

TAKE TWO INTERACTIVE SOFTWARE INC  
Form 10-Q  
March 01, 2007

# UNITED STATES SECURITIES AND EXCHANGE COMMISSION

WASHINGTON, D.C. 20549

## FORM 10-Q

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

For the quarterly period ended July 31, 2006

OR

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

For the transition period from to

Commission file number 0-29230

## TAKE-TWO INTERACTIVE SOFTWARE, INC.

(Exact Name of Registrant as Specified in Its Charter)

Delaware  
(State or Other Jurisdiction  
of Incorporation or Organization)

51-0350842  
(I.R.S. Employer  
Identification No.)

622 Broadway, New York, New York 10012

(Address of principal executive offices including zip code)

Registrant's Telephone Number, Including Area Code (646) 536-2842

Indicate by check mark whether the Registrant (1) has filed all reports required to be filed by Section 13 or 15(d) of the Securities Exchange Act of 1934 during the preceding 12 months (or for such shorter period that the registrant was required to file such reports), and (2) has been subject to such filing requirements for the past 90 days. Yes ☒ No ☐

Indicate by check mark whether the registrant is 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).

Large Accelerated Filer ☒ Accelerated Filer ☐ Non-Accelerated Filer ☐

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

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As of February 16, 2007, there were 72,838,149 shares of the Registrant's Common Stock outstanding.

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*This Quarterly Report on Form 10-Q contains forward-looking statements that are based on the beliefs of management and assumptions made by and information currently available to them. The words expect, anticipate, believe, may, estimate, intend and similar expressions are intended to identify such forward-looking statements. Forward-looking statements involve risks, uncertainties and assumptions including those described in Risk Factors, which could cause our actual results to be materially different from results expressed or implied by such forward-looking statements.*

### EXPLANATORY NOTE

Take-Two Interactive Software, Inc. ( the Company ) has restated its condensed consolidated balance sheet as of October 31, 2005, the related condensed consolidated statements of operations for the three and nine months ended July 31, 2005 and the related condensed consolidated statement of cash flows for the nine months ended July 31, 2005. In the Company's Form 10-K for the fiscal year ended October 31, 2006 that was filed with the Securities and Exchange Commission (the 2006 Form 10-K ), the Company restated its consolidated balance sheet as of October 31, 2005 and the related statements of operations, stockholders' equity and cash flows for each of the fiscal years ended October 31, 2005 and 2004, as well as consolidated financial information for each of the quarters in fiscal year 2005.

The 2006 Form 10-K also reflects the restatement of Selected Consolidated Financial Data in Item 6 for the fiscal years ended October 31, 2005, 2004, 2003, and 2002, and Management's Discussion and Analysis of Financial Condition and Results of Operations in Item 7 for the fiscal years ended October 31, 2005 and October 31, 2004.

As the Company previously reported, on June 23, 2006, the Company's Board of Directors (the Board ), based on the recommendation of the Company's management, initiated an investigation of all of the Company's stock option grants during the period from its April 15, 1997 initial public offering ( IPO ) through June 2006 and assigned the investigation to a Special Committee of its Board consisting of three independent members of the Board (the Special Committee ). On July 7, 2006, the Special Committee retained independent legal counsel, and such counsel retained independent accounting advisors (collectively the Investigative Team ). The investigation included a broad and extensive document review (including the Company's 1997 and 2002 Stock Option Plans, all Compensation Committee minutes, Board minutes, employment agreements, stock option agreements, offer letters, emails, accounting records such as earnings per share schedules, master option tracking schedules and other correspondence and materials contained in personnel files) and interviews of certain present and former Company officers, Directors and employees who were involved in or appeared to have knowledge of the issuance of the grants. During the period from April 15, 1997 through June 2006 the Company issued approximately 1,100 stock option grants at irregular intervals and for a variety of reasons including employee hiring, retention and promotion awards, broad-based awards, executive incentive awards and awards made in connection with business acquisitions. The Investigative Team found that the Company, in granting options, failed in many cases to comply with the terms of its Stock Option Plans, did not maintain adequate control and compliance procedures for option grants, and did not generate or maintain adequate or appropriate documentation of such grants.

In particular, the Investigative Team concluded that between April 1997 and August 2003, the former Chairman/CEO of the Company, who resigned from his last (non-executive) position with the Company in October 2006, controlled and dominated the stock option granting process. More specifically, during that period, numerous option grants appear to have been backdated through a variety of methods. It was determined that the former Chairman/CEO of the Company was primarily responsible for the selection of exercise prices and grant dates and the resulting backdating issues and was assisted by certain past employees and past members of management. The Investigative Team concluded, among other things, that the conduct of these individuals raised concerns about the reliability of their representations to the

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Company's independent auditors and as a result the Company has concluded that such concerns are applicable to representations made by these individuals to the Company.

Furthermore, available contemporaneous documentation that was used by the Company to support its stock option grants was found by the Investigative Team to be unreliable, deficient or nonexistent in many cases. This documentation primarily took the form of stock option agreements, interoffice stock grant requests and beginning in May 2002, undated stock option grant letters, most of which were authorized and signed by the former Chairman/CEO. The Investigative Team found no evidence that the Company's current senior executive management engaged in any misconduct with respect to the Company's option granting practices. They also determined that while the members of the Compensation Committee abdicated their responsibility, with respect to the granting of stock options, they did not engage in any willful misconduct or other dishonest acts.

It was determined that due to the backdating practices and the lack of contemporaneous or reliable documentation, all stock option grants should be reviewed, analyzed and re-measured based on the most reliable existing documentation.

The Investigative Team employed forensic analysis of all available written and electronic documents, the result of which established a set of documents to analyze stock option granting activity. Consistent with the accounting literature and recent guidance from the Securities and Exchange Commission (SEC) staff, the grants during the relevant period were organized into categories based on the grant type. After reviewing all available relevant documentation, a general hierarchy of documentation was considered when establishing an appropriate measurement date for accounting purposes. Although the hierarchy was considered, each grant was evaluated individually based on the particular facts and circumstances in each case. The documentation considered was:

- Minutes of Board of Directors or Compensation Committee meetings (Minutes);
- Date of hire (if the grant was a new hire grant, evidenced by an employment agreement or offer letter);
- Correspondence or other documentation supporting the option grant (e.g. emails, internal memos, Forms 4, and other materials contained in personnel files);
- Earliest date as evidenced by (a) updating of the Company's master stock option tracking spreadsheets (the Company's tracking system which accumulated all stock option grants and all relevant terms, which was updated with new grants continuously, for which forensic analysis provided a date on which the option grant was first included in the Company's master option spreadsheet) (b) stock option exercise dates or (c) inclusion in quarterly diluted earnings per share calculation records (the EPS Records).

The Company identified certain stock option grants as having approvals of the allocation of shares to specific individuals and an exercise price evidenced by dated Minutes, which differed from the measurement date that was indicated within the Company's master stock option tracking spreadsheets. Often, awards had an approval date in the Minutes that was subsequent to the grant and measurement date reported by the Company within the Company's stock option award documentation. Other grants were found to have been assigned measurement dates subsequent to documented approval in the minutes which would have indicated a potential re-pricing of the options, specifically when there was a significant time lag between the approval in the minutes and the measurement date and the price on the measurement date was significantly lower. Accordingly, certain of these grants were determined to have been awarded on the date approved by the Compensation Committee and re-priced on a subsequent date, particularly for grants that the Investigative Team believed the recipients would have been knowledgeable of the Compensation Committee's approval and the key terms and conditions of the grant. Furthermore, in certain instances the Minutes acknowledged prior approvals of stock-based compensation awards although

no documentation of such approval exists in the Company's records. In each of the cases described above, the Company determined that the originally assigned measurement dates could not be reliably supported and such grants should be based on dates documented in the Minutes. As a result, the Company re-measured and accounted for these awards as fixed (variable with respect to the options considered to be re-priced) on the date indicated in the Minutes.

The Company issued stock options in connection with employment agreements, offer letters, or other documentation indicative of an employee's start of employment, but such awards often had measurement dates prior to the actual commencement of employment. The Company determined the appropriate measurement date for these grants to be the date on which the employee commenced employment.

The Company also identified certain stock option grants where the sole evidence was the aforementioned stock option agreements, interoffice request forms or stock option grant letters and employment agreement amendments (collectively, "Non-contemporaneous Dated Documents"). Stock option agreements included terms of the option grant and typically used "as of" dating to document such terms, and the Investigative Team concluded that it was unlikely that such agreements were signed by the Company and the employee on a contemporaneous basis. The interoffice request forms were undated standard forms that reflected the term of the option grants including, in some cases, grant dates. Stock option grant letters were also undated correspondence that reflected all of the terms of the options. The stock option grant letter became the primary means of documenting all of the terms of the option grants beginning in May 2002. At that time, the Company memorialized all prior option grants by preparing stock option grant letters and these grant letters were not contemporaneously prepared. All of the Non-contemporaneous Dated Documents were either authorized or signed by the former Chairman/CEO until March 2004 when he stepped-down as Chairman. As noted above, the Investigative Team found the former Chairman/CEO to have engaged in a pattern and practice of backdating option grants and determined that his representations could not be relied upon. Accordingly, any form of stock grant documentation that was authorized and/or signed by him and for which there was no other evidence that corroborated the measurement date, was deemed to be unreliable for measurement purposes.

Employment agreement amendments typically acknowledged a previous grant of options or a new grant and there was either limited or no documentation supporting the previous grant. Frequently, the indicated date of the grant was considered a "fortuitous" date (i.e. a date on which the Company's stock price was at a low point during the period). The Investigative Team found evidence that the indicated grant date within such agreements was often unreliable for measurement purposes, and in some cases the amendment itself was backdated.

With respect to the Non-contemporaneous Dated Documents or otherwise unsupported grants, the Investigative Team reviewed and analyzed all available correspondence, including the master stock option tracking spreadsheets to determine the date on which the option was first entered into the spreadsheet, and the first period the grant was included in the EPS Records. The Company used available metadata and other computer generated records to determine the date on which the award was first entered into these spreadsheets. If the first date that the option was entered into the spreadsheet was identified, that date was used as the measurement date after considering any other available documentation. In cases where the date of first entry in the master option tracking spreadsheet was subsequent to the quarter in which the grant was first included in the EPS Records, the EPS Records were used for the determination of the measurement date. EPS Records were only considered when there was no earlier correspondence or other evidence to document a more reliable measurement date.

The Company believes that this evidence, as supported by the Investigative Team's conclusions, is consistent with the provisions of APB 25 whereby the measurement date is the first date on which the number of shares that each individual is allocated and the related option price is determined with employee notification soon afterwards (i.e. a "mutual understanding" between the employee and the

Company of the key terms and conditions of an award) (See paragraph below regarding actual date selected). While the number of shares and their corresponding exercise prices were identified in all of the Non-contemporaneous Dated Documents or employment agreement amendments referred to above, the Investigative Team determined that in many instances these documents were not contemporaneously prepared and, as noted above, could not be relied upon for the measurement date. Additionally, the Investigative Team noted that the granting process and related approvals, whether formally approved by the Compensation Committee or authorized by the former Chairman/CEO, occurred prior to including the grant and its terms in master stock option tracking spreadsheets and the EPS Records. Once grants and their relevant terms were included in these spreadsheets or the EPS Records, changes to key terms (exercise price, number of shares, vesting period and identified employee) did not occur.

Where evidence of a stock option grant was limited to the EPS Records, this evidence does not result in a specific date as required under APB 25, but rather the period in which the measurement date occurred. Accordingly, the Company considered the qualitative and quantitative attributes of several alternatives, including using the date of the Company's high and median closing stock price in each quarter. In the absence of evidence to support a more appropriate measurement date, the Company has selected the first instance of the highest quoted stock price in the quarter that the stock option grant was first included in the EPS Records as its measurement date for such stock option grants. The Company believes that this ensures that a sufficient amount of compensation expense results and that this date is equally probable to any other date in the quarter. Furthermore, neither existing documentation nor the results of the investigation indicate that there is a more appropriate date. This methodology resulted in the Company recognizing approximately \$25 million of cumulative pre-tax stock-based compensation expense for the period April 15, 1997, the date of the Company's IPO, through October 31, 2005.

If the Company had instead used the median closing price of its common stock in the corresponding quarters, rather than the highest price, the Company estimates that it would have reduced its cumulative pre-tax stock-based compensation charge by approximately \$13 million. Restated cumulative net income (i.e. net income from the date of the Company's IPO through October 31, 2005) would have been approximately 3% higher if the Company had used the median closing price of its common stock, rather than the highest price. The Company has deemed the difference between recording compensation expense based on the Company's high and median closing stock prices to be quantitatively immaterial in the aggregate and to each individual fiscal year since the Company's IPO, except for the Company's fiscal years ended 2001 and 2000, when such difference would have impacted the Company's previously reported net income by approximately \$1.1 million and \$0.7 million, respectively. However, the Company believes that these differences, in isolation, are not qualitatively material and would not impact an investor's prospective opinion or valuation of the Company.

The Company also reviewed 84 restricted stock awards that were issued between May 2002 and June 2006 and identified 10 instances in which such awards had measurement dates that did not correspond with Minutes, employment agreements, offer letters, or other documentation indicative of an employee's start date of employment. As a result, the Company recognized additional cumulative stock-based compensation expense of \$0.6 million, net of tax, through October 31, 2005 related to these awards. The re-measurement of restricted stock awards resulted in \$1.0 million of additional stock-based compensation expense, net of tax, in fiscal 2006, through the second quarter ended April 30, 2006, and did not have a material impact on the Company's previously reported 2006 quarterly financial statements.

Based on the relevant facts and circumstances, the Company applied the controlling accounting standards in each year to determine, for every grant within each category, the proper measurement date. If the measurement date was not the original date that was reported in the records of the Company, accounting adjustments were made to record compensation expense based on the difference between the closing price on the revised measurement date and the exercise price. The restatement as a result of the Special Committee investigation resulted in stock-based compensation expense and tax effects totaling

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approximately \$54.6 million (\$42.1 million, net of tax) from the IPO through October 31, 2005. The Investigative Team used a significant amount of judgment in examining each separate option grant and also in determining the new measurement date applied to each grant in the Company's calculation of compensation expense.

The Company has restated previously filed financial statements in this Form 10-Q. The impact of the restatement adjustments on the Company's 2006 statements of operations was recorded in the third quarter of fiscal year 2006 due to its immateriality, and therefore the Company's previously reported 2006 quarterly results of operations for the first and second quarters have not been restated.

The incremental impact from recognizing stock-based compensation expense resulting from the investigation of past stock-based compensation awards is shown below (dollars in thousands). Amounts for the year ended October 31, 2003, and in all periods prior thereto, have been derived from the Company's unaudited historical statements of operations.

Category of adjustment:	Year Ended October 31,				1997 through 2001(b),(c)
	2005(a)	2004(a)	2003(b)	2002(b)	
Selling and marketing	\$ 328	\$ 1,651	\$ 3,721	\$ 6,968	\$ 2,712
General and administrative	691	2,698	6,005	8,939	17,468
Research and development	564	514	532	892	863
Interest income, net	13	3	1		
Total pre-tax stock based compensation and related expense adjustments	1,596	4,866	10,259	16,799	21,043
Income tax impact of restatement adjustments above	331	(1,607)	(813)	(4,903)	(5,476)
Total adjustments to net income (loss)	\$ 1,927	\$ 3,259	\$ 9,446	\$ 11,896	\$ 15,567

(a) See Note 3 of the Company's Consolidated Condensed Financial Statements included in this Form 10-Q for additional information regarding the restatement of its consolidated financial statements for this period.

(b) The impact on the 2003 and 2002 periods has been reflected in Item 6. Selected Financial Data in the 2006 Form 10-K.

(c) The cumulative effect of the stock-based compensation adjustments through October 31, 2001 is reflected as an adjustment to beginning retained earnings/stockholders' equity in the 2002 period information presented in Item 6, Selected Financial Data in the 2006 Form 10-K. The following is a summary of the pre-tax and after-tax expense, by year (all amounts have been derived from the Company's unaudited historical statements of operations):

(in thousands)	Pre-tax adjustment to Selling and marketing	General and administrative	Research and development	Income tax benefit	Net of tax adjustment
Year ended October 31, 1997	\$	\$ 76	\$	\$ (31)	\$ 45
Year ended October 31, 1998	68	334	6	(142)	266
Year ended October 31, 1999	267	2,648	171	(1,241)	1,845
Year ended October 31, 2000	1,080	3,504	159	(690)	4,053
Year ended October 31, 2001	1,297	10,906	527	(3,372)	9,358
	\$ 2,712	\$ 17,468	\$ 863	\$ (5,476)	\$ 15,567

Additionally, the Company has restated the pro forma expense under Statement of Financial Accounting Standards (SFAS) No. 123 in Note 4 of the Notes to Condensed Consolidated Financial Statements of this Form 10-Q.

The Company is in the process of determining the extent of the adverse tax consequences that may be incurred by the holders of re-measured stock options. The adverse tax consequences relate to re-measured stock options vesting after December 31, 2004 ( 409A Affected Options ) and subject the option holder to a penalty tax under Internal Revenue Code ( IRC ) IRC Section 409A (and, as applicable, similar penalty taxes). One action being considered by the Company is to offer to amend the 409A Affected Options to increase the exercise price to the market price on the accounting measurement date or, if lower, the market price at the time of the option amendment. The amended options would not be subject to taxation under IRC Section 409A. Under IRS regulations, these option amendments had to be completed by December 31, 2006 for anyone who was an executive officer when he or she received 409A Affected Options; the amendments for non-executive officers cannot be offered until after this Form 10-Q is filed and do not need to be completed until December 31, 2007. Another possible action is to approve bonuses payable to holders of the amended options to compensate them for the resulting increase in their option exercise price. The amount of these bonuses would be effectively repaid to the Company if and when the options are exercised and the increased exercise price is paid (but there is no assurance that the options will be exercised). The Company has not determined what actions it will take, if any, with respect to 409A Affected Options. Any charges that arise from actions taken by the Company will be recorded in the period in which the determinations are made.

