$44.2 million. The decrease was primarily due to slow sales of hardware

consoles up until the recent European price cuts in late August. This was partially offset by a positive impact of the year-over-year strengthening of the EUR and the GBP in relation to the U.S. dollar of \$4.7 million. Excluding the impact of the changing foreign currency rates, our distribution net revenue decreased 14% year-over-year.

Distribution net revenues for the six months ended September 30, 2004 increased 4% from the prior fiscal year, from \$90.0 million to \$93.9 million. The increase was primarily due to the positive impact of the year-over-year strengthening of the EUR and the GBP in relation to the U.S. dollar for the six months ended September 30, 2004 of \$9.5 million, partially offset by the reduced hardware console sales discussed above. Excluding the impact of the changing foreign currency rates, our distribution net revenue decreased 6.3% year-over-year

The mix of future distribution net revenues will be driven by a number of factors including the occurrence of further hardware price reductions instituted by hardware manufacturers, the introduction of new hardware platforms, our ability to establish and maintain distribution agreements with hardware manufacturers and third-party software publishers and the success of third-party published titles. We are expecting our total fiscal 2005 distribution revenues to be in line with fiscal 2004.

#### Costs and Expenses

##### Cost of Sales — Product Costs (in thousands)

|                    | September 30,<br>2004 | % of<br>Consolidated<br>Net Revenue | September 30,<br>2003 | % of<br>Consolidated<br>Net Revenue | Increase/<br>(Decrease) | Percent<br>Change |
|--------------------|-----------------------|-------------------------------------|-----------------------|-------------------------------------|-------------------------|-------------------|
| Three Months Ended | \$ 123,177            | 40%                                 | \$ 72,391             | 61%                                 | \$ 50,786               | 70%               |
| Six Months Ended   | 212,265               | 41%                                 | 149,001               | 54%                                 | 63,264                  | 42%               |

Cost of sales — product costs represented 40% and 61% of consolidated net revenues for the three months ended September 30, 2004 and 2003, respectively. In absolute dollars, cost of sales — product costs increased 70% due to significantly higher sales volume in the second quarter of fiscal 2005 as compared to the second quarter of fiscal 2004.

Cost of sales — product costs represented 41% and 54% of consolidated net revenues for the six months ended September 30, 2004 and 2003, respectively. In absolute dollars, cost of sales — product costs increased 42% due to significantly higher sales volume in the first six months of fiscal 2005 as compared to the first six months of fiscal 2004.

The primary factors affecting the reduction in the cost of sales — product costs as a percentage of consolidated net revenues are:

- Increased ability to maintain premium pricing on “big proposition” titles for both the three and six months ended September 30, 2004.
- A lower percentage of revenues generated from our distribution business in the three and six months ended September 30, 2004.
- Our PC revenues jumped from 30% to 36% of Publishing net revenue for the three months ended September 30, 2004 and from 23% to 28% of Publishing net revenues for the six months ended September 30, 2004 due to the releases of *Doom 3*, *Rome: Total War*, and *Call of Duty: United Offensive*. PC platform titles typically carry the lowest product costs as a percentage of selling price.

We expect cost of sales — product costs as a percentage of net revenues to continue to be lower than the comparable period in the prior fiscal year throughout fiscal 2005. This is primarily due to a lower percentage of revenue generated from our distribution business in fiscal 2005, which is a lower margin business. We may also continue to experience a benefit from changes in product mix in fiscal 2005 due to the increase in PC publishing net revenues as a percentage of total publishing net revenues and the focus on “big proposition” titles, for which we could benefit from higher retail pricing and manufacturing volume discounts.

*Cost of Sales — Software Royalties and Amortization (in thousands)*

|                    | <u>September 30,<br/>2004</u> | <u>% of<br/>Publishing<br/>Net Revenue</u> | <u>September 30,<br/>2003</u> | <u>% of<br/>Publishing<br/>Net Revenue</u> | <u>Increase/<br/>(Decrease)</u> | <u>Percent<br/>Change</u> |
|--------------------|-------------------------------|--|-------------------------------|--|---------------------------------|---------------------------|
| Three Months Ended | \$ 46,363                     | 17%  | \$ 11,397                     | 16%  | \$ 34,966                       | 307%                      |
| Six Months Ended   | 58,646                        | 14%  | 26,895                        | 14%  | 31,751                          | 118%                      |

Cost of sales — software royalties and amortization as a percentage of publishing net revenues of 17% for the three months ended September 30, 2004 remained relatively flat compared to 16% for the three months ended September 30, 2003. In absolute dollars, cost of sales — software royalties and amortization for the three months ended September 30, 2004 increased from the prior fiscal year, from \$11.4 million to \$46.4 million. This increase is due to a substantially higher sales volume which results in greater royalties paid to the console hardware manufacturers.

Cost of sales — software royalties and amortization as a percentage of publishing net revenues remained flat at 14% for the six months ended September 30, 2004 and 2003. In absolute dollars, cost of sales — software royalties and amortization for the six months ended September 30, 2004 increased \$31.8 million from the prior fiscal year, from \$26.9 million for the six months ended September 30, 2003 to \$58.6 million. This increase is due to substantially higher sales volume which results in greater royalties paid to the console hardware manufacturers.

*Cost of Sales — Intellectual Property Licenses (in thousands)*

|                    | <u>September 30,<br/>2004</u> | <u>% of<br/>Publishing<br/>Net Revenue</u> | <u>September 30,<br/>2003</u> | <u>% of<br/>Publishing<br/>Net Revenue</u> | <u>Increase/<br/>(Decrease)</u> | <u>Percent<br/>Change</u> |
|--------------------|-------------------------------|--|-------------------------------|--|---------------------------------|---------------------------|
| Three Months Ended | \$ 17,551                     | 7%   | \$ 7,401                      | 10%  | \$ 10,150                       | 137%                      |
| Six Months Ended   | 35,199                        | 8%   | 17,544                        | 9%   | 17,655                          | 101%                      |

Cost of sales — intellectual property licenses for the three months ended September 30, 2004 increased in absolute dollars by 137% from \$7.4 million for the three months ended September 30, 2003 to \$17.6 million for the three months ended September 30, 2004 while the percentage of publishing net revenues decreased from 10% to 7%. The decrease in the percentage of publishing net revenues was due primarily to the release of titles with higher royalty rates in the three months ended September 30, 2003.

Cost of sales — intellectual property licenses for the six months ended September 30, 2004 increased in absolute dollars by 101% from \$17.5 million for the six months ended September 30, 2003 to \$35.2 million for the six months ended September 30, 2004 while the percentage of publishing net revenues remained relatively flat over the same period last year, decreasing from 9% to 8%.

We expect cost of sales — intellectual property licenses to increase in fiscal 2005 as compared to fiscal 2004, as we expect to have more titles releasing with licensed intellectual property.

*Product Development (in thousands)*

|                    | September 30,<br>2004 | % of<br>Publishing<br>Net Revenue | September 30,<br>2003 | % of<br>Publishing<br>Net Revenue | Increase/<br>(Decrease) | Percent<br>Change |
|--------------------|-----------------------|-----------------------------------|-----------------------|-----------------------------------|-------------------------|-------------------|
| Three Months Ended | \$ 19,881             | 7%                                | \$ 15,894             | 22%                               | \$ 3,987                | 25%               |
| Six Months Ended   | 40,986                | 10%                               | 29,474                | 16%                               | 11,512                  | 39%               |

Product development expenses for the three months ended September 30, 2004 decreased as a percentage of publishing net revenues as compared to the three months ended September 30, 2003, from 22% to 7%. In absolute dollars, product development expenses for the three months ended September 30, 2004 increased approximately \$4.0 million compared to the three months ended September 30, 2003, from \$15.9 million to \$19.9 million.

Product development expenses for the six months ended September 30, 2004 decreased as a percentage of publishing net revenues as compared to the six months ended September 30, 2003, from 16% to 10%. In absolute dollars, product development expenses for the six months ended September 30, 2004 increased approximately \$11.5 million compared to the six months ended September 30, 2003, from \$29.5 million to \$41.0 million.

The decrease in product development as a percentage of publishing net revenues for both the three and six months ended September 30, 2004 resulted from substantially higher sales volumes due to the release of many more “big proposition” titles compared to the same periods last year.

The increase in product development in absolute dollars for both the three and six months ended September 30, 2004 resulted from:

- Higher game development costs as development time and team sizes as well as quality assurance time increased due to enhanced production values and to support more complex and robust gaming experiences.
- The increase in absolute dollars is also due to an increase in studio employee incentive compensation as a result of the strong performances of key fiscal 2005 title releases such as *Spider-Man 2*, *Shrek 2*, and *X-Men Legends*.

*Sales and Marketing (in thousands)*

|                    | September 30,<br>2004 | % of<br>Consolidated<br>Net Revenue | September 30,<br>2003 | % of<br>Consolidated<br>Net Revenue | Increase/<br>(Decrease) | Percent<br>Change |
|--------------------|-----------------------|-------------------------------------|-----------------------|-------------------------------------|-------------------------|-------------------|
| Three Months Ended | \$ 53,234             | 17%                                 | \$ 17,237             | 15%                                 | \$ 35,997               | 209%              |
| Six Months Ended   | 94,968                | 18%                                 | 43,522                | 16%                                 | 51,446                  | 118%              |

Sales and marketing expenses of \$53.2 million and \$17.2 million represented 17% and 15% of consolidated net revenues for the three months ended September 30, 2004 and 2003, respectively. The increases both in absolute dollars and as a percentage of net revenues was primarily generated by our publishing business as a result of significant marketing programs, including television and in-theatre ad campaigns and in-

store promotions, run in support of our three key fiscal 2005 second quarter “big proposition” title releases, *Doom 3*, *Dreamworks’ Shark Tale*, and *X-Men Legends* as well as continued expenses to support the *Spider-Man 2* and *Shrek 2* titles.

