ACTIVISION INC /NY
Form 10-Q
February 11, 2008

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, 2007

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, a non-accelerated filer, or a smaller reporting company. See the definitions of large accelerated filer, accelerated filer, and smaller reporting company in Rule 12b-2 of the Exchange Act. (Check one):

Large Accelerated Filer x Accelerated Filer o Non-accelerated filer o (Do not check if a smaller reporting company) Smaller reporting company 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 February 4, 2008 was 293,913,474.

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, outlook, plan, positioned, potential, project, remain, scheduled, set to, subject to, to be, upcoming, will, 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 I, Item 1A of our Annual Report on Form 10-K for the fiscal year ended March 31, 2007 and in Part II, Item 1A of this Quarterly Report. All references to we, us, our, Activision or the Company in the following discussion and analysis mean Activision, Inc. and its subsidiaries.

Part I. Financial Information

Item 1. Financial Statements

ACTIVISION, INC. AND SUBSIDIARIES
CONSOLIDATED BALANCE SHEETS

(In thousands, except share data)

	December 31, 2007	March 31, 2007
	(Unaudited)	
Assets		
Current assets:		
Cash and cash equivalents	$ 648,659	$ 384,409
Short-term investments	539,914	570,440
Accounts receivable, net of allowances of $177,533 and $91,418 at December 31, 2007 and March 31, 2007, respectively	704,075	148,694
Inventories	153,423	91,231
Software development	68,240	107,779
Intellectual property licenses	16,686	27,784
Deferred income taxes	20,552	51,564
Other current assets	25,812	19,332
Total current assets	2,177,361	1,401,233
Software development	31,555	23,143
Intellectual property licenses	60,940	72,490
Property and equipment, net	54,203	46,540
Deferred income taxes	119	48,791
Other assets	9,639	6,376
Goodwill	279,297	195,374
Total assets	$ 2,613,114	$ 1,793,947
Liabilities and Shareholders Equity		
Current liabilities:		
Accounts payable	$ 243,338	$ 136,517
Accrued expenses and other liabilities	482,367	204,652
Total current liabilities	725,705	341,169
Other liabilities	21,009	41,246
Total liabilities	746,714	382,415
Commitments and contingencies (Note 12)		
Shareholders equity:		
Preferred stock, $.000001 par value, 3,750,000 shares authorized, no shares issued at December 31, 2007 and March 31, 2007		
Series A Junior Preferred stock, $.000001 par value, 1,250,000 shares authorized, no shares issued at December 31, 2007 and March 31, 2007		
Common stock, $.000001 par value, 450,000,000 shares authorized, 293,720,682 and 283,310,734 shares issued and outstanding at December 31, 2007 and March 31, 2007, respectively		
Additional paid-in capital	1,113,963	963,553
Retained earnings	728,497	427,777
Accumulated other comprehensive income	23,940	20,202

Total shareholders equity	1,866,400	1,411,532
Total liabilities and shareholders equity	$ 2,613,114	$ 1,793,947

The accompanying notes are an integral part of these Consolidated Financial Statements.

ACTIVISION, INC. AND SUBSIDIARIES
CONSOLIDATED STATEMENTS OF OPERATIONS

(Unaudited)

(In thousands, except per share data)

	For the three months ended December 31,		For the nine months ended December 31,	
	2007	2006	2007	2006
Net revenues	$ 1,482,484	$ 824,259	$ 2,295,685	$ 1,200,500
Costs and expenses:				
Cost of sales product costs	597,046	382,165	966,271	618,162
Cost of sales software royalties and amortization	125,614	77,449	242,293	106,058
Cost of sales intellectual property licenses	39,630	23,566	86,642	37,838
Product development	124,501	37,162	190,483	88,395
Sales and marketing	120,090	87,410	240,670	156,139
General and administrative	71,069	43,387	144,245	91,647
Total costs and expenses	1,077,950	651,139	1,870,604	1,098,239
Operating income	404,534	173,120	425,081	102,261
Investment income, net	12,018	9,724	35,712	26,031
Income before income tax provision	416,552	182,844	460,793	128,292
Income tax provision	144,356	40,024	160,073	28,083
Net income	$ 272,196	$ 142,820	$ 300,720	$ 100,209
Basic earnings per share	$ 0.93	$ 0.51	$ 1.05	$ 0.36
Weighted average common shares outstanding	291,176	282,512	287,439	280,499
Diluted earnings per share	$ 0.86	$ 0.46	$ 0.96	$ 0.33
Weighted average common shares outstanding assuming dilution	316,472	307,175	313,546	304,317

The accompanying notes are an integral part of these Consolidated Financial Statements.