The Company also believes that United States tax deductions taken for stock option exercises in prior years, which pertained to certain executives, may not be deductible under limitations imposed by IRC Section 162(m). Section 162(m) limits the deductibility of compensation above \$1 million to certain executive officers of public companies when such compensation is not incentive-based. The Special Committee found that many of the stock options granted to executives had intrinsic value on the basis of the new measurement dates determined for US GAAP financial statement purposes and therefore, under Section 162(m), may not be incentive-based and may not be tax deductible by the Company. As a result the Company has reduced its available tax net operating loss carry-forwards arising from certain exercised stock options and restricted stock. Separately, the Company also identified certain restricted stock grants and bonuses paid in prior periods that may be ineligible for deduction under section 162(m). The Company restated its tax provisions in the periods in which the benefits were recorded. The Company is in discussions with the IRS to settle these uncertainties regarding additional liabilities; however, there is no assurance that they will be settled on terms favorable to the Company.

As a result of its review, the Company also determined that it failed to properly withhold an immaterial amount of employment taxes associated with certain stock option exercises. The Company has recorded such amounts in its consolidated statements of operations in the period in which the Company was originally obligated to make the withholding.



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**PART I. FINANCIAL INFORMATION****Item 1. Financial Statements**

**TAKE-TWO INTERACTIVE SOFTWARE, INC. and SUBSIDIARIES**  
**CONDENSED CONSOLIDATED BALANCE SHEETS (Unaudited)**  
(in thousands, except per share amounts)

	July 31, 2006	October 31, 2005 (Restated)
<b>ASSETS</b>		
Cash and cash equivalents	\$ 179,130	\$ 107,195
Accounts receivable, net of allowances of \$82,532 and \$69,904 at July 31, 2006 and October 31, 2005, respectively	98,027	197,861
Inventory, net	83,221	136,227
Software development costs	69,997	88,826
Licenses	5,907	7,651
Prepaid taxes and taxes receivable	68,732	40,453
Prepaid expenses and other	25,968	34,588
Total current assets	530,982	612,801
Fixed assets, net	46,482	48,617
Software development costs, net of current portion	30,057	19,602
Licenses, net of current portion	1,448	2,330
Goodwill	186,881	179,893
Other intangibles, net	46,063	58,666
Other assets	13,155	13,311
Total assets	\$ 855,068	\$ 935,220
<b>LIABILITIES AND STOCKHOLDERS' EQUITY</b>		
Accounts payable	\$ 80,081	133,353
Accrued expenses and other current liabilities	165,972	113,570
Total current liabilities	246,053	246,923
Deferred revenue	50,000	
Other long-term liabilities	3,988	2,467
Total liabilities	300,041	249,390
Commitments and contingencies		
Stockholders' Equity:		
Common Stock, \$.01 par value, 100,000 shares authorized; 72,573 and 70,667 shares issued and outstanding at July 31, 2006 and October 31 2005, respectively	726	707
Additional paid-in capital	473,695	451,470
Deferred compensation		(12,581 )
Retained earnings	74,674	245,548
Accumulated other comprehensive income	5,932	686
Total stockholders' equity	555,027	685,830
Total liabilities and stockholders' equity	\$ 855,068	\$ 935,220

The accompanying Notes are an integral part of the unaudited condensed consolidated financial statements.

**TAKE-TWO INTERACTIVE SOFTWARE, INC. and SUBSIDIARIES**  
**CONDENSED CONSOLIDATED STATEMENTS OF OPERATIONS (Unaudited)**  
(in thousands, except per share amounts)

	Three months ended July 31,		Nine Months Ended July 31,	
	2006	2005	2006	2005
		As restated		As restated
Net revenue	\$ 241,181	\$ 169,899	\$ 771,284	\$ 894,441
Cost of goods sold:				
Product costs	115,245	92,525	407,038	453,514
Royalties	56,443	25,608	171,592	127,755
Software development costs	12,367	4,046	62,089	13,031
Total cost of goods sold	184,055	122,179	640,719	594,300
Gross Profit	57,126	47,720	130,565	300,141
Selling and marketing	27,585	32,449	101,423	119,961
General and administrative	44,260	32,381	116,276	90,991
Research and development	17,406	19,899	51,212	57,424
Impairment of goodwill and long-lived assets	8,529		14,778	
Depreciation and amortization	6,290	5,691	19,778	15,579
Total operating expenses	104,070	90,420	303,467	283,955
Income (loss) from operations	(46,944 )	(42,700 )	(172,902 )	16,186
Interest income, net	1,199	1,258	1,456	2,956
Income (loss) before income taxes	(45,745 )	(41,442 )	(171,446 )	19,142
Income taxes	45,634	(12,466 )	(572 )	2,689
Net income (loss)	\$ (91,379 )	\$ (28,976 )	\$ (170,874 )	\$ 16,453
Earnings (loss) per share:				
Basic	\$ (1.29 )	\$ (0.41 )	\$ (2.41 )	\$ 0.24
Diluted	\$ (1.29 )	\$ (0.41 )	\$ (2.41 )	\$ 0.23
Weighted average shares outstanding:				
Basic	71,095	70,556	70,954	69,768
Diluted	71,095	70,556	70,954	71,000

The accompanying Notes are an integral part of the unaudited condensed consolidated financial statements.

**TAKE-TWO INTERACTIVE SOFTWARE, INC. and SUBSIDIARIES**  
**CONDENSED CONSOLIDATED STATEMENTS OF CASH FLOWS (Unaudited)**  
**(in thousands)**

	Nine months ended July 31, 2006	2005 As restated
<b>Cash flows from operating activities:</b>		
Net income (loss)	\$ (170,874 )	\$ 16,453
Adjustments to reconcile net income (loss) to net cash provided by operating activities:		
Depreciation and amortization	19,778	15,579
Write-off of goodwill and other long-lived assets	14,778	
Loss on disposal of fixed assets	409	14
Amortization of intellectual property and other	8,429	7,905
Stock-based compensation	14,419	14,563
Amortization of software development costs and licenses	101,560	40,254
Write-off of software development costs and licenses	19,328	5,523
Provision (benefit) for deferred income taxes	19,540	(575 )
Provision for (recovery of) sales allowances and doubtful accounts	7,863	(12,056 )
Tax benefit from exercise of stock options		8,527
Foreign currency translation gain and other	(1,440 )	(693 )
Changes in assets and liabilities, net of effect from purchases of businesses:		
Accounts receivable	93,803	234,162
Inventory	53,006	49,509
Software development costs	(101,190 )	(99,162 )
Licenses	(7,527 )	(7,474 )
Prepaid expenses and other	(28,279 )	(33,939 )
Other non-current assets	(7,676 )	2,246
Accounts payable	(51,975 )	(87,616 )
Accrued expenses and other current liabilities	62,692	(34,505 )
Deferred revenue and other long-term liabilities	47,938	62
Income taxes payable	(10,220 )	(6,838 )
Total adjustments	255,236	95,486
Net cash provided by operating activities	84,362	111,939
<b>Cash flows used in investing activities:</b>		
Purchase of fixed assets	(18,600 )	(22,456 )
Acquisitions of intangible assets		(24,250 )
Payments for purchases of businesses, net of cash acquired	1,143	(33,542 )
Payments for prior acquisitions	(1,334 )	(965 )
Net cash used for investing activities	(18,791 )	(81,213 )
<b>Cash flows provided by financing activities:</b>		
Proceeds from exercise of options	2,787	29,980
Purchase of treasury stock		(14,998 )
Excess tax benefit on exercise of stock options	163	
Other		(70 )
Net cash provided by financing activities	2,950	14,912
Effects of exchange rates on cash	3,414	(5,378 )
Net increase in cash and cash equivalents	71,935	40,260
Cash and cash equivalents, beginning of year	107,195	155,095
Cash and cash equivalents, end of period	\$ 179,130	\$ 195,355

The accompanying Notes are an integral part of the unaudited condensed consolidated financial statements.

**TAKE-TWO INTERACTIVE SOFTWARE, INC. and SUBSIDIARIES**  
**Condensed Consolidated Statements of Cash Flows (Unaudited) (continued)**  
**For the nine months ended July 31, 2006 and 2005**  
**(In thousands)**

	Nine months ended July 31,	
	2006	2005
<b>Supplemental information of businesses acquired:</b>		
Fair value of assets acquired		
Current assets	\$ 112	\$ 934
Non-current assets	421	1,724
Intangible assets	5,644	11,920
Goodwill	11,085	37,351
Less, liabilities assumed		
Current liabilities	(200 )	(5,084 )
Deferred income taxes	(1,620 )	(3,192 )
Net assets of businesses acquired, excluding cash	\$ 15,442	\$ 43,653
Net cash paid (received) for businesses acquired	\$ (1,143 )	\$ 33,542
Additional consideration in connection with acquisitions	4,085	5,921
Deferred contingent consideration		4,190
Issuance of common stock in connection with acquisitions	12,500	
Total consideration	\$ 15,442	\$ 43,653
<b>Supplemental data:</b>		
Issuance of warrants to licensor	\$	\$ 1,183
Interest paid	901	163
Income taxes paid	7,237	34,332

The accompanying Notes are an integral part of the unaudited condensed consolidated financial statements.

**TAKE-TWO INTERACTIVE SOFTWARE, INC. and SUBSIDIARIES**  
**Condensed Consolidated Statements of Stockholders' Equity (Unaudited)**  
(In thousands)

	Common Stock Shares	Common Stock Amount	Additional Paid-in Capital	Deferred Compensation	Retained Earnings	Accumulated Other Comprehensive Income (Loss)	Total Stockholders Equity
Balance, October 31, 2005, as restated	70,667	707	451,470	(12,581 )	245,548	686	685,830
Net loss					(170,874 )		(170,874 )
Change in cumulative foreign currency translation adjustment						5,246	5,246
Comprehensive loss							(165,628 )
Deferred compensation			(12,581 )	12,581			
Proceeds from exercise of stock options	232	2	2,785				2,787
Stock based compensation related to compensatory stock options			13,058				13,058
Amortization of restricted stock			6,617				6,617
Issuance of common stock in connection with acquisition	679	7	12,493				12,500
Issuance of restricted stock, net of forfeitures and cancellations	995	10	(10 )				
Tax benefit from exercise of stock options			(137 )				(137 )
<b>Balance, July 31, 2006</b>	<b>72,573</b>	<b>\$ 726</b>	<b>\$ 473,695</b>	<b>\$</b>	<b>\$ 74,674</b>	<b>\$ 5,932</b>	<b>\$ 555,027</b>

The accompanying Notes are an integral part of the unaudited condensed consolidated financial statements.

**TAKE-TWO INTERACTIVE SOFTWARE, INC. and SUBSIDIARIES**  
**Notes to the Unaudited Condensed Consolidated Financial Statements**  
**(Dollars in thousands, except per share amounts)**

**1. ORGANIZATION AND DESCRIPTION OF BUSINESS**

Take-Two Interactive Software, Inc. (the Company) was incorporated in the State of Delaware in September 1993. The Company develops, publishes and distributes interactive software games designed for personal computers, video game consoles and handheld platforms.

**2. SIGNIFICANT ACCOUNTING POLICIES AND BASIS OF PRESENTATION**

**Basis of Presentation**

The unaudited condensed consolidated financial statements of the Company have been prepared in accordance with the instructions to Form 10-Q and Article 10 of Regulation S-X. Accordingly, the financial statements do not include all information and disclosures necessary for a presentation of the Company's financial position, results of operations and cash flows in conformity with generally accepted accounting principles in the United States of America. In the opinion of management, the financial statements reflect all adjustments (consisting only of normal recurring accruals) necessary for a fair statement of the Company's financial position, results of operations and cash flows. The results of operations for an interim period are not necessarily indicative of the results for the full year. The financial statements should be read in conjunction with the audited financial statements and notes thereto contained in the Company's Annual Report on Form 10-K for the fiscal year ended October 31, 2006.

**Estimates**

The preparation of financial statements in conformity with generally accepted accounting principles requires management to make estimates and assumptions that affect the reported amounts of assets and liabilities and disclosure of contingent assets and liabilities at the dates of the financial statements and the reported amounts of revenues and expenses during the reported periods. The most significant estimates and assumptions relate to the adequacy of allowances for returns, price concessions and doubtful accounts; the amortization and recoverability of software development costs, licenses and other intangibles; valuation of inventories, fair value of stock compensation and realization of deferred income taxes. Actual amounts could differ significantly from these estimates.

**Stock Split**

In April 2005, the Company effected a three-for-two stock split in the form of a stock dividend. Accordingly, all share and per share data in the accompanying unaudited condensed consolidated financial statements and notes thereto give retroactive effect to the stock split.

**Financial Instruments**

The carrying amounts of the Company's financial instruments, including cash and cash equivalents, accounts receivable, income tax receivable and payable, accounts payable and accrued liabilities, approximate fair value because of their short maturities. The Company considers all highly liquid instruments purchased with original maturities of three months or less to be cash equivalents.

The Company transacts business in various foreign currencies and has significant sales and purchase transactions denominated in foreign currencies. The Company sometimes uses forward exchange contracts to seek to mitigate foreign currency risk associated with foreign currency assets and liabilities, primarily certain intercompany receivables and payables. The Company does not designate foreign currency forward contracts as hedging instruments under SFAS No. 133, Accounting for Derivative Instruments and

Hedging Activities. As a result, the Company marks to market its foreign currency forward contracts each period and any gains and losses are recognized in net income. At July 31, 2006, the Company had no outstanding foreign currency forward contracts.

#### Reclassifications

Certain prior year amounts have been reclassified to conform to current year presentation.

#### Recently Issued Accounting Pronouncements

In September 2006, the Financial Accounting Standards Board ( FASB ) issued SFAS No. 157, *Fair Value Measurements* ( SFAS 157 ), which clarifies the definition of fair value, establishes a framework for measuring fair value in generally accepted accounting principles, and expands disclosures about fair value measurement. SFAS 157 does not require any new fair value measurements and eliminates inconsistencies in guidance found in various prior accounting pronouncements. SFAS 157 will be effective for the Company on November 1, 2008. The Company is currently assessing whether the adoption of SFAS 157 will have an impact on the Company's financial statements.

In September 2006, the SEC released Staff Accounting Bulletin No. 108, *Considering the Effects of Prior Year Misstatements when Quantifying Misstatements in Current Year Financial Statements* ( SAB 108 ). SAB 108 provides interpretive guidance on the SEC's views on how the effects of the carryover or reversal of prior year misstatements should be considered in quantifying a current year misstatement. The provisions of SAB 108 will be effective for the Company on November 1, 2007. The Company is currently evaluating the impact of applying SAB 108 but does not believe that the application of SAB 108 will have a material effect on its financial position, cash flows, or results of operations.

In June 2006, the FASB issued Interpretation No. 48, *Accounting for Uncertainty in Income Taxes, an interpretation of SFAS No. 109* ( FIN 48 ), to create a single model to address the accounting for uncertainty in tax positions. FIN 48 clarifies the accounting for income taxes by prescribing the minimum recognition threshold a tax position is required to meet before being recognized in the financial statements. FIN 48 also provides guidance on derecognition, measurement, classification, interest, and penalties, accounting in interim periods, disclosure, and transition. FIN 48 will be effective for the Company beginning November 1, 2007. The cumulative-effect of adopting FIN 48 will be recorded to opening retained earnings. Management is currently evaluating the effect, if any, that the adoption of FIN 48 will have on the Company's consolidated financial statements.

### 3. RESTATEMENT OF CONDENSED CONSOLIDATED FINANCIAL STATEMENTS

The Company has restated its consolidated balance sheet as of October 31, 2005, and the related statements of operations, stockholders' equity and cash flows for each of the fiscal years ended October 31, 2005 and 2004, as well as consolidated financial information for each of the quarters in fiscal year 2005 in its 2006 Annual Report on Form 10-K. In addition, the Company has restated its statements of operations for the three and nine months ended July 31, 2005 and its statement of cash flows for the nine months ended July 31, 2005 in this Form 10-Q.

As the Company previously reported, on June 23, 2006, the Board, based on the recommendation of the Company's management, initiated an investigation of all of the Company's stock option grants during the period from its April 15, 1997 initial public offering ( IPO ) through June 2006 and assigned the investigation to a Special Committee of its Board consisting of three independent members of the Board (the Special Committee ). On July 7, 2006, the Special Committee retained independent legal counsel, and such counsel retained independent accounting advisors (collectively the Investigative Team ). The investigation included a broad and extensive document review (including the Company's 1997 and 2002 Stock Option Plans, all Compensation Committee minutes, Board minutes, employment agreements, stock



option agreements, offer letters, emails, accounting records such as earnings per share schedules, master option tracking schedules and other correspondence and materials contained in personnel files) and interviews of certain present and former Company officers, Directors and employees who were involved in or appeared to have knowledge of the issuance of the grants. During the period from April 15, 1997 through June 2006 the Company issued approximately 1,100 stock option grants at irregular intervals and for a variety of reasons including employee hiring, retention and promotion awards, broad-based awards, executive incentive awards and awards made in connection with business acquisitions. The Investigative Team found that the Company, in granting options, failed in many cases to comply with the terms of its Stock Option Plans, did not maintain adequate control and compliance procedures for option grants, and did not generate or maintain adequate or appropriate documentation of such grants.

In particular, the Investigative Team concluded that between April 1997 and August 2003, the former Chairman/CEO of the Company, who resigned from his last (non-executive) position with the Company in October 2006, controlled and dominated the stock option granting process. More specifically, during that period, numerous option grants appear to have been backdated through a variety of methods. It was determined that the former Chairman/CEO of the Company was primarily responsible for the selection of exercise prices and grant dates and the resulting backdating issues and was assisted by certain past employees and past members of management. The Investigative Team concluded, among other things, that the conduct of these individuals raised concerns about the reliability of their representations to the Company's independent auditors and as a result the Company has concluded that such concerns are applicable to representations made by these individuals to the Company.

Furthermore, available contemporaneous documentation that was used by the Company to support its stock option grants was found by the Investigative Team to be unreliable, deficient or nonexistent in many cases. This documentation primarily took the form of stock option agreements, interoffice stock grant requests and beginning in May 2002, undated stock option grant letters, most of which were authorized and signed by the former Chairman/CEO. The Investigative Team found no evidence that the Company's current senior executive management engaged in any misconduct with respect to the Company's option granting practices. They also determined that while the members of the Compensation Committee abdicated their responsibility, with respect to the granting of stock options, they did not engage in any willful misconduct or other dishonest acts.

It was determined that due to the backdating practices and the lack of contemporaneous or reliable documentation, all stock option grants should be reviewed, analyzed and re-measured based on the most reliable existing documentation.

