

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 DECEMBER 31, 1999

OR

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)

94-2606438  
(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 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

The number of shares of the registrant's Common Stock outstanding as of February 10, 2000 was 25,540,813.

ACTIVISION, INC. AND SUBSIDIARIES

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and March 31, 1999

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Part I. FINANCIAL INFORMATION  
Item 1. Financial Statements

ACTIVISION, INC. AND SUBSIDIARIES  
Condensed Consolidated Balance Sheets  
(Unaudited)  
(all amounts in thousands except per share data)

	December 31, 1999	March 31, 1999
	-----	-----
		Restated
<b>Assets</b>		
Current assets:		
Cash and cash equivalents	\$ 51,734	\$ 33,037
Accounts receivable, net of allowances of \$27,401 and \$14,979 , respectively	215,559	117,541
Inventories, net	42,973	30,931
Prepaid royalties and capitalized software costs	42,876	38,093
Deferred income taxes	521	6,383
Other current assets	19,382	9,965
	-----	-----
Total current assets	373,045	235,950
Prepaid royalties and capitalized software costs	7,525	6,923
Property and equipment, net	10,428	10,924
Deferred income taxes	2,618	2,618
Intangible assets, net	52,252	21,647
Other assets	9,100	5,283
	-----	-----
Total assets	\$ 454,968	\$ 283,345
	=====	=====
<b>Liabilities and Shareholders' Equity</b>		
Current liabilities:		
Current portion of notes payable to bank	\$ 41,871	\$ 5,992

Accounts payable	86,112	43,853
Accrued expenses	75,100	45,160
	-----	-----
Total current liabilities	203,083	95,005
Notes payable to bank, less current portion	16,308	1,143
Convertible subordinated notes	60,000	60,000
Other liabilities	2	6
	-----	-----
Total liabilities	279,393	156,154
	-----	-----
Shareholders' equity:		
Common stock, \$.000001 par value, 50,000,000 shares authorized, 25,660,097 and 23,303,762 shares issued and 25,160,097 and 23,803,762 outstanding, respectively	-	-
Additional paid-in capital	139,725	109,251
Retained earnings	44,518	25,728
Accumulated other comprehensive income (loss)	(3,390)	(2,510)
Less: Treasury stock, cost of 500,000 shares	(5,278)	(5,278)
	-----	-----
Total shareholders' equity	175,575	127,191
	-----	-----
Total liabilities and shareholders' equity	\$ 454,968	\$ 283,345
	=====	=====

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

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ACTIVISION, INC. AND SUBSIDIARIES  
Condensed Consolidated Statements of Operations  
For the Three and Nine Months ended December 31,  
(Unaudited)  
(all amounts in thousands except per share data)

	Three Months Ended		Nine Months Ended	
	December 31,		December 31,	
	1999	1998	1999	1998
	Restated		Restated	
Net revenues	\$ 268,862	\$ 193,537	\$ 468,367	\$ 321,260
Costs and expenses:				
Cost of sales - product costs	139,357	107,693	259,180	190,557
Cost of sales - royalties and software amortization	39,733	23,828	61,213	31,577
Product development	6,235	4,440	16,576	14,747
Sales and marketing	35,879	26,040	73,045	50,577
General and administrative	8,046	5,265	19,335	14,395
Amortization of intangible assets	1,371	398	3,202	1,191
Merger expenses	-	-	150	600
	-----	-----	-----	-----
Total operating expenses	230,621	167,664	432,701	303,644
	-----	-----	-----	-----
Operating income	38,241	25,873	35,666	17,616
Interest expense, net	(2,835)	(854)	(5,833)	(2,079)
	-----	-----	-----	-----
Income before income tax provision	35,406	25,019	29,833	15,537
Income tax provision	13,105	9,283	11,043	5,677
	-----	-----	-----	-----
Net income	\$ 22,301	\$ 15,736	\$ 18,790	\$ 9,860
	=====	=====	=====	=====
Other comprehensive income (loss):				
Foreign currency translation adjustment	(1,645)	61	(880)	51
	-----	-----	-----	-----
Comprehensive income	\$ 20,656	\$ 15,797	\$ 17,910	\$ 9,911
	=====	=====	=====	=====
Basic net income per share	\$ 0.89	\$ 0.69	\$ 0.77	\$ 0.43
Diluted net income per share	\$ 0.75	\$ 0.61	\$ 0.71	\$ 0.42

Number of shares used in computing basic net income per share	25,075	22,886	24,367	22,749
Number of shares used in computing diluted net income per share	30,483	26,767	29,431	23,581

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

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ACTIVISION, INC. AND SUBSIDIARIES  
Condensed Consolidated Statements of Cash Flows  
For the Nine Months ended December 31,  
(Unaudited)  
(all amounts in thousands)

	Nine Months Ended December 31,	
	1999	1998
	Restated	
	Increase (decrease) in cash	
	-----	-----
Cash flows from operating activities:		
Net income	\$ 18,790	\$ 9,860
Adjustments to reconcile net income to net cash provided by operating activities:		
Deferred income taxes	12,130	1,458
Depreciation and amortization	6,400	4,842
Amortization of prepaid royalties and capitalized software costs	49,546	17,900
Change in assets and liabilities:		
Accounts receivable	(97,299)	(75,667)
Inventories	(8,761)	(17,825)
Other current assets	(7,241)	(4,678)
Other assets	(1,013)	782
Accounts payable	39,790	58,933
Accrued liabilities	22,479	24,163
Other liabilities	(4)	(44)
	-----	-----
Net cash provided by operating activities	34,817	19,724
Cash flows from investing activities:		
Cash used for purchase acquisitions, net of cash acquired	(20,523)	-
Cash acquired in pooling transactions	-	78
Capital expenditures	(2,520)	(2,908)
Investment in prepaid royalties and capitalized software costs	(54,931)	(50,579)
	-----	-----
Net cash used in investing activities	(77,974)	(53,409)
Cash flows from financing activities:		
Proceeds from issuance of common stock pursuant to employee stock option plan	14,916	3,478
Proceeds from employee stock purchase plan	419	389
Note payable to bank, net	(5,449)	(216)
Proceeds from term loan	25,000	-
Cash paid to secure line of credit and term loan	(3,355)	-
Borrowings under line of credit agreement	202,956	10,006
Payments under line of credit agreement	(171,463)	(2,600)
	-----	-----
Net cash provided by financing activities	63,024	11,057
Effect of exchange rate changes on cash	(1,170)	52
	-----	-----
Net increase (decrease) in cash and cash equivalents	18,697	(22,576)

