ACTIVISION INC /NY
Form 10-Q
June 07, 2007

UNITED STATES

SECURITIES AND EXCHANGE COMMISSION

Washington, D.C. 20549

FORM 10-Q

(Mark one)

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

For the Quarterly Period Ended December 31, 2006

OR

o **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 001-15839

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 x No o

Indicate by check mark whether the registrant is a large accelerated filer, an accelerated filer, or a non-accelerated filer. See definition of accelerated filer and large accelerated filer in Rule 12b-2 of the Exchange Act. (Check one):

Large Accelerated Filer x Accelerated Filer o Non-accelerated filer o

Indicate by check mark whether the registrant is a shell company (as defined in Rule 12b-2 of the Act). Yes o No x

The number of shares of the registrant s Common Stock outstanding as of June 1, 2007 was 283,310,734.

ACTIVISION, INC. AND SUBSIDIARIES

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CAUTIONARY STATEMENT

This Quarterly Report on Form 10-Q contains, or incorporates by reference, certain forward-looking statements within the meaning of the Private Securities Litigation Reform Act of 1995. Such statements include, but are not limited to, (1) projections of revenues, expenses, income or loss, earnings or loss per share, cash flow projections or other financial items; (2) statements of our plans and objectives, including those relating to product releases; (3) statements of future economic performance; and (4) statements of assumptions underlying such statements. We generally use words such as anticipate , believe , could , estimate , expect , forecast , future , intend , may , plan , positioned , potential , project , scheduled , set to , subject to , upcoming and other similar expressions to help identify forward-looking statements. These forward-looking statements are subject to business and economic risk, reflect management s current expectations, estimates and projections about our business, and are inherently uncertain and difficult to predict. Our actual results could differ materially. The forward-looking statements contained herein speak only as of the date on which they were made, and we disclaim any obligation to update any forward-looking statements to reflect events or circumstances after the date of this Quarterly Report. Risks and uncertainties that may affect our future results include, but are not limited to, those discussed under the heading Risk Factors , included in Part II, Item 1A. All references to we , us , our , Activision or the Company in the following discussion and analysis mean Activision, Inc. and its subsidiaries.

EXPLANATORY NOTE

Restatement of Consolidated Financial Results

We recently completed a voluntary review of our historical stock option granting practices and a restatement of our consolidated financial statements as of and for the fiscal years ended March 31, 2006, 2005 and 2004 and related disclosures and a restatement of our selected consolidated financial data as of and for the fiscal years ended March 31, 2006, 2005, 2004, 2003 and 2002 and our unaudited quarterly financial data for each of the quarters in the fiscal years ended March 31, 2006 and 2005, and for the fiscal quarter ended June 30, 2006. The impacts of the restatement adjustments extend to periods from the fiscal year ended March 31, 1994 through the fiscal quarter ended June 30, 2006.

The restatement reflected the findings of a special subcommittee of independent members of our Board of Directors, which was established in July 2006 to review our historical stock option granting practices (the Special Subcommittee). The Special Subcommittee conducted its investigation with the assistance of Munger Tolles & Olson LLP as its independent counsel and Deloitte & Touche USA LLP (Deloitte) as forensic accounting experts retained by counsel. The Special Subcommittee found that 3,450 of the option grants reviewed, covering 148,747,202 shares, required measurement date corrections. As a result, we recorded approximately $66.7 million in additional pre-tax ($45.4 million after-tax) non-cash stock-based compensation expense over the thirteen year period from April 1, 1993 through March 31, 2006 in accordance with Accounting Principles Board Opinion No. 25, Accounting for Stock Issued to Employees (APB No. 25), and $0.6 million in additional pre-tax non-cash stock-based compensation expense during the quarter ended June 30, 2006 in accordance with Statement of Financial Accounting Standards (SFAS) No. 123(R), Share-Based Payment . More than 80% or $55.4 million of the $66.7 million relates to periods through March 31, 2003 and 4% or $2.6 million of the non-cash pre-tax expense relates to the fiscal year ended March 31, 2006. Separately, the restatement reflects an additional $1.7 million pre-tax charge ($1.1 million after-tax) related to recently identified insufficient payroll tax withholdings in fiscal 2005.