The Investigative Team conducted forensic analysis of all available written and electronic documents, the result of which established a set of documents to analyze stock option granting activity. Consistent with the accounting literature and recent guidance from the Securities and Exchange Commission (SEC) staff, the grants during the relevant period were organized into categories based on the grant type. After reviewing all available relevant documentation, a general hierarchy of documentation was considered when establishing an appropriate measurement date for accounting purposes. Although the hierarchy was considered, each grant was evaluated individually based on the particular facts and circumstances in each case. The documentation considered was:

- Minutes of Board of Directors or Compensation Committee meetings ( Minutes );
- Date of hire (if the grant was a new hire grant, evidenced by an employment agreement or offer letter);
- Correspondence or other documentation supporting the option grant (e.g. emails, internal memos, Forms 4, and other materials contained in personnel files);

- Earliest date as evidenced by (a) updating of the Company's master stock option tracking spreadsheets (the Company's tracking system which accumulated all stock option grants and all relevant terms, which was updated with new grants continuously, for which forensic analysis provided a date on which the option grant was first included in the Company's master option spreadsheet) (b) stock option exercise dates or (c) inclusion in quarterly diluted earnings per share calculation records (the EPS Records).

The Company identified certain stock option grants as having approvals of the allocation of shares to specific individuals and an exercise price evidenced by dated Minutes, which differed from the measurement date that was indicated within the Company's master stock option tracking spreadsheets. Often, awards had an approval date in the Minutes that was subsequent to the grant and measurement date reported by the Company within the Company's stock option award documentation. Other grants were found to have been assigned measurement dates subsequent to documented approval in the Minutes which would have indicated a potential re-pricing of the options, specifically when there was a significant time lag between the approval in the minutes and the measurement date and the price on the measurement date was significantly lower. The grantees were senior executives or others who would have been aware that they were granted awards by the Compensation Committee and a mutual understanding would have occurred. Accordingly, certain of these grants were determined to have been awarded on the date approved by the Compensation Committee and re-priced on a subsequent date, particularly for grants that the Investigative Team believed the recipients would have been knowledgeable of the Compensation Committee's approval and the key terms and conditions of the grant. Furthermore, in certain instances the Minutes acknowledged prior approvals of stock-based compensation awards although no documentation of such approval exists in the Company's records. In each of the cases described above, the Company determined that the originally assigned measurement dates could not be reliably supported and such grants should be based on dates documented in the Minutes. As a result, the Company re-measured and accounted for these awards as fixed (variable with respect to the options considered to be re-priced) on the date indicated in the Minutes.

The Company issued stock options in connection with employment agreements, offer letters, or other documentation indicative of an employee's start of employment, but such awards often had measurement dates prior to the actual commencement of employment. The Company determined the appropriate measurement date for these grants to be the date on which the employee commenced employment.

The Company also identified certain stock option grants where the sole evidence was the aforementioned stock option agreements, interoffice request forms or stock option grant letters and employment agreement amendments (collectively, Non-contemporaneous Dated Documents). Stock option agreements included terms of the option grant and typically used as of dating to document such terms, and the Investigative Team concluded that it was unlikely that such agreements were signed by the Company and the employee on a contemporaneous basis. The interoffice request forms were undated standard forms that reflected the term of the option grants including, in some cases, grant dates. Stock option grant letters were also undated correspondence that reflected all of the terms of the options. The stock option grant letter became the primary means of documenting all of the terms of the option grants beginning in May 2002. At that time, the Company memorialized all prior option grants by preparing stock option grant letters and these grant letters were not contemporaneously dated. All of the Non-contemporaneous Dated Documents were either authorized or signed by the former Chairman/CEO until March 2004 when he stepped-down as Chairman. As noted above, the Investigative Team found the former Chairman/CEO to have engaged in a pattern and practice of backdating option grants and determined that his representations could not be relied upon. Accordingly, any form of stock grant documentation that was authorized and/or signed by him and for which there was no other evidence that corroborated the measurement date, was deemed to be unreliable for measurement purposes.

Employment agreement amendments typically acknowledged a previous grant of options or a new grant and there was either limited or no documentation supporting the previous grant. Frequently, the indicated date of the grant was considered a fortuitous date (i.e. a date on which the Company's stock price was at a low point during the period). The Investigative Team found evidence that the indicated grant date within such agreements was often unreliable for measurement purposes, and in some cases the amendment itself was backdated.

With respect to the Non-contemporaneous Dated Documents or otherwise unsupported grants, the Investigative Team reviewed and analyzed all available correspondence, including the master stock option tracking spreadsheets to determine the date on which the option was first entered into the spreadsheet, and the first period the grant was included in the EPS Records. The Company used available metadata and other computer generated records to determine the date on which the award was first entered into these spreadsheets. If the first date that the option was entered into the spreadsheet was identified, that date was used as the measurement date after considering any other available documentation. In cases where the date of first entry in the master option tracking spreadsheet was subsequent to the quarter in which the grant was first included in the EPS Records, these EPS Records were used for the determination of the measurement date. EPS Records were only considered when there was no earlier correspondence or other evidence to document a more reliable measurement date.

The Company believes that this evidence, as supported by the Investigative Team's conclusions, is consistent with the provisions of APB 25 whereby the measurement date is the first date on which the number of shares that each individual is allocated and the related option price is determined with employee notification soon afterwards (i.e. a mutual understanding between the employee and the Company of the key terms and conditions of an award) (See paragraph below regarding actual date selected). While the number of shares and their corresponding exercise prices were identified in all of the Non-contemporaneous Dated Documents or employment agreement amendments referred to above, the Investigative Team determined that in many instances these documents were not contemporaneously prepared and, as noted above, could not be relied upon for the measurement date. Additionally, the Investigative Team noted that the granting process and related approvals, whether formally approved by the Compensation Committee or authorized by the former Chairman/CEO, occurred prior to including the grant and its terms in master stock option tracking spreadsheets and the EPS Records. Once grants and their relevant terms were included in these spreadsheets or the EPS Records, changes to key terms (exercise price, number of shares, vesting period and identified employee) did not occur.

Where evidence of a stock option grant was limited to the EPS Records, this evidence does not result in a specific date as required under APB 25, but rather the period in which the measurement date occurred. Accordingly, the Company considered the qualitative and quantitative attributes of several alternatives, including using the date of the Company's high and median closing stock price in each quarter. In the absence of evidence to support a more appropriate measurement date, the Company has selected the first instance of the highest quoted stock price in the quarter that the stock option grant was first included in the EPS Records as its measurement date for such stock option grants. The Company believes that this ensures that a sufficient amount of compensation expense results and that this date is equally probable to any other date in the quarter. Furthermore, neither existing documentation nor the results of the investigation indicate that there is a more appropriate date. This methodology resulted in the Company recognizing approximately \$25 million of cumulative pre-tax stock-based compensation expense for the period April 15, 1997, the date of the Company's IPO, through October 31, 2005.

If the Company had instead used the median closing price of its common stock in the corresponding quarters, rather than the highest price, the Company estimates that it would have reduced its cumulative pre-tax stock-based compensation charge by approximately \$13 million. Restated cumulative net income (i.e. net income from the date of the Company's IPO through October 31, 2005) would have been approximately 3% higher if the Company had used the median closing price of its common stock, rather

than the highest price. The Company has deemed the difference between recording compensation expense based on the Company's high and median closing stock prices to be quantitatively immaterial in the aggregate and to each individual fiscal year since the Company's IPO, except for the Company's fiscal years ended 2001 and 2000, when such difference would have impacted the Company's previously reported net income by approximately \$1.1 million and \$0.7 million, respectively. However, the Company believes that these differences, in isolation, are not qualitatively material and would not impact an investor's prospective opinion or valuation of the Company.

The Company also reviewed 84 restricted stock awards that were issued between May 2002 and June 2006 and identified 10 instances in which such awards had measurement dates that did not correspond with Minutes, employment agreements, offer letters, or other documentation indicative of an employee's start date of employment. As a result, the Company recognized additional cumulative stock-based compensation expense of \$0.6 million, net of tax, through October 31, 2005 related to these awards.

Based on the relevant facts and circumstances, the Company applied the controlling accounting standards in each year to determine, for every grant within each category, the proper measurement date. If the measurement date was not the original date that was reported in the records of the Company, accounting adjustments were made to record compensation expense based on the difference between the closing price on the revised measurement date and the exercise price. The restatement as a result of the Special Committee investigation resulted in stock-based compensation expense and tax effects totaling approximately \$54.6 million (\$42.1 million, net of tax) from the IPO through October 31, 2005. The Investigative Team used a significant amount of judgment in examining each separate option grant and also in determining the new measurement date applied to each grant in the Company's calculation of compensation expense.

The Company has restated previously filed financial statements in this Form 10-Q. The impact of the restatement adjustments on the Company's 2006 statements of operations was recorded in the third quarter of 2006 due to its immateriality, and therefore the Company's previously reported 2006 quarterly results of operations for the first and second quarters have not been restated.

Additionally, the Company has restated the pro forma expense under Statement of Financial Accounting Standards (SFAS) No. 123 in Note 4 to reflect the impact of these adjustments.

The Company is in the process of determining the extent of the adverse tax consequences that may be incurred by the holders of re-measured stock options. The adverse tax consequences relate to re-measured stock options vesting after December 31, 2004 ( 409A Affected Options ) and subject the option holder to a penalty tax under Internal Revenue Code ( IRC ) IRC Section 409A (and, as applicable, similar penalty taxes). One action being considered by the Company is to offer to amend the 409A Affected Options to increase the exercise price to the market price on the accounting measurement date or, if lower, the market price at the time of the amendment. The amended options would not be subject to taxation under IRC Section 409A. Under IRS regulations, these option amendments had to be completed by December 31, 2006 for anyone who was an executive officer when he or she received 409A Affected Options; the amendments for non-executive officers cannot be offered until after this Form 10-Q is filed and do not need to be completed until December 31, 2007. Another possible action is to approve bonuses payable to holders of the amended options to compensate them for the resulting increase in their option exercise price. The amount of these bonuses would be effectively repaid to the Company if and when the options are exercised and the increased exercise price is paid (but there is no assurance that the options will be exercised). The Company has not determined what actions it will take, if any, with respect to 409A Affected Options. Any charges that arise from actions taken by the Company will be recorded in the period in which the determinations are made.

The Company also believes that United States tax deductions taken for stock option exercises in prior years, which pertained to certain executives, may not be deductible under limitations imposed by IRC Section 162(m). Section 162(m) limits the deductibility of compensation above \$1 million to certain executive officers of public companies when such compensation is not incentive-based. The Special Committee found that many of the stock options granted to executives had intrinsic value on the basis of the new measurement dates determined for US GAAP financial statement purposes and therefore, under Section 162(m), may not incentive-based and may not be tax deductible by the Company. As a result the Company has reduced its available tax net operating loss carry-forwards arising from certain exercised stock options and restricted stock. Separately, the Company also identified certain restricted stock grants and bonuses paid in prior periods that may be ineligible for deduction under section 162(m). The Company restated its tax provisions in the periods in which the benefits were recorded. The Company is in discussions with the IRS to settle these uncertainties regarding additional liabilities; however, there is no assurance that they will be settled on terms favorable to the Company.

As a result of its review, the Company also determined that it failed to properly withhold an immaterial amount of employment taxes associated with certain stock option exercises. The Company has recorded such amounts in its consolidated statements of operations in the period in which the Company was originally obligated to make the withholding.

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The following table presents the effects of the stock-based compensation and related tax adjustments made to the Company's previously reported condensed consolidated statements of operations:

	Three months ended July 31, 2005			Nine months ended July 31, 2005		
	As previously reported	Adjustments	As restated	As previously reported	Adjustments	As restated
Net revenue	\$ 169,899	\$	\$ 169,899	\$ 894,441	\$	\$ 894,441
Cost of goods sold:						
Product costs	92,525		92,525	453,514		453,514
Royalties	25,608		25,608	127,755		127,755
Software development costs	4,046		4,046	13,031		13,031
Total cost of goods sold	122,179		122,179	594,300		594,300
Gross Profit	47,720		47,720	300,141		300,141
Selling and marketing	32,437	12	32,449	119,643	318	119,961
General and administrative	32,539	(158 )	32,381	89,931	1,060	90,991
Research and development	19,736	163	19,899	56,938	486	57,424
Impairment of goodwill and long-lived assets						
Depreciation and amortization	5,691		5,691	15,579		15,579
Total operating expenses	90,403	17	90,420	282,091	1,864	283,955
Income (loss) from operations	(42,683 )	(17 )	(42,700 )	18,050	(1,864 )	16,186
Interest income, net	1,261	(3 )	1,258	2,965	(9 )	2,956
Income (loss) before income taxes	(41,422 )	(20 )	(41,442 )	21,015	(1,873 )	19,142
Income taxes	(12,642 )	176	(12,466 )	2,732	(43 )	2,689
Net income (loss)	\$ (28,780 )	\$ (196 )	\$ (28,976 )	\$ 18,283	\$ (1,830 )	\$ 16,453
Earnings (loss) per share*:						
Basic	\$ (0.41 )	\$ (0.00 )	\$ (0.41 )	\$ 0.26	\$ (0.03 )	\$ 0.24
Diluted	\$ (0.41 )	\$ (0.00 )	\$ (0.41 )	\$ 0.26	\$ (0.03 )	\$ 0.23
Weighted average shares outstanding:						
Basic	70,556		70,556	69,768		69,768
Diluted	70,556		70,556	70,974	26	71,000

\* Certain per share amounts do not add due to rounding

All applicable amounts relating to the aforementioned restatements have been reflected in these condensed consolidated financial statements and notes thereto.

## 4. STOCK-BASED COMPENSATION

Effective November 1, 2005, the Company adopted SFAS 123(R), which revised Statement of Financial Accounting Standards No. 123. SFAS 123(R) requires all share-based payment transactions with employees, including grants of employee stock options, to be recognized as compensation expense over the requisite service period based on their relative fair values. Prior to the adoption of SFAS 123(R), stock-

based compensation expense related to employee stock options was not recognized in the statement of operations if the exercise price was at least equal to the market value of the common stock on the grant date, in accordance with Accounting Principles Board Opinion No. 25,

Accounting for Stock Issued to Employees. Prior to November 1, 2005, the Company had adopted the disclosure-only provisions under SFAS 123.

The Company elected to use the Modified Prospective Application ( MPA ) method for implementing SFAS 123(R). Under the MPA method, prior periods are not restated and new awards are valued and accounted for prospectively upon adoption. Outstanding prior stock option awards that are non-vested as of October 31, 2005 are recognized as compensation expense in the statement of operations over the remaining requisite service period.

The Company has stock-based compensation plans under which directors, officers and other employees are eligible to receive stock options and restricted stock awards. Generally, stock options are granted with an exercise price equal to the market value of a share of common stock on the date of grant, expire within five years and vest over three years. As of July 31, 2006, the Company's 2002 stock option plan provides for a total of 11.0 million shares of common stock to be issued upon exercise of options, of which approximately 1.9 million shares were available for grant. As of July 31, 2006, the Company's Incentive Stock Plan (restricted stock awards) provides for a total of 2.5 million shares of common stock to be issued of which approximately 0.2 million shares were available for grant.

As discussed in Note 3, the Company, in granting options, was found in many cases not to be in compliance with the terms of its Stock Option Plans.

The following table summarizes the activity in options under the Company's stock-based compensation plans:

(options in thousands)	Three months ended July 31, 2006		April 30, 2006		January 31, 2006	
	Options	Weighted Average Exercise Price	Options	Weighted Average Exercise Price	Options	Weighted Average Exercise Price
Outstanding at beginning of period	7,131	\$ 20.61	7,409	\$ 20.55	7,495	\$ 20.47
Granted			116	16.77	65	18.13
Exercised	(45 )	14.42	(98 )	10.37	(86 )	12.87
Forfeited	(825 )	20.43	(296 )	20.87	(65 )	19.56
Outstanding at period-end	6,261	\$ 20.68	7,131	\$ 20.61	7,409	\$ 20.55
Exercisable at period-end	4,021	\$ 19.34				

As of July 31, 2006, the weighted average remaining contractual term of the Company's options outstanding and exercisable is 2.9 years and 2.5 years, respectively. As of July 31, 2006, due to the Company's stock price, there is no aggregate intrinsic value related to options outstanding or exercisable. As of July 31, 2006, the total future unrecognized compensation cost, net of estimated forfeitures, related to outstanding unvested options is \$21,600 which will be recognized as compensation expense, on a straight-line basis, over the remaining vesting period through 2009.

The weighted average per share fair values of options granted were \$13.81 for the three months ended July 31, 2005 and \$7.86 and \$13.86 for the nine months ended July 31, 2006 and 2005, respectively. No stock options were granted during the three months ended July 31, 2006. The fair value of the Company's options was estimated using the Black-Scholes option-pricing model. This model requires the input of assumptions regarding a number of complex and subjective variables that will usually have a significant impact on the fair value estimate. These variables include, but are not limited to, the volatility of the Company's stock price and employee stock option exercise behavior. The assumptions and variables used for the current period grants were developed based on SFAS 123(R) and SEC guidance contained in Staff

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Accounting Bulletin (SAB) No. 107, Share-Based Payment. The following table summarizes the assumptions and variables used by the Company to compute the weighted average fair value of stock option grants:

	Three months ended				Nine months ended			
	July 31, 2006		2005		July 31, 2006		2005	
			As restated				As restated	
Risk-free interest rate	4.9	%	3.7	%	4.6	%	3.8	%
Expected stock price volatility	57.7	%	63.5	%	55.0	%	65.8	%
Expected term until exercise (years)	n/a		4.4		3.8		4.9	
Dividends	None		None		None		None	

For the three and nine months ended July 31, 2006, the Company used a combination of historical volatility and the implied volatility for publicly traded options on the Company's stock as the expected volatility assumption required in the Black-Scholes option-pricing model consistent with SFAS 123(R) and SAB 107. Prior to fiscal 2006, the Company had used its historical stock price volatility in accordance with SFAS 123 for purposes of its pro forma information. The selection of the implied volatility approach was based upon the availability of actively traded options on the Company's stock and the Company's assessment that implied volatility is more representative of future stock price trends than historical volatility.

SFAS 123(R) requires the recognition of stock-based compensation for the number of awards that are ultimately expected to vest. As a result, for most awards, recognized stock compensation was reduced for estimated forfeitures prior to vesting primarily based on a historical annual forfeiture rate of approximately 7%. Estimated forfeitures will be reassessed at each balance sheet date and may change based on new facts and circumstances. Prior to October 31, 2005, actual forfeitures were accounted for as they occurred for purposes of required pro forma stock compensation disclosures.