Cash and cash equivalents at beginning of period	33,037	74,241
	-----	-----
Cash and cash equivalents at end of period	\$ 51,734	\$ 51,665
	=====	=====

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

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ACTIVISION, INC. AND SUBSIDIARIES  
Notes to Condensed Consolidated Financial Statements  
For the Nine Months ended December 31, 1999  
(Unaudited)

1. BASIS OF PRESENTATION

The accompanying condensed consolidated financial statements include the accounts of Activision, Inc. (together with its subsidiaries, "Activision" or "the Company"). The information furnished is unaudited and reflects all adjustments that, in the opinion of management, are necessary to provide a fair statement of the results for the interim periods presented. The financial statements should be read in conjunction with the financial statements included in the Company's Annual Report on Form 10-K for the year ended March 31, 1999 as filed with the Securities and Exchange Commission (the "SEC").

The consolidated financial statements for the period ended June 30, 1999 and all prior periods have been retroactively restated to reflect the Company's acquisition of JCM Productions, Inc. dba Neversoft Entertainment ("Neversoft") on September 30, 1999, which was accounted for as a pooling of interests.

Certain amounts in the condensed consolidated financial statements have been reclassified to conform to the current period's presentation. These reclassifications had no impact on previously reported working capital or results of operations.

2. SIGNIFICANT ACCOUNTING POLICIES

Intangible assets, net of amortization, at December 31, 1999 and March 31, 1999, of \$52.3 million and \$21.6 million, respectively, includes goodwill and costs of acquired licenses, brands and trade names which are amortized using the straight-line method over their estimated useful lives, typically from three to twenty years.

Statement of Financial Accounting Standards No. 130, Reporting Comprehensive Income, was adopted as of April 1, 1999. This Statement establishes standards for the reporting and display of changes in shareholders' equity that do not result directly from transactions with shareholders. The Company has displayed comprehensive income and its components in the condensed consolidated statements of operations for the three and nine months ended December 31, 1999 and 1998.

3. PREPAID ROYALTIES AND CAPITALIZED SOFTWARE COSTS

Prepaid royalties include payments made to independent software developers under development agreements and license fees paid to intellectual property rights holders for use of their trademarks or copyrights. Intellectual property rights that have alternative future uses are capitalized. Capitalized software costs represent costs incurred for development that are not recoupable against future royalties.

The Company accounts for prepaid royalties relating to development agreements and capitalized software costs in accordance with Statement of Financial Accounting Standards ("SFAS") No. 86, "Accounting for the Costs of Computer Software to be Sold, Leased, or Otherwise Marketed". Software development costs and prepaid royalties are capitalized once technological feasibility is established. Technological feasibility is evaluated on a product-by-product basis.

For products where proven game engine technology exists, this may occur early in the development cycle. Software development costs are expensed if and when they are deemed unrecoverable. Amounts related to software development, which are not capitalized, are charged immediately to product development expense.

The following criteria is used to evaluate recoverability of software development costs: historical performance of comparable products; the commercial acceptance of prior products released on a given game engine; orders for the product prior to its release; estimated performance of a sequel product based on the performance of the product on which the sequel is based; and actual development costs of a product as compared to the Company's budgeted amount.

Capitalized software development costs are amortized to cost of sales -royalties and software amortization on a straight-line basis over the estimated product life (generally one year or less) commencing upon product release, or on the ratio of current revenues to total projected revenues, whichever amortization amount is greater. Prepaid royalties are amortized to cost of sales - royalties and software amortization commencing upon the product release at the contractual royalty rate based on actual net product sales, or on the ratio of current revenues to total projected revenues, whichever amortization amount is greater. For products that have been released, management evaluates the future recoverability of capitalized amounts on a quarterly basis.

As of December 31, 1999, prepaid royalties and unamortized capitalized software costs totaled \$38.0 million (including \$7.5 million classified as non-current) and \$12.4 million, respectively. As of March 31, 1999, prepaid

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ACTIVISION, INC. AND SUBSIDIARIES  
Notes to Condensed Consolidated Financial Statements

(Unaudited)

royalties and unamortized capitalized software costs totaled \$36.0 million (including \$6.9 million classified as non-current) and \$9.0 million, respectively.

5. REVENUE RECOGNITION

The AICPA's Statement of Position 97-2 "Software Revenue Recognition" (SOP 97-2"), provides guidance on applying generally accepted accounting principles in recognizing revenue on software transactions. SOP 97-2 is effective for all transactions entered into subsequent to March 31, 1999. The Company has adopted SOP 97-2 and such adoption did not have a material impact on the Company's financial position, results of operations or liquidity. Effective December 15, 1998, the American Institute of Certified Public Accounts issued Statement of Position 98-9, "Modification of SOP 97-2, Software Revenue Recognition with Respect to Certain Transactions" ("SOP 98-9"), which is effective for transactions entered into after March 15, 1999. SOP 98-9 deals with the determination of vendor specific objective evidence of fair value in multiple element arrangements, such as maintenance agreements sold in conjunction with software packages. The Company does not believe this will have a material impact on the Company's financial position, result of operations or liquidity.

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

**Software Licenses:** For those license agreements that provide the customers the right to multiple copies in exchange for guaranteed

amounts, revenue is recognized at delivery of the product master or the first copy. Per copy royalties on sales that exceed the guarantee are recognized as earned.