Sales and marketing expenses increased 118% from \$43.5 million and 16% of consolidated net revenue for the six months ended September 30, 2003 to approximately \$95.0 million and 18% of consolidated net revenue for the six months ended September 30, 2004. The increases both in absolute dollars and as a percentage of net revenues was primarily generated by our publishing business as a result of significant marketing programs, including television and in-theatre ad campaigns and in-store promotions, run in support of our key fiscal 2005 first half “big proposition” title releases, *Spider-Man 2*, *Shrek 2*, *Doom 3*, *Dreamworks’ Shark Tale*, and *X-Men Legends*. We currently believe that this increased spending will lengthen the product sales life cycle and add to the long term prospects of the respective product lines.

We expect to continue to provide significant marketing support for our future “big proposition” titles in launch and subsequent quarters. Accordingly, we expect fiscal 2005 sales and marketing costs to exceed fiscal 2004 spending levels.

*General and Administrative (in thousands)*

|                    | September 30,<br>2004 | % of<br>Consolidated<br>Net Revenue | September 30,<br>2003 | % of<br>Consolidated<br>Net Revenue | Increase/<br>(Decrease) | Percent<br>Change |
|--------------------|-----------------------|-------------------------------------|-----------------------|-------------------------------------|-------------------------|-------------------|
| Three Months Ended | \$ 15,762             | 5%                                  | \$ 10,136             | 9%                                  | \$ 5,626                | 56%               |
| Six Months Ended   | 29,447                | 5%                                  | 21,599                | 8%                                  | 7,848                   | 36%               |

General and administrative expenses for the three months ended September 30, 2004 increased \$5.6 million over the same period last year, from \$10.1 million to \$15.8 million. As a percentage of consolidated net revenues, general and administrative expenses decreased from 9% to 5% for the three months ended September 30, 2003 and 2004, respectively. The increase in absolute dollars was primarily due to an increase in internal and external costs to support Sarbanes-Oxley related compliance combined with costs associated with our European expansion into Spain and Italy. The decrease as a percentage of consolidated net revenue is due mainly to the significant increase in sales volume.

For the six months ended September 30, 2004, general and administrative expenses increased \$7.8 million or 36% over the same period last year, from \$21.6 million to \$29.4 million. As a percentage of consolidated net revenues, general and administrative expenses declined from 8% to 5%. Consistent with above, the increase in absolute dollars was primarily due to an increase in internal and external costs to support Sarbanes-Oxley related compliance combined with the our European expansion into Spain and Italy. The decrease as a percentage of consolidated net revenue is due mainly to the significant increase in sales volume.

*Operating Income (Loss) (in thousands)*

|                    | September 30,<br>2004 | % of<br>Segment<br>Net Revs. | September 30,<br>2003 | % of<br>Segment<br>Net Revs. | Increase/<br>(Decrease) | Percent<br>Change |
|--------------------|-----------------------|------------------------------|-----------------------|------------------------------|-------------------------|-------------------|
| Three Months Ended |                       |                              |                       |                              |                         |                   |
| Publishing         | \$ 31,609             | 12%                          | \$ (16,894)           | (24)%                        | \$ 48,503               | 287%              |
| Distribution       | 3,049                 | 7%                           | (39)                  | -                            | 3,088                   | 7,918%            |
| Consolidated       | <u>\$ 34,658</u>      | 11%                          | <u>\$ (16,933)</u>    | (14)%                        | <u>\$ 51,591</u>        | 305%              |

Publishing operating income (loss) for the three months ended September 30, 2004 increased \$48.5 million or 287% from the same period last year, from a loss of \$(16.9) million to income of \$31.6 million. International publishing operating income for the three months ended September 30, 2004 benefited from the positive impact of the year-over-year strengthening of the EUR and the GBP in relation to the U.S. dollar. Excluding the impact of changes in foreign currency rates, publishing operating income for the three months ended June 30, 2004 increased approximately \$43.5 million from the same period last year. This increase is primarily due to:

- Strong performance in both the domestic and international markets of our fiscal 2005 second quarter title releases.

Partially offset by:

- Increased sales and marketing spending to support our “big proposition” titles.

Distribution operating income (loss) for the three months ended September 30, 2004 increased by \$3.1 million over the same period last year, from a loss of \$(39,000) to income of \$3.0 million. Excluding the impact of changes in foreign currency rates, distribution operating income for the three months ended September 30, 2004 increased by approximately \$2.8 million from the same period last year. This increase is primarily due to a shift in the mix of hardware versus software sales as software tends to be a higher margin business.

|                         | <u>September 30,</u><br><u>2004</u> | <u>% of</u><br><u>Segment</u><br><u>Net Revs.</u> | <u>September 30,</u><br><u>2003</u> | <u>% of</u><br><u>Segment</u><br><u>Net Revs.</u> | <u>Increase/</u><br><u>(Decrease)</u> | <u>Percent</u><br><u>Change</u> |
|-------------------------|-------------------------------------|---|-------------------------------------|---|---------------------------------------|---------------------------------|
| <b>Six Months Ended</b> |                                     |   |                                     |   |                                       |                                 |
| Publishing              | \$ 47,503                           | 11%   | \$ (11,724)                         | (6)%  | \$ 59,227                             | 505%                            |
| Distribution            | 2,888                               | 3%  | (63)                                | -   | 2,951                                 | 4,684%                          |
| Consolidated            | <u>\$ 50,391</u>                    | 10%   | <u>\$ (11,787)</u>                  | (4)%  | <u>\$ 62,178</u>                      | 528%                            |

Publishing operating income for the six months ended September 30, 2004 increased \$59.2 million from the same period last year, from a loss of \$(11.7) million to income of \$47.5 million. International publishing operating income for the six months ended September 30, 2004 benefited from the positive impact of the year-over-year strengthening of the EUR and the GBP in relation to the U.S. dollar. Excluding the impact of changes in foreign currency rates, publishing operating income for the six months ended September 30, 2004 increased approximately \$53.4 million from the same period last year. This increase is primarily due to:

- Strong performance in both the domestic and international markets of our fiscal 2005 title releases.

Partially offset by:

- Increased sales and marketing spending to support our “big proposition” titles.

Distribution operating income (loss) for the six months ended September 30, 2004 increased \$3.0 million over the same period last year, from a loss of \$(63,000) to income of \$2.9 million. Excluding the impact of changes in foreign currency rates, distribution operating income for the six months ended September 30, 2004 increased by \$2.7 million from the same period last year. This increase is primarily due to a shift in the mix of hardware versus software sales as software tends to be a higher margin business.

*Investment Income, Net (in thousands)*

|                    | <u>September 30,<br/>2004</u> | <u>% of<br/>Consolidated<br/>Net Revenue</u> | <u>September 30,<br/>2003</u> | <u>% of<br/>Consolidated<br/>Net Revenue</u> | <u>Increase/<br/>(Decrease)</u> | <u>Percent<br/>Change</u> |
|--------------------|-------------------------------|--|-------------------------------|--|---------------------------------|---------------------------|
| Three Months Ended | \$ 2,645                      | 1%   | \$ 1,404                      | 1%   | \$ 1,241                        | 88%                       |
| Six Months Ended   | 4,757                         | 1%   | 2,661                         | 1%   | 2,096                           | 79%                       |

Investment income, net for the three months ended September 30, 2004 was \$2.6 million as compared to \$1.4 million for the three months ended September 30, 2003. The increase was primarily due to higher invested balances during the three months ended September 30, 2004 as compared to the three months ended September 30, 2003 and a realized gain of \$0.5 million on the partial sale of an investment in common stock.

Investment income, net for the six months ended September 30, 2004 increased \$2.1 million from \$2.7 million for the six months ended September 30, 2003 as compared to \$4.8 million for the six months ended September 30, 2004. The increase was primarily due to higher invested balances during the six months ended September 30, 2004 as compared to the six months ended September 30, 2003 and a realized gain in the second quarter of fiscal 2005 of \$0.5 million on the partial sale of an investment in common stock.

*Provision (Benefit) for Income Taxes (in thousands)*

|                    | <u>September 30,<br/>2004</u> | <u>% of<br/>Pretax<br/>Income</u> | <u>September 30,<br/>2003</u> | <u>% of<br/>Pretax<br/>Income</u> | <u>Increase/<br/>(Decrease)</u> | <u>Percent<br/>Change</u> |
|--------------------|-------------------------------|-----------------------------------|-------------------------------|-----------------------------------|---------------------------------|---------------------------|
| Three Months Ended | \$ 11,760                     | 32%                               | \$ (5,436)                    | 35%                               | \$ 17,196                       | 316%                      |
| Six Months Ended   | 17,648                        | 32%                               | (3,196)                       | 35%                               | 20,844                          | 652%                      |

The income tax provision of \$11.8 million and \$17.6 million for the three months and six months ended September 30, 2004, respectively, reflects our effective income tax rate of 32%. The significant items that generated the variance between our effective rate and our statutory rate of 35% were research and development tax credits and the impact of foreign tax rate differentials, offset by an increase in state taxes. The realization of deferred tax assets depends primarily on the generation of future taxable income. We believe that it is more likely than not that we will generate taxable income sufficient to realize the benefit of net deferred tax assets recognized.