Restricted stock awards are expensed on a straight-line basis over the vesting period, which typically ranges from one to four years. As of July 31, 2006, the total future unrecognized compensation cost related to outstanding unvested restricted stock is approximately \$22,400 and will be recognized as compensation expense over the remaining vesting period, which is through fiscal year ended October 31, 2009.

The following table summarizes the activity in non-vested restricted stock under the Company's stock-based compensation plans:

	Shares (in thousands)	Weighted Average Exercise Price
Non-vested restricted stock at October 31, 2005	600	\$ 23.03
Granted	45	19.24
Vested	(52 )	22.35
Forfeited	(6 )	19.00
Non-vested restricted stock at January 31, 2006	587	\$ 22.84
Granted	962	15.59
Vested	(57 )	22.25
Forfeited	(5 )	22.78
Non-vested restricted stock at April 30, 2006	1,487	\$ 18.17
<b>Granted</b>	<b>86</b>	<b>16.44</b>
<b>Vested</b>	<b>(57 )</b>	<b>25.18</b>
<b>Forfeited</b>		
<b>Non-vested restricted stock at July 31, 2006</b>	<b>1,516</b>	<b>\$ 17.81</b>



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The following table summarizes the components and classification of stock-based compensation expense in the Company's condensed consolidated statements of operations:

	Three months ended July 31,		Nine months ended July 31,	
	2006	2005	2006	2005
		As restated		As restated
Stock options	\$ 2,561	\$ 425	\$ 9,440	\$ 1,898
Restricted stock	1,861	3,295	4,979	12,665
Total stock-based compensation expense	\$ 4,422	\$ 3,720	\$ 14,419	\$ 14,563
Selling and marketing	\$ (290 )	\$ 806	\$ 942	\$ 3,370
General and administrative	3,474	1,285	10,064	4,364
Research and development	1,238	1,629	3,413	6,829
Total stock-based compensation expense	\$ 4,422	\$ 3,720	\$ 14,419	\$ 14,563

Selling and marketing, general and administrative, and research and development were increased by \$0.3 million, \$0.8 million and \$0.5 million, respectively in the nine months ended July 31, 2005 as a result of the restatement. For the three months ended July 31, 2005, research and development was increased by \$0.2 million and general and administrative was decreased by \$0.2 million as a result of the Company's restatement.

Effective November 1, 2005, in connection with the adoption of SFAS 123(R), the Company capitalizes a portion of its stock-based compensation costs as software development costs. Stock-based compensation expense for the three and nine months ended July 31, 2006 excludes approximately \$2,100 and \$5,200, respectively, in stock-based compensation costs which were capitalized as software development costs in connection with the development of software titles. In prior periods, the Company's disclosures regarding the pro forma impact on net income of stock-based compensation do not reflect the capitalization of these costs.

Amortization of such capitalized costs as a component of costs of goods sold is recorded on a title-by-title basis based on the greater of the proportion of current year sales to the total of current and estimated future sales for the title or the straight-line method over the remaining estimated useful life of the title. At each balance sheet date, the Company evaluates the recoverability of capitalized software costs based on undiscounted future cash flows and charges to cost of goods sold any amounts that are deemed unrecoverable.

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For the three and nine months ended July 31, 2005, had the compensation cost for the Company's stock option plans been determined based on the fair value at the grant date for awards consistent with the provisions of SFAS 123, the Company's net income and net income per share would have been adjusted to the pro forma amounts indicated below:

	Three months ended July 31, 2005 As restated	Nine months ended July 31, 2005 As restated
Net income as reported	\$ (28,976 )	\$ 16,453
Add: Stock-based employee compensation expense included in reported net income, net of related tax effects	2,290	9,077
Deduct: Total stock-based employee compensation expense determined under the fair value based method for all awards, net of related tax effects	(7,556 )	(24,056 )
Pro forma net income (loss)	\$ (34,242 )	\$ 1,474
<b>Basic and diluted earnings (loss) per share:</b>		
Basic as reported	\$ (0.41 )	\$ 0.24
Basic proforma	(0.49 )	0.02
Diluted as reported	(0.41 )	0.23
Diluted proforma	(0.49 )	0.02

The Company's restatement of stock-based compensation expense, as discussed in Note 3, and the related impact that the re-measurement of stock-option awards had on previously reported expected term until exercise, as disclosed above, reduced pro forma net income by \$382 and \$3,012 in the three and nine months ended July 31, 2005, respectively.

## 5. BUSINESS ACQUISITIONS AND CONSOLIDATION

The acquisitions described below have been accounted for as purchase transactions. Accordingly, the results of operations and financial position of the acquired businesses are included in the Company's condensed consolidated financial statements from the respective dates of acquisition. To the extent that the purchase price allocation for these acquisitions is preliminary, the Company does not expect that the final purchase price allocation will be materially different. Pro forma information has not been provided as the impact of these acquisitions was not material.

In November 2005, the Company acquired all of the outstanding capital stock of Firaxis Games, Inc. (Firaxis), a developer of PC and strategy titles, including the *Civilization* franchise. The purchase price of approximately \$15,442 consisted of \$12,500 of unregistered common stock and \$4,085 of development advances previously paid to Firaxis reduced by net cash acquired of \$1,143. In connection with the acquisition, the Company recorded \$5,644 of identifiable intangible assets, comprised of \$1,130 of non-competition agreements and \$4,514 of intellectual property, \$11,085 of goodwill, which is not deductible for tax purposes, \$333 of net assets and \$1,620 of deferred tax liabilities, on a preliminary basis. The Company also agreed to make additional payments up to \$11,250 based on future product sales, of which approximately \$10,000 will be recorded as additional purchase price and \$1,250 will be recorded as employee compensation expense when the conditions requiring their payment are met.

In August 2005, the Company acquired all of the outstanding membership interests in Irrational Studios (Irrational), the developer of certain of the Company's titles. The purchase price consisted of \$4,212 in cash and \$2,000 of unregistered common stock, which was payable at closing, \$1,550 of development advances previously paid to Irrational and \$2,000 of deferred consideration, which is payable in equal amounts on the first and second anniversary of the acquisition. In connection with the acquisition, the Company recorded \$2,250 of identifiable intangible assets, \$7,665 of goodwill, which is deductible for tax purposes, \$187 of non-current assets and \$340 of net current liabilities. The Company also agreed to make additional payments of \$2,000 based on the delivery of products which will be recorded as additional purchase price when the conditions requiring their payment are met.

In June 2005, the Company acquired all of the outstanding capital stock of Gaia Capital Group and its wholly-owned subsidiaries (Gaia), the developers of certain of the Company's titles for console and handheld platforms. The purchase price consisted of \$5,748 in cash, \$4,055 of development advances previously paid to Gaia and deferred consideration of \$1,597. In connection with the acquisition, the Company recorded \$3,940 of identifiable intangible assets, \$7,918 of goodwill, which is deductible for tax purposes, \$528 of non-current assets, and \$986 of net current liabilities.

In January 2005, the Company acquired from SEGA all of the outstanding capital stock of Visual Concepts Entertainment and its wholly-owned subsidiary, Kush Games, the developers of certain of the Company's sports titles, and certain intellectual property rights associated with these products. The purchase price consisted of \$27,794 in cash, \$1,866 of prepaid royalties previously advanced to SEGA and contingent consideration of \$2,593 based on the release of certain titles. In connection with the acquisition, the Company recorded \$7,980 of identifiable intangible assets, \$29,433 of goodwill, which is not deductible for tax purposes, \$1,196 of non-current assets, \$3,164 of net current liabilities and \$3,192 of deferred tax liabilities related to identifiable intangible assets.

The Company has product development agreements with Blue Castle Games, Inc. (Blue Castle), a software development studio responsible for creating certain of the Company's sports titles. Based on the

terms of the agreements, Blue Castle is considered a variable interest entity and the Company is considered to be the primary beneficiary of Blue Castles' future profits or losses. As a result, pursuant to FIN 46 (R), the financial position and results of operations of Blue Castle are included in the Company's consolidated financial statements for the three and nine months ended July 31, 2006. The Company does not have any equity ownership of Blue Castle. The consolidation of Blue Castle did not have a material impact on the Company's consolidated financial statements.

## 6. INCOME TAXES

At each balance sheet date, the Company evaluates its estimated annual effective tax rate based on updated information on forecasted income generated in each of its jurisdictions. Any revisions to the rates are recorded in the current period to reflect management's current best estimate of the annual effective tax rate.

The Company recorded a valuation allowance of approximately \$59,500 in the third quarter of 2006, or approximately \$0.84 per share, to reduce the Company's deferred tax assets to net realizable value. The valuation allowance was recorded primarily due to uncertainty regarding the Company's ability to utilize its net operating loss carryforwards.

Recent tax legislation replaced the extraterritorial income (ETI) exclusion, subject to a phase-out of the exclusion. The Company currently derives benefits from the ETI exclusion, which is limited to 80% and 60% of the otherwise allowable exclusion in calendar years 2005 and 2006, respectively. There will be no ETI deduction available after calendar year 2006. This recent legislation replaces the ETI with a deduction from taxable income based on certain qualified income from domestic production activities. The Company does not expect to derive any benefits from the domestic manufacturing deduction in fiscal 2006 due to limitations associated with claiming the benefits of this deduction.

This legislation also provided for a one-time 85% dividends received deduction on repatriation of foreign earnings, which was not utilized by the Company. Historically, the Company has considered undistributed earnings of its foreign subsidiaries to be indefinitely reinvested and, accordingly, no incremental taxes have been provided thereon. The Company did not repatriate any foreign earnings under this provision. The total amount of undistributed earnings of foreign subsidiaries was approximately \$154,000 as of July 31, 2006.

The Company adopted FAS 123(R) on November 1, 2005, which requires, among other items, the recognition of stock option expense in the results of operations. As a result of the adoption of SFAS 123(R), the income tax effects of compensatory stock options are included in the computation of the income tax expense (benefit), and deferred tax assets and liabilities, subject to certain prospective adjustments to stockholders' equity for the differences between the income tax effects of expenses recognized in the results of operations and the related amounts deducted for income tax purposes. Prior to the Company's adoption of SFAS 123(R), the tax benefits relating to the income tax deductions for compensatory stock options were recorded directly to stockholders' equity.

## 7. NET INCOME (LOSS) PER SHARE

The following table provides a reconciliation of basic net income (loss) per share to diluted net income (loss) per share for the three and nine months ended July 31, 2006 and 2005:

	Net Income (loss)	Shares (in thousands)	Per Share Amount
Three Months Ended July 31, 2006:			
Basic and Diluted	\$ (91,379 )	71,095	\$ (1.29 )
Three Months Ended July 31, 2005			
Basic and Diluted, as restated	\$ (28,976 )	70,556	\$ (0.41 )
Nine Months Ended July 31, 2006			
Basic and Diluted	\$ (170,874 )	70,954	\$ (2.41 )
Nine Months Ended July 31, 2005			
Basic, as restated	\$ 16,453	69,768	\$ 0.24
Effect of dilutive securities    Stock options, restricted stock and warrants, as restated		1,232	
Diluted, as restated	\$ 16,453	71,000	\$ 0.23

The effect of the Company's restatement for stock-based compensation, as discussed in Note 2, did not have a significant impact on diluted weighted average shares outstanding in the years ended October 31, 2005 and 2004. The computation of diluted number of shares excludes unexercised stock options, warrants and non-vested restricted shares which are antidilutive. A net loss was reported for the three and nine months ended July 31, 2006, therefore, the diluted number of shares excludes 7,776 of unexercised stock options and non-vested restricted shares, which are antidilutive due to the net loss. The computation of diluted number of shares excludes 8,020 and 1,764 of unexercised stock options and warrants for the three and nine months ended July 31, 2005, which are antidilutive.

## 8. INVENTORY, NET

As of July 31, 2006 and October 31, 2005, inventory consists of:

	July 31, 2006	October 31, 2005
Finished products, net	\$ 75,236	\$ 128,753
Parts and supplies, net	7,985	7,474
Inventory, net	\$ 83,221	\$ 136,227

Estimated product returns included in the inventory balance were \$8,018 and \$8,857 at July 31, 2006 and October 31, 2005, respectively.

**9. SOFTWARE DEVELOPMENT COSTS**

The following table provides the details of software development costs:

	<b>Fiscal 2006</b>	<b>Fiscal 2005</b>
Balance, November 1	<b>\$ 108,428</b>	<b>\$ 64,322</b>
Additions	<b>32,268</b>	39,510
Amortization	<b>(22,583)</b>	(13,358)
Write down	<b>(520)</b>	(2,964)
Foreign exchange	<b>337</b>	498
Balance, January 31	<b>117,930</b>	88,008
Additions	<b>34,354</b>	23,066
Amortization	<b>(38,437)</b>	(12,779)
Write down	<b>(17,942)</b>	(33)
Foreign exchange	<b>709</b>	(37)
Balance, April 30	<b>96,614</b>	98,225
Additions	<b>34,639</b>	27,386
Amortization	<b>(31,237)</b>	(10,467)
Write down	<b>(16)</b>	(1,970)
Foreign exchange	<b>54</b>	(386)
Balance, July 31	<b>100,054</b>	112,788
Less: current portion	<b>69,997</b>	51,423
Non-current portion	<b>\$ 30,057</b>	<b>\$ 61,365</b>

Software development costs at July 31, 2006 and October 31, 2005 included amounts of \$90,096 and \$77,544, respectively, related to titles that have not yet been released. In addition, software development costs resulting from advance payments and guarantees to third-party developers was \$31,799 and \$48,104 at July 31, 2006 and October 31, 2005, respectively.

As a result of weaker market conditions, the closure of development studios and uncertainty involved in the console transition, the Company wrote-down software development costs (and charged cost of goods sold), in the second quarter of 2006, for several titles that were in development and were unlikely to recover their capitalized costs.

**10. LICENSES**

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The following table provides the details of licenses:

	<b>Fiscal 2006</b>	<b>Fiscal 2005</b>
Balance, November 1	<b>\$ 9,981</b>	<b>\$ 5,665</b>
Additions	<b>6,096</b>	4,480
Amortization	<b>(4,943 )</b>	(1,256 )
Write down		(400 )
Balance, January 31	<b>11,134</b>	8,489
Additions	<b>1,122</b>	1,076
Amortization	<b>(3,019 )</b>	(934 )
Write down		
Balance, April 30	<b>9,237</b>	8,631
Additions	<b>309</b>	1,918
Amortization	<b>(1,341 )</b>	(1,460 )
Write down	<b>(850 )</b>	(156 )
Balance, July 31	<b>7,355</b>	8,933
Less: current portion	<b>5,907</b>	6,787
Non-current portion	<b>\$ 1,448</b>	<b>\$ 2,146</b>

Included in licenses at July 31, 2006 and October 31, 2005 are \$7,352 and \$5,466, respectively, related to titles that have not yet been released.

## 11. FIXED ASSETS, NET

As of July 31, 2006 and October 31, 2005, fixed assets consist of:

	July 31, 2006	October 31, 2005
Computer equipment	\$ 25,909	\$ 22,893
Office equipment	11,960	13,940
Computer software	33,522	26,411
Furniture and fixtures	6,047	6,338
Leasehold improvements	20,000	19,031
Capital leases	398	398
	97,836	89,011
Less: accumulated depreciation	51,354	40,394
Fixed assets, net	\$ 46,482	\$ 48,617

Depreciation expense for the three and nine months ended July 31, 2006 and 2005 was \$5,342 and \$15,998, respectively, and \$4,372 and \$11,697, respectively. In addition, in connection with its goodwill impairment testing, the Company recognized a charge of \$1,738 related to fixed assets at its Joytech subsidiary that had book values in excess of fair value.

## 12. GOODWILL AND INTANGIBLES, NET

The Company assesses goodwill and indefinite-lived intangible assets for impairment annually in August, or more frequently if circumstances indicate impairment may have occurred. During the third quarter of the year ending October 31, 2006, the Company recorded a goodwill impairment charge at its Joytech subsidiary, the Company's manufacturer and distributor of video game accessories operated within its publishing segment. The impairment charge of approximately \$6,341 was recorded as a component of operating expenses in the accompanying consolidated statement of operations and was determined by comparing the fair value of the Joytech business and the implied value of the goodwill and other long-lived assets, with the carrying amounts on the balance sheet. The decline in the fair value of Joytech's business was due to continued competition and a decline in the price and sales volume of current generation accessories due to weaker market conditions and the ongoing transition to next generation hardware platforms. In addition, the Company wrote-down approximately \$7,212 of trademarks and other intangibles in the second and third quarters of 2006 of which \$3,465 was related to studio closures.



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Intangible assets consist of trademarks, customer lists and relationships, intellectual property, non-competition agreements and acquired technology in connection with acquisitions. Intangible assets are amortized under the straight-line method over the period of expected benefit ranging from two to ten years or amortized based on the expected revenue stream.

	Estimated Useful Lives (Years)	July 31, 2006 Gross Carrying Amount	Accumulated Amortization	Net Book Value	October 31, 2005 Gross Carrying Amount	Accumulated Amortization	Net Book Value
Trademarks	7-10	\$ 17,716	\$ (8,364 )	\$ 9,352	\$ 29,365	\$ (14,145 )	\$ 15,220
Customer lists and relationships	5-10	4,673	(3,487 )	1,186	4,673	(3,282 )	1,391
Intellectual property	2-6	69,249	(40,854 )	28,395	69,927	(36,371 )	33,556
Non-compete	5-10	7,617	(4,808 )	2,809	8,738	(4,472 )	4,266
Technology	3	11,509	(7,188 )	4,321	9,032	(4,799 )	4,233
Total		\$ 110,764	\$ (64,701 )	\$ 46,063	\$ 121,735	\$ (63,069 )	\$ 58,666

Amortization expense for the three and nine months ended July 31, 2006 and 2005 is as follows:

Included in:	Three months ended July 31, 2006	2005	Nine months ended July 31, 2006	2005
Cost of goods sold product costs	\$ 991	\$ 1,318	\$ 7,301	\$ 7,227
Depreciation and amortization	948	1,319	3,780	3,882
Total amortization of intangible assets	\$ 1,939	\$ 2,637	\$ 11,081	\$ 11,109

### 13. LINES OF CREDIT

In August 2005, the Company entered into a credit agreement with JPMorgan Chase Bank, N.A. ( JPMorgan ). The JPMorgan credit agreement provided for borrowings of up to \$50,000 through the expiration of the agreement on August 23, 2006. The Company had no borrowings under the credit agreement and was in compliance with all financial and other covenants at July 31, 2006. The Company did not renew its credit agreement with JPMorgan.