ACTIVISION, INC. AND SUBSIDIARIES
CONSOLIDATED STATEMENTS OF CASH FLOWS

(Unaudited)
(In thousands)

	For the nine months ended December 31, 2007	2006
Cash flows from operating activities:		
Net income	$ 300,720	$ 100,209
Adjustments to reconcile net income to net cash provided by (used in) operating activities:		
Deferred income taxes	76,258	(33,254)
Realized gain on short-term investments	(2)	(1,823)
Depreciation and amortization	26,115	13,303
Loss on disposal of property and equipment	1,204	
Amortization and write-offs of capitalized software development costs and intellectual property licenses (1)	181,983	77,358
Stock-based compensation expense (2)	35,933	18,433
Tax benefit of stock options and warrants exercised	50,737	11,377
Excess tax benefits from stock option exercises	(50,548)	(9,012)
Changes in operating assets and liabilities:		
Accounts receivable	(553,071)	(416,697)
Inventories	(62,192)	(20,573)
Software development and intellectual property licenses	(127,057)	(117,636)
Other assets	(7,101)	21,128
Accounts payable	106,945	98,473
Accrued expenses and other liabilities	251,983	133,297
Net cash provided by (used in) operating activities	231,907	(125,417)
Cash flows from investing activities:		
Capital expenditures	(22,750)	(13,106)
Proceeds from disposal of property and equipment	351	
Cash payment to effect business combinations, net of cash acquired	(68,875)	(30,545)
Increase in restricted cash	(4,135)	
Purchases of short-term investments	(507,591)	(215,721)
Proceeds from sales and maturities of short-term investments	543,450	361,339
Net cash provided by (used in) investing activities	(59,550)	101,967
Cash flows from financing activities:		
Proceeds from issuance of common stock to employees	38,964	18,956
Excess tax benefits from stock option exercises	50,548	9,012
Net cash provided by financing activities	89,512	27,968
Effect of exchange rate changes on cash	2,381	9,061
Net increase in cash and cash equivalents	264,250	13,579
Cash and cash equivalents at beginning of period	384,409	354,331
Cash and cash equivalents at end of period	$ 648,659	$ 367,910

(1) Excludes amortization of stock-based compensation expense.

(2) Includes the net effects of capitalization and amortization of stock-based compensation expense.

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, 2007

(Unaudited)
(In thousands)

	Common Stock Shares	Common Stock Amount	Additional Paid-In Capital	Retained Earnings	Accumulated Other Comprehensive Income	Shareholders Equity
Balance, March 31, 2007	**283,311**	**$**	**$ 963,553**	**$ 427,777**	**$ 20,202**	**$ 1,411,532**
Components of comprehensive income:						
Net income				300,720		300,720
Unrealized appreciation on short-term investments, net of taxes					733	733
Foreign currency translation adjustment					3,005	3,005
Total comprehensive income						304,458
Issuance of common stock pursuant to employee stock options, restricted stock rights, employee stock purchase plans and employee bonuses	9,024		40,821			40,821
Issuance of common stock to effect business combination (see Note 4)	1,386		25,864			25,864
Stock-based compensation expense related to employee stock options, restricted stock rights, and employee stock purchase plans			36,051			36,051
Tax benefit associated with employee stock options			50,737			50,737
Employee tender offer (see Note 13)			(3,063)			(3,063)
Balance, December 31, 2007	**293,721**	**$**	**$ 1,113,963**	**$ 728,497**	**$ 23,940**	**$ 1,866,400**

The accompanying notes are an integral part of these Consolidated Financial Statements.

ACTIVISION, INC. AND SUBSIDIARIES

Notes to Consolidated Financial Statements

(Unaudited)

1. Basis of Presentation

The accompanying unaudited Consolidated Financial Statements as of December 31, 2007 and for the three and nine month periods ended December 31, 2007 and 2006 include the accounts of Activision, Inc. and its subsidiaries (Activision or we). The information furnished is unaudited and the adjustments included consist 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 accompanying unaudited Consolidated Financial Statements should be read in conjunction with the Consolidated Financial Statements included in our Annual Report on Form 10-K for the fiscal year ended March 31, 2007 as filed with the Securities and Exchange Commission (SEC) on June 14, 2007.

Certain financial information that is normally included in annual financial statements prepared in accordance with U.S. generally accepted accounting principles, but is not required for interim reporting purposes, has been condensed or omitted.

Management must make estimates and assumptions that affect the Consolidated Financial Statements and the related footnote disclosures. While management makes its best judgment, actual results could differ from those estimates.