6. SUPPLEMENTAL CASH FLOW INFORMATION

Non-cash activities and supplemental cash flow information for the nine months ended December 31, 1999 and 1998 are as follows (amounts in thousands):

	December 31,	
	1999	1998
Non-cash activities:		
Conversion of note payable to common stock in connection with pooling acquisition	-	\$ 4,500
Warrants to acquire common stock issued in exchange for licensing rights	\$ 6,482	\$ 3,368
Common stock issued in connection with purchase acquisition	\$ 2,700	-
Options to acquire common stock issued in connection with purchase acquisition	\$ 3,271	-
Tax benefit attributable to stock option exercises	\$ 2,686	\$ 653
Supplemental cash flow information:		
Cash paid for income taxes	\$ 4,775	\$ 4,868
Cash paid for interest	\$ 9,133	\$ 2,775

ACTIVISION, INC. AND SUBSIDIARIES  
Notes to Condensed Consolidated Financial Statements

(Unaudited)

7. OPERATIONS BY REPORTABLE SEGMENTS AND GEOGRAPHIC AREA

The Company adopted SFAS No. 131, "Disclosures about Segments of an Enterprise and Related Information," as of April 1, 1998. SFAS No. 131 establishes standards for reporting information about an enterprise's operating segments and related disclosures about its products, geographic areas and major customers.

The Company publishes, develops and distributes interactive entertainment and leisure products for a variety of game platforms, including PCs, the Sony PlayStation console system and the Nintendo 64 console system. Based on its organizational structure, the Company operates in two reportable segments: publishing and distribution.

The Company's publishing segment develops and publishes titles both internally through the studios owned by the Company and externally through third party developers. In addition, the Company's publishing segment distributes titles that are developed and marketed by other third party developers through its "affiliate label" program. In the United States, the Company's products are sold primarily on a direct basis to major computer and software retailing organizations, mass market retailers, consumer electronic stores, discount warehouses and mail order companies. The Company conducts its international publishing activities through offices in the United Kingdom, Germany, France, Australia and Japan. The Company's products are sold internationally on a direct to retail basis, through third party distribution and licensing arrangements, and through the Company's owned distribution subsidiaries located in the United Kingdom, the Benelux territories and Germany.

The Company's distribution segment conducts operations in the United Kingdom, the Benelux territories and Germany. This segment distributes interactive entertainment software and hardware and provides logistical services for a variety of publishers and manufacturers in these

territories. A small percentage of distribution sales are derived from Activision-published titles.

The President and Chief Operating Officer allocates resources to each of the segments using information on their respective revenues and operating profits before interest and taxes. The President and Chief Operating Officer has been identified as the Chief Operating Decision Maker as defined by SFAS No. 131.

The President and Chief Operating Officer does not evaluate individual segments based on assets or depreciation.

The accounting policies of these segments are the same as those described in the Summary of Significant Accounting Policies in the Company's Annual Report on Form 10-K for the year ended March 31, 1999. Revenue derived from sales between segments is eliminated in consolidation.

Information on the reportable segments for the three and nine months ended December 31, 1999 and 1998 is as follows:

	Three months Ended December 31, 1999			
	Publishing	Distribution	Corporate	Total
Revenues from external customers	\$ 168,554	\$ 100,308	\$ 0	\$ 268,862
Revenues from sales between segments	14,950	0	0	14,950
Operating income (loss)	33,681	5,850	(1,290)	38,241

	Nine Months Ended December 31, 1999			
	Publishing	Distribution	Corporate	Total
Revenues from external customers	\$ 295,356	\$ 173,011	\$ 0	\$ 468,367
Revenues from sales between segments	28,620	0	0	28,620
Operating income (loss)	34,682	4,094	(3,110)	35,666

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ACTIVISION, INC. AND SUBSIDIARIES  
Notes to Condensed Consolidated Financial Statements

(Unaudited)

	Three Months Ended December 31, 1998			
	Publishing	Distribution	Corporate	Total
Revenues from external customers	\$ 84,863	\$ 108,674	\$ 0	\$ 193,537
Revenues from sales between segments	12,083	0	0	12,083
Operating income (loss)	16,541	9,645	(313)	25,873

	Nine Months Ended December 31, 1998			
	Publishing	Distribution	Corporate	Total



Revenues from external customers	\$ 129,892	\$ 191,368	\$ 0	\$ 321,260
Revenues from sales between segments	14,346	0	0	14,346
Operating income (loss)	9,207	9,950	(1,541)	17,616

Operating expenses in the corporate column consist of amortization of goodwill and merger expenses resulting from the Company's merger with The Disc Company, Inc. on April 1, 1992, the Company's acquisition of Expert Software on June 22, 1999 and the Company's acquisition of Elsinore Multimedia on June 29, 1999.

Geographic information for the three and nine months ended December 31, 1999 and 1998 is based on the location of the selling entity. Revenues from external customers by geographic region were as follows:

	Three months Ended December 31,		Nine Months Ended December 31,	
	1999	1998	1999	1998
United States	\$ 144,133	\$ 69,472	\$ 237,291	\$ 106,633
International	124,729	124,065	231,076	214,627
Total	\$ 268,862	\$ 193,537	\$ 468,367	\$ 321,260

Revenues by platform were as follows:

	Three months Ended December 31,		Nine Months Ended December 31,	
	1999	1998	1999	1998
Console	\$ 193,921	\$ 116,703	\$ 329,469	\$ 204,205
PC	74,941	76,834	138,898	117,055
Total	\$ 268,862	\$ 193,537	\$ 468,367	\$ 321,260

#### 8. COMPUTATION OF NET INCOME (LOSS) PER SHARE

Statement of Financial Accounting Standards No. 128 ("SFAS 128" per share,") requires companies to compute net earnings per share under two different methods, basic and diluted earnings per share, for all periods for which an income statement is presented. Basic earnings per share is computed by dividing net income by the weighted average number of common shares outstanding for all periods. Diluted earnings per share reflects the potential dilution that could occur if income were divided by the weighted average number of common and common stock equivalent shares outstanding during the period. Diluted earnings per share is computed by dividing net income by the weighted average number of common shares and common stock equivalents from outstanding stock options and warrants. Common stock equivalents are calculated using the treasury stock method and represent incremental shares issuable upon exercise of the Company's outstanding options and warrants.