In May 2006, the Company's United Kingdom subsidiary renewed its credit facility agreement with Lloyds TSB Bank plc ( Lloyds ) under which Lloyds agreed to make available borrowings of up to approximately \$23,000. Advances under the credit facility bear interest at the rate of 1.25% per annum over the bank's base rate, and are guaranteed by the Company. Available borrowings under the agreement are reduced by the amount of outstanding guarantees. The facility expires on March 31, 2007. The Company had no outstanding guarantees and no borrowings under this facility as of July 31, 2006.

### 14. ACCRUED EXPENSES AND OTHER CURRENT LIABILITIES

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Accrued expenses and other current liabilities as of July 31, 2006 and October 31, 2005 consist of:

	July 31, 2006	October 31, 2005 As Restated
Royalties	\$ 51,680	\$ 17,940
Licenses	26,151	9,743
Compensation and benefits	18,645	24,293
Deferred revenue	10,235	6,414
Rent and deferred rent obligations	7,552	6,484
Professional fees	6,429	7,219
Co-op advertising	3,312	3,802
Freight	1,452	2,321
Income taxes payable	26,631	22,511
Other	13,885	12,843
<b>Total</b>	<b>\$ 165,972</b>	<b>\$ 113,570</b>

## 15. LEGAL AND OTHER PROCEEDINGS

In July 2005, the Company received three purported class action complaints against the Company and Rockstar Games, two of which were filed in the United States District Court for the Southern District of New York and one such complaint which was filed in the United States District Court, Eastern District of Pennsylvania. On September 8, 2005, another similar complaint was filed in the Circuit Court for the Twentieth Judicial District, St. Clair County, Illinois and then removed to United States District Court for the Southern District of Illinois. The plaintiffs, alleged purchasers of the Company's *Grand Theft Auto: San Andreas* game, allege that the Company and Rockstar Games engaged in consumer deception, false advertising and common law fraud and were unjustly enriched as a result of the alleged failure of the Company and Rockstar Games to disclose that *Grand Theft Auto: San Andreas* contained hidden content, which resulted in the game receiving an M rating from the ESRB rather than an AO rating. The complaints seek unspecified damages, declarations of various violations of law and litigation costs. The New York and Pennsylvania actions, together with an action commenced against the Company and Rockstar Games in the United States District for the Southern District of New York in August 2006, have been consolidated in the Southern District of New York under the caption *In re Grand Theft Auto Video Game Consumer Litigation*, (05-CV-6734 (BSJ)) and the Illinois action has been transferred to the Southern District of New York for coordinated pretrial proceedings pursuant to an Order of Judicial Panel on Multidistrict Litigation. These cases have been consolidated for pretrial proceedings under the caption *In re Grand Theft Auto Video Game Consumer Litigation (No. II)*, 06-MD-1739 (SWK)(MHD). On June 7, 2006 plaintiffs filed a Consolidated and Amended Complaint. On July 31, 2006, the Company and Rockstar Games filed a Partial Motion to Dismiss those claims brought under the laws of states other than states where the named plaintiff resides and were purportedly injured. By an Opinion and Order dated October 25, 2006, the Partial Motion to Dismiss was denied. On November 10, 2006 the Company and Rockstar Games filed a Motion to Deny Certification of the proposed nationwide class. On November 17, 2006 the Company and Rockstar Games served an answer denying the allegations in the Consolidated and Amended Complaint and asserting various affirmative defenses. On January 24, 2007, the Plaintiffs cross-moved for certification of the proposed nationwide class. Consolidated discovery in these actions is proceeding.

In January 2006, the City Attorney for the City of Los Angeles filed a complaint against the Company and Rockstar Games in the Superior Court of the State of California. The complaint alleges that the Company and Rockstar Games violated sections of the California Business and Professions Code prohibiting untrue and misleading statements and unfair competition and that the Company and Rockstar Games were unjustly enriched as a result of the alleged failure to disclose that *Grand Theft Auto: San Andreas* contained hidden content which should have resulted in the game receiving an Adults Only (AO) rating from the ESRB rather than a Mature (M) rating. The complaint also alleges that the Company made misleading statements as to the origin of the hidden content. The complaint seeks injunctive relief, restitution for purchasers of the game and civil fines. The action has been removed to the United States District Court, Central District of California and the Company moved to dismiss the complaint. The plaintiff has moved to remand the action to state court and the Judicial Panel on Multidistrict Litigation has issued an order transferring the action to the Southern District of New York and the action was consolidated for pre-trial purposes with *In re Grand Theft Auto Video Game Consumer Litigation (No. II)*, 06-MD-1739 (SWK)(MHD).

In November 2006, a complaint was filed against the Company and Rockstar Games in the United States District Court, Eastern District of Pennsylvania, alleging that the Company and Rockstar Games engaged in consumer deception, were unjustly enriched and in breach of warranty as a result of the alleged failure of the Company and Rockstar Games to disclose that *Grand Theft Auto: San Andreas* contained hidden content, which resulted in the game receiving an M rating from the ESRB rather than an AO rating. The complaint seeks unspecified damages, declarations of various violations of law and litigation costs. The

Company and Rockstar Games have filed a Notice of Tag-along Action with the Judicial Panel on Multi-District Litigation, requesting that the case be transferred to the Southern District of New York for pretrial consolidation with *In re Grand Theft Auto Video Game Consumer Litigation (No. II)*, 06-MD-1739 (SWK)(MHD). On January 26, 2007, the Judicial Panel on Multidistrict Litigation issued a Conditional Transfer Order, transferring this action to the Southern District of New York for pre-trial consolidation with *In re Grand Theft Auto Video Game Consumer Litigation (No. II)*, 06-MD-1739 (SWK)(MHD).

In February and March 2006, an aggregate of four purported class action complaints were filed against the Company, its Chief Executive Officer, Chief Financial Officer and former Chief Global Operating Officer in the United States District Court for the Southern District of New York (the New York Actions ) and one such purported class action was filed in the United States District Court for the Eastern District of Michigan (the Michigan Action ). The New York plaintiffs are Max Kaplan, John Fenninger, David Andrews and David Toth and the Michigan plaintiff was The City of Flint and Daniel J. Hall on behalf of The City of Flint Employees Retirement Pension Fund. The complaints allege that the defendants violated Sections 10(b), 20(a) and Rule 10b-5 of the Securities Exchange Act of 1934 ( Exchange Act ) by making or causing the Company to make untrue statements or failing to disclose in certain press releases and SEC periodic reports that, among other things: *Grand Theft Auto: San Andreas* contained hidden content which should have resulted in the game receiving an Adults Only ( AO ) rating from the ESRB rather than a Mature ( M ) rating; the defendants attempted to bolster sales of *Grand Theft Auto: San Andreas* by concealing the adult content from retailers who refused to carry AO material; the Company's management failed to keep its Board of Directors informed of important issues or failed to do so in a timely fashion; and the Company was misstating capitalized software development costs and amortization expense and had inadequate internal controls and procedures to ensure accuracy in its reported financial results. The plaintiffs seek to recover unspecified damages and their costs. The plaintiffs in the Michigan Action voluntarily dismissed their complaint without prejudice. On July 12, 2006, the Court entered Orders appointing the New York City Pension Funds as lead plaintiff and directing the filing of a consolidated amended complaint within sixty (60) days. Plaintiffs filed a consolidated and amended complaint on September 11, 2006. The amended complaint added claims for violations of Sections 10(b) and 20(a) of the Exchange Act related to allegedly improper stock option granting practices at the Company. On December 11, 2006, the Company announced the preliminary results of an internal investigation into its historical stock option granting practices. The preliminary findings showed that there were improprieties in the process of granting and documenting stock options, and that incorrect measurement dates for certain stock option grants were used for financial accounting purposes. The Company further announced that it will need to restate previous financial statements and that its statements between 1997 and April 30, 2006, should not be relied upon. As a result of these announcements the parties have entered into a stipulation modifying the current scheduling order. Pursuant to the stipulation, all pending deadlines have been stayed pending a decision by plaintiffs as to whether they will file a second amended complaint reflecting the Company's recent announcements.

***In January 2006, the St. Clair Shores General Employees Retirement System filed a purported class and derivative action complaint in the Southern District of New York against the Company, as nominal defendant, and certain of its officers and directors and certain former officers and directors. The factual allegations in this action are similar to the allegations contained in the New York Actions. Plaintiff asserts that certain defendants breached their fiduciary duty by selling the Company's stock while in possession of certain material non-public information and breached their fiduciary duty and violated Section 14(a) and Rule 14a-9 of the Exchange Act by failing to disclose material facts in the Company's 2003, 2004 and 2005 proxy statements in which the Company solicited approval to increase share availability under its 2002 Stock Option Plan. Plaintiff seeks the return of all profits from the alleged insider trading conducted by the individual defendants who sold the Company's stock, unspecified compensatory damages with interest and their costs in the action. A motion to stay the action pending the determination of an investigation by the Special Committee was filed with the Court. On October 4, 2006, the Court issued an order granting the***

*motion and staying the proceedings for a period of 150 days from the date of the Order. On January 17, 2007, the plaintiffs moved for an order granting limited relief from the Court's October 4, 2006 stay of the proceedings in order to file an Amended Derivative and Class Action Complaint.*

In July 2006, Richard Lasky filed a purported derivative action complaint in the Southern District of New York against the Company, as nominal defendant, and certain of its officers and directors and certain former officers and directors. The complaint alleges violations of federal and state law, including violations of the Sarbanes-Oxley Act of 2002, the Exchange Act, breaches of fiduciary duties, abuse of control, gross mismanagement, waste of corporate assets and unjust enrichment that allegedly occurred between January 2000 and the present. The complaint also asserts claims alleging the defendants breached their fiduciary duties in connection with the granting of stock options to certain officers and directors between 1997 and the present. The complaint seeks unspecified damages against all of the individual defendants, reimbursement from certain of the defendants of bonuses or other incentive or equity based compensation paid to them by the Company during its fiscal year ended October 31, 2003, equitable and other relief relating to the proceeds from certain of the defendants' alleged improper trading activity in the Company's stock, adoption of certain corporate governance proposals and recovery of litigation costs.

On August 22, 2006, a shareholder derivative complaint was filed by Raeda Karadsheh in the United States District Court of the Southern District of New York against the Company, as nominal defendant, and certain of its current and former officers and directors. The Karadsheh Complaint asserts claims related to the Company's stock option granting practices. On November 22, 2006, the Court entered an Order consolidating the two actions and providing plaintiffs with forty-five (45) days from the date of the Order to file a consolidated complaint. The Plaintiffs filed a consolidated complaint on January 22, 2007. The consolidated complaint focuses exclusively on the Company's historical stock option granting practices.

In January 2006, Todd Veeck filed a complaint in the Court of Chancery of the State of Delaware against the Company pursuant to 8 DEL. C. § 220 to compel inspection of the Company's books and records in order to investigate possible breaches of fiduciary duties with regard to the creation, development, marketing and sale of its *Grand Theft Auto* line of products. The parties were able to amicably resolve this action, which was dismissed with prejudice on December 11, 2006.

In February 2005, the personal representatives of the Estates of Arnold Strickland, James Crump and Ace Mealer brought an action in the Circuit Court of Fayette County, Alabama against the Company, Rockstar Games, Sony Computer Entertainment America Inc. (SCEA), Sony Corporation of America (SCA), Wal-Mart, GameStop and Devin Moore alleging under Alabama's manufacturers' liability and wrongful death statutes that the Company's video games designed, manufactured, marketed and/or supplied to Mr. Moore resulted in copycat violence that caused the death of Messrs. Strickland, Crump and Mealer. The suit seeks damages (including punitive damages) against all of the defendants in excess of \$600 million. Wal-Mart, SCEA and SCA have tendered their defense and requested indemnification from the Company, and the Company has accepted such tender. The Company's motion to dismiss the action was denied and the Company moved to have certain issues certified for an immediate interlocutory appeal before the Alabama Supreme Court. The Company also separately pursued a petition to dismiss claims against it and Rockstar Games, for lack of personal jurisdiction. The Alabama Supreme Court declined to accept the interlocutory appeal, but agreed to hear the petition to dismiss the action for lack of personal jurisdiction. Briefing has been completed on such petition, and the matter is now pending before the Supreme Court. In April 2006, the plaintiffs filed a Third Amended Complaint to add a claim for civil conspiracy; the Company and its co-defendants have moved to dismiss that claim and the motion is pending. In October 2006, the trial court amended a prior Scheduling Order to set (a) a hearing on the admissibility of Plaintiffs' expert opinions for April 6, 2007; (b) completion of all fact and expert discovery by October 12, 2007; (c) mediation for November 8, 2007; and (d) trial (if necessary) to commence no earlier than January 14, 2008.

In September 2006, the personal representatives of the Estates of Verlin Posey, Tryone Posey, and Marilea Schmid brought an action in the Second Judicial District of Bernalillo County, New Mexico in Albuquerque against the Company; Rockstar Games; SCEA; SCA and Cody Posey ( Posey ), alleging under New Mexico's products liability and wrongful death statutes that the Company's video games resulted in copycat violence that caused Posey to shoot and kill his father (Verlin Posey), stepmother (Tryone Posey) and stepsister (Marilea Schmid). At his criminal trial, Posey argued self-defense, and presented extensive testimony of long-term substantial physical abuse by his father. Posey was convicted of manslaughter in his father's death, second degree murder for his stepmother's death, and first degree murder for his stepsister's death. At sentencing in April 2006, the judge concluded that Posey suffered from post-traumatic stress disorder and depression, and had snapped when he committed the killings; rather than sentence Posey to life in prison, the judge sentenced him to a juvenile facility until he turns twenty-one. The suit seeks damages (including punitive damages) against all of the defendants in excess of \$600 million. SCEA and SCA have tendered their defense and requested indemnification from the Company, and the Company has accepted such tender. Copies of the Complaint and Summonses were received by the Company in December 2006; and the Company moved to dismiss the Complaint on January 19, 2007.

The Company intends to vigorously defend and seek dismissal of these matters and, with respect to the derivative actions, the Company has been advised that the individual defendants will vigorously defend such actions. However, the Company cannot predict the outcome of these matters and, if determined adversely to the Company, such matters, either singly or in the aggregate, could result in the imposition of significant judgments, fines and/or penalties which could have a material adverse effect on its financial condition, cash flows or results of operations.

The Company has received notice from the SEC that it is conducting an informal non-public investigation into certain stock option grants made by it from January 1997 to the present. Prior to receiving the notice, the Company had initiated an internal review of its option grants, led by a committee consisting of independent board members who have retained independent legal counsel and accountants to assist in the review. The Company and the Special Committee are fully cooperating with the SEC.

The Company has received grand jury subpoenas issued by the District Attorney of the County of New York requesting production of documents covering various periods beginning on January 1, 1997, including those relating to, among other things: the so-called Hot Coffee scenes in Grand Theft Auto: San Andreas; the work of the Company's Board of Directors, all Board Committees, and the Special Litigation Committee; certain acquisitions entered into by the Company; billing and payment records relating to Pricewaterhouse Coopers LLC ( PWC ) and the termination of PWC as the Company's auditors; communications to financial analysts and stockholders about acquisitions and financial results; compensation and human resources documents of certain of the Company's directors and employees; stock-based compensation; the SEC's June 2006 inquiry; legal services performed for employees; corporate credit card and expense records of certain individuals; the SEC bar of the Company's former Chief Executive Officer, Ryan Brant; and ethics, securities, and conflict of interest policies and questionnaires. The Company is fully cooperating and providing the documents and information called for by the subpoenas.

The Company has also received a request for information from the Internal Revenue Service that includes a request for records relating to the grant and exercise of options and tax deductions taken by the Company pursuant to Internal Revenue Code Section 162(m) for the period from October 31, 2000 to October 31, 2004. The Company is fully cooperating and providing the requested documents.

The Company is also involved in routine litigation in the ordinary course of its business, which in its opinion will not have a material adverse effect on its financial condition, cash flows or results of operations.

**16. COMMITMENTS AND CONTINGENCIES**

A summary of annual minimum contractual obligations and commitments as of July 31, 2006 is as follows:

<b>Fiscal years ending October 31,</b>	<b>Licensing and Marketing</b>	<b>Software Development</b>	<b>Operating Leases</b>	<b>Distribution</b>	<b>Total</b>
Remainder of 2006	\$ 34,738	\$ 21,669	\$ 5,321	\$ 1,327	\$ 63,055
2007	60,046	28,771	16,643	1,293	106,753
2008	53,201	9,547	15,021		77,769
2009	53,959	16	14,539		68,514
2010	53,967		13,082		67,049
Thereafter	100,280		35,504		135,784
<b>Total</b>	<b>\$ 356,191</b>	<b>\$ 60,003</b>	<b>\$ 100,110</b>	<b>\$ 2,620</b>	<b>\$ 518,924</b>

*Licensing and Marketing Agreements:* The Company's license expense consists primarily of payments made to licensors for intellectual property rights under agreements which expire at various times through December 2012. As of July 31, 2006, the Company has minimum guaranteed licensing and marketing commitments of \$356,191 outstanding, of which \$2,871 are recorded in the Company's condensed consolidated balance sheet as the licensor does not have any significant performance obligation to the Company. Minimum guaranteed licensing and marketing commitments primarily reflect the Company's agreements with major sports leagues and players' associations.

*Software Development Agreements:* The Company's payments made to third-party software developers include contractual advances and royalties under agreements which expire at various times through November 2008. Assuming performance by third-party developers, the Company has aggregate outstanding commitments of \$60,003 under various software development agreements at July 31, 2006. The Company has also established an internal royalty program pursuant to which it pays royalties to certain of its development personnel based on product sales. Royalties earned under the Company's internal royalty program continue to be expensed as incurred.

*Lease Commitments:* The Company's offices and warehouse facilities are occupied under non-cancelable operating leases expiring at various times from October 2006 to September 2014. The Company also leases certain furniture, equipment and automobiles under non-cancelable leases expiring through July 2010. Future minimum rental payments for fiscal 2006 are \$5,321 and aggregate minimum rental payments through applicable lease expirations are \$100,110.