## Liquidity and Capital Resources

### Sources of Liquidity

(in thousands)

|                            | September 30, 2004 | March 31, 2004    | Increase/<br>(Decrease) |
|----------------------------|--------------------|-------------------|-------------------------|
| Cash and cash equivalents  | \$ 389,791         | \$ 466,552        | \$ (76,761)             |
| Short-term investments     | 216,296            | 121,097           | 95,199                  |
|                            | <u>\$ 606,087</u>  | <u>\$ 587,649</u> | <u>\$ 18,438</u>        |
| Percentage of total assets | 55%                | 61%               |                         |

|   | For the six months<br>ended September 30,<br>2004 | For the six months<br>ended September 30,<br>2003 | Increase/<br>(Decrease) |
|---|---|---|-------------------------|
| Cash flows provided by (used in) operating activities | \$ 10,710   | \$ (52,089)                                       | \$ 62,799               |
| Cash flows provided by (used in) investing activities | (98,841)  | 15,165  | (114,006)               |
| Cash flows provided by financing activities           | 12,602  | 61,348  | (48,746)                |

As of September 30, 2004, our primary source of liquidity is comprised of \$389.8 million of cash and cash equivalents and \$216.3 million of short-term investments. We believe that we have sufficient working capital (\$738.5 million at September 30, 2004), as well as funds available from our international credit facilities, to finance our operational requirements for at least the next twelve months, including purchases of inventory and equipment, the funding of the development, production, marketing and sale of new products and the acquisition of intellectual property rights for future products.

We actively manage our capital structure as a component of our overall business strategy. When we determine that market conditions are appropriate, we may seek to achieve long-term value for the shareholders through, among other things, new debt or equity financings or refinancings, share repurchases and other transactions involving our equity or debt securities.

### Cash Flows

Cash and cash equivalents were \$389.8 million at September 30, 2004 compared to \$466.6 million at March 31, 2004. Activity in cash and cash equivalents for the six months ended September 30, 2004 included \$10.7 million provided by operating activities, \$98.8 million used in investing activities, and \$12.6 million provided by financing activities. The primary drivers of operating cash flows were net income generated by increased sales volume and amortization of capitalized software development costs and intellectual property licenses for titles released in the first half of fiscal 2005. This was offset by increased accounts receivable and inventories at the end of the six months and continued investment in software development and intellectual property rights. The increase in accounts receivable and inventories was due to the late second quarter releases in North America of *Dreamworks' Shark Tale* and *X-Men Legends* and an early fiscal third quarter worldwide release of *Tony Hawk's Underground 2*. In the six months ended September 30, 2004, we spent approximately \$66.3 million in connection with the development and acquisition of publishing or distribution rights for products being developed by third parties and the execution of new license agreements granting us long-term rights to intellectual property of third parties, as well as incurrence of product development costs relating to internally developed products.

We expect that we will continue to make significant expenditures relating to our investment in software development and intellectual property licenses. Our future cash commitments relating to these



investments are detailed below in “Commitments.” Cash flows from operations are affected by our ability to release highly successful titles. Though many of these titles have substantial production or acquisition costs and marketing budgets, once a title recoups these costs, incremental net revenues typically will directly and positively impact cash flows. We currently expect that a primary source of future liquidity, both short-term and long-term, will cash flows from continuing operations.

For the six months ended September 30, 2004, cash flows used in investing activities were principally due to the purchase of short-term investments. Cash provided by financing activities for the same period is the result of the issuance of common stock related to employee stock option and stock purchase plans.

*Key Balance Sheet Accounts*

Accounts Receivable

| <u>(amounts in thousands)</u> | <u>September 30, 2004</u> | <u>March 31, 2004</u> | <u>Increase/<br/>(Decrease)</u> |
|-------------------------------|---------------------------|-----------------------|---------------------------------|
| Gross accounts receivable     | \$ 200,265                | \$ 109,605            | \$ 90,660                       |
| Net accounts receivable       | 138,586                   | 62,577                | 76,009                          |

The increase in gross accounts receivable was primarily the result of the number and timing of late quarter releases. *Dreamworks' Shark Tale*, *Rome: Total War*, and *X-Men Legends* were all released in North America in late September and combined for sales of approximately 1.9 million units as of September 30, 2004. Significant shipments were made to customers at the end of the quarter and the related receivables were not due prior to quarter end.

Reserves for returns and price protection as a percentage of gross accounts receivable declined from 41% as of March 31, 2004 to 29% as of September 30, 2004. Reserves for returns and price protection are a function of the number of units and pricing of titles in retail inventory (see description of *Allowances for Returns, Price Protection, Doubtful Accounts and Inventory Obsolescence* in Item 2: Critical Accounting Policies). The decrease in reserves for returns and price protection as a percentage of receivables reflects the fact that there were no new releases in the fourth quarter of fiscal 2004 compared to five “big proposition” new releases in the second quarter of fiscal 2005. Catalog titles typically have a higher reserve as a percentage of accounts receivable compared to new releases as they are later in their life cycle and at a reduced selling price.

Inventories

| <u>(amounts in thousands)</u> | <u>September 30, 2004</u> | <u>March 31, 2004</u> | <u>Increase/<br/>(Decrease)</u> |
|-------------------------------|---------------------------|-----------------------|---------------------------------|
| Inventories                   | \$ 63,690                 | \$ 26,427             | \$ 37,263                       |

The increase in inventories was primarily the result of:

- Higher inventory in our European territories in anticipation of our early October European releases of *Rome: Total War*, *Dreamworks' Shark Tale*, and *X-Men Legends*.
- Higher inventory in all territories in anticipation of the early October release of one of our biggest titles, *Tony Hawk's Underground 2*.

### Software Development and Intellectual Property Licenses

| <u>(amounts in thousands)</u>                           | <u>September 30, 2004</u> | <u>March 31, 2004</u> | <u>Increase/<br/>(Decrease)</u> |
|---|---------------------------|-----------------------|---------------------------------|
| Software development and intellectual property licenses | \$ 136,285                | \$ 135,201            | \$ 1,084                        |

Software development and intellectual property licenses was slightly higher at the end of the second quarter of fiscal 2005 as a result of:

- Continued investment in software development and intellectual property licenses. We capitalized approximately \$66.3 million in the six months ended September 30, 2004 in connection with the development and acquisition of publishing or distribution rights for products being developed by third parties, the execution of new license agreements granting us long-term rights to intellectual property of third parties, as well as the capitalization of product development costs relating to internally developed products.

Offset by:

- \$65.2 million of amortization of capitalized software development costs and intellectual property licenses.

### Accounts Payable

| <u>(amounts in thousands)</u> | <u>September 30, 2004</u> | <u>March 31, 2004</u> | <u>Increase/<br/>(Decrease)</u> |
|-------------------------------|---------------------------|-----------------------|---------------------------------|
| Accounts payable              | \$103,001                 | \$72,874              | \$30,127                        |

The increase in accounts payable was primarily the result of:

- Increased inventory purchases by our publishing business to support the launch of several of our early October title releases.

### Accrued Expenses

| <u>(amounts in thousands)</u> | <u>September 30, 2004</u> | <u>March 31, 2004</u> | <u>Increase/<br/>(Decrease)</u> |
|-------------------------------|---------------------------|-----------------------|---------------------------------|
| Accrued expenses              | \$ 113,341                | \$ 63,205             | \$ 50,136                       |

The increase in accrued expenses was primarily driven by increases in accrued royalties of \$23.7 million due to strong sales on titles released in the second quarter of fiscal 2005 combined with increases in marketing accruals. This is partially offset by a decrease in the bonus accrual due to the payment of fiscal 2004 bonuses in the first quarter of fiscal 2005.

### Credit Facilities

We have revolving credit facilities with our Centresoft subsidiary located in the UK (the "UK Facility") and our NBG subsidiary located in Germany (the "German Facility"). The UK Facility provides Centresoft with the ability to borrow up to GBP 8.0 million (\$14.3 million), including issuing letters of credit, on a revolving basis as of September 30, 2004. Furthermore, under the UK Facility, Centresoft provided a GBP 0.6 million (\$1.1 million) guarantee for the benefit of our CD Contact subsidiary as of September 30, 2004. The UK Facility bore interest at LIBOR plus 2.0% as of September 30, 2004, is collateralized by substantially all of

the assets of the subsidiary and expires in November 2005. The UK Facility also contains various covenants that require the subsidiary to maintain specified financial ratios related to, among other things, fixed charges. As of September 30, 2004, we were in compliance with these covenants. No borrowings were outstanding against the UK Facility as of September 30, 2004. The German Facility provided for revolving loans up to EUR 0.5 million (\$0.6 million) as of September 30, 2004, bore interest at a Eurocurrency rate plus 2.5%, is collateralized by certain of the subsidiary's property and equipment and has no expiration date. No borrowings were outstanding under the German Facility as of September 30, 2004.