For the three months ended December 31, 1999, outstanding weighted average options to purchase approximately 719,363 shares were not included in the computation of diluted earnings per share as a result of their antidilutive effect. For the nine months ended December 31, 1999, outstanding weighted average options to purchase approximately 948,120 shares were not included in the computation of diluted earnings per share as a result of their antidilutive effect. For the three and nine months ended December 31, 1998, 1.9 million and 2.5 million shares, respectively, of the Company's common stock were outstanding but were not included in the

ACTIVISION, INC. AND SUBSIDIARIES  
Notes to Condensed Consolidated Financial Statements

(Unaudited)

computation of diluted net income per share as a result of their antidilutive effect. Such stock options could have a dilutive effect in future periods. For the nine months ended December 31, 1998, the effect of convertible subordinated notes was excluded as a result of its antidilutive effect.

The following table sets forth the computation of basic and diluted net income per common share for the three and nine months periods ended December 31, 1999 and 1998 (in thousands, except per share data):

	Three Months Ended December 31,		Nine Months Ended December 31,	
	1999	1998	1999	1998
Numerator:				
Net income	\$22,301	\$15,736	\$18,790	\$9,860
Interest relating to dilutive convertible subordinated notes (net of tax)	666	666	1,997	-
Numerator for diluted earnings per share - income available to common stockholders	<u>\$22,967</u>	<u>\$16,402</u>	<u>\$20,787</u>	<u>\$9,860</u>
Denominator:				
Denominator for basic net (loss) per common share - weighted average shares outstanding	25,075	22,886	24,367	22,749
Effect of dilutive securities:				
Employee stock options	1,958	677	1,614	801
Warrants	271	25	271	31
Conversion of convertible subordinated notes	3,179	3,179	3,179	-
Denominator for diluted net (loss) per common share - adjusted weighted-average shares for assumed conversions	<u>30,483</u>	<u>26,767</u>	<u>29,431</u>	<u>23,581</u>
Basic net income per share	<u>\$0.89</u>	<u>\$0.69</u>	<u>\$0.77</u>	<u>\$0.43</u>
Diluted net income per share	<u>\$0.75</u>	<u>\$0.61</u>	<u>\$0.71</u>	<u>\$0.42</u>

## 9. COMMITMENTS

In December 1997, the Company completed the private placement of \$60.0 million principal amount of 6 3/4% convertible subordinated notes due 2005 (the "Notes"). The Notes are convertible, in whole or in part, at the option of the holder at any time after December 22, 1997 (the date of original issuance) and prior to the close of business on the business day immediately preceding the maturity date, unless previously redeemed or repurchased, into common stock, \$.000001 par value, of the Company, at a conversion price of \$18.875 per share, (equivalent to a conversion rate of 52.9801 shares per \$1,000 principal amount of Notes), subject to adjustment in certain circumstances. The Notes are redeemable, in whole or in part, at the option of the Company at any time on or after January 10, 2001. If redemption occurs prior to December 31, 2001, the Company must pay a premium on such redeemed Notes.

As of December 31, 1998, the Company had a \$40.0 million revolving credit and letter of credit facility (the "Prior Facility") with a group of banks. The Prior Facility provided the Company with the ability to borrow funds and issue letters of credit against eligible accounts receivable up to \$40.0 million. The Prior Facility was scheduled to expire in October 2001. As of December 31, 1998, the Company had no outstanding letters of credit or borrowings against the Prior Facility.

In June 1999, the Company replaced the Prior Facility with a \$125.0 million revolving credit facility and term loan (the "Facility") with

a new group of banks that provides the Company with the ability to borrow up to \$100.0

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ACTIVISION, INC. AND SUBSIDIARIES  
Notes to Condensed Consolidated Financial Statements

(Unaudited)

million and issue letters of credit up to \$80.0 million on a revolving basis against eligible accounts receivable and inventory. The \$25.0 million term loan portion of the Facility was used to acquire Expert Software in June 1999 and to pay costs related to such acquisition and the securing of the Facility. The term loan has a three-year term with principal amortization on a straight-line quarterly basis beginning December 31, 1999 and a borrowing rate based on the banks' base rate (which is generally equivalent to the published prime rate) plus 2.0% or LIBOR plus 3.0%. The revolving portion of the Facility has a borrowing rate based on the banks' base rate plus 1.75% or LIBOR plus 2.75%. The Company pays a commitment fee of 1/2% based on the unused portion of the Facility. At December 31, 1999, the Company had an outstanding balance of \$27.0 million on the revolving portion of the Facility. Letters of credit outstanding against the Facility totaled \$20.9 million at December 31, 1999.

The Company's CentreSoft subsidiary has a revolving credit facility (the "UK Facility") with a bank in the United Kingdom in the amount of \$21.0 million. The UK Facility can be used for working capital requirements and expires in June 2000. The Company had no borrowings outstanding against the UK Facility as of December 31, 1999 or March 31, 1999. Letters of credit outstanding against the UK Facility totaled \$9.7 million at December 31, 1999.

The Company's NBG subsidiary has a revolving credit facility (the "German Facility") with a bank in Germany in the amount of \$2.0 million. The German Facility can be used for working capital requirements and has no expiration date. The Company had no borrowings outstanding against the German Facility as of December 31, 1999 or March 31, 1999.

The Company's CD Contact subsidiary has a revolving credit facility (the "Netherlands Facility") with a bank in the Netherlands that permits borrowings against eligible accounts receivable and inventory up to \$25.0 million. Borrowings under the Netherlands Facility are due on demand and totaled \$4.5 million at December 31, 1999 and \$6.0 million at March 31, 1999. Letters of credit outstanding under the Netherlands Facility totaled \$4.0 million at December 31, 1999 and \$6.9 million at March 31, 1999. The Netherlands Facility expires on March 31, 2001.

In addition, the Company had a line of credit agreement (the "Asset Line") with a bank that expired in September 1998. As of December 31, 1999, \$387 thousand was outstanding on this line.

Under the terms of a production financing arrangement, the Company has a commitment to purchase a future Playstation 2 title from an independent third party developer upon its completion for an estimated \$4.2 million. Failure by the developer to complete the project within the contractual time frame or specifications alleviates the Company's commitment.