*Distribution Agreements:* The Company periodically enters into distribution agreements to purchase various software games. These agreements, which expire at various dates through July 2007, require remaining aggregate minimum guaranteed payments of \$2,620 at July 31, 2006.

*Contingent Consideration:* In November 2005, in connection with the acquisition of Firaxis, the Company agreed to make additional payments of \$11,250 based on future product sales, of which approximately \$10,000 will be recorded as additional purchase price and \$1,250 will be recorded as employee compensation expense.

In fiscal 2005, in connection with the acquisition of Irrational, the Company agreed to make additional payments of \$2,000 to the former owners of Irrational based on the delivery of products. The Company anticipates making a payment of \$1,000 related to these contingent payments within the next twelve months and \$1,000 in fiscal 2008 due to the expected timing of product releases. Additionally, in fiscal 2005, in connection with the acquisition of Visual Concepts and Kush Games, the Company agreed to make additional payments of approximately \$1,400 to SEGA based on the commercial release of products. The additional payments to SEGA are expected to be made in fiscal 2006.





**17. SEGMENT REPORTING**

The Company is a publisher and distributor of interactive software games designed for personal computers, video game consoles and handheld platforms. The Company's operations involve similar products and customers worldwide and include products that are developed and sold domestically and internationally. Publishing revenues are derived from the sale of internally developed software titles and software titles developed by third parties. Distribution revenues are derived from the sale of third-party software titles, accessories and hardware to retail outlets in North America. Generally, publishing activities generate higher margins than distribution activities, with sales of PC software titles resulting in higher margins than sales of product designed for video game consoles and handheld platforms.

The Company's chief operating decision maker is considered to be the Chief Executive Officer. The Company continues to be centrally managed and the chief operating decision maker primarily uses consolidated financial information supplemented by sales information by product category, major product title and platform for making operational decisions and assessing financial performance.

Beginning February 1, 2006, the Company's chief operating decision maker began to be presented with financial information that contained additional information that separately identified the Company's publishing and distribution activities, including gross margin information. Accordingly, the Company currently considers its publishing and distribution activities as two separate reportable segments. The Company has revised prior period financial information to reflect this change and to conform to current year presentation.

The Company's operating segments do not record inter-segment revenue and therefore none has been reported. The Company does not allocate operating expenses, interest and other income, interest expense or income taxes to operating segments. The Company's accounting policies for segment reporting are the same as for the Company as a whole.

**Information about the Company's reportable segments is as follows:**

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Net revenue:	Three months ended July 31		Nine months ended July 31,	
	2006	2005	2006	2005
Publishing	\$ 192,149	\$ 126,605	\$ 550,497	\$ 628,912
Distribution	49,032	43,294	220,787	265,529
<b>Total net revenue</b>	<b>\$ 241,181</b>	<b>\$ 169,899</b>	<b>\$ 771,284</b>	<b>\$ 894,441</b>

Gross profit:	Three months ended July 31		Nine months ended July 31,	
	2006	2005	2006	2005
Publishing	\$ 50,648	\$ 47,219	\$ 109,870	\$ 281,744
Distribution	6,478	501	20,695	18,397
<b>Total gross profit</b>	<b>\$ 57,126</b>	<b>\$ 47,720</b>	<b>\$ 130,565</b>	<b>\$ 300,141</b>

The publishing segment's gross profit for the nine months ended July 31, 2006 included impairment charges of approximately \$20,454 due to the write-down of several titles.

	As of July 31, 2006			As of October 31, 2005		
	Publishing	Distribution	Total	Publishing As restated	Distribution	Total As restated
Accounts receivable, net	\$ 71,103	\$ 26,924	\$ 98,027	\$ 140,017	\$ 57,844	\$ 197,861
Inventory, net	35,970	47,251	83,221	54,149	82,078	136,227
Long-term assets	284,608	39,478	324,086	278,061	44,358	322,419
Total assets	720,302	134,766	855,068	717,756	217,464	935,220

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The Company attributes net revenue to geographic regions based on product destination. Information about the Company's net revenue by geographic region is as follows:

Revenue by Geographic Region:	Three months ended July 31,		Nine months ended July 31,	
	2006	2005	2006	2005
United States	\$ 140,710	\$ 98,615	\$ 470,532	\$ 531,719
Canada	14,256	10,754	66,013	62,849
North America	154,966	109,369	536,545	594,568
United Kingdom	15,589	15,651	54,625	99,024
Continental Europe	58,740	42,822	152,395	178,282
Asia Pacific and other	11,886	2,057	27,719	22,567
<b>Total net revenue</b>	<b>\$ 241,181</b>	<b>\$ 169,899</b>	<b>\$ 771,284</b>	<b>\$ 894,441</b>

Information about the Company's net revenue by product platforms is as follows:

Net Revenue by Product Platform:	Three months ended July 31,		Nine months ended July 31,	
	2006	2005	2006	2005
Sony PlayStation 2	\$ 77,742	\$ 25,257	\$ 190,054	\$ 478,529
Microsoft Xbox 360	46,070		144,236	
Sony PSP	12,453	12,078	84,106	15,412
Microsoft Xbox	14,736	58,925	47,501	147,687
PC	49,605	37,653	138,549	91,404
Nintendo handheld devices	6,077	7,906	46,937	49,820
Nintendo GameCube	3,304	3,784	12,175	22,419
Hardware	23,867	14,755	73,378	49,558
Accessories and other	7,327	9,541	34,348	39,612
<b>Total net revenue</b>	<b>\$ 241,181</b>	<b>\$ 169,899</b>	<b>\$ 771,284</b>	<b>\$ 894,441</b>

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

The following information has been adjusted to reflect the restatement of our financial results, which is more fully described in the Explanatory Note immediately preceding Item 1 and in Note 3, Restatement of Consolidated Condensed Financial Statements in Notes to the Consolidated Financial Statements of this Form 10-Q. The net of tax impact of the adjustments, which aggregated to \$0.9 million in the first and second quarters of 2006, was recorded by the Company in its third quarter of 2006. The impact of these adjustments was not significant to the Company's operating results, trends, or liquidity for the quarterly periods in 2006.

We have incurred material expenses in 2006 as a direct result of the investigation into our stock option grant practices and related accounting. These costs primarily relate to professional services for legal, accounting and tax guidance. In addition, we have incurred costs related to litigation, the informal investigation by the SEC, the subpoenas from the District Attorney for the County of New York and the preparation and review of our restated consolidated financial statements. We expect that we will continue to incur costs associated with these matters.

### Overview

We are a leading global publisher, developer and distributor of interactive entertainment software, hardware and accessories. Our publishing segment, which consists of Rockstar Games, 2K Games, 2K Sports and Global Star Software, develops, markets and publishes software titles for the following leading gaming and entertainment hardware platforms: Sony's PlayStation®2 and PLAYSTATION®3 computer entertainment systems; Sony's PSP® (PlayStation®Portable) system; Microsoft's Xbox® and Xbox 360 video game and entertainment systems; Nintendo's Wii, GameCube, DS and Game Boy® Advance; and for PCs. Our distribution segment, which includes our Jack of All Games subsidiary, distributes our products as well as third-party software hardware and accessories to retail outlets in North America.

Revenue in our publishing segment is primarily derived from the sale of internally developed software titles, software titles developed on our behalf by third parties and the sale of certain video game accessories and peripherals. Operating margins in our publishing business are dependent in part upon our ability to continually release new, commercially successful products and to manage costs associated with business acquisitions and software product development. We develop most of our frontline products internally, and we own major intellectual properties, which we believe permits us to maximize profitability. Operating margins for titles developed on our behalf by third parties, or for which we do not own the intellectual property, are affected by costs to acquire licenses and amounts due to developers.

Distribution revenue is derived from the sale of third-party software titles, accessories and hardware. Operating margins in our distribution business are dependent in part on the mix of software and hardware sales, with software generating higher margins than hardware. Publishing activities generate significantly higher margins than distribution activities, with sales of PC software titles resulting in higher margins than sales of products designed for video game consoles and handheld platforms.

We have pursued a growth strategy by capitalizing on the widespread market acceptance of interactive entertainment, as well as the growing popularity of innovative action games that appeal to the expanding demographics of video game players. We have established a portfolio of successful proprietary software content for the major hardware platforms. We expect Rockstar, the publisher of our *Grand Theft Auto* franchise, to continue to be a leader in the action product category by leveraging our existing titles and developing new brands. In addition, we have diversified our product offerings by capitalizing on significant growth opportunities in the market for sports and other action and strategy titles. During 2005, we made several strategic acquisitions of sports development studios and entered into license agreements with major sports leagues to develop titles under our 2K Sports publishing label. We also entered into license agreements for several popular entertainment properties, acquired well-known intellectual property rights, and entered into distribution and publishing arrangements for major action and strategy PC titles under our 2K Games and Global Star Software publishing labels.

In response to the business environment during the industry transition and our assessment of market conditions, we took steps to streamline our operations by implementing cost saving initiatives including the closure of several underperforming development studios. In the nine months ended July 31 2006, we recorded non-cash charges of approximately \$27.1 million related to several titles, certain trademarks and acquired intangibles, and incurred severance and other costs of approximately \$5.0 million, of which \$26.1 million is related to development studio closings.

In addition, during the third quarter of fiscal 2006, we recorded an impairment charge related to goodwill and fixed assets at our Joytech subsidiary, our manufacturer and distributor of video game accessories, which operates within our publishing segment. The impairment charge of approximately \$8.1 million reflects a decline in the fair value of Joytech's business resulting from continued competition and a decline in the price and sales volume of current generation accessories due to weaker market conditions and the ongoing transition to next generation hardware platforms.

### Estimates

The preparation of financial statements in conformity with generally accepted accounting principles in the United States of America requires management to make estimates and assumptions that affect the reported amounts of assets and liabilities and the disclosure of contingent assets and liabilities at the dates of the financial statements and the reported amounts of net revenues and expenses during the reporting periods. The most significant estimates and assumptions relate to the adequacy of allowances for returns, price concessions and doubtful accounts; the amortization and recoverability of software development costs, licenses and other intangibles; valuation of inventories, fair value of stock compensation and realization of deferred income taxes. Actual amounts could differ significantly from these estimates.

## **Stock Split**

In April 2005, we effected a three-for-two stock split in the form of a stock dividend. Accordingly, all share and per-share data in the accompanying unaudited condensed consolidated financial statements and notes thereto give retroactive effect to the stock split.

## **Critical Accounting Policies and Estimates**

The preparation of financial statements in conformity with generally accepted accounting principles in the United States of America ( GAAP ) requires management to make estimates and assumptions about future events and apply judgments that affect the reported amounts of assets and liabilities and the disclosure of contingent assets and liabilities at the dates of the financial statements and the reported amounts of net revenues and expenses during the reporting periods. We base our estimates, assumptions and judgments on historical experience, current trends and other factors that management believes to be relevant at the time our consolidated financial statements are prepared. On a regular basis, management reviews the accounting policies, assumptions, estimates and judgments to ensure that our financial statements are fairly presented in accordance with GAAP. However, because future events and their effects cannot be determined with certainty, actual amounts could differ significantly from these estimates.

We have identified the policies below as critical to our business operations and the understanding of our financial results and they require management's most difficult, subjective or complex judgments, resulting from the need to make estimates about the effect of matters that are inherently uncertain. The impact and any associated risks related to these policies on our business operations is discussed throughout Management's Discussion and Analysis of Financial Condition and Results of Operations where such policies affect our reported and expected financial results. For a detailed discussion on the application of these and other accounting policies, see Note 2 to the condensed consolidated financial statements. Management has reviewed these critical accounting estimates and related disclosures with the Audit Committee of our Board of Directors.

### ***Revenue Recognition***

We recognize revenue upon the transfer of title and risk of loss to our customers. We apply the provisions of Statement of Position 97-2, Software Revenue Recognition in conjunction with the applicable provisions of Staff Accounting Bulletin No. 104, Revenue Recognition. Accordingly, we recognize revenue for software when there is (1) persuasive evidence that an arrangement with our customer exists, which is generally a customer purchase order, (2) the software is delivered, (3) the selling price is fixed or determinable and (4) collection of the customer receivable is deemed probable. Our payment arrangements with customers typically provide net 30 and 60-day terms.

In certain circumstances, management determines that it is prudent to cancel a development project. At the time such a decision is made, we expense the related capitalized software development costs. At each balance sheet date, we evaluate the recoverability of capitalized software costs using an undiscounted future cash flow analysis, and charge any amounts that are deemed unrecoverable to cost of goods sold. We use various measures to estimate future net revenues for our software titles, including past performance of similar titles and orders for titles prior to their release. For sequels, the performance of predecessor titles is also taken into consideration.

Revenue is recognized after deducting estimated reserves for returns and price concessions. In specific circumstances when we do not have a reliable basis to estimate returns and price concessions or are unable to determine that collection of receivables is probable, we defer the revenue until such time as we can reliably estimate any related returns and allowances and determine that collection of the receivables is probable. Advances received for software development are reported on the balance sheet as deferred revenue.

### ***Allowances for Returns and Price Concessions***

We accept returns and grant price concessions in connection with our publishing arrangements. Following reductions in the price of our products, we grant price concessions to permit customers to take credits against amounts they owe us with respect to merchandise unsold by them. Our customers must satisfy certain conditions to entitle them to return products or receive price concessions, including compliance with applicable payment terms and confirmation of field inventory levels.

Our distribution arrangements with customers do not give them the right to return titles or to cancel firm orders. However, we sometimes accept returns from our distribution customers for stock balancing and make accommodations to customers, which includes credits and returns, when demand for specific titles falls below expectations.

We make estimates of future product returns and price concessions related to current period product revenue. We estimate the amount of future returns and price concessions for published titles based upon, among other factors, historical experience and performance of the titles in similar genres, historical performance of the hardware platform, customer inventory levels, analysis of sell-through rates, sales force and retail customer feedback, industry pricing, market conditions and changes in demand and acceptance of our products by consumers.

Significant management judgments and estimates must be made and used in connection with establishing the allowance for returns and price concessions in any accounting period. We believe we can make reliable estimates of returns and price concessions. However, actual results may differ from initial estimates as a result of changes in circumstances, market conditions and assumptions. Adjustments to estimates are recorded in the period in which they become known.

### ***Software Development Costs***

We utilize both internal development teams and third-party software developers to develop the titles we publish.

We capitalize internal software development costs (including stock-based compensation, specifically identifiable employee payroll expense and incentive compensation costs related to the completion and release of titles), third-party production and other content costs, subsequent to establishing technological feasibility of a software title. Amortization of such capitalized costs is recorded on a title-by-title basis in cost of goods sold (software development costs) using (1) the proportion of current year net revenues to the total net revenues expected to be recorded over the life of the title or (2) the straight-line method over the remaining estimated useful life of the title, whichever is greater.

We have established an internal royalty program that allows certain of our employee software developers to participate in the success of software titles that they assist in developing. Royalties earned by employees under this program are recorded to cost of goods sold (royalties) as they are incurred.

We frequently enter into agreements with third-party developers that require us to make advance payments for game development and production services. In exchange for our advance payments, we receive the exclusive publishing and distribution rights to the finished game title as well as, in some cases, the underlying intellectual property rights. Such agreements allow us to recover the advance payments to the developers at an agreed royalty rate earned on the subsequent retail sales of such software, net of any agreed costs. We capitalize advance payments as software development costs subsequent to establishing technological feasibility of a software title and amortize them, on a title-by-title basis, as royalties in cost of goods sold. Royalty amortization is recorded using (1) the proportion of current year net revenues to the total net revenues expected to be recorded over the life of the title or (2) the contractual, net revenue based royalty rate defined in the respective agreement, whichever is greater. At each balance sheet date, we evaluate the recoverability of advanced development payments and any other unrecognized minimum

commitments that have not been paid. To the extent that advance payments are deemed unrecoverable, they are charged to cost of goods sold in the period in which such determination is made.

### *Licenses*

Licenses consist of payments and guarantees made to holders of intellectual property rights for use of their trademarks, copyrights, technology or other intellectual property rights in the development of our products. Agreements with rights holders generally provide for guaranteed minimum royalty payments for use of their intellectual property. Guaranteed minimum payments are initially recorded as an asset (licenses) and as a liability (accrued licenses) upon execution of a licensing agreement, provided that no significant performance remains with the licensor. When significant performance remains with the licensor, we record payments when actually paid.

Certain licenses, especially those related to our sports products, extend over multi-year periods and encompass multiple game titles. In addition to guaranteed minimum payments, these licenses frequently contain provisions that could require us to pay royalties to the license holder based on pre-agreed unit sales thresholds.

Capitalized licensing fees are amortized as royalties in cost of goods sold on a title-by-title basis at a ratio of (1) current period net revenues to the total net revenues expected to be recorded over the remaining life of the title or (2) the contractual royalty rate based on actual net product sales as defined in the licensing agreement, whichever is greater. Similar to software development costs, we review our sales projections quarterly to determine the likely recoverability of our capitalized licenses as well as any unpaid minimum obligations. When management determines that the value of a license is unlikely to be recovered by product sales, capitalized licenses are charged to cost of goods sold, based on current and expected net revenues, in the period in which such determination is made. Criteria used to evaluate expected product performance and to estimate future sales for a title include: historical performance of comparable titles; orders for titles prior to release; and the estimated performance of a sequel title based on the performance of the title on which the sequel is based.

### *Asset Impairment*

*Business Combinations Goodwill and Intangible Assets.* The purchase method of accounting requires that assets acquired and liabilities assumed be recorded at their fair values on the date of a business acquisition. Our condensed consolidated financial statements and results of operations reflect an acquired business from the completion date of an acquisition. The costs to acquire a business, including transaction, integration and restructuring costs, are allocated to the fair value of net assets acquired upon acquisition. Any excess of the purchase price over the estimated fair values of the net tangible and intangible assets acquired is recorded as goodwill.

We evaluate our goodwill annually for impairment or more frequently if indicators of potential impairment exist. The determination of whether or not goodwill has become impaired involves a significant level of judgment in the assumptions underlying the approach used to determine the value of our reporting units. We generally use either the income, cost or market approach to aid in our conclusions of such fair values and asset lives. The income approach presumes that the value of an asset can be estimated by the net economic benefit to be received over the life of the asset, discounted to present value. The cost approach presumes that an investor would pay no more for an asset than its replacement or reproduction cost. The market approach estimates value based on what other participants in the market have paid for reasonably similar assets. Although each valuation approach is considered in valuing the assets acquired, the approach ultimately selected is based on the characteristics of the asset and the availability of information. Changes in our strategy and/or market conditions could significantly impact these judgments and require reductions to recorded intangible asset balances.