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. (SFAS No. 86) Software development costs are capitalized once technological feasibility of a product is established and such costs are determined to be recoverable. Technological feasibility of a product encompasses both technical design documentation and game design documentation. For products where proven technology exists, this may occur early in the development cycle. Technological feasibility is evaluated on a product-by-product basis. Prior to a product s release, we expense, as part of cost of sales software royalties and amortization, capitalized costs when we believe such amounts are not recoverable. Capitalized costs for those products that are cancelled or abandoned are charged to product development expense in the period of cancellation. Amounts related to software development which are not capitalized are charged immediately to product development expense. We evaluate the future recoverability of capitalized amounts on a quarterly basis. The recoverability of capitalized software development costs is evaluated based on the expected performance of the specific products to 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.

ACTIVISION, INC. AND SUBSIDIARIES

Notes to Consolidated Financial Statements

(Unaudited)

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

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

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

Significant management judgments and estimates are utilized in the assessment of the recoverability of capitalized costs. In evaluating the recoverability of capitalized costs, the assessment of expected product performance utilizes forecasted sales amounts and estimates of additional 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, and once any performance obligations have been completed. Certain products are sold to customers with a street date (the earliest date these products may be sold by retailers). For these products we recognize revenue on the later of the street date or the sale 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 a master copy. Per copy royalties on sales that exceed the guarantee are recognized as earned.

ACTIVISION, INC. AND SUBSIDIARIES

Notes to Consolidated Financial Statements

(Unaudited)

Some of our software products provide limited online features at no additional cost to the consumer. Generally, we consider such features to be incidental to the overall product offering and an inconsequential deliverable. Accordingly, we do not defer any revenue related to products containing these limited online features. In instances where online features or additional functionality is considered a substantive deliverable in addition to the software product, we take this into account when determining the appropriate revenue recognition. This evaluation is performed for each software product when it is released. We determined that one of our software titles, *Enemy Territory: Quake Wars* (which is primarily an online multiplayer personal computer (PC) game), contains online functionality that constitutes a more-than-inconsequential separate service deliverable in addition to the product, principally because of its importance to game play. As such, our performance obligations for this title extend beyond the sale of the game, which is unique compared to other prior titles. Vendor-specific objective evidence of fair value (VSOE) does not exist for the online functionality, as we do not separately charge for this component of the title. As a result, we are recognizing all of the revenue from the sale of this title ratably over an estimated service period, which is estimated to be six months beginning the month after shipment. In addition, we are deferring the costs of sales for this title. Cost of sales includes: manufacturing costs, software royalties and amortization, and intellectual property licenses. Overall, online play functionality is still an emerging area for us. As we move forward, we will monitor this developing functionality and its significance for our products. Our assessment of our obligations with respect to this functionality and the resulting accounting may change in the future.

With respect to online transactions, such as electronic downloads of titles or product add-ons, revenue is recognized when the fee is paid by the online 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.

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

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Notes to Consolidated Financial Statements

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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, 2007 allowance for returns and price protection would impact net revenues by $1.8 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.

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 Expense

On April 1, 2006, we adopted Statement of Financial Accounting Standards No. 123 (revised 2004), Share-Based Payment, (SFAS No. 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 No. 123R supersedes our previous accounting under Accounting Principles Board Opinion No. 25, Accounting for Stock Issued to Employees (APB No. 25). In March 2005, the SEC issued Staff Accounting Bulletin No. 107 (SAB 107) relating to SFAS No. 123R. We have applied the provisions of SAB 107 in our adoption of SFAS No. 123R.

SFAS No. 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. Stock-based compensation expense recognized under SFAS No. 123R for the three and nine months ended December 31, 2007 was $20.9 million and $35.9 million, respectively, and for the three and nine months ended December 31, 2006 was $7.7 million and $18.4 million, respectively. See Note 13 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 Statement of Operations for the three and nine months ended December 31, 2007, 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

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accordance with the pro forma provisions of SFAS No. 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 No. 123R. Stock-based compensation expense recognized in the Consolidated Statement of Operations is based on awards ultimately expected to vest and has been reduced for estimated forfeitures. SFAS No. 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.

We estimate the value of employee stock options on the date of grant using a binomial-lattice model. For additional information, see Note 13. 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.