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

The following discussion and analysis contains forward-looking statements regarding future events or the future financial performance of the Company that involve certain risks and uncertainties discussed in the Company's Annual Report on Form 10-K under "Factors Affecting Future Performance." Actual events or the actual future results of the Company may differ materially from any forward-looking statement due to such risks and uncertainties.

## OVERVIEW

The Company is a leading international publisher, developer and distributor of interactive entertainment and leisure products. The Company currently focuses its publishing, development and distribution efforts on products designed for personal computers ("PCs") as well as the Sony PlayStation ("PSX"), Nintendo 64 ("N64"), Nintendo Gameboy Color ("Gameboy") and Sega Dreamcast ("Dreamcast") console systems. The Company's products span a wide range of genres and target markets.

The Company distributes its products worldwide through its direct sales forces, through its distribution subsidiaries, and through third party distributors and licensees.

The Company recognizes revenue from the sale of its products upon shipment. Subject to certain limitations, the Company permits customers to obtain exchanges and returns within certain specified periods and provides price protection on certain unsold merchandise. Revenue from product sales is reflected after deducting the estimated allowance for returns and price protection. With respect to license agreements that provide customers the right to multiple copies in exchange for guaranteed amounts, revenue is recognized upon delivery of the product master or the first copy. Per copy royalties on sales that exceed the guarantee are recognized as earned. The AICPA's Statement of Position 97-2 "Software Revenue Recognition" ("SOP 97-2"), provides guidance on applying generally accepted accounting principles in recognizing revenue on software transactions. SOP 97-2 is effective for all transactions entered into subsequent to March 31, 1999. The Company has adopted SOP 97-2 and such adoption did not have a material impact on the Company's financial position, results of operations or liquidity. Effective December 15, 1998, the American Institute of Certified Public Accountants issued Statement of Position 98-9, "Modification of SOP 97-2, Software Revenue Recognition with Respect to Certain Transactions" ("SOP 98-9"), which is effective for transactions entered into after March 15, 1999. SOP 98-9 deals with the determination of vendor specific objective evidence of fair value in multiple element arrangements, such as maintenance agreements sold in conjunction with software packages. The Company does not believe this will have a material impact on the Company's financial position, results of operations or liquidity.

Cost of sales-product costs represents the cost to purchase, manufacture and distribute PC and console product units. Manufacturers of the Company's PC software are located worldwide and are readily available. Console CDs and cartridges are manufactured by the respective video game console manufacturers, Sony, Nintendo and Sega or its agents, who often require significant lead time to fulfill the Company's orders.

Cost of sales-royalties and software amortization represents amounts due developers, product owners and other royalty participants as a result of product sales, as well as amortization of capitalized software development costs. The costs incurred by the Company to develop products are accounted for in accordance with accounting standards that provide for the capitalization of certain software development costs once technological feasibility is established and such costs are determined to be recoverable. Various contracts are maintained with developers, product owners or other royalty participants, which state a royalty rate, territory and term of agreement, among other items. Upon a product's release, prepaid royalties and license fees are charged to royalty expense based on the contractual royalty rate. The capitalized software costs are then amortized to cost of sales-royalties and software amortization on a straight-line basis over the estimated product life commencing upon product release or on the ratio of current revenues to total projected revenues, whichever amortization amount is greater.

For products that have been released, management evaluates the future recoverability of prepaid royalties and capitalized software costs on a quarterly basis. Prior to a product's release, the Company charges to expense, as part of product development costs, capitalized costs when, in management's estimate, such amounts are not recoverable. The following criteria is used to evaluate recoverability: historical performance of comparable products; the commercial acceptance of prior products released on a given game engine; orders for the product prior to its release; estimated performance of a sequel product based on the performance of the product on which the sequel is based; and actual development costs of a product as compared to the company's budgeted amount.

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, platform, channel and segment:

	THREE MONTHS ENDED DECEMBER 31,				NINE MONTHS ENDED DECEMBER 31,			
	1999		1998		1999		1998	
	Amount	% of Net Revenues	Amount	% of Net Revenues	Amount	% of Net Revenues	Amount	% of Net Revenues
Statements of Operations Data:								
Net revenues	\$268,862	100.0%	\$193,537	100.0%	\$468,367	100.0%	\$321,260	100.0%
Costs and expenses:								
Cost of sales - product costs	139,357	51.9%	107,693	55.6%	259,180	55.3%	190,557	59.3%
Cost of sales - royalties and software amortization	39,733	14.8%	23,828	12.3%	61,213	13.1%	31,577	9.8%
Product development	6,235	2.3%	4,440	2.3%	16,576	3.5%	14,747	4.6%
Sales and marketing	35,879	13.3%	26,040	13.5%	73,045	15.6%	50,577	15.7%
General and administrative	8,046	3.0%	5,265	2.7%	19,335	4.2%	14,395	4.5%
Amortization of intangible assets	1,371	0.5%	398	0.2%	3,202	0.7%	1,191	0.4%
Merger expenses	-	-	-	-	150	-	600	0.2%
Total costs and expenses	230,621	85.8%	167,664	86.6%	432,701	92.4%	303,644	94.5%
Operating income	38,241	14.2%	25,873	13.4%	35,666	7.6%	17,616	5.5%
Interest income (expense), net	(2,835)	(1.0%)	(854)	(0.4%)	(5,833)	(1.2%)	(2,079)	(0.7%)
Income before income tax provision	35,406	13.2%	25,019	13.0%	29,833	6.4%	15,537	4.8%
Income tax provision	13,105	4.9%	9,283	4.9%	11,043	2.4%	5,677	1.8%
Net income	\$ 22,301	8.3%	\$ 15,736	8.1%	\$ 18,790	4.0%	\$ 9,860	3.0%
Net Revenues by Territory:								
United States	\$144,133	53.6%	\$69,472	35.9%	\$ 237,291	50.7%	\$106,633	33.2%
International	124,729	46.4%	124,065	64.1%	231,076	49.3%	214,627	66.8%
Total net revenues	\$268,862	100.0%	\$193,537	100.0%	\$ 468,367	100.0%	\$321,260	100.0%
Net Revenues by Activity/Platform Mix:								
Publishing:								
Console	\$132,427	72.2%	\$47,242	48.7%	\$ 225,993	69.8%	\$ 71,024	49.2%
PC	51,077	27.8%	49,704	51.3%	97,983	30.2%	73,214	50.8%
Total publishing net revenues	183,504	68.3%	96,946	50.1%	323,976	69.2%	144,238	44.9%
Distribution:								
Console	61,494	72.0%	69,461	71.9%	103,476	71.7%	133,181	75.2%
PC	23,864	28.0%	27,130	28.1%	40,915	28.3%	43,841	24.8%
Total distribution net revenues	85,358	31.7%	96,591	49.9%	144,391	30.8%	177,022	55.1%
Total net revenues	\$268,862	100.0%	\$193,537	100.0%	\$ 468,367	100.0%	\$321,260	100.0%
Net Revenues by Channel:								
Retailer/Reseller	\$260,328	96.8%	\$185,810	96.0%	\$ 448,853	95.8%	\$307,401	95.7%
OEM, licensing, on-line and other	8,534	3.2%	7,727	4.0%	19,514	4.2%	13,859	4.3%
Total net revenues	\$268,862	100.0%	\$193,537	100.0%	\$ 468,367	100.0%	\$321,260	100.0%
Operating Income (Loss) by Segment:								
Publishing	\$33,681	85.5%	16,541	63.9%	34,682	91.2%	9,207	52.3%
Distribution	5,850	15.3%	9,645	37.3%	4,094	11.4%	9,950	56.5%
Corporate	(1,290)	(0.8%)	(313)	(1.2%)	(3,110)	(2.6%)	(1,541)	(8.8%)
Total operating income by segment	38,241	100.0%	25,873	100.0%	95,666	100.0%	17,616	100.0%