This Quarterly Report on Form 10-Q should be read in conjunction with our Amended Annual Report on Form 10-K/A for the year ended March 31, 2006 filed with the SEC on May 25, 2007 and our Amended Quarterly Report on Form 10-Q/A for the three months ended June 30, 2006 filed with the SEC on June 7, 2007. Information regarding the effect of the restatement on our financial position and results of operations is provided in Note 2 of the Notes to Unaudited Consolidated Financial Statements included in Part I, Item 1 of this Report and Management s Discussion and Analysis of Financial Condition and Results of Operations in Part I, Item 2 of this Report.

Financial information included in our previously filed reports on Form 10-K and Form 10-Q, the related opinions of our independent registered public accounting firm, and all earnings press releases and similar communications issued by us, for all periods ended on or before June 30, 2006 should not be relied upon and are superseded in their entirety by the information in our amended Annual Report on Form 10-K/A for the year ended March 31, 2006 filed with the SEC on May 25, 2007 and our Amended Quarterly Report on Form 10-Q/A for the three months ended June 30, 2006 and our Quarterly Reports on Form 10-Q for the three months ended September 30, 2006 and the three months ended December 31, 2006 filed with the SEC today.

All share and per share information presented in this report has been adjusted to reflect splits and dividends of our common stock.

PART I. **FINANCIAL INFORMATION.**

Item 1. Financial Statements.

ACTIVISION, INC. AND SUBSIDIARIES
CONSOLIDATED BALANCE SHEETS

(In thousands, except share data)

	December 31, 2006	March 31, 2006
	(Unaudited)	
Assets		
Current assets:		
Cash and cash equivalents	$ 367,910	$ 354,331
Short-term investments	437,290	590,629
Accounts receivable, net of allowances of $107,124 and $98,253 at December 31, 2006 and March 31, 2006, respectively	456,589	28,782
Inventories	85,680	61,483
Software development	86,119	40,260
Intellectual property licenses	28,628	4,973
Deferred income taxes	4,266	9,664
Other current assets	17,896	25,933
Total current assets	1,484,378	1,116,055
Software development	15,688	20,359
Intellectual property licenses	64,800	82,073
Property and equipment, net	46,713	45,368
Deferred income taxes	85,552	52,545
Other assets	5,941	1,409
Goodwill	188,398	100,446
Total assets	$ 1,891,470	$ 1,418,255
Liabilities and Shareholders Equity		
Current liabilities:		
Accounts payable	$ 193,875	$ 88,994
Accrued expenses	247,581	104,862
Total current liabilities	441,456	193,856
Other liabilities	41,128	1,776
Total liabilities	482,584	195,632
Commitments and contingencies (Note 14)		
Shareholders equity:		
Preferred stock, $.000001 par value, 3,750,000 shares authorized, no shares issued at December 31, 2006 and March 31, 2006		

Series A Junior Preferred stock, $.000001 par value, 1,250,000 shares authorized, no shares issued at December 31, 2006 and March 31, 2006		
Common stock, $.000001 par value, 450,000,000 shares authorized, 282,934,869 and 277,020,898 shares issued and outstanding at December 31, 2006 and March 31, 2006, respectively		
Additional paid-in capital	948,028	867,297
Retained earnings	442,199	341,990
Accumulated other comprehensive income	18,659	16,369
Unearned compensation (Note 1)		(3,033)
Total shareholders equity	1,408,886	1,222,623
Total liabilities and shareholders equity	$ 1,891,470	$ 1,418,255

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

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ACTIVISION, INC. AND SUBSIDIARIES
CONSOLIDATED STATEMENTS OF OPERATIONS

(Unaudited)

(In thousands, except per share data)