#### Commitments

In the normal course of business, we enter into contractual arrangements with third parties for the development of products, as well as for the rights to intellectual property. Under these agreements, we commit to provide specified payments to a developer or intellectual property holder, based upon contractual arrangements. Typically, the payments to third-party developers are conditioned upon the achievement by the developers of contractually specified development milestones. These payments to third-party developers and intellectual property holders typically are deemed to be advances and are recoupable against future royalties earned by the developer or intellectual property holder based on the sale of the related game. Additionally, in connection with certain intellectual property rights acquisitions and development agreements, we will commit to spend specified amounts for marketing support for the related game(s) which is to be developed or in which the intellectual property will be utilized. Assuming all contractual provisions are met, the total future minimum commitments for these and other contractual arrangements in place as of September 30, 2004, are scheduled to be paid as follows (amounts in thousands):

|                              | Contractual Obligations |                  |           |            |
|------------------------------|-------------------------|------------------|-----------|------------|
|                              | Facility Leases         | Developer and IP | Marketing | Total      |
| Fiscal year ending March 31, |                         |                  |           |            |
| 2005                         | \$ 4,930                | \$ 35,750        | \$ 14,872 | \$ 55,552  |
| 2006                         | 9,058                   | 21,451           | 11,500    | 42,009     |
| 2007                         | 8,175                   | 8,475            | 10,000    | 26,650     |
| 2008                         | 5,341                   | 1,775            | 5,000     | 12,116     |
| 2009                         | 4,476                   | 2,900            | —         | 7,376      |
| Thereafter                   | 18,914                  | —                | —         | 18,914     |
| Total                        | \$ 50,894               | \$ 70,351        | \$ 41,372 | \$ 162,617 |

The developer and intellectual property commitments above exclude approximately \$9.3 million of commitments originally scheduled to be paid between fiscal 2004 through fiscal 2007 relating to an intellectual property rights agreement with a third party. Effective June 30, 2003, we terminated the agreement and filed a breach of contract suit against the third party.

#### Financial Disclosure

We maintain internal controls over financial reporting, which generally include those controls relating to the preparation of our financial statements in conformity with accounting principles generally accepted in the United States of America. We also are focused on our "disclosure controls and procedures," which, as defined by the Securities and Exchange Commission, are generally those controls and procedures designed to ensure that financial and non-financial information required to be disclosed in our reports filed with the Securities and Exchange Commission is reported within the time periods specified in the Securities and Exchange Commission's rules and forms, and that such information is communicated to management, including our chief executive officer and our chief financial officer, as appropriate, to allow timely decisions regarding required disclosure.

Our Disclosure Committee, which operates under the Board-approved Disclosure Committee Charter and Disclosure Controls & Procedures Policy, includes senior management representatives and assists executive management in its oversight of the accuracy and timeliness of our disclosures, as well as in implementing and evaluating our overall disclosure process. As part of our disclosure process, senior finance and operational representatives from all of our corporate divisions and business units prepare quarterly reports regarding their current quarter operational performance, future trends, subsequent events, internal controls, changes in internal controls and other accounting and disclosure-relevant information. These quarterly reports are reviewed by certain key corporate finance representatives. These corporate finance representatives also conduct quarterly interviews on a rotating basis with the preparers of selected quarterly reports. The results of the quarterly reports and related interviews are reviewed by the Disclosure Committee. Finance representatives also conduct reviews with our senior management team, our external counsel and other appropriate personnel involved in the disclosure process, as appropriate. Additionally, senior finance and operational representatives provide internal certifications regarding the accuracy of information they provide that is utilized in the preparation of our periodic public reports filed with the Securities and Exchange Commission. Financial results and other financial information also are reviewed with the Audit Committee of the Board of Directors on a quarterly basis. As required by applicable regulatory requirements, the Principal Executive Officers and the Chief Financial Officer review and make various certifications regarding the accuracy of our periodic public reports filed with the Securities and Exchange Commission, our disclosure controls and procedures, and our internal controls over financial reporting. With the assistance of the Disclosure Committee, we will continue to assess and monitor our disclosure controls and procedures, and our internal controls over financial reporting, and will make refinements as necessary.

### **Inflation**

Our management currently believes that inflation has not had a material impact on continuing operations.

### **Factors Affecting Future Performance**

In connection with the Private Securities Litigation Reform Act of 1995 (the "Litigation Reform Act"), we have disclosed certain cautionary information to be used in connection with written materials (including this Quarterly Report on Form 10-Q) and oral statements made by or on behalf of our 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. For a discussion that highlights some of the more important risks identified by management, but which should not be assumed to be the only factors that could affect future performance, see our Annual Report on Form 10-K for the fiscal year ended March 31, 2004 which is incorporated herein by reference. The reader or listener is cautioned that we do 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.

### **Item 3. Quantitative and Qualitative Disclosures about Market Risk**

Market risk is the potential loss arising from fluctuations in market rates and prices. Our market risk exposures primarily include fluctuations in interest rates, foreign currency exchange rates and market prices. Our market risk sensitive instruments are classified as "other than trading." Our views on market risk are not necessarily indicative of actual results that may occur and do not represent the maximum possible gains and losses that may occur, since actual gains and losses will differ from those estimated, based upon actual fluctuations in interest rates, foreign currency exchange rates and market prices and the timing of transactions.

### **Interest Rate Risk**

Our exposure to market risk for changes in interest rates relates primarily to our investment portfolio. We do not use derivative financial instruments in our investment portfolio. We manage our interest rate risk by maintaining an investment portfolio consisting primarily of debt instruments with high credit quality and relatively short average maturities. We also manage our interest rate risk by maintaining sufficient cash and cash equivalent balances such that we are typically able to hold our investments to maturity. As of September 30, 2004, our cash equivalents and short-term investments included debt securities of \$338.0 million.

The following table presents the amounts and related weighted average interest rates of our investment portfolio as of September 30, 2004 (amounts in thousands):

|                                | <u>Average<br/>Interest Rate</u> | <u>Amortized<br/>Cost</u> | <u>Fair<br/>Value</u> |
|--------------------------------|----------------------------------|---------------------------|-----------------------|
| <b>Cash equivalents:</b>       |                                  |                           |                       |
| Fixed rate                     | 1.83%                            | \$ 123,100                | \$ 123,100            |
| Variable rate                  | 1.61                             | 131,023                   | 131,023               |
| <b>Short-term investments:</b> |                                  |                           |                       |
| Fixed rate                     | 1.74%                            | \$ 215,702                | \$ 214,875            |

Our short-term investments generally mature between three months and two years.

### **Foreign Currency Exchange Rate Risk**

We transact business in many different foreign currencies and may be exposed to financial market risk resulting from fluctuations in foreign currency exchange rates, particularly GBP and EUR. The volatility of GBP and EUR (and all other applicable currencies) will be monitored frequently throughout the coming year. When appropriate, we enter into hedging transactions in order to mitigate our risk from foreign currency fluctuations. We will continue to use hedging programs in the future and may use currency forward contracts, currency options and/or other derivative financial instruments commonly utilized to reduce financial market risks if it is determined that such hedging activities are appropriate to reduce risk. We do not hold or purchase any foreign currency contracts for trading purposes. As of September 30, 2004, there were no hedging contracts outstanding.

## **Item 4. Controls and Procedures**

### **Evaluation of Disclosure Controls and Procedures**

As of the end of the period covered by this report, our management conducted an evaluation, under the supervision and with the participation of the principal executive officers and principal financial officer, of our disclosure controls and procedures (as defined in Rules 13a-15(e) and 15d-15(e) under the Exchange Act). Based on this evaluation, the principal executive officers and principal financial officer concluded that, as of the end of the period covered by this report, our disclosure controls and procedures are effective. Notwithstanding the foregoing, a control system, no matter how well designed and operated, can provide only reasonable, not absolute, assurance that it will detect or uncover failures within Activision to disclose material information otherwise required to be set forth in our periodic reports.

**Changes in Internal Controls**

There was no change in our internal controls over financial reporting (as such term is defined in Rules 13a-15(f) and 15d-15(f) under the Exchange Act) during our most recently completed fiscal quarter that has materially affected, or is reasonably likely to materially affect, our internal controls over financial reporting.

## **PART II. OTHER INFORMATION**

### **Item 1. Legal Proceedings**

On March 5, 2004, a class action lawsuit was filed against us and certain of our current and former officers and directors. The complaint, which asserts claims under Sections 10(b) and 20(a) of the Securities Exchange Act of 1934 based on allegations that our revenues and assets were overstated during the period between February 1, 2001 and December 17, 2002, was filed in the United States District Court, Central District of California by the Construction Industry and Carpenters Joint Pension Trust for Southern Nevada purporting to represent a class of purchasers of Activision stock. Five additional purported class actions have subsequently been filed by Gianni Angeloni, Christopher Hinton, Stephen Anish, the Alaska Electrical Pension Fund, and Joseph A. Romans asserting similar claims. Five of the six actions have been transferred to the same court where the first-filed complaint was pending. In addition, on March 12, 2004, a shareholder derivative lawsuit was filed, which in large measure asserts the same claims set forth in the federal class action lawsuit. That complaint was filed in Superior Court for the County of Los Angeles. We strongly deny these allegations and will vigorously defend these cases.

On July 11, 2003, we were informed by the staff of the Securities and Exchange Commission that the Securities and Exchange Commission has commenced a non-public formal investigation captioned "In the Matter of Certain Video Game Manufacturers and Distributors." The investigation appears to be focused on certain accounting practices common to the interactive entertainment industry, with specific emphasis on revenue recognition. In connection with this inquiry, the Securities and Exchange Commission submitted to us a request for information. We responded to this inquiry on September 2, 2003. To date, we have not received a request from the Securities and Exchange Commission for any additional information. The Securities and Exchange Commission staff also informed us that other companies in the video game industry received similar requests for information. The Securities and Exchange Commission has advised us that this request for information should not be construed as an indication from the Securities and Exchange Commission or its staff that any violation of the law has occurred, nor should it reflect negatively on any person, entity or security. We have cooperated and intend to continue to cooperate fully with the Securities and Exchange Commission in the conduct of this inquiry.