## RESULTS OF OPERATIONS

### NET REVENUES

Net revenues for the three months ended December 31, 1999 increased 39.0% from the same period last year, from \$193.5 million to \$268.9 million. The increase was primarily due to a 66.2% increase in console net revenues from \$116.7 million to \$193.9 million, partially offset by a 2.5% decrease in PC net revenues from \$76.8 million to \$74.9 million. Domestic net revenues grew 107.3% from \$69.5 million to \$144.1 million. International net revenues remained stable.

Net revenues for the nine months ended December 31, 1999 increased 45.8% from the same period last year, from \$321.3 million to \$468.4 million. The increase was due to a 61.4% increase in console net revenues from \$204.2 million to \$329.5 million and an 18.6% increase in PC net revenues from \$117.1 million to \$138.9 million. Domestic net revenues grew 122.6% from \$106.6 million to \$237.3 million. International net revenues grew 7.7% from \$214.6 million to \$231.1 million.

Publishing net revenues for the three and nine months ended December 31, 1999

increased 89.4% from \$96.9 million to \$183.5 million and 124.7% from \$144.2 million to \$324.0 million, respectively. These increases primarily were due to publishing console net revenues for the three and nine months ended December 31, 1999 increasing 180.5% from \$47.2 million to \$132.4 million and 218.3% from \$71.0 million to \$226.0 million, respectively. The increases in publishing console net revenues were attributable to the initial release in the current periods of a larger number of titles that sold well in the marketplace, including Blue Stinger (Dreamcast), Space Invaders and Toy Story II (PSX and N64), Tarzan (Gameboy), A Bug's Life (N64) and Vigilante 8: Second Offense, WuTang: Shaolin Style and Tony Hawk's Pro Skater (PSX). Publishing PC net revenues for the three and nine months ended December 31, 1999 increased 2.8% from \$49.7 million to \$51.1 million and 33.9% from \$73.2 million to \$98.0 million, respectively. These increases primarily were due to the initial release of Quake 3 Arena, Cabela's Big Game Hunter 3, Star Trek: Hidden Evil and Interstate '82.

For the three months ended December 31, 1999, distribution net revenues decreased 11.6% from \$96.6 million to \$85.4 million. Distribution net revenues also decreased 18.4% for the nine months then ended from \$177.0 million to \$144.4 million. The decrease for both the three month and nine month period was mainly attributable to the pricing reductions initiated by leading retail chains in the United Kingdom (UK), which in turn reduced market share for the independent retail channel in the UK to which the Company's Centresoft subsidiary is the sole authorized Playstation distributor.

Distribution console net revenues decreased by 11.5% during the three months ended December 31, 1999 from \$69.5 million to \$61.5 million. Distribution console net revenue decreased by 22.3% for the nine months then ended from \$133.2 million to \$103.5 million. Distribution PC net revenues decreased 11.8% for the three months ended December 31, 1999 from \$27.1 million to \$23.9 million. Distribution PC net revenues decreased 6.7% for the nine months then ended from \$43.8 million to \$40.9 million. These decreases were due to the lower overall sales experienced in the Distribution segment of the Company.

Net OEM, licensing, on-line and other revenues for the three and nine months ended December 31, 1999 increased 10.4% from \$7.7 million to \$8.5 million and 40.3% from \$13.9 million to \$19.5 million, respectively.

#### COSTS AND EXPENSES

Cost of sales - product costs represented 51.9% and 55.6% of net revenues for the three months ended December 31, 1999 and 1998, respectively. Cost of sales - product costs represented 55.3% and 59.3% of net revenues for the nine months ended December 31, 1999 and 1998, respectively. The decrease in cost of sales - product costs as a percentage of net revenues for both the three and nine months ended December 31, 1999 was due to the decrease in distribution net revenue, partially offset by a higher publishing console net revenue mix. Distribution products have a higher per unit product cost than publishing products and console products have a higher per unit product cost than PC products.