	For the three months ended December 31,		For the nine months ended December 31,	
	2006	2005	2006	2005
		As restated(1)		As restated(1)
Net revenues	$ 824,259	$ 816,242	$ 1,200,500	$ 1,279,875
Costs and expenses:				
Cost of sales product costs	382,165	367,685	618,162	617,021
Cost of sales software royalties and amortization	77,449	104,264	106,058	139,267
Cost of sales intellectual property licenses	23,566	26,376	37,838	55,765
Product development	37,162	53,254	88,395	99,698
Sales and marketing	87,410	156,013	156,139	259,110
General and administrative	43,387	24,757	91,647	67,228
Total costs and expenses	651,139	732,349	1,098,239	1,238,089
Operating income	173,120	83,893	102,261	41,786
Investment income, net	9,724	9,162	26,031	22,840
Income before income tax provision	182,844	93,055	128,292	64,626
Income tax provision	40,024	25,199	28,083	15,247
Net income	$ 142,820	$ 67,856	$ 100,209	$ 49,379
Basic earnings per share	$ 0.51	$ 0.25	$ 0.36	$ 0.18
Weighted average common shares outstanding	282,512	274,965	280,499	272,089
Diluted earning per share	$ 0.46	$ 0.23	$ 0.33	$ 0.17
Weighted average common shares outstanding assuming dilution	307,175	296,205	304,317	293,397

(1) See Note 2 Restatement of Unaudited Consolidated Financial Statements.

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

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

	For the nine months ended December 31,	
	2006	**2005**
		As restated(1)
Cash flows from operating activities:		
Net income	$ 100,209	$ 49,379
Adjustments to reconcile net income to net cash used in operating activities:		
Deferred income taxes	(33,254)	(6,023)
Realized gain on short-term investments	(1,823)	(4,295)
Depreciation and amortization	13,303	10,228
Amortization and write-offs of capitalized software development costs and intellectual property licenses	77,358	168,351
Stock-based compensation expense	18,433	2,506
Tax benefit of stock options and warrants exercised	11,377	21,269
Excess tax benefit from stock option exercises	(9,012)	
Changes in operating assets and liabilities:		
Accounts receivable	(416,697)	(305,305)
Inventories	(20,573)	(36,810)
Software development and intellectual property licenses	(117,636)	(162,793)
Other assets	21,128	321
Accounts payable	98,473	104,895
Accrued expenses and other liabilities	133,297	74,345
Net cash used in operating activities	(125,417)	(83,932)
Cash flows from investing activities:		
Capital expenditures	(13,106)	(20,174)
Cash payment to effect business combinations, net of cash acquired	(30,545)	(7,081)
Increase in restricted cash		(7,500)
Purchases of short-term investments	(215,721)	(143,162)
Proceeds from sales and maturities of short-term investments	361,339	182,504
Net cash provided by investing activities	101,967	4,587
Cash flows from financing activities:		
Proceeds from issuance of common stock to employees	18,956	37,850
Excess tax benefit from stock option exercises	9,012	
Net cash provided by financing activities	27,968	37,850
Effect of exchange rate changes on cash	9,061	(5,044)
Net increase (decrease) in cash and cash equivalents	13,579	(46,539)
Cash and cash equivalents at beginning of period	354,331	313,608
Cash and cash equivalents at end of period	$ 367,910	$ 267,069

(1) See Note 2 Restatement of Unaudited Consolidated Financial Statements.

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 Nine Months ended December 31, 2006
(Unaudited)
(In thousands)

	Common Stock Shares	Amount	Additional Paid-In Capital	Retained Earnings	Accumulated Other Comprehensive Income	Unearned Compensation	Shareholders Equity
Balance, March 31, 2006	**277,021**	**$**	**$ 867,297**	**$ 341,990**	**$ 16,369**	**$ (3,033)**	**$ 1,222,623**
Components of comprehensive income:							
Net income				100,209			100,209
Unrealized loss on short-term investments (net of tax benefit of $0.9 million)					(8,693)		(8,693)
Foreign currency translation adjustment					10,983		10,983
Total comprehensive income							102,499
Issuance of common stock pursuant to employee stock option and stock purchase plans	3,532		18,956				18,956
Issuance of stock to effect business combination	2,382		30,000				30,000
Stock based compensation expense related to employee stock options, restricted stock, and employee stock purchases			23,431				23,431
Tax benefit associated with options and warrants			11,377				11,377
Reclassification of unearned compensation			(3,033)			3,033	
Balance, December 31, 2006	**282,935**	**$**	**$ 948,028**	**$ 442,199**	**$ 18,659**	**$**	**$ 1,408,886**