2. Acquisitions

Bizarre Creations

On September 26, 2007, we acquired 100% of Bizarre Creations Limited (Bizarre Creations) for an aggregate purchase price of $67.4 million in cash. In addition, in the event that certain financial performance measures of Bizarre Creations business over a certain period of time (currently estimated to be 5 years from fiscal 2008) exceed specified target levels, the former shareholders of Bizarre Creations will be entitled to an additional amount of up to $40.0 million payable in shares of our common stock. The contingent consideration will be recorded as an addition to the purchase price if the specified target levels are met. Based in the United Kingdom (UK), Bizarre Creations is a video game developer focusing on the racing category with its multi-million unit selling franchise Project Gotham Racing, a series for the Microsoft Xbox and the Microsoft Xbox360 platforms. Bizarre Creations has also developed and owns the Geometry Wars intellectual property. We expect that Bizarre Creations will play a role in our growth strategy as we develop intellectual property for the racing segment, expand our development capability and capacity for other genres and utilize Bizarre Creations proprietary development technology.

The results of operations of Bizarre Creations and the estimated fair market values of the acquired assets and liabilities have been included in our Consolidated Financial Statements since the date of acquisition. Pro forma consolidated statements of operations for this acquisition are not shown, as they would not differ materially from reported results. The acquired finite-lived intangible assets are being amortized over the estimated useful life in proportion to the economic benefits consumed, which for some intangible assets are approximated by using the straight-line method. Goodwill has been included in the publishing segment of our business and is amortized over 15 years for tax purposes.

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Notes to Consolidated Financial Statements

(Unaudited)

Preliminary Purchase Price Allocation

We accounted for this acquisition in accordance with Statement of Financial Accounting Standards No. 141, Business Combinations (SFAS No. 141). SFAS No. 141 addresses financial accounting and reporting for business combinations, requiring that the purchase method be used to account and report for all business combinations. The purchase price for the Bizarre Creations transaction was preliminarily allocated to assets acquired and liabilities assumed as set forth below (amounts in thousands):

Current assets	$	4,352
Property and equipment, net		2,203
Goodwill		55,833
Trademark, acquired contracts and other intangibles		9,500
Deferred tax liability		(1,876)
Other liabilities		(2,639)
Total consideration	$	67,373

Purchased Intangible Assets

The following table presents the components of the purchased finite-lived intangible assets acquired in the Bizarre Creations acquisition (amounts in thousands):

	Estimated Useful Life (in years)		Amount
Finite-lived intangibles:			
Trademark	8	$	1,100
Acquired contracts	0.5		2,800
Other intangibles	1 - 5		5,600
Total finite-lived intangibles		$	9,500

The following table presents the gross and net balances, and accumulated amortization of the components of our purchased finite-lived intangible assets acquired in the Bizarre Creations acquisition as of December 31, 2007 (amounts in thousands):

	Gross	Accumulated Amortization	Effect of foreign currency rates	Net
Trademark	$ 1,100	$	$ (25)	$ 1,075
Acquired contracts	2,800	(2,363)	(35)	402
Other intangibles	5,600	(346)	(122)	5,132
Total	$ 9,500	$ (2,709)	$ (182)	$ 6,609

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(Unaudited)

The estimated future amortization expense of our purchased finite-lived intangible assets acquired in the Bizarre Creations acquisition as of December 31, 2007 is as follows (amounts in thousands):

Fiscal year ending March 31,		**Amount**
2008 (remaining three months)	$	745
2009		684
2010		1,127
2011		1,503
2012		1,503
Thereafter		1,047
Total	$	6,609

DemonWare

On May 11, 2007, Activision completed its acquisition of DemonWare, Ltd., a provider of network middleware technologies for console and PC games headquartered in Dublin, Ireland. We expect the acquisition to enable Activision to gain efficiencies related to online game development and to position us to take advantage of the growth in online gameplay that is expected to be driven by the next-generation consoles. We expect the acquisition to be immaterial to fiscal 2008 earnings per share and cash flow. Additionally, pro forma consolidated statements of operations for this acquisition are not shown, as they would not differ materially from reported results.

3. **Inventories**

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

	December 31, 2007		**March 31, 2007**	
Finished goods	$	143,224	$	89,048
Purchased parts and components		10,199		2,183
	$	153,423	$	91,231

4. **Goodwill**

The changes in the carrying amount of goodwill for the nine months ended December 31, 2007 are as follows (amounts in thousands):

	Publishing	Distribution	Total
Balance as of March 31, 2007	$ 189,342	$ 6,032	$ 195,374
Goodwill acquired during the period	58,609		58,609
Issuance of contingent consideration	25,864		25,864
Adjustment-prior period purchase allocation	(240)		(240)
Effect of foreign currency exchange rates	(384)	74	(310)
Balance as of December 31, 2007	$ 273,191	$ 6,106	$ 279,297

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Goodwill acquired during the period represents goodwill of $55.8 million and $2.8 million related to the acquisitions of Bizarre Creations and DemonWare, respectively. See Note 2 for additional information. Issuance of contingent consideration consists of additional purchase consideration related to the acquisition of RedOctane Inc. and Vicarious Visions Inc. for $22.7 million and $3.1 million, respectively, which was paid in shares of our common stock.