On June 30, 2003, we terminated our Star Trek Merchandising License Agreement with Viacom Consumer Products, Inc. and filed a complaint in the Superior Court of the State of California for breach of contract and constructive trust against Viacom Consumer Products and Viacom International, Inc. ("Viacom"). On August 15, 2003, Viacom filed its response to our complaint as well as a cross-complaint alleging, among other matters, a breach of contract by Activision and seeking claimed damages in excess of \$50 million. We strongly dispute the claims by Viacom, consider the damages alleged by Viacom to be speculative and without merit, and intend to defend vigorously and aggressively against the cross-complaint.

In addition, we are party to other routine claims and suits brought by us and against us in the ordinary course of business, including disputes arising over the ownership of intellectual property rights, contractual claims and collection matters. In the opinion of management, after consultation with legal counsel, the outcome of such routine claims will not have a material adverse effect on our business, financial condition, results of operations or liquidity.

### **Item 4. Submission of Matters to a Vote of Security Holders**

We held our 2004 Annual Meeting of the Stockholders on September 21, 2004 in Beverly Hills, California. Two items were submitted to a vote of the stockholders: (1) the election of eight directors to hold office for one year terms and until their respective successors are duly elected and qualified; and (2) the approval of the selection of PricewaterhouseCoopers LLP as our independent auditors for the fiscal year ending March 31, 2005.

All eight directors were recommended by the Board of Directors and all were elected. Set forth below are the results of the voting for each director.

|                      | <u>For</u>  | <u>Withheld</u> |
|----------------------|-------------|-----------------|
| Robert J. Corti      | 116,971,081 | 6,262,635       |
| Ronald Doomink       | 73,458,102  | 49,775,614      |
| Kenneth L. Henderson | 64,969,050  | 58,264,666      |
| Barbara S. Isgur     | 110,256,126 | 12,977,590      |
| Brian G. Kelly       | 75,580,145  | 47,653,571      |
| Robert A. Kotick     | 76,162,496  | 47,071,220      |
| Robert J. Morgado    | 120,764,304 | 2,469,412       |
| Peter J. Nolan       | 117,073,914 | 6,159,802       |

The selection of PricewaterhouseCoopers LLP as our independent auditors for the fiscal year ending March 31, 2005 was approved. Set forth below are the results of the voting.

| <u>For</u>  | <u>Against</u> | <u>Abstain</u> |
|-------------|----------------|----------------|
| 121,440,749 | 1,697,830      | 95,137         |

## Item 6. Exhibits

### (a) Exhibits

- 3.1 Amended and Restated Certificate of Incorporation, dated June 1, 2000 (incorporated by reference to Exhibit 2.5 of our Current Report on Form 8-K, filed on June 16, 2000).
- 3.2 Certificate of Amendment of Amended and Restated Certificate of Incorporation, dated June 9, 2000 (incorporated by reference to Exhibit 2.7 of our Current Report on Form 8-K, filed on June 16, 2000).
- 3.3 Certificate of Amendment of Amended and Restated Certificate of Incorporation, dated August 23, 2001 (incorporated by reference to Exhibit 3.3 of Amendment No. 1 to our Registration Statement on Form S-3, Registration No. 333-66280, filed on August 31, 2001).
- 3.4 Certificate of Designation of Series A Junior Preferred Stock, dated December 27, 2001 (incorporated by reference to Exhibit 3.4 of our Quarterly Report on Form 10-Q for the quarterly period ended December 31, 2001).
- 3.5 Amended and Restated By-laws dated August 1, 2000 (incorporated by reference to Exhibit 3.2 of our Current Report on Form 8-K, filed July 11, 2001).
- 4.1 Rights Agreement dated as of April 18, 2000, between us and Continental Stock Transfer & Trust Company, which includes as exhibits the form of Right Certificates as Exhibit A, the Summary of Rights to Purchase Series A Junior Preferred Stock as Exhibit B and the form of Certificate of Designation of Series A Junior Preferred Stock of Activision as Exhibit C (incorporated by reference to our Registration Statement on Form 8-A, Registration No. 001-15839, filed April 19, 2000).



- 10.1 Employment agreement dated August 20, 2004 between Activision and William J. Chardavoine.
- 31.1 Certification of Robert A. Kotick pursuant to Section 302 of the Sarbanes-Oxley Act of 2002.
- 31.2 Certification of Ronald Doomink pursuant to Section 302 of the Sarbanes-Oxley Act of 2002.
- 31.3 Certification of William J. Chardavoine pursuant to Section 302 of the Sarbanes-Oxley Act of 2002.
- 32.1 Certification of Robert A. Kotick pursuant to Section 906 of the Sarbanes-Oxley Act of 2002.
- 32.2 Certification of Ronald Doomink pursuant to Section 906 of the Sarbanes-Oxley Act of 2002.
- 32.3 Certification of William J. Chardavoine pursuant to Section 906 of the Sarbanes-Oxley Act of 2002.

**SIGNATURES**

Pursuant to the requirements of the Securities Exchange Act of 1934, the Registrant has duly caused this report to be signed on its behalf by the undersigned thereunto duly authorized.

Date: November 5, 2004

ACTIVISION, INC.

*/s/ William J. Chardavoyne*

\_\_\_\_\_  
William J. Chardavoyne  
Executive Vice President and Chief Financial Officer  
(Principal Financial and Accounting Officer)



August 20, 2004

William Chardavoyne  
1721 Elm Avenue  
Manhattan Beach, California 90266

Dear Bill:

This letter agreement, dated August 20, 2004 (this "agreement"), confirms the terms of your employment by Activision Publishing, Inc. ("Employer"), on the terms and conditions set forth below.

**1. Term**

This agreement shall commence effective as of the date set forth above and shall continue until terminated in accordance with the terms specifically set forth in this agreement.

**2. Salary**

(a) In full consideration for all rights and services provided by you under this agreement, you shall receive an annual base salary ("Base Salary") of \$365,000.

(b) Base Salary payments shall be made in accordance with Employer's then prevailing payroll policy. The Base Salary referred to in Paragraph 2(a) shall constitute your minimum Base Salary during the applicable period. On an annual basis, your Base Salary may be reviewed to determine if an increase above the minimum is appropriate. Any decision regarding whether to change your base salary shall be made in the sole discretion of executive management and/or the Compensation Committee of the Board of Directors of Employer.

(c) In addition to your base salary, you may be eligible to receive an annual discretionary bonus ("Annual Bonus") targeted at sixty percent (60%) of your annual Base Salary (which may be pro-rated for the amount of time that you actually perform services for Employer during a particular fiscal year). The amount of this Annual Bonus, if any, is within the sole and absolute discretion of the Employer's Board of Directors (or the Compensation Committee of the Board of Directors). Certain of the criteria that will be considered to evaluate your eligibility for an Annual Bonus is your achievement of specific objectives and/or your contribution to the success of the corporate goals and objectives. Employer's overall financial performance will also be considered in determining whether any bonus is awarded and, if so, the amount. Discretionary Annual Bonuses, if granted, are generally paid to employees in May of each year. You must remain continuously employed by Employer through the date on which the discretionary bonus is paid to be eligible to receive a bonus. Employer retains the right to modify, at any time, any and all of the criteria used to determine whether Employee is eligible for a bonus and, if so, the amount of any such bonus, so long as such Annual Bonus modifications are applied consistently to other employees in similar officer positions.

3. **Title**

You are being employed under this agreement in the position of Executive Vice President and Chief Financial Officer.

4. **Duties**

You shall personally and diligently perform, on a full-time and exclusive basis, such services consistent with your position or consistent with duties involved in the transition of your position as Employer and its Board of Directors/ Committees of the Board of Directors may reasonably require. You are also required to read, review and observe all of Employer's existing policies, procedures, rules and regulations as well as those adopted by Employer during the term of your employment. You will at all times perform all of the duties and obligations required by you under this agreement in a loyal and conscientious manner and to the best of your ability and experience.

5. **Expenses**

To the extent you incur necessary and reasonable business expenses in the course of your employment, you shall be reimbursed for such expenses, subject to Employer's then current policies regarding reimbursement of such business expenses.

6. **Other Benefits**

You shall be entitled to those benefits which are standard for persons in similar positions with Employer, including coverage under Employer's health, life insurance and disability plans, and eligibility to participate in Employer's 401(k) plan. Nothing paid to you under any such plans and arrangements (nor any bonus or stock options which Employer's Board of Directors (or the Compensation Committee of such Board of Directors), in its sole and absolute discretion, shall provide to you) shall be deemed in lieu, or paid on account, of your Base Salary. You expressly agree and acknowledge that after the expiration or early termination of the term of your employment under this agreement, you are entitled to no additional benefits, except as specifically provided in this agreement or under the benefit plans referred to above and those benefit plans in which you subsequently may become a participant, and subject in each case to the terms and conditions of each such plan, or as required by applicable law. Notwithstanding anything to the contrary set forth above, you shall be entitled to receive those benefits provided by COBRA upon the expiration or earlier termination of this agreement.

7. **Vacation and Paid Holidays**

(a) You will be entitled to paid vacation days in accordance with the normal vacation policies of Employer in effect from time to time, provided that in no event shall you be entitled to less than twenty (20) days of paid vacation per year.

(b) You shall be entitled to all paid holidays given by Employer to its full-time employees.