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

ACTIVISION, INC. AND SUBSIDIARIES

Notes to Consolidated Financial Statements

For the Three and Nine Months ended December 31, 2006

(Unaudited)

1. Summary of Significant Accounting Policies

Basis of Presentation

The accompanying consolidated financial statements include the accounts of Activision, Inc. and its subsidiaries (Activision, the Company, 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. The Consolidated Financial Statements should be read in conjunction with the Consolidated Financial Statements included in our Amended Annual Report on Form 10-K/A for the year ended March 31, 2006 as filed with the Securities and Exchange Commission (SEC) on May 25, 2007.

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 Statement of Financial Accounting Standards No. 86, Accounting for the Costs of Computer Software to Be Sold, Leased, or Otherwise Marketed. Software development costs are capitalized once the 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 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 net realizable value may be lower than originally estimated in any given quarter, which could result in an impairment charge.

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.

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ACTIVISION, INC. AND SUBSIDIARIES

Notes to Consolidated Financial Statements

For the Three and Nine Months ended December 31, 2006

(Unaudited)

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 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 net realizable value may be lower than originally estimated in any given quarter, which could result in an impairment charge. 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 (i.e., a date on which products are made widely available by retailers). For these products we recognize revenue no earlier than 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. With respect to on-line transactions, such as electronic downloads of titles or product add-ons, revenue is recognized when the fee is paid by the on-line customer to purchase online content and we are notified by the online retailer that the product has been downloaded. 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.

ACTIVISION, INC. AND SUBSIDIARIES

Notes to Consolidated Financial Statements

For the Three and Nine Months ended December 31, 2006

(Unaudited)

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.

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 us 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, and consistent delivery to us of inventory and sell-through reports. 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; our 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 factors or market conditions change or if management makes different judgments or utilizes different estimates in determining the allowances for returns and price protection. For example, a 1% change in our December 31, 2006 allowance for returns and price protection would impact net revenues by $1.1 million.

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 affect management s estimates in establishing our allowance for doubtful accounts.

ACTIVISION, INC. AND SUBSIDIARIES

Notes to Consolidated Financial Statements

For the Three and Nine Months ended December 31, 2006

(Unaudited)

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.

Stock-Based Compensation

On April 1, 2006, we adopted Statement of Financial Accounting Standards No. 123 (revised 2004), Share-Based Payment (SFAS 123R), which requires the measurement and recognition of compensation expense for all share-based payment awards made to employees and directors, including employee stock options and employee stock purchases related to the Employee Stock Purchase Plan (employee stock purchases), based on estimated fair values. SFAS 123R supersedes our previous accounting under Accounting Principles Board Opinion No. 25, Accounting for Stock Issued to Employees (APB 25). In March 2005, the SEC issued Staff Accounting Bulletin No. 107 (SAB 107) relating to SFAS 123R. We have applied the provisions of SAB 107 in our adoption of SFAS 123R.

We adopted SFAS 123R using the modified prospective transition method, which requires the application of the accounting standard as of April 1, 2006, the first day of our fiscal year 2007. The Company s Consolidated Financial Statements as of and for the three and nine months ended December 31, 2006 reflect the impact of SFAS 123R. In accordance with the modified prospective transition method, the Company s Consolidated Financial Statements for prior periods have not been restated to reflect, and do not include, the impact of SFAS 123R. Stock-based compensation expense recognized under SFAS 123R for the three and nine months ended December 31, 2006 was $7.7 million and $18.4 million, respectively. See Note 15 for additional information.

SFAS 123R requires companies to estimate the fair value of share-based payment awards on the measurement date using an option-pricing model. The value of the portion of the award that is ultimately expected to vest is recognized as expense over the requisite service periods in our Consolidated Statement of Operations. Prior to the adoption of SFAS 123R, the Company accounted for stock-based awards to employees and directors using the intrinsic value method in accordance with APB 25 as allowed under Statement of Financial Accounting Standards No. 123, Accounting for Stock-Based Compensation (SFAS 123). Under APB 25, compensation expense was 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 was recorded on the measurement date only if the current market price of the underlying stock exceeded the stock option or other stock-based award s exercise price. For the three and nine months ended December 31, 2005, we recognized $322,000 and $2.5 million, respectively, in stock-based compensation expense related to employee stock options and restricted stock, under APB 25. See Notes 2 and 15 for additional information.