5. Income Taxes

The income tax provision of $144.4 million for the three months ended December 31, 2007 reflects our effective income tax rate for the third quarter fiscal 2008 of 35%, and the income tax provision of $160.1 million for the nine months ended December 31, 2007 reflects our effective income tax rate for fiscal 2008 of 35%. While our effective income tax rate for the period equals our statutory rate there are certain items that would normally generate a variance between the two rates. Those items are the federal and state research and development tax credits and the impact of foreign tax rate differentials partially offset by state taxes. However, the net effect of those items for the three and the nine months ended December 31, 2007 was zero.

Our effective income tax rate for the third quarter fiscal 2008 of 35% differs from our effective income tax rate of 22% for the three months ended December 31, 2006 due to an increase in anticipated pretax income for fiscal 2008 determined at December 31, 2007 versus the anticipated pretax income for fiscal 2007 determined at December 31, 2006, without a corresponding increase in the benefit of book/tax differences.

The income tax expense of $40.0 million for the three months ended December 31, 2006 reflects our effective income tax rate for the third quarter fiscal 2007 of 22% which is the same as the effective tax rate of 22% for the year ended March 31, 2007. The significant items that generated the variance between our effective rate and our statutory rate of 35% for the three and the nine months ended December 31, 2006 were research and development tax credits for state purposes, and the impact of foreign tax rate differentials, partially offset by state taxes.

We adopted the provisions of Financial Accounting Standards Board Interpretation No. 48 Accounting for Uncertainty in Income Taxes (FIN 48) an interpretation of Statement of Financial Accounting Standards No. 109 (SFAS 109) on April 1, 2007. As a result of the implementation of FIN 48, we recognized no material adjustment in the liability for unrecognized income tax benefits. At the adoption date of April 1, 2007, we had $65.5 million of unrecognized tax benefits, of which $26.2 million would affect our effective tax rate if recognized. The liability for unrecognized tax benefits was unchanged during the three months ended December 31, 2007.

In addition, consistent with the provisions of FIN 48, we reclassified $15.6 million of income tax liabilities from current to non-current liabilities because payment of cash is not anticipated within one year of the balance sheet date. These non-current income tax liabilities are recorded in Other Liabilities in the Consolidated Balance Sheets.

We recognize interest and penalties related to uncertain tax positions in income tax expense. As of April 1, 2007, we had approximately $296,000 of accrued interest related to uncertain tax positions. There were no material changes to the accrued interest expense related to estimated obligations for unrecognized tax benefits net of federal benefit during the three and the nine months ended December 31, 2007.

The tax years 2002 through 2007 remain open to examination by the major taxing jurisdictions to which we are subject, including United States of America (U.S.) and non-U.S. locations. We are currently under audit by the Internal Revenue Service and the California Franchise Tax Board, and it is reasonably possible that the current portion of our unrecognized tax benefits will significantly decrease within the next twelve months due to the outcome of these audits.

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6. Software Development Costs and Intellectual Property Licenses

As of December 31, 2007, capitalized software development costs included $83.1 million of internally developed software costs and $16.7 million of payments made to third-party software developers. As of March 31, 2007, capitalized software development costs included $94.3 million of internally developed software costs and $36.6 million of payments made to third-party software developers. Capitalized intellectual property licenses were $77.6 million and $100.3 million as of December 31, 2007 and March 31, 2007, respectively. Amortization and write-offs of capitalized software development costs and intellectual property licenses were $191.8 million and $79.2 million for the nine months ended December 31, 2007 and 2006, respectively.

7. Comprehensive Income and Accumulated Other Comprehensive Income

Comprehensive Income

The components of comprehensive income (loss) for the three and nine months ended December 31, 2007 and 2006 were as follows (amounts in thousands):

	Three months ended December 31,		Nine months ended December 31,	
	2007	2006	2007	2006
Net income	$ 272,196	$ 142,820	$ 300,720	$ 100,209
Other comprehensive income (loss):				
Foreign currency translation adjustment	(3,608)	4,742	3,005	10,983
Unrealized appreciation (depreciation) on short-term investments, net of taxes	190	1,342	733	(8,693)
Other comprehensive income (loss)	(3,418)	6,084		