Cost of sales - royalty and software amortization expense represented 14.8% and 12.3% of net revenues for the three months ended December 31, 1999 and 1998, respectively. Cost of sales - royalty and software amortization expense represented 13.1% and 9.8% of net revenues for the nine months ended December 31, 1999 and 1998, respectively. The increase in cost of sales - royalty and software amortization expense as a percentage of net revenues for both the

three and nine months ended December 31, 1999 primarily was due to changes in the Company's product mix, with an increase in the number of branded products with higher royalty obligations as compared to the same periods last fiscal year, and increases in amortization expenses relating to the release of a greater number of products with capitalizable development costs.

Product development expenses for the three months ended December 31, 1999 increased 40.9% from the same period last year, from \$4.4 million to \$6.2 million. Product development expenses for the nine months ended December 31, 1999 increased 12.9% from the same period last year, from \$14.7 million to \$16.6 million. These increases primarily were due to a decrease in capitalizable development costs relating to sequel products being developed on proven engine technologies which are capitalized in accordance with Statement of Accounting Standards ("SFAS") No. 86, "Accounting for the Cost

of Computer Software to be Sold, Leased or Otherwise Marketed." As a percentage of net revenues, total product creation costs (i.e., royalties and software amortization expense plus product development expenses) increased from 14.6% to 17.1% and from 14.4% to 16.6% for the three and nine months ended December 31, 1999, respectively. Such increases primarily were attributable to the increase in product development costs, as stated above.

Sales and marketing expenses for the three months ended December 31, 1999 increased 38.1% from the same period last year, from \$26.0 million to \$35.9 million, yet decreased slightly as a percentage of net revenues to 13.3% from 13.5%. Sales and marketing expenses for the nine months ended December 31, 1999 increased 44.3% from \$50.6 million to \$73.0 million, while as a percentage of net revenues, they decreased slightly from 15.7% to 15.6%. The increases in the amount of sales and marketing expenses for the three and nine month periods primarily were due to an increase in the number of titles released during those respective periods and an increase in television advertising during the three months ended December 31, 1999. The slight decreases in sales and marketing expenses as a percentage of net revenues during the three and nine months ended December 31, 1999 primarily were due to lower marketing expenses required on branded properties such as Toy Story 2 and Quake 3 Arena.

General and administrative expenses for the three months ended December 31, 1999 increased 50.9% from the same period last year, from \$5.3 million to \$8.0 million. As a percentage of net revenues, general and administrative expenses for the three month period increased from 2.7% to 3.0%. General and administrative expense for the nine months ended December 31, 1999 increased 34.0%, from \$14.4 million to \$19.3 million. As a percentage of net revenues, general and administrative expenses for the nine month period decreased from 4.5% to 4.2%. The increases in the amount of general and administrative expenses for the three and nine month periods primarily were due to an increase in worldwide administrative support needs and headcount related expenses.

#### OPERATING INCOME (LOSS)

Operating income for the three months ended December 31, 1999 increased 47.5% from the same period last year, from \$25.9 million to \$38.2 million. Operating income for the nine months ended December 31, 1999 increased 102.8% from the same period last year, from \$17.6 million to \$35.7 million.

Publishing operating income for the three months ended December 31, 1999 increased 104.2% to \$33.7 million, compared to \$16.5 million in the same period last year. The period over period increase was due to an increase in publishing net revenues. Distribution operating income for the three months ended December 31, 1999 decreased 39.6% to \$5.8 million, compared to \$9.6 million in the same period last year. The period over period change primarily was due to a decrease in distribution sales and the UK price reductions, as noted earlier.

Publishing operating income for the nine months ended December 31, 1999 increased 277.2% to \$34.7 million, compared to \$9.2 million in the same period last year. The period over period increase primarily was due to an increase in publishing net revenues. Distribution operating income for the nine months ended December 31, 1999 decreased 59.0% to \$4.1 million, compared to \$10.0 million in the same period last year. The period over period change primarily was due to a decrease in distribution sales and the UK price reductions, as noted earlier.

#### PROVISION FOR INCOME TAXES

The income tax provision of approximately \$13.1 million and \$11.0 million for the three and nine months ended December 31, 1999, respectively, reflects the Company's estimated tax provision from the Company's net income for these periods using the estimated effective income tax rate of 37% for the fiscal year ended March 31, 2000. The realization of deferred tax assets primarily is dependent on the generation of future taxable income. Management

believes that it is more likely than not that the Company will generate taxable income sufficient to realize the benefit of the deferred tax assets recognized.

#### LIQUIDITY AND CAPITAL RESOURCES

The Company's cash and cash equivalents increased \$18.7 million, from \$33.0

million at March 31, 1999 to \$51.7 million at December 31, 1999. Approximately \$34.8 million in cash and cash equivalents were provided by operating activities during the nine months ended December 31, 1999.

In addition, approximately \$78.0 million in cash and cash equivalents were used in investing activities during the nine months ended December 31, 1999, as compared with approximately \$53.4 million used during the same period last year. The increase in cash used for investing activities is attributable to a large extent to the acquisition of Expert Software in June 1999 for approximately \$20.5 million in cash and other acquisition costs related to the transaction. Cash used in investing activities also increased due to an increase in prepaid royalties and capitalized software costs incurred by the Company as a result of its execution of new license and development agreements granting the Company long term rights to intellectual property of third parties, as well as the acquisition of publishing and distribution rights to products being developed by third parties. Capital expenditures totaled \$2.5 million during the nine months ended December 31, 1999.

Cash and cash equivalents provided by financing activities totaled \$63.0 million for the nine months ended December 31, 1999, compared to \$11.1 million provided by financing activities for the same period last year. This increase principally was due to the Company's receipt of \$25 million in proceeds from the term loan described below, \$14.9 million in proceeds from the exercise of employee stock options and \$31.5 million of net borrowings under the revolving credit facility described below.

In connection with the Company's purchases of N64 hardware and software cartridges for distribution in North America and Europe, Nintendo requires the Company to provide irrevocable letters of credit prior to accepting purchase orders from the Company for the purchase of these cartridges. Furthermore, Nintendo maintains a policy of not accepting returns of N64 hardware and software cartridges. Because of these and other factors, the carrying of an inventory of N64 hardware and software cartridges entails significant capital and risk.