Stock-based compensation expense recognized during the period is based on the value of the portion of share-based payment awards that is ultimately expected to vest during the period. Stock-based compensation expense recognized in our Consolidated Statements of Operations for the three and nine months ended December 31, 2006 included compensation expense for share-based payment awards granted prior to, but not yet vested as of, April 1, 2006 based on the grant date fair value estimated in accordance with the pro forma provisions of SFAS 123, and compensation expense for the share-based payment awards granted subsequent to April 1, 2006 based on the grant date fair value estimated in accordance with the provisions of SFAS 123R. As stock-based compensation expense recognized in the Consolidated Statements of Operations for the three and nine months ended December 31, 2006 is based on awards ultimately expected to vest, it has been reduced for estimated forfeitures. SFAS 123R requires forfeitures to be estimated at the time of grant and revised, if necessary, in subsequent periods if actual forfeitures differ from those estimates.

ACTIVISION, INC. AND SUBSIDIARIES

Notes to Consolidated Financial Statements

For the Three and Nine Months ended December 31, 2006

(Unaudited)

As of April 1, 2005, we changed our method of valuation for share-based awards to a binomial-lattice model from the Black-Scholes option-pricing model (Black-Scholes model) which was used for options granted prior to April 1, 2005. For additional information, see Note 15. Our determination of fair value of share-based payment awards on the date of grant using an option-pricing model is affected by our stock price as well as assumptions regarding a number of highly complex and subjective variables. These variables include, but are not limited to our expected stock price volatility over the term of the awards, and actual and projected employee stock option exercise behaviors.

Restricted Stock

In June 2005, we issued the rights to 155,763 shares of restricted stock to an employee. Additionally, in October 2005 we issued the rights to 96,712 shares of restricted stock to an employee. These shares all vest over a five-year period and remain subject to forfeiture if vesting conditions are not met. In accordance with APB 25, we recognized unearned compensation in connection with the grant of restricted shares equal to the fair value of our common stock on the date of grant. The fair value of these shares when issued was approximately $12.84 and $15.51 per share, respectively, and resulted in a total increase in Additional paid-in capital and Unearned compensation of $2.0 million and $1.5 million on the respective balance sheets at the times of grant. Prior to the adoption of SFAS 123R, we reduced unearned compensation and recognized compensation expense over the vesting periods. Upon adoption of SFAS 123R, unearned compensation was reclassified against additional paid in capital and we will increase additional paid in capital and recognize compensation expense over the respective remaining vesting periods. Additionally, in the third quarter of fiscal 2007 we issued the rights to an aggregate of 81,000 shares of restricted stock to various employees. These shares vest over two and three year periods (with some subject to vesting acceleration clauses if the holder achieves certain performance objectives) and remain subject to forfeiture if vesting conditions are not met. In accordance with SFAS 123R we will recognize compensation expense and increase additional paid in capital related to these restricted stock shares over the requisite service period. For the three and nine months ended December 31, 2006, we recorded expenses related to these shares of approximately $292,000 and $642,000, respectively, which was included as a component of stock-based compensation expense within General and administrative on the accompanying Consolidated Statements of Operations. Since the issuance dates, we have recognized $1.1 million of the $4.8 million total fair value, with the remainder to be recognized over a weighted-average period of 3.12 years.

2. <u>Restatement of Unaudited Consolidated Financial Statements</u>

We recently completed a voluntary review of our historical stock option granting practices and a restatement of our consolidated financial statements as of and for the fiscal years ended March 31, 2006, 2005 and 2004 and related disclosures and a restatement of our selected consolidated financial data as of and for the fiscal years ended March 31, 2006, 2005, 2004, 2003 and 2002 and our unaudited quarterly financial data for each of the quarters in the fiscal years ended March 31, 2006 and 2005, and the fiscal quarter ended June 30, 2006. The impacts of the restatement adjustments extend to periods from the fiscal year ended March 31, 1994 through the fiscal quarter ended June 30, 2006.