**8. Protection of Employer's Interests**

(a) **Duty of Loyalty.** During the term of your employment, you will not compete in any manner, whether directly or indirectly, as a principal, employee, agent or owner, with Employer, or any affiliate of Employer, except that the foregoing will not prevent you from holding at any time less than five percent (5%) of the outstanding capital stock of any company whose stock is publicly traded.

(b) **Property of Employer.** All rights worldwide with respect to any and all intellectual or other property of any nature produced, created or suggested by you during the term of your employment and/or resulting from your services to Employer which (i) relate in any manner at the time of conception or reduction to practice to the actual or demonstrably anticipated business of Employer, (ii) result from or are suggested by any task assigned to you or any work performed by you on behalf of Employer, or (iii) are based on any property owned or idea conceived by Employer, shall be deemed to be a work made for hire and shall be the sole and exclusive property of Employer. You agree to execute, acknowledge and deliver to Employer, at Employer's request and expense, such further documents, including copyright and patent assignments, as Employer reasonably finds appropriate to evidence Employer's rights in such property.

(c) **Confidentiality.** Any confidential and/or proprietary information of Employer or any affiliate of Employer shall not be used by you or disclosed or made available by you to any person except, in furtherance of or as required in the course of your employment, and upon expiration or earlier termination of the term of your employment, you shall return to Employer all such information which exists in written or other physical form (and all copies thereof) under your control. Without limiting the generality of the foregoing, you acknowledge signing and delivering to Employer the Activision Employee Proprietary Information Agreement and you agree that all terms and conditions contained in such agreement, and all of your obligations and commitments provided for in such agreement, shall be deemed, and hereby are, incorporated into this agreement as if set forth in full herein. The provisions of this paragraph shall survive the expiration or earlier termination of this agreement.

(d) **Covenant Not to Solicit.** After the termination of your employment pursuant to Paragraph 9(a) or the termination of this agreement pursuant to Paragraph 9(b) of this agreement for any reason whatsoever, you shall not, either alone or jointly, with or on behalf of others, directly or indirectly, whether as principal, partner, agent, shareholder, director, employee, consultant or otherwise, at any time during a period of one (1) year following such expiration or termination, offer employment to, or directly or indirectly solicit the employment or engagement of, or otherwise entice away from the employment of Employer or any affiliated entity, either for your own account or for any other person firm or company, any person who was employed by Employer or any such affiliated entity during the term of your employment, whether or not such person would commit any breach of his or her contract of employment by reason of his or her leaving the service of Employer or any affiliated entity.

**9. Termination**

(a) **For Cause.** At any time during the continuation of this agreement, Employer may terminate your employment under this agreement for Cause defined as your (i) willful, reckless or gross misconduct or fraud, (ii) gross negligent performance of job responsibilities, and (iii) conviction of or pleading no contest to a felony or crime involving dishonesty or moral turpitude.

(b) **Without Cause.** The parties agree that this agreement may be terminated for convenience without Cause by either party on no less than twelve (12) months prior written notice and such termination shall not be deemed to constitute a wrongful discharge or a wrongful termination of your employment by Employer or a breach by Employer or by you of any term of this agreement and/or any other duty or obligation, expressed or implied, which the parties may owe each other pursuant to any principle or provision of law. The date on which such written termination notice is received by either you or Employer is referred to in this agreement as "Termination Notice Date".

(c) **Death or Disability.** In the event of your death during the continuation of this agreement, this agreement shall terminate and Employer only shall be obligated to pay your estate or legal representative only the amounts set forth in Paragraph 9(d)(ii) below. In the event you are unable, with reasonable accommodation, to perform the essential services required of your position as a result of any physical or mental condition ("disability"), then Employer shall have the right, at its option, to terminate your employment under this agreement, and Employer shall be obligated to pay you only the amounts set forth in Paragraph 9(d)(iii) below. You acknowledge and agree that your ability to continuously perform your duties for Employer is an essential part of your position and that any inability to perform such duties during the term of this agreement for a period of 60 or more consecutive days or an aggregate of 90 or more days during any 12-month period would create an undue hardship for Employer and the operation of its business. Unless and until so terminated, during any period of disability during which you are unable, with reasonable accommodation, to perform the services required of you under this agreement, your Base Salary shall be payable to the extent of, and subject to, Employer's policies and practices then in effect with regard to sick leave and disability benefits.

(d) **Termination of Obligations.** In the event of the termination of your employment under this agreement pursuant to Paragraphs 9(a), 9(b) or 9(c), all obligations of Employer to you under this agreement shall immediately terminate except as follows:

- i. **Termination Without Cause.** In the event either party terminates this agreement pursuant to Paragraph 9(b), then the following shall apply:
  - a. You and Employer shall promptly agree on a reasonable transition plan acceptable to Employer in its reasonable discretion which shall allow, among other matters, for an orderly transition of your responsibilities as a Chief Financial Officer to another individual who is then engaged or will be engaged by Employer to perform such duties, including, without limitation full understanding of Employer's financial,

accounting and forecasting systems, corporate reporting, internal controls, internal and external communications, staffing matters and your continuing participation and assistance with any then on-going corporate litigation matters. You agree to devote such time as is reasonably required to conduct such transition timely and effectively, including on full time, exclusive basis in the initial stages of such transition if the executive management of Employer determines such level of your involvement in the transition process to be reasonable and desirable. You hereby acknowledge and agree that while Employer may agree in its discretion to a shorter transition schedule, it is anticipated that transition process may continue for a minimum of one (1) month to as long as six (6) months from the Termination Notice Date. The parties acknowledge that notwithstanding the actual duration of transition process, your status as employee of Employer will continue for the full period of twelve (12) months from the Termination Notice Date and you will continue to provide such advisory services until the end of your employment consistent with your prior position with Employer as Employer may reasonably request.

- b. Conditioned on your full, complete and continuing compliance with the conditions set forth in Paragraph 9(d)(i)(a) above, you shall receive: (i) continuing payments of your Base Salary then in effect, payable in accordance with Employer normal payroll practices for a period of twelve (12) months following the Termination Notice Date; (ii) full Annual Bonus for the fiscal year during which the Termination Notice Date occurs to the extent such Annual Bonus is awarded to you pursuant to the terms of Paragraph 2(c) of this agreement by the Board of Directors (or the Compensation Committee of such Board of Directors), payable in accordance with Employer's normal practices applicable to Annual Bonus payments; (iii) should the Termination Notice Date occur during the course of any fiscal year such that there are then fewer than twelve (12) months remaining in such fiscal year at the time of such termination (it being understood that Employer's fiscal year is April to March), the portion of the Annual Bonus for the following fiscal year if such Annual Bonus is awarded pursuant to the terms of Paragraph 2(c) of this agreement by the Board of Directors (or the Compensation Committee of such Board of Directors) pro-rated for the number of months to allow you to receive your bonus payment for the full twelve (12) month period from the Termination Notice Date (such bonus payment to be calculated and paid out in accordance with Employer's normal practices applicable to Annual Bonus

payments); and (iv) continuing reimbursement of expenses if any due to you pursuant to Paragraph 5. For illustration purposes and for avoidance of doubt, in regards to Paragraphs 9(d)(i)(b)(i), (ii) and (iii), it is the understanding of the parties that should this agreement, for example, be terminated without cause effective as of Termination Notice Date on October 31, 2004, you will receive:

- Continuing Base Salary payments through October 31, 2005;
- Annual Bonus for Employer's fiscal year 2005 ending March 31, 2005, to the extent earned, and payable on or about May 2005 if such continues to be Employer's normal payment time period for the disbursement of bonuses; and
- Annual Bonus for Employer's fiscal year 2006 ending March 31, 2006, to the extent earned, pro-rated for the month of April-October 2006, and payable on or about May 2006 if such continues to be Employer's normal payment time period for the disbursement of bonuses
- Above payments are conditioned on your full, complete and continuing compliance with the conditions set forth in Paragraph 9(d)(i)(a).

- ii. Compensation upon Death. In the event this agreement is terminated as a result of your death, your heirs, successors or legal representatives shall receive: (i) the Base Salary through the date of termination of this agreement; (ii) any unpaid Annual Bonus for any previously completed fiscal year if such Annual Bonus is awarded to you pursuant to the terms of Paragraph 2(c) of this agreement by the Board of Directors (or the Compensation Committee of such Board of Directors) and remain not paid; (iii) the pro rata portion of the Annual Bonus for the fiscal year in which termination occurs to the extent such Annual Bonus is awarded to you pursuant to the terms of Paragraph 2(c) of this agreement by the Board of Directors (or the Compensation Committee of such Board of Directors); (v) reimbursement of expenses due to you pursuant to Paragraph 5. Bonus payments will be made notwithstanding the fact that you are not employed by Employer at the time such payment is paid. All such payments shall be in addition to any payments or benefits your widow, beneficiaries or estate may be entitled to receive pursuant to any pension or employee benefit plan or life insurance policy



maintained by Employer; and (v) all payments and benefits due you under any of Employer's employee benefit plans.

iii. **Compensation upon Disability.** In the event this agreement is terminated as a result of your disability, you shall receive: (i) the Base Salary through the date of your termination; (ii) any unpaid Annual Bonus for any previously completed fiscal year if such Annual Bonus is actually awarded to you pursuant to the terms of Paragraph 2(c) of this agreement by the Board of Directors (or the Compensation Committee of such Board of Directors) and remain not paid in whole or in part; (iii) the pro rata portion of the Annual Bonus for the fiscal year in which your termination occurs to the extent such Annual Bonus is awarded pursuant to the terms of Paragraph 2(c) of this agreement by the Board of Directors (or the Compensation Committee of such Board of Directors); (iv) reimbursement of expenses due to you pursuant to Paragraph 5. Bonus payments will be made notwithstanding the fact that you are not employed by Employer at the time such payment is paid.