In December 1997, the Company completed the private placement of \$60.0 million principal amount of 6 3/4% convertible subordinated notes due 2005 (the "Notes"). The Notes are convertible, in whole or in part, at the option of the holder at any time after December 22, 1997 (the date of original issuance) and prior to the close of business on the business day immediately preceding the maturity date, unless previously redeemed or repurchased, into common stock, \$.000001 par value, of the Company, at a conversion price of \$18.875 per share, (equivalent to a conversion rate of 52.9801 shares per \$1,000 principal amount of Notes), subject to adjustment in certain circumstances. The Notes are redeemable, in whole or in part, at the option of the Company at any time on or after January 10, 2001. If redemption occurs prior to December 31, 2001, the Company must pay a premium on such redeemed Notes.

The Company has a \$125.0 million revolving credit facility and term loan (the "Facility") with a group of banks. The Facility provides the Company with the ability to borrow up to \$100.0 million and issue letters of credit up to \$80.0 million on a revolving basis against eligible accounts receivable and inventory. The \$25.0 million term loan portion of the Facility was used to acquire Expert Software in June 1999 and to pay costs related to such acquisition and the securing of the Facility. The term loan has a three-year term with principal amortization on a straight-line quarterly basis beginning December 31, 1999 and a borrowing rate based on the banks' base rate (which is generally equivalent to the published prime rate) plus 2.0%, or LIBOR plus 3.0%. The revolving portion of the Facility has a borrowing rate based on the banks' base rate plus 1.75% or LIBOR plus 2.75%. The Company pays a commitment fee of 1/2% based on the unused portion of the facility. The Company had a balance outstanding of \$27.0 million under the revolving portion of the Facility at December 31, 1999. Letters of credit outstanding against the Facility totaled \$20.9 million at December 31, 1999.

The Company's CentreSoft subsidiary has a revolving credit facility (the "UK Facility") with its bank in the United Kingdom in the amount of approximately \$21.0 million. The UK Facility can be used for working capital requirements and expires in June 2000. The Company had no borrowings outstanding against the UK facility as of December 31, 1999 or March 31, 1999. Letters of credit outstanding against the UK Facility approximately totaled \$9.7 million at December 31, 1999.



The Company's NBG subsidiary has a revolving credit facility (the "German Facility") with a bank in Germany in the amount of \$2.0 million. The German Facility can be used for working capital requirements and has no expiration date. The Company had no borrowings outstanding against the German Facility as of December 31, 1999 or March 31, 1999.

The Company's CD Contact subsidiary has a credit facility in the Netherlands, ("the Netherlands Facility") with a bank that permits borrowings against eligible accounts receivable and inventory up to approximately \$25 million. Borrowings under the Netherlands Facility are due on demand and totaled \$4.5 at December 31, 1999 and \$6.0 million at March 31, 1999. Letters of credit outstanding under the Netherlands Facility totaled \$4.0 million at December 31, 1999 and \$6.9 million at March 31, 1999. The Netherlands Facility expires on March 31, 2001.

In addition, the Company had a line of credit agreement (the "Asset Line") with a bank that expired in September 1998. As of December 31, 1999, \$387 thousand was outstanding on this line.

Under the terms of a production financing arrangement, the Company has a commitment to purchase a future Playstation 2 title from an independent third party developer upon its completion for an estimated \$4.2 million. Failure by the developer to complete the project within the contractual time frame or specifications alleviates the Company's commitment.

The Company will use its working capital (\$170 million at December 31, 1999), as well as the proceeds available from the Facility, the UK Facility, the Netherlands Facility and the German Facility, to finance the Company's operational requirements, including acquisitions of inventory, equipment, the funding of development, production, marketing and selling of new products, and the acquisition of intellectual property rights for future products from third parties.

The Company's management currently believes that inflation has not had a material impact on continuing operations.

#### YEAR 2000

The Company in the transition to the year 2000 encountered no significant problems. All of the Company's internal systems are functioning normally, and no year 2000 problems have been reported by any of its trading partners. The Company will continue to monitor its systems for any latent issues, but expects no significant year 2000 issues to affect critical systems or products sold to customers. Adequate and customary contingency plans will be maintained to address any unexpected failures.

#### FACTORS AFFECTING FUTURE PERFORMANCE

In connection with the Private Securities Litigation Reform Act of 1995 (the "Litigation Reform Act"), the Company has 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 its employees and representatives that may contain "forward-looking statements" within the meaning of the Litigation Reform Act. Such statements consist of any statement other than a recitation of historical fact and can be identified by the use of forward-looking terminology such as "may," "expect," "anticipate," "estimate" or "continue" or the negative thereof or other variations thereon or comparable terminology. The listener or reader is cautioned that all forward-looking statements are necessarily speculative and there are numerous risks and uncertainties that could cause actual events or results to differ materially from those referred to in such forward-looking statements. For 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 the Company's Annual Report on Form 10-K which is incorporated herein by reference. The reader or listener is cautioned that the Company does not have a policy of updating or revising forward-looking statements and thus he or she should not assume that silence by management over time means that actual events are bearing out as estimated in such forward-looking statements.

Reference is made to Part II, Item 7A, Quantitative and Qualitative Disclosures About Market Risk, in the Registrant's Annual Report on Form 10-K for the year ended March 31, 1999. There has been no significant change in the nature or amount of market risk since year end.

PART II. - OTHER INFORMATION

ITEM 1. LEGAL PROCEEDINGS

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

ITEM 6. EXHIBITS AND REPORTS ON FORM 8-K

(a) Exhibits

None.

(b) Reports on Form 8-K

On October 13, 1999, the Company filed a Current Report on Form 8-K reporting its acquisition of JCM Productions, Inc. dba Neversoft Entertainment.

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SIGNATURES

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

Date: February 14, 2000

ACTIVISION, INC.

/s/ Ron Doornink	President and Chief Operating Officer	February 14, 2000
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(Ron Doornink)	(Principal Financial Officer)	

/s/ Jenniffer Koh	Corporate Controller	February 14, 2000
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(Jenniffer Koh)	(Principal Accounting Officer)	

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