We recorded a pre-tax goodwill impairment charge of approximately \$6.3 million in our Publishing segment for the quarter ended July 31, 2006. The impairment was related to our Joytech subsidiary, a manufacturer of video game accessories and peripherals.

*Long-lived assets.* We review long-lived assets for impairment whenever events or changes in circumstances indicate that the related carrying amounts may not be recoverable. Determining whether impairment has occurred typically requires various estimates and assumptions, including determining which cash flows are directly related to the potentially impaired asset, the useful life over which cash flows will occur, their amount and the asset's residual value, if any. In turn, measurement of an impairment loss requires a determination of fair value, which is based on the best information available. We use internal discounted cash flow estimates, quoted market prices when available and independent appraisals, as appropriate, to determine fair value. We derive the required cash flow estimates from our historical experience and our internal business plans and apply an appropriate discount rate.

In response to the difficult industry environment in 2006, we evaluated our businesses, reduced costs and closed our underperforming development studios, which resulted in certain fixed asset abandonment and write-off of capitalized software costs, certain intangibles and other assets. Through July 31, 2006, we recorded non-cash charges of \$28.9 million (\$20.5 million as a component of cost of goods sold), primarily in the second and third quarters of 2006.

#### ***Stock-based Compensation***

We account for stock-based compensation in accordance with SFAS No. 123(R), *Share-Based Payment*. Under the fair value recognition provisions of this statement, share-based compensation expense is measured at the grant date based on the fair value of the award and is recognized as expense over the vesting period. Determining the fair value of share-based awards at the grant date requires judgment, including estimating expected stock volatility. In addition, judgment is also required in estimating the amount of share-based awards that are expected to be forfeited. If actual results differ significantly from these estimates, stock-based compensation expense and our results of operations could be materially impacted.

Prior to November 1, 2005, we accounted for stock-based compensation in accordance with Accounting Principles Board ( APB ) Opinion No. 25, *Accounting for Stock Issued to Employees* ( APB 25 ). Under APB 25, generally, no compensation expense was recognized in connection with the awarding of stock option grants to employees provided that, as of the grant date, all terms associated with the award are fixed and the quoted market price of the stock is equal to or less than the amount an employee must pay to acquire the stock as defined. For fixed awards, compensation expense was measured as the excess, if any, of the quoted market price of our common stock at the date of grant over the exercise price of the option granted. Compensation expense for fixed awards was recognized ratably over the vesting period on a straight-line basis.

As a result of the review of the Special Committee, it was determined that the original grant dates reported in our records for a substantial number of stock option awards during the periods between April 1997 and August 2003 were not the proper measurement date for accounting purposes. As a result of the Special Committee investigation, we have recorded a pre-tax non-cash cumulative charge of \$54.6 million (\$42.1 million on an after-tax basis) in our consolidated financial statements through October 31, 2005 to reflect additional stock-based compensation costs. Significant judgment was applied in determining measurement dates for many of our stock option awards. Information regarding the restatement, including ranges of compensation expense if other measurement dates has been selected for certain grants, is set forth in the Explanatory Note immediately preceding Item 1 and in Note 3 to the Condensed Consolidated Financial Statements.



### ***Income Taxes***

GAAP requires that we record a valuation allowance to reduce our deferred tax assets to the amount that is more likely than not to be realized. Our cumulative U.S. pre-tax loss in the three most recent fiscal years represents sufficient negative evidence for us to determine that the establishment of a full valuation allowance against the deferred tax asset is appropriate. This valuation allowance offsets deferred tax assets associated with future tax deductions as well as carryforward items. Although management expects that these assets will ultimately be utilized, future realization cannot be assured.

Our future effective tax rates could be adversely affected by earnings being lower than anticipated in countries where we have lower statutory rates, changes in the valuation of our deferred tax assets or liabilities, or changes in tax laws or interpretations thereof. In addition, our filed tax returns are subject to examination by the Internal Revenue Service and other tax authorities. We regularly assess the likelihood of adverse outcomes resulting from these examinations to determine the adequacy of our provision for income taxes.

### **Recently Issued Accounting Pronouncements**

In September 2006, the Financial Accounting Standards Board ( FASB ) issued SFAS No. 157, *Fair Value Measurements* ( SFAS 157 ), which clarifies the definition of fair value, establishes a framework for measuring fair value in generally accepted accounting principles, and expands disclosures about fair value measurement. SFAS 157 does not require any new fair value measurements and eliminates inconsistencies in guidance found in various prior accounting pronouncements. SFAS 157 will be effective for the Company on November 1, 2008. We are currently assessing whether the adoption of SFAS 157 will have an impact on the Company's financial statements.

In September 2006, the SEC released Staff Accounting Bulletin No. 108, *Considering the Effects of Prior Year Misstatements when Quantifying Misstatements in Current Year Financial Statements* ( SAB 108 ). SAB 108 provides interpretive guidance on the SEC's views on how the effects of the carryover or reversal of prior year misstatements should be considered in quantifying a current year misstatement. The provisions of SAB 108 will be effective for the Company on November 1, 2007. The Company is currently evaluating the impact of applying SAB 108 but does not believe that the application of SAB 108 will have a material effect on its financial position, cash flows, or results of operations.

In June 2006, the FASB issued Interpretation No. 48, *Accounting for Uncertainty in Income Taxes, an interpretation of SFAS No. 109* ( FIN 48 ), to create a single model to address the accounting for uncertainty in tax positions. FIN 48 clarifies the accounting for income taxes by prescribing the minimum recognition threshold a tax position is required to meet before being recognized in the financial statements. FIN 48 also provides guidance on derecognition, measurement, classification, interest, and penalties, accounting in interim periods, disclosure, and transition. FIN 48 will be effective for the Company beginning November 1, 2007. The cumulative-effect of adopting FIN 48 will be recorded to opening retained earnings. Management is currently evaluating the effect, if any, that the adoption of FIN 48 will have on the Company's consolidated financial statements.

**Results of Operations**

The following table sets forth for the periods indicated the percentage of net revenues represented by certain items reflected in our statement of operations, and sets forth net revenues by territory, sales mix, platform and principal products:

	Three months ended July 31, 2006				Nine months ended July 31, 2006			
			2005 As restated				2005 As restated	
Net revenue:								
Publishing	79.7	%	74.5	%	71.4	%	70.3	%
Distribution	20.3	%	25.5	%	28.6	%	29.7	%
Net revenue	100.0	%	100.0	%	100.0	%	100.0	%
Cost of goods sold:								
Product costs	47.8	%	54.5	%	52.8	%	50.7	%
Royalties	23.4	%	15.1	%	22.2	%	14.3	%
Software development costs	5.1	%	2.4	%	8.1	%	1.5	%
Total cost of goods sold	76.3	%	71.9	%	83.1	%	66.4	%
Gross profit	23.7	%	28.1	%	16.9	%	33.6	%
Selling and marketing	11.4	%	19.1	%	13.2	%	13.4	%
General and administrative	18.4	%	19.1	%	15.1	%	10.2	%
Research and development	7.2	%	11.7	%	6.6	%	6.4	%
Impairment of goodwill and long-lived assets	3.5	%	0.0	%	1.9	%	0.0	%
Depreciation and amortization	2.6	%	3.3	%	2.6	%	1.7	%
Total operating expenses	43.2	%	53.2	%	39.3	%	31.7	%
Income (loss) from operations	(19.5)	%	(25.1)	%	(22.4)	%	1.8	%
Interest income, net	0.5	%	0.7	%	0.2	%	0.3	%
Income (loss) before income taxes	(19.0)	%	(24.4)	%	(22.2)	%	2.1	%
Income taxes	18.9	%	(7.3)	%	(0.0)	%	0.3	%
Net income (loss)	(38.2)	%	(17.1)	%	(22.2)	%	1.8	%
Net revenue by geographic region:								
North America	64.3	%	64.4	%	69.6	%	66.5	%
International	35.7	%	35.6	%	30.4	%	33.5	%
Net sales mix:								
Publishing	79.7	%	74.5	%	71.4	%	70.3	%
Distribution	20.3	%	25.5	%	28.6	%	29.7	%
Publishing revenue by platform:								
Console	71.2	%	61.4	%	62.3	%	86.3	%
PC	19.6	%	25.1	%	17.9	%	8.7	%
Handheld	7.0	%	10.6	%	16.3	%	3.1	%
Accessories	2.2	%	2.9	%	3.5	%	1.9	%

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Our best-selling titles for the three and nine months ended July 31, 2006 and 2005 as a percentage of net revenues are as follows:

<b>Top Ten Titles</b>	<b>Three months ended July 31, 2006</b>	<b>Platform</b>	<b>Release Date</b>	<b>% of Net Revenues</b>
<i>Grand Theft Auto: Liberty City Stories</i>		PS2	June 2006	16.6 %
<i>Prey</i>		Xbox 360	July 2006	7.6
<i>The Da Vinci Code</i>		PS2	May 2006	5.3
<i>Rockstar Games presents Table Tennis</i>		Xbox 360	May 2006	4.0
<i>The Elder Scrolls IV: Oblivion</i>		Xbox 360	March 2006	3.7
<i>Grand Theft Auto: Liberty City Stories</i>		PSP	October 2005	3.6
<i>Prey</i>		PC	July 2006	3.4
<i>Grand Theft Auto: San Andreas</i>		PS2	October 2004	3.2
<i>Midnight Club 3: DUB Edition Remix</i>		PS2	March 2006	2.5
<i>The Elder Scrolls IV: Oblivion</i>		PC	March 2006	2.1

<b>Top Ten Titles</b>	<b>Three months ended July 31, 2005</b>	<b>Platform</b>	<b>Release Date</b>	<b>% of Net Revenues</b>
<i>Grand Theft Auto: San Andreas</i>		Xbox	June 2005	23.5 %
<i>Grand Theft Auto: San Andreas</i>		PC	June 2005	13.8
<i>Midnight Club 3: DUB Edition</i>		PSP	June 2005	6.0
<i>Midnight Club 3: DUB Edition</i>		PS2	April 2005	4.1
<i>Charlie and the Chocolate Factory</i>		PS2	July 2005	3.3
<i>Sid Meier's Pirates!</i>		Xbox	July 2005	2.6
<i>Midnight Club 3: DUB Edition</i>		Xbox	April 2005	2.4
<i>Charlie and the Chocolate Factory</i>		GBA	July 2005	1.4
<i>Charlie and the Chocolate Factory</i>		Xbox	July 2005	1.3
<i>Stronghold 2</i>		PC	April 2005	1.3

<b>Top Ten Titles</b>	<b>Nine months ended July 31, 2006</b>	<b>Platform</b>	<b>Release Date</b>	<b>% of Net Revenues</b>
<i>Grand Theft Auto: Liberty City Stories</i>		PSP	October 2005	9.1 %
<i>The Elder Scrolls IV: Oblivion</i>		Xbox 360	March 2006	7.4
<i>Grand Theft Auto: Liberty City Stories</i>		PS2	June 2006	5.2
<i>The Elder Scrolls IV: Oblivion</i>		PC	March 2006	4.9
<i>Grand Theft Auto: San Andreas</i>		PS2	October 2004	3.8
<i>Prey</i>		Xbox 360	July 2006	2.4
<i>Sid Meier's Civilization IV</i>		PC	October 2005	2.4
<i>The Da Vinci Code</i>		Xbox 360	April 2006	1.7
<i>Major League Baseball 2K6</i>		PS2	May 2006	1.6
<i>Midnight Club 3: DUB Edition Remix</i>		PS2	March 2006	1.5

<b>Top Ten Titles</b>	<b>Nine months ended July 31, 2005</b>	<b>Platform</b>	<b>Release Date</b>	<b>% of Net Revenues</b>
<i>Grand Theft Auto: San Andreas</i>		PS2	October 2004	33.4 %
<i>Midnight Club 3: DUB Edition</i>		PS2	April 2005	5.6
<i>Grand Theft Auto: San Andreas</i>		Xbox	June 2005	4.5
<i>Midnight Club 3: DUB Edition</i>		Xbox	April 2005	2.9
<i>Grand Theft Auto: San Andreas</i>		PC	June 2005	2.6
<i>Stronghold 2</i>		PC	April 2005	1.3
<i>Grand Theft Auto: Vice City</i>		PS2	October 2002	1.3
<i>Midnight Club 3: DUB Edition</i>		PSP	June 2005	1.1
<i>ESPN NBA 2K5</i>		PS2	September 2004	1.0
<i>Major League Baseball 2K5</i>		PS2	February 2005	1.0



## Business Acquisitions

During fiscal 2005 and the nine months ended July 31, 2006, we consummated the acquisitions described below. To the extent that the purchase price allocation for these acquisitions is preliminary, we do not expect that the final purchase price allocation will be materially different. The acquisitions have been accounted for as purchase transactions and, accordingly, the results of operations and financial position of the acquired businesses are included in our condensed consolidated financial statements from the respective dates of acquisition. Pro forma information has not been provided as the impact of these acquisitions was not material (amounts below in thousands of dollars).

*Firaxis Games, Inc.* In November 2005, we acquired all of the outstanding capital stock of Firaxis Games, Inc., a developer of PC and strategy titles, including the *Civilization* franchise. The purchase price of approximately \$15,442 consisted of \$12,500 of unregistered common stock and \$4,085 of development advances previously paid to Firaxis reduced by net cash acquired of \$1,143. In connection with the acquisition, we recorded \$5,644 of identifiable intangible assets, comprised of \$1,130 of non-competition agreements and \$4,514 of intellectual property, \$11,085 of goodwill, which is not deductible for tax purposes, \$333 of net assets and \$1,620 of deferred tax liabilities, on a preliminary basis. We also agreed to make additional payments up to \$11,250 based on future product sales, of which approximately \$10,000 will be recorded as additional purchase price and \$1,250 will be recorded as employee compensation expense when the conditions requiring their payment are met.

*Irrational Studios LLC.* In August 2005, we acquired all of the outstanding membership interests in Irrational Studios, the developer of certain of our titles. The purchase price consisted of \$4,212 in cash and \$2,000 of unregistered common stock, which was payable at closing, \$1,550 of development advances previously paid to Irrational and \$2,000 of deferred consideration, which is payable in equal amounts on the first and second anniversary of the acquisition. In connection with the acquisition, we recorded \$2,250 of identifiable intangible assets, \$7,665 of goodwill, which is deductible for tax purposes, \$187 of non-current assets and \$340 of net current liabilities. We also agreed to make additional payments of \$2,000 based on the delivery of products which will be recorded as additional purchase price when the conditions requiring their payment are met.

*Gaia Capital Group.* In June 2005, we acquired all of the outstanding capital stock of Gaia Capital Group and its wholly-owned subsidiaries, the developers of certain of our titles. The purchase price consisted of \$5,748 in cash, \$4,055 of development advances previously paid to Gaia and deferred consideration of \$1,597. In connection with the acquisition, we recorded \$3,940 of identifiable intangible assets, \$7,918 of goodwill, which is deductible for tax purposes, \$528 of non-current assets and \$986 of net current liabilities.

*Visual Concepts Entertainment and Kush Games.* In January 2005, we acquired from SEGA all of the outstanding capital stock of Visual Concepts Entertainment and its wholly-owned subsidiary, Kush Games, the developers of certain of our sports titles, and certain intellectual property rights associated with these products. The purchase price consisted of \$27,794 in cash, \$1,866 of development advances previously paid to SEGA and contingent consideration of \$2,593 based on the release of certain titles. In connection with the acquisition, we recorded \$7,980 of identifiable intangible assets, \$29,433 of goodwill, which is not deductible for tax purposes, \$1,196 of non-current assets, \$3,164 of net current liabilities and \$3,192 of deferred tax liabilities related to identifiable intangible assets.

## Three Months ended July 31, 2006 and 2005

## Net Revenues

(thousands of dollars)	Three months ended July 31,				Increase/		% Increase/	
	2006	%	2005	%	(decrease)		(decrease)	
Publishing	\$ 192,149	79.7 %	\$ 126,605	74.5 %	\$ 65,544		51.8 %	
Distribution	49,032	20.3 %	43,294	25.5 %	5,738		13.3 %	
<b>Net revenue</b>	<b>\$ 241,181</b>	<b>100.0 %</b>	<b>\$ 169,899</b>	<b>100.0 %</b>	<b>\$ 71,282</b>		<b>42.0 %</b>	

**Net Revenues.** The increase in net revenues for the three months ended July 31, 2006 was primarily due to higher publishing revenues resulting from additional sales of titles released in the current period partially offset by a decline in the prices of current generation software titles due to weaker market conditions and the ongoing transition to next generation hardware platforms. The increase over the prior comparable period was also due to additional reserves of approximately \$32.6 million recorded in the three months ended July 31, 2005 for product returns related to *Grand Theft Auto: San Andreas* as a result of the re-rating of the title by the Entertainment Software Rating Board ( ESRB ) in July 2005.

Publishing revenues for the three months ended July 31, 2006 primarily reflect sales of *Grand Theft Auto: Liberty City Stories* for PlayStation 2 and PSP, *Prey* for Xbox 360 and PC, *The Da Vinci Code* on multiple platforms, *The Elder Scrolls IV: Oblivion* for Xbox 360 and PC, *Rockstar Games presents Table Tennis* for Xbox 360 and *Grand Theft Auto: San Andreas* on multiple platforms. Publishing revenues for the three months ended July 31, 2005 primarily reflect sales of *Grand Theft Auto: San Andreas* for Xbox and PC, *Midnight Club 3: DUB Edition* for PSP, PlayStation 2 and Xbox and *Charlie and the Chocolate Factory* on multiple platforms. Publishing revenues for the three months ended July 31, 2006 and 2005 include licensing revenues of \$2.2 million and \$4.3 million, respectively.

Products designed for video game console platforms accounted for 71.2% of publishing revenues as compared to 61.4% for the comparable period last year. PC products accounted for 19.6% of publishing revenues as compared to 25.1% for the prior comparable period. The decrease in sales of products for PC platforms as a percentage of publishing revenues was primarily attributable to strong sales of *Grand Theft Auto: San Andreas* in the prior comparable period. For the three months ended July 31, 2006, sales of PC products were primarily attributable to *Prey*, *The Elder Scrolls IV: Oblivion*, *Sid Meier's Civilization IV*, *Sid Meier's Civilization IV: Warlords* and *The Da Vinci Code*. For the three months ended July 31, 2005, sales of PC products were primarily attributable to *Grand Theft Auto: San Andreas* and *Stronghold 2*. We anticipate that our platform mix will be weighted toward console platforms and the PSP handheld system, but may fluctuate from period to period.