(e) **Disposition of Stock Options Upon Termination.** Upon termination of your employment for any reason, the following terms shall apply to the Options to acquire shares of common stock of Activision, Inc. that may have been issued to you during the course of your employment with Employer prior to such termination ("Options"):

- (i) In the event of termination of your employment without Cause and conditioned on your full, complete and continuing compliance with the conditions set forth in Paragraph 9(d)(i)(a) above, all such stock options shall continue to vest and be exercisable for a period of twelve (12) months following the Termination Notice Date, **provided that** at all times during such period you remain an employee. Upon termination of such twelve (12) month period or earlier termination of your employment, all then unvested stock options shall be cancelled and only vested stock options shall continue to be exercisable until the earlier of (a) the end of the 30th day after such date, or (b) the expiration of such stock option pursuant to the terms of the stock option agreement for such stock option; and upon the expiration of such period, all stock options then remaining unexercised shall be cancelled.
- (ii) In the event of your termination of employment by reason of your death or disability, all such stock options shall cease to vest immediately as of the date of such termination of your employment, all unvested stock options shall be cancelled and only vested stock options shall continue to be exercisable until the earlier of (a) the end of the 30th day after the date of such termination of your employment, or (b) the expiration of such stock option pursuant to the terms of the stock option agreement

for such stock option; and upon the expiration of such period, all stock options then remaining unexercised shall be cancelled.

- (iii) In the event of termination of your employment for Cause, or by your material breach of this agreement, all such stock options, whether or not vested, shall expire immediately on the date of termination of your employment and all such stock options shall immediately be cancelled and no longer continue vest or be exercisable as of the date of termination of your employment.
- (iv) In the event of termination of your employment for any reason not otherwise described in Paragraphs 9(e)(i)-(iii), all such stock options shall cease to vest immediately as of the date of such termination of your employment, all unvested stock options shall be cancelled and only vested stock options shall continue to be exercisable until the earlier of (a) the end of the 30th day after the date of such termination of your employment, or (b) the expiration of such stock option pursuant to the terms of the stock option agreement for such stock option; and upon the expiration of such period, all stock options then remaining unexercised shall be cancelled.

**10. Use of Employee's Name**

Employer shall have the right, but not the obligation, to use your name or likeness for any publicity or advertising purpose.

**11. Assignment**

Employer may assign this agreement or all or any part of its rights under this agreement to any entity which succeeds to all or substantially all of Employer's assets (whether by merger, acquisition, consolidation, reorganization or otherwise) or which Employer may own substantially, and this agreement shall inure to the benefit of such assignee.

**12. No Conflict with Prior Agreements**

You represent to Employer that neither your commencement of employment under this agreement nor the performance of your duties under this agreement conflicts or will conflict with any contractual commitment on your part to any third party, nor does it or will it violate or interfere with any rights of any third party.

**13. Representations and Warranties**

You represent and warrant that you have provided Employer with complete and accurate information regarding your skills and experience. Employee further represents and warrants that you have the skills and abilities to perform the job responsibilities for which you are being hired (*see* paragraphs 3 and 4, above) based on your skills and experience. Based on your

representations regarding your skills and abilities, Employer has agreed to hire and compensate you pursuant to the terms of this agreement.

#### 14. **General Provisions**

(a) **Entire Agreement.** This agreement supersedes all prior or contemporaneous agreements and statements, whether written or oral, concerning the terms of your employment with Employer, and no amendment or modification of this agreement shall be binding unless it is set forth in a writing signed by both Employer and you. To the extent that this agreement conflicts with any of Employer's policies, procedures, rules or regulations, this agreement shall supersede the other policies, procedures, rules or regulations. Without limiting the generality of the foregoing, you acknowledge that this agreement supersedes your prior written agreement with Employer dated April 1, 2002 and any related letters and memorandums of understanding, and such agreement and related letters and memorandums are hereby declared terminated and of no further force and effect.

(b) **No Broker.** You have given no indication, representation or commitment of any nature to any broker, finder, agent or other third party to the effect that any fees or commissions of any nature are, or under any circumstances might be, payable by Employer or any affiliate of Employer in connection with your employment under this agreement.

(c) **Waiver.** No waiver by either party of any breach by the other party of any provision or condition of this agreement shall be deemed a waiver of any similar or dissimilar provision or condition at the same or any prior or subsequent time.

(d) **Prevailing Law.** Nothing contained in this agreement shall be construed so as to require the commission of any act contrary to law and wherever there is any conflict between any provision of this agreement and any present or future statute, law, ordinance or regulation, the latter shall prevail, but in such event the provision of this agreement affected shall be curtailed and limited only to the extent necessary to bring it within legal requirements.

(e) **No Employment Commitments.** This agreement does not constitute a commitment of Employer with regard to your employment, express or implied, other than to the extent expressly provided for herein.

(f) **Choice of Law.** This agreement shall be governed by and construed in accordance with the laws of the State of California without regard to conflict of law principles.

(g) **Immigration.** In accordance with the Immigration Reform and Control Act of 1986, employment under this agreement is conditioned upon satisfactory proof of your identity and legal ability to work in the United States. Employer acknowledges that Employee has satisfied this condition.

(h) **Venue and Jurisdiction.** The parties agree that all actions or proceedings initiated by either party hereto arising directly or indirectly out of this agreement shall be litigated in federal or state court in Los Angeles, California. The parties hereto expressly submit and consent in advance to such jurisdiction and agree that service of summons and complaint or other process

or papers may be made by registered or certified mail addressed to the relevant party at the address set forth below. The parties hereto waive any claim that a federal or state court in Los Angeles, California, is an inconvenient or an improper forum.

(i) **Severability.** If any provision of this agreement is held to be illegal, invalid or unenforceable under existing or future laws effective during the term of this agreement, such provisions shall be fully severable, the agreement shall be construed and enforced as if such illegal, invalid or unenforceable provision had never comprised a part of this agreement, and the remaining provisions of this agreement shall remain in full force and effect and shall not be affected by the illegal, invalid or unenforceable provision or by its severance from this agreement. Furthermore, in lieu of such illegal, invalid or unenforceable provision, there shall be added automatically as part of this agreement a provision as similar in terms to such illegal, invalid or unenforceable provision as may be possible and be legal and enforceable.

(j) **Legal Counsel.** You acknowledge that you have been given the opportunity to consult with legal counsel of his own choosing regarding this agreement. You understand and agree that Activision's General Counsel, or any other attorney or member of management who has discussed any term or condition of this agreement with you, is only acting on behalf of the company and not on behalf of Employee.

(k) **Right to Negotiate.** You hereby acknowledges that you have been given the opportunity to participate in the negotiation of the terms of this agreement.

(l) **Services Unique.** You recognize that the services being performed by you under this agreement are of a special, unique, unusual, extraordinary and intellectual character giving them a peculiar value, the loss of which cannot be reasonably or adequately compensated for in damages in the event of a breach of this agreement by you (particularly, but without limitation, with respect to the provisions hereof relating to the exclusivity of your services and the provisions of paragraph 8 of this agreement).

(m) **Injunctive Relief.** In the event of a breach or threatened breach of this agreement, you hereby agree that any remedy at law for any breach or threatened breach of this agreement will be inadequate and, accordingly, each party hereby stipulates that the other is entitled to obtain injunctive relief for any such breaches or threatened breaches. The injunctive relief provided for in this paragraph is in addition to, and is not in limitation of, any and all other remedies at law or in equity otherwise available to the applicable party. The parties agree to waive the requirement of posting a bond in connection with a court's issuance of an injunction.

(n) **Remedies Cumulative.** The remedies in this paragraph are not exclusive, and the parties shall have the right to pursue any other legal or equitable remedies to enforce the terms of this agreement.

(o) **Attorneys' Fees And Costs.** If either party brings an action to enforce, interpret or apply the terms of this agreement or declare its rights under this agreement, the prevailing party in such action, including all appeals, shall receive all of its or his attorneys' fees, experts' fees, and all of its or his costs, in addition to such other relief as may be granted.

**15. Notices**

All notices which either party is required or may desire to give the other shall be in writing and given either personally or by depositing the same in the United States mail addressed to the party to be given notice as follows:

To Employer: 3100 Ocean Park Boulevard  
Santa Monica, California 90405  
Attention: Senior Vice President,  
Business Affairs and General Counsel

To Employee: 1721 Elm Avenue  
Manhattan Beach, California 90266

Either party may by written notice designate a different address for giving of notices. The date of mailing of any such notices shall be deemed to be the date on which such notice is given.

**16. Headings**

The headings set forth herein are included solely for the purpose of identification and shall not be used for the purpose of construing the meaning of the provisions of this agreement.

If the foregoing accurately reflects our mutual agreement, please sign where indicated.