The restatement reflects the findings of a special subcommittee of independent members of our Board of Directors, which was established in July 2006 to review our historical stock option granting practices (the Special Subcommittee). The Special Subcommittee conducted its investigation with the assistance of Munger Tolles & Olson LLP as its independent counsel and Deloitte & Touche USA LLP (Deloitte) as forensic accounting experts retained by counsel. The Special Subcommittee found that 3,450 of the option grants reviewed, covering 148,747,202 shares, required measurement date corrections. As a result, we recorded approximately $66.7 million in additional pre-tax ($45.4 million after-tax) non-cash stock-based compensation expense over the thirteen year period from April 1, 1993 through March 31, 2006 in accordance with APB 25, and $0.6 million in additional pre-tax non-cash stock-based compensation expense during the quarter ended June 30, 2006 in accordance with SFAS 123R. More than 80% or $55.4 million of the $66.7 million relates to periods through March 31, 2003 and 4% or $2.6 million of the non-

ACTIVISION, INC. AND SUBSIDIARIES

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For the Three and Nine Months ended December 31, 2006

(Unaudited)

cash pre-tax expense relates to the fiscal year ended March 31, 2006. Separately, the restatement reflected an additional $1.7 million pre-tax charge ($1.1 million after-tax) related to recently identified insufficient payroll tax withholdings in fiscal 2005. Additional information regarding the restatement is available with the Company s Amended Annual Report on Form 10-K/A for the period ending March 31, 2006.

The following table summarizes additional pre-tax stock-based compensation expense and related tax adjustments resulting from the review of our equity award practices for the three and nine months ended December 31, 2005 (in thousands):

	For the three months ended December 31, 2005	**For the nine months ended December 31, 2005**
Net income, as previously reported	$ 67,945	$ 51,118
Additional compensation expense resulting from improper measurement dates for stock option grants (1)	174	2,286
Tax related effects	(85)	(547)
Total effect on net income	89	1,739
Net income, as restated	$ 67,856	$ 49,379

(1) Also includes an immaterial amount of interest expense related to our $1.7 million charge for insufficient payroll tax withholdings in fiscal 2005.

The following tables reflect the impact of the additional non-cash charges for stock-based compensation expense and related tax effects on:

Certain Tax Consequences: Certain stock options were granted with an exercise price lower than the fair market value on the actual measurement dates, with vesting occurring after December 31, 2004, which resulted in nonqualified deferred compensation for purposes of Section 409A of the Internal Revenue Code. Section 409A subjects the option holders to additional income tax, penalties and interest on the value of the options deferred and, in certain cases, exercised each year. We do not have any tax liability associated with Section 409A. For options that have already been exercised by non-executive officer employees, that are subject to Section 409A consequences, the Company has elected to participate in the Internal Revenue Service program described in IRS Announcement 2007-18 pursuant to which the Company was able to pay the Section 409A taxes on behalf of its non-executive officer employees, and has incurred $7.3 million in additional pre-tax compensation expense in the fiscal quarter ended March 31, 2007, in absorbing these related costs on behalf of these employees. With respect to unexercised options subject to Section 409A held by such current and former non-executive officer employees, the Company on or about June 7, 2007 is commencing an offer to amend the exercise price of these options to eliminate their Section 409A tax liability consistent with Internal Revenue Service guidance. Pursuant to the offer, the Company will also make a cash payment in January 2008 to employees who accept the offer, in an amount equal to the difference between the original exercise price of each amended option and the amended exercise price of each amended option. This will likely result in additional future compensation expense to the Company once these actions occur.

- the Consolidated Statements of Operations for the three and nine months ended December 31, 2005 (Unaudited).

- the Consolidated Statement of Cash Flows for the nine months ended December 31, 2005 (Unaudited).

- the pro forma information required by SFAS No. 123 for the three and nine months ended December 31, 2005 (Unaudited).

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Notes to Consolidated Financial Statements

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Consolidated Statement of Operations (Unaudited)

(in thousands, except per share data)	For the three months ended December 31, 2005 As previously reported	Adjustments	As restated
Net revenues	$ 816,242	$	$ 816,242
Costs and expenses:			
Cost of sales product costs	367,685		367,685
Cost of sales software royalties and amortization	104,264		104,264
Cost of sales intellectual property licenses	26,376		26,376
Product development	53,139	115	53,254
Sales and marketing	155,999	14	156,013
General and administrative	24,712	45	24,757
Total costs and expenses	732,175	174	732,349
Operating income	84,067	(174)	83,893
Investment income, net	9,162		9,162
Income before income tax provision	93,229	(174)	93,055
Income tax provision	25,284	(85)	25,199
Net income	$ 67,945	$ (89)	$ 67,856
Basic earnings per share	$ 0.25	$	$ 0.25
Weighted average common shares outstanding	274,965		274,965
Diluted earnings per share	$ 0.23	$	$ 0.23
Weighted average common shares outstanding assuming dilution	298,752	(2,547)	296,205

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For the Three and Nine Months ended December 31, 2006

(Unaudited)

Consolidated Statement of Operations (Unaudited)

(in thousands, except per share data)	**For the nine months ended December 31, 2005** **As previously reported**	**Adjustments**	**As restated**
Net revenues	$ 1,279,875	$	$ 1,279,875
Costs and expenses:			
Cost of sales product costs	617,021		617,021
Cost of sales software royalties and amortization	139,267		139,267
Cost of sales intellectual property licenses	55,765		55,765
Product development	99,013	685	99,698
Sales and marketing	258,957	153	259,110
General and administrative	65,780	1,448	67,228
Total costs and expenses	1,235,803	2,286	1,238,089
Operating income	44,072	(2,286)	41,786
Investment income, net	22,840		22,840
Income before income tax provision	66,912	(2,286)	64,626
Income tax provision	15,794	(547)	15,247
Net income	$ 51,118	$ (1,739)	$ 49,379
Basic earnings per share	$ 0.19	$ (0.01)	$ 0.18
Weighted average common shares outstanding	272,089		272,089
Diluted earnings per share	$ 0.17	$	$ 0.17
Weighted average common shares outstanding assuming dilution	295,963	(2,566)	293,397

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For the Three and Nine Months ended December 31, 2006

(Unaudited)

Consolidated Statement of Cash Flows (Unaudited)

	For the nine months ended December 31, 2005		
(in thousands)	**As previously reported**	**Adjustments**	**As restated**
Cash flows from operating activities:			
Net income	$ 51,118	$ (1,739)	$ 49,379
Adjustments to reconcile net loss to net cash used in operating activities:			
Deferred income taxes	(10,819)	4,796	(6,023)
Realized gain on sale of short term investments	(4,295)		(4,295)
Depreciation and amortization	10,228		10,228
Amortization of capitalized software development costs and intellectual property licenses	168,351		168,351
Stock-based compensation expense	292	2,214	2,506
Tax benefit of stock options and warrants exercised	26,612	(5,343)	21,269
Changes in operating assets and liabilities (net of effects of acquisitions):			
Accounts receivable	(305,305)		(305,305)
Inventories	(36,810)		(36,810)
Software development and intellectual property licenses	(162,793)		(162,793)
Other assets	321		321
Accounts payable	104,895		104,895
Accrued expenses and other liabilities	74,273	72	74,345
Net cash used in operating activities	(83,932)		(83,932)
Cash flows from investing activities:			
Capital expenditures	(20,174)		(20,174)
Cash payments to effect business combinations, net of cash acquired	(7,081)		(7,081)
Increase in restricted cash	(7,500)		(7,500)
Purchases of short-term investments	(143,162)		(143,162)
Proceeds from sales and maturities of short-term investments	182,504		182,504
Net cash provided by investing activities	4,587		4,587
Cash flows from financing activities:			
Proceeds from issuance of common stock to employees	37,850		37,850
Net cash provided by financing activities	37,850		37,850
Effect of exchange rate changes on cash	(5,044)		(5,044)
Net decrease in cash and cash equivalents	(46,539)		(46,539)
Cash and cash equivalents at beginning of period			