**ACCEPTED AND AGREED TO:**

**Employer**

**Employee**

By: \_\_\_\_\_  
Ron Doomink  
Chief Executive Officer

By: \_\_\_\_\_  
William Chardavoyne

**Exhibit 31.1**

**CERTIFICATION**

I, Robert A. Kotick, Chief Executive Officer of Activision, Inc., certify that:

1. I have reviewed this quarterly report on Form 10-Q of Activision, Inc.;
2. Based on my knowledge, this report does not contain any untrue statement of a material fact or omit to state a material fact necessary to make the statements made, in light of the circumstances under which such statements were made, not misleading with respect to the period covered by this report;
3. Based on my knowledge, the financial statements, and other financial information included in this report, fairly present in all material respects the financial condition, results of operations and cash flows of the registrant as of, and for, the periods presented in this report;
4. The registrant's other certifying officers and I are responsible for establishing and maintaining disclosure controls and procedures (as defined in Exchange Act Rules 13a-15(e) and 15d-15(e)) for the registrant and have:
  - a) Designed such disclosure controls and procedures, or caused such disclosure controls and procedures to be designed under our supervision, to ensure that material information relating to the registrant, including its consolidated subsidiaries, is made known to us by others within those entities, particularly during the period in which this report is being prepared;
  - b) Evaluated the effectiveness of the registrant's disclosure controls and procedures and presented in this report our conclusions about the effectiveness of the disclosure controls and procedures, as of the end of the period covered by this report based on such evaluation; and
  - c) Disclosed in this report any change in the registrant's internal control over financial reporting that occurred during the registrant's most recent fiscal quarter (the registrant's fourth fiscal quarter in the case of an annual report) that has materially affected, or is reasonably likely to materially affect, the registrant's internal control over financial reporting; and
5. The registrant's other certifying officers and I have disclosed, based on our most recent evaluation of internal control over financial reporting, to the registrant's auditors and the audit committee of the registrant's board of directors (or persons performing the equivalent functions):
  - a) All significant deficiencies and material weaknesses in the design or operation of internal control over financial reporting which are reasonably likely to adversely affect the registrant's ability to record, process, summarize and report financial information; and
  - b) Any fraud, whether or not material, that involves management or other employees who have a significant role in the registrant's internal control over financial reporting.

Date: November 5, 2004

/s/ Robert A. Kotick  
Robert A. Kotick  
Chief Executive Officer

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**Exhibit 31.2**

**CERTIFICATION**

I, Ronald Doornink, President of Activision Inc., and Chief Executive Officer of Activision Publishing, Inc., certify that:

1. I have reviewed this quarterly report on Form 10-Q of Activision, Inc.;
2. Based on my knowledge, this report does not contain any untrue statement of a material fact or omit to state a material fact necessary to make the statements made, in light of the circumstances under which such statements were made, not misleading with respect to the period covered by this report;
3. Based on my knowledge, the financial statements, and other financial information included in this report, fairly present in all material respects the financial condition, results of operations and cash flows of the registrant as of, and for, the periods presented in this report;
4. The registrant's other certifying officers and I are responsible for establishing and maintaining disclosure controls and procedures (as defined in Exchange Act Rules 13a-15(e) and 15d-15(e)) for the registrant and have:
  - a) Designed such disclosure controls and procedures, or caused such disclosure controls and procedures to be designed under our supervision, to ensure that material information relating to the registrant, including its consolidated subsidiaries, is made known to us by others within those entities, particularly during the period in which this report is being prepared;
  - b) Evaluated the effectiveness of the registrant's disclosure controls and procedures and presented in this report our conclusions about the effectiveness of the disclosure controls and procedures, as of the end of the period covered by this report based on such evaluation; and
  - c) Disclosed in this report any change in the registrant's internal control over financial reporting that occurred during the registrant's most recent fiscal quarter (the registrant's fourth fiscal quarter in the case of an annual report) that has materially affected, or is reasonably likely to materially affect, the registrant's internal control over financial reporting; and
5. The registrant's other certifying officers and I have disclosed, based on our most recent evaluation of internal control over financial reporting, to the registrant's auditors and the audit committee of the registrant's board of directors (or persons performing the equivalent functions):
  - a) All significant deficiencies and material weaknesses in the design or operation of internal control over financial reporting which are reasonably likely to adversely affect the registrant's ability to record, process, summarize and report financial information; and
  - b) Any fraud, whether or not material, that involves management or other employees who have a significant role in the registrant's internal control over financial reporting.

Date: November 5, 2004

/s/ Ronald Doornink  
Ronald Doornink  
President, Activision, Inc. and  
Chief Executive Officer,  
Activision Publishing, Inc.

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**Exhibit 31.3**

**CERTIFICATION**

I, William J. Chardavoyne, Executive Vice President and Chief Financial Officer of Activision, Inc., certify that:

1. I have reviewed this quarterly report on Form 10-Q of Activision, Inc.;
2. Based on my knowledge, this report does not contain any untrue statement of a material fact or omit to state a material fact necessary to make the statements made, in light of the circumstances under which such statements were made, not misleading with respect to the period covered by this report;
3. Based on my knowledge, the financial statements, and other financial information included in this report, fairly present in all material respects the financial condition, results of operations and cash flows of the registrant as of, and for, the periods presented in this report;
4. The registrant's other certifying officers and I are responsible for establishing and maintaining disclosure controls and procedures (as defined in Exchange Act Rules 13a-15(e) and 15d-15(e)) for the registrant and have:
  - a) Designed such disclosure controls and procedures, or caused such disclosure controls and procedures to be designed under our supervision, to ensure that material information relating to the registrant, including its consolidated subsidiaries, is made known to us by others within those entities, particularly during the period in which this report is being prepared;
  - b) Evaluated the effectiveness of the registrant's disclosure controls and procedures and presented in this report our conclusions about the effectiveness of the disclosure controls and procedures, as of the end of the period covered by this report based on such evaluation; and
  - c) Disclosed in this report any change in the registrant's internal control over financial reporting that occurred during the registrant's most recent fiscal quarter (the registrant's fourth fiscal quarter in the case of an annual report) that has materially affected, or is reasonably likely to materially affect, the registrant's internal control over financial reporting; and
5. The registrant's other certifying officers and I have disclosed, based on our most recent evaluation of internal control over financial reporting, to the registrant's auditors and the audit committee of the registrant's board of directors (or persons performing the equivalent functions):
  - a) All significant deficiencies and material weaknesses in the design or operation of internal control over financial reporting which are reasonably likely to adversely affect the registrant's ability to record, process, summarize and report financial information; and
  - b) Any fraud, whether or not material, that involves management or other employees who have a significant role in the registrant's internal control over financial reporting.

Date: November 5, 2004

/s/ William J. Chardavoyne  
William J. Chardavoyne  
Executive Vice President and  
Chief Financial Officer

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**Exhibit 32.1**

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

In connection with the quarterly report of Activision, Inc. (the "Company") on Form 10-Q for the period ending September 30, 2004 as filed with the Securities and Exchange Commission on the date hereof (the "Report"), I, Robert A. Kotick, Chief Executive Officer of the Company, certify, to my knowledge, pursuant to 18 U.S.C. § 1350, as adopted pursuant to § 906 of the Sarbanes-Oxley Act of 2002, that:

- (1) The Report fully complies with the requirements of Section 13(a) or 15(d) of the Securities Exchange Act of 1934; and
- (2) The information contained in the Report fairly presents, in all material respects, the financial condition and results of operations of the Company.

/s/ Robert A. Kotick  
Robert A. Kotick  
Chief Executive Officer,  
November 5, 2004

A signed original of this written statement required by Section 906, or other document authenticating, acknowledging, or otherwise adopting the signature that appears in typed form within the electronic version of this written statement required by Section 906, has been provided to the Company and will be retained by the Company and furnished to the Securities and Exchange Commission or its staff upon request.

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

In connection with the quarterly report of Activision, Inc. (the "Company") on Form 10-Q for the period ending September 30, 2004 as filed with the Securities and Exchange Commission on the date hereof (the "Report"), I, Ronald Doomink, President of the Company and Chief Executive Officer of Activision Publishing, Inc., certify, to my knowledge, pursuant to 18 U.S.C. § 1350, as adopted pursuant to § 906 of the Sarbanes-Oxley Act of 2002, that:

- (1) The Report fully complies with the requirements of Section 13(a) or 15(d) of the Securities Exchange Act of 1934; and
- (2) The information contained in the Report fairly presents, in all material respects, the financial condition and results of operations of the Company.

/s/ Ronald Doomink  
Ronald Doomink  
President, Activision, Inc.  
Chief Executive Officer,  
Activision Publishing, Inc.  
November 5, 2004

A signed original of this written statement required by Section 906, or other document authenticating, acknowledging, or otherwise adopting the signature that appears in typed form within the electronic version of this written statement required by Section 906, has been provided to the Company and will be retained by the Company and furnished to the Securities and Exchange Commission or its staff upon request.

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

In connection with the quarterly report of Activision, Inc. (the "Company") on Form 10-Q for the period ending September 30, 2004 as filed with the Securities and Exchange Commission on the date hereof (the "Report"), I, William J. Chardavoyne, Executive Vice President and Chief Financial Officer of the Company, certify, to my knowledge, pursuant to 18 U.S.C. § 1350, as adopted pursuant to § 906 of the Sarbanes-Oxley Act of 2002, that:

- (1) The Report fully complies with the requirements of Section 13(a) or 15(d) of the Securities Exchange Act of 1934; and
- (2) The information contained in the Report fairly presents, in all material respects, the financial condition and results of operations of the Company.

/s/ William J. Chardavoyne  
William J. Chardavoyne  
Executive Vice President and  
Chief Financial Officer,  
November 5, 2004

A signed original of this written statement required by Section 906, or other document authenticating, acknowledging, or otherwise adopting the signature that appears in typed form within the electronic version of this written statement required by Section 906, has been provided to the Company and will be retained by the Company and furnished to the Securities and Exchange Commission or its staff upon request.

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