Distribution revenues are derived from the sale of third-party software titles, accessories and hardware. The increase in distribution revenues was primarily attributable to higher sales of hardware products and peripherals, including the Xbox 360, partially offset by a continued decline in sales volume of value and front-line software titles, a decrease in average selling prices of interactive entertainment products as our industry transitions to next generation platforms and increased competition in the value software market.

Our businesses based outside of North America accounted for approximately \$86.2 million, or 35.7% of net revenues for the three months ended July 31, 2006 compared to \$60.5 million, or 35.6% of net revenues for the three months ended July 31, 2005. The increase was primarily attributable to sales of *Grand Theft Auto: Liberty City Stories* for PlayStation 2 and PSP, *Prey* for Xbox 360 and PC, *The Da Vinci Code* on multiple platforms and *Rockstar Games presents Table Tennis* for Xbox 360. International revenues for the three months ended July 31, 2005 primarily reflect sales of *Grand Theft Auto: San Andreas* for Xbox and PC, *Charlie and the Chocolate Factory* on multiple platforms and *Midnight Club 3: DUB Edition* for PSP, PlayStation 2 and Xbox.

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Net revenues related to international operations increased by approximately \$3.8 million and \$1.1 million due to changes in foreign exchange rates in the three months ended July 31, 2006 and July 31, 2005, respectively. We expect international revenues to continue to account for a significant portion of our revenues.

## Cost of Goods Sold

(thousands of dollars)	Three months ended July 31,		2005	% of net revenue	Increase/ (decrease)	% Increase/ (decrease)
	2006	% of net revenue				
Product costs	\$ 115,245	47.8 %	\$ 92,525	54.5 %	\$ 22,720	24.6 %
Royalties	56,443	23.4 %	25,608	15.1 %	30,835	120.4 %
Software development costs	12,367	5.1 %	4,046	2.4 %	8,321	205.7 %
<b>Cost of goods sold</b>	<b>\$ 184,055</b>	<b>76.3 %</b>	<b>\$ 122,179</b>	<b>71.9 %</b>	<b>\$ 61,876</b>	<b>50.6 %</b>

**Product costs.** The increase in product costs in absolute dollars was consistent with the increase in publishing revenues. The decrease as a percentage of net revenues was primarily due to the higher proportion of publishing revenues, including an increase in sales of PC products which have lower product costs than console products. The decrease as a percentage of net revenues was slightly offset by additional sales of hardware products and lower prices of current generation software titles.

**Royalties.** The increase in royalties was primarily due to the increase in publishing revenues and higher external royalty costs related to sales of certain of our published products. Royalties as a percentage of net revenue increased in the 2006 period reflecting a greater portion of externally developed titles in the current period. Royalty expense for the three months ended July 31, 2006 was primarily attributable to royalty costs related to sales of *The Da Vinci Code*, *Prey*, *Major League Baseball 2K6* and *The Elder Scrolls IV: Oblivion*. In the comparable prior period, royalty costs were primarily related to sales of *Charlie and the Chocolate Factory* and *Major League Baseball 2K5*. Royalty costs related to sales of our internally developed products accounted for \$10.3 million and \$12.9 million, respectively, of royalty expense for the three months ended July 31, 2006 and 2005.

**Software development costs.** The increase in software development costs was primarily due to higher amortization of software development costs associated with sales of our internally developed titles, including *Rockstar Games presents Table Tennis* and *Major League Baseball 2K6*. In the comparable fiscal 2005 period, software development costs were primarily attributable to sales of *Grand Theft Auto: San Andreas* and *Midnight Club 3: DUB Edition*.

In future periods, cost of goods sold may be adversely affected by manufacturing and other costs, price competition and by changes in product and sales mix, distribution channels and royalty arrangements.

## Operating Expenses

(thousands of dollars)	Three months ended July 31,		2005 As restated	% of net revenue	Increase/ (decrease)	% Increase/ (decrease)
	2006	% of net revenue				
Selling and marketing	\$ 27,585	11.4 %	\$ 32,449	19.1 %	\$ (4,864 )	(15.0 )%
General and administrative	44,260	18.4 %	32,381	19.1 %	11,879	36.7 %
Research and development	17,406	7.2 %	19,899	11.7 %	(2,493 )	(12.5 )%
Impairment of goodwill and long-lived assets	8,529	3.5 %		0.0 %	8,529	N/M
Depreciation and amortization	6,290	2.6 %	5,691	3.3 %	599	10.5 %
<b>Total operating expenses</b>	<b>\$ 104,070</b>	<b>43.2 %</b>	<b>\$ 90,420</b>	<b>53.2 %</b>	<b>\$ 13,650</b>	<b>15.1 %</b>





**Selling and marketing.** The decrease in selling and marketing expense was primarily due to lower in-store promotional spending of approximately \$2.4 million and lower trade show costs of approximately \$0.9 million primarily associated with E3, an industry trade exhibition held in May 2006.

**General and administrative.** The increase in general and administrative expense in absolute dollars was due to an increase in professional fees of approximately \$2.8 million primarily related to various on-going legal matters, including a review of our stock option grants, and process improvement projects. The increase was also due to additional rent and office related expenses of approximately \$2.4 million associated with development studios acquired subsequent to the third quarter of fiscal 2005 and lease termination costs associated with the closure of a development studio in the current period. Higher personnel expenses, which include an increase in stock compensation expense due to the adoption of SFAS 123(R), effective November 1, 2005, also contributed to the increase. General and administrative expense also increased by \$1.5 million in the 2006 period resulting from stock-based compensation expense recorded in connection with the review performed by our Special Committee.

**Research and development.** The decrease in research and development costs was primarily due to a decrease in production expenses of approximately \$2.0 million which reflects additional product development costs in the comparable prior period related to titles that had not yet reached technological feasibility. The decrease was also attributable to lower personnel expenses resulting from higher capitalization of compensation costs for development personnel, partially offset by additional employee severance costs in connection with the closure of a development studio in the current period.

A substantial portion of our research and development costs are capitalized once software development projects reach technological feasibility, which is relatively early in the development process, and subsequently amortized as cost of goods sold. However, amounts earned under our internal royalty program continue to be expensed as incurred in cost of goods sold. During fiscal 2006, incentive compensation directly related to the completion and release of our titles has been capitalized as software development costs and will subsequently be amortized as cost of goods sold upon release of the titles.

**Impairment of intangibles and long-lived assets.** In the three months ended July 31, 2006, we recorded an impairment charge of \$8.1 million related to goodwill and fixed assets at our Joytech subsidiary, our manufacturer and distributor of video game accessories, which operates within our publishing segment. The impairment charges reflect a decline in the fair value of Joytech's business resulting from continued competition and a decline in the price and sales volume of current generation accessories due to weaker market conditions and the ongoing transition to next generation hardware platforms. The additional impairment charges of \$0.4 million were due to the write-off of fixed assets related to a development studio closing.

**Provision (benefit) for income taxes.** Income tax expense was \$45.6 million for the three months ended July 31, 2006 as compared to income tax benefit of \$12.5 million for the three months ended July 31, 2005. The increase was primarily due to a valuation allowance of approximately \$59.5 million that was recorded in accordance with SFAS 109 to reduce our deferred tax assets. The effective tax rate was -99.8% for the three months ended July 31, 2006, compared to an effective tax rate for the comparable period in fiscal 2005, which was a benefit of 30.1%. The valuation allowance was recorded primarily due to uncertainty regarding the realization of deferred tax assets attributable to net operating loss carryforwards.

The effective tax rate for the comparable period in fiscal 2005 was impacted by additional reserves recorded for product returns primarily related to our North American retail inventory of *Grand Theft Auto: San Andreas*.

We adopted SFAS 123(R) on November 1, 2005, which requires, among other items, the recognition of stock option expense in the results of operations. As a result of the adoption of SFAS 123(R), the income tax effects of compensatory stock options are included in the computation of the income tax expense



(benefit), and deferred tax assets and liabilities, subject to certain prospective adjustments to stockholders' equity for the differences between the income tax effects of expenses recognized in the results of operations and the related amounts deducted for income tax purposes. Prior to our adoption of SFAS 123(R) the tax benefits relating to the income tax deductions for compensatory stock options were recorded directly to stockholders' equity.

We are regularly audited by domestic and foreign taxing authorities. Audits may result in tax assessments in excess of amounts claimed and the payment of additional taxes. We believe that our tax positions comply with applicable tax law, and that we have adequately provided for reasonably foreseeable tax assessments.

**Net loss.** For the three months ended July 31, 2006, net loss was \$91.4 million as compared to a net loss of \$29.0 million for the three months ended July 31, 2005, resulting from the changes referred to above.

**Diluted net loss per share.** Diluted net loss per share for the three months ended July 31, 2006 of \$1.29, increased \$0.88 as compared to diluted net loss per share of \$0.41 for the three months ended July 31, 2005, principally due to the increase in net loss for the period and an increase in the weighted average common shares outstanding.

#### Nine Months ended July 31, 2006 and 2005

##### Net Revenues

(thousands of dollars)	Nine months ended July 31,						Increase/ (decrease)	% Increase/ (decrease)
	2006	%	2005	%				
Publishing	\$ 550,497	71.4 %	\$ 628,912	70.3 %	\$ (78,415 )		(12.5 )%	
Distribution	220,787	28.6 %	265,529	29.7 %	(44,742 )		(16.9 )%	
Net revenue	\$ 771,284	100.0 %	\$ 894,441	100.0 %	\$ (123,157 )		(13.8 )%	

**Net Revenues.** The decrease in net revenues for the nine months ended July 31, 2006 primarily reflects an unfavorable comparison to the comparable 2005 period, which included significant sales of *Grand Theft Auto: San Andreas* which was released in October 2004 for PlayStation 2 and June 2005 for Xbox and PC. The decrease was also attributable to lower distribution revenues and a decline in the prices of current generation software titles due to weaker market conditions and the ongoing transition to next generation hardware platforms. Net revenues for the nine months ended July 31, 2005 were reduced by additional reserves of approximately \$32.6 million recorded for product returns related to *Grand Theft Auto: San Andreas* as a result of the re-rating of the title by the ESRB in July 2005.

Publishing revenues for the nine months ended July 31, 2006 primarily reflect sales of *Grand Theft Auto: Liberty City Stories* for PSP and PlayStation 2, *The Elder Scrolls IV: Oblivion* for Xbox 360 and PC, *Grand Theft Auto: San Andreas* on multiple platforms, *Prey* for Xbox 360 and PC and sales of our sports titles, including *Major League Baseball 2K6*, *NBA 2K6* and *NHL 2K6* for current and next generation console platforms. Publishing revenues for the nine months ended July 31, 2005 primarily reflect sales of *Grand Theft Auto: San Andreas* for PlayStation 2, Xbox and PC and *Midnight Club 3: DUB Edition* on multiple platforms. Publishing revenues for the nine months ended July 31, 2006 and 2005 include licensing revenues of \$8.0 million and \$13.7 million, respectively.

Products designed for video game console platforms accounted for 62.3% of publishing revenues as compared to 86.3% for the comparable period last year. PC products accounted for 17.9% of publishing revenues as compared to 8.7% for the prior comparable period. The increase in sales of PC products as a percentage of publishing revenues was primarily attributable to sales of *The Elder Scrolls IV: Oblivion*, *Sid Meier's Civilization IV*, *Prey* and *The Da Vinci Code*. For the nine months ended July 31, 2005, sales of products for PC platforms was primarily attributable to sales of *Grand Theft Auto: San Andreas* and

**Stronghold 2.** We anticipate that our platform mix will be weighted toward console platforms and the PSP handheld system, but may fluctuate from period to period.

Distribution revenues are derived from the sale of third-party software titles, accessories and hardware. The decrease in distribution revenues was primarily attributable to a continued decline in sales volume of value and front-line software titles, a decrease in average selling prices of interactive entertainment products as our industry transitions to next generation platforms and increased competition in the value software market. The decline in sales of software titles was partially offset by an increase in hardware sales and peripherals, primarily attributable to the Xbox 360 and related accessories.

International operations accounted for approximately \$234.7 million, or 30.4% of net revenues for the nine months ended July 31, 2006 compared to \$299.9 million, or 33.5% of net revenues for the nine months ended July 31, 2005. The decrease was primarily attributable to lower publishing revenues in Europe, which reflected the unfavorable comparison to a period with significant sales of *Grand Theft Auto: San Andreas* which was released in October 2004 for PlayStation 2 and June 2005 for Xbox and PC. International revenues for the nine months ended July 31, 2006 were primarily attributable to sales of *Grand Theft Auto: Liberty City Stories* for PSP and PlayStation 2, *The Elder Scrolls IV: Oblivion* for PC and Xbox 360, *Grand Theft Auto: San Andreas* on multiple platforms and *Prey* for Xbox 360 and PC.

Net revenues related to international operations decreased by \$7.0 million and increased by \$22.6 million due to changes in foreign exchange rates (including Canada) for the nine months ended July 31, 2006 and July 31, 2005, respectively. We expect international revenues to continue to account for a significant portion of our revenues.

#### **Cost of Goods Sold**

(thousands of dollars)	Nine months ended July 31,		2005	% of net revenue	Increase/ (decrease)	% Increase/ (decrease)
	2006	% of net revenue				
Product costs	\$ 407,038	52.8 %	\$ 453,514	50.7 %	\$ (46,476 )	(10.2 )%
Royalties	171,592	22.2 %	127,755	14.3 %	43,837	34.3 %
Software development costs	62,089	8.1 %	13,031	1.5 %	49,058	376.5 %
Cost of goods sold	\$ 640,719	83.1 %	\$ 594,300	66.4 %	\$ 46,419	7.8 %

**Product costs.** The decrease in product costs in absolute dollars was consistent with the decrease in publishing and distribution revenues. The increase as a percentage of net revenues was primarily due to the higher sales of hardware products and peripherals, including Xbox 360, which have higher product costs than sales of software titles. Additionally, net revenues for the nine months ended July 31, 2006 were reduced by lower prices on current generation software titles, which also contributed to an increase in product costs as a percentage of net revenues for the current period.

**Royalties.** The increase in royalties was primarily due to higher external royalty costs related to sales of certain of our published products. Royalties as a percentage of net revenue increased in the 2006 period reflecting a greater portion of externally developed titles in the current period. Royalty expense for the nine months ended July 31, 2006 was primarily attributable to sales of *The Elder Scrolls IV: Oblivion*, *Major League Baseball 2K6*, *The Da Vinci Code*, *Prey*, *Grand Theft Auto: Liberty City Stories* and *Grand Theft Auto: San Andreas*. In the comparable prior period, royalty costs were primarily related to sales of *Grand Theft Auto: San Andreas*. Royalty costs related to sales of our internally developed products accounted for \$30.6 million and \$78.8 million, respectively, of our royalty expense for the nine months ended July 31, 2006 and 2005.

**Software development costs.** The increase in software development costs was primarily due to impairment charges of approximately \$17.0 million related to several titles in development. The impairment charges



were based on an assessment of the future recoverability of capitalized software balances related to these titles and the determination that these titles were unlikely to recover capitalized costs given a change in sales expectations as a result of weaker market conditions, the closure of development studios, uncertainty involved in the console transition and historical performance of these titles.

The increase in costs was also due to sales of a larger number of internally developed titles resulting in higher amortization of capitalized costs as compared to the prior period. In the current period, software development costs related to sales of internally developed sports and other titles included *The Warriors*, *Rockstar Games Presents Table Tennis*, *Amped 3*, *Major League Baseball 2K6*, *NBA 2K6*, *Midnight Club 3: DUB Edition Remix* and *Top Spin 2*. In the comparable fiscal 2005 period, software development costs were primarily attributable to sales of *Midnight Club 3: DUB Edition* and *Grand Theft Auto: San Andreas*.

In future periods, cost of goods sold may be adversely affected by manufacturing and other costs, price competition and by changes in product and sales mix, distribution channels and royalty arrangements.

### Operating Expenses

(thousands of dollars)	Nine months ended July 31,		2005 As restated	% of net revenue	Increase/ (decrease)	% Increase/ (decrease)
	2006	% of net revenue				
Selling and marketing	\$ 101,423	13.2 %	\$ 119,961	13.4 %	\$ (18,538 )	(15.5 )%
General and administrative	116,276	15.1 %	90,991	10.2 %	25,285	27.8 %
Research and development	51,212	6.6 %	57,424	6.4 %	(6,212 )	(10.8 )%
Impairment of goodwill and long-lived assets	14,778	1.9 %			14,778	N/M
Depreciation and amortization	19,778	2.6 %	15,579	1.7 %	4,199	27.0 %
Total operating expenses	\$ 303,467	39.3 %	\$ 283,955	31.7 %	\$ 19,512	6.9 %

**Selling and marketing.** The decrease in selling and marketing expense in absolute dollars was primarily due to lower marketing and promotional spending of approximately \$11.4 million in the current period, lower in-store promotional spending of approximately \$4.9 million and lower trade show costs of approximately \$0.7 million primarily associated with E3, an industry trade exhibition held in May 2006. The decrease was also due to lower personnel expenses, primarily resulting from a decrease in incentive and stock compensation, which is consistent with current business performance. In the comparable fiscal 2005 period, higher advertising and marketing costs were primarily attributable to the release of *Grand Theft Auto: San Andreas* for PlayStation 2, which occurred in October 2004, and additional spending to promote titles under our 2K Games and 2K Sports publishing labels, which were established in fiscal 2005.

**General and administrative.** The increase in general and administrative expense was primarily due to higher personnel costs, which included an increase in stock compensation expense resulting from the adoption of SFAS 123(R), effective November 1, 2005, higher benefit costs of approximately \$3.0 million and an increase in severance costs of \$0.6 million primarily due to the closure of development studios. The increase in personnel costs was partially offset by a decrease in incentive compensation, which is consistent with lower revenues.

The increase in general and administrative expense was also due to additional rent and office related expenses of approximately \$6.2 million primarily due to newly acquired development studios and lease termination costs associated with the closure of development studios, an increase in information technology expenses of \$2.3 million related to system improvements and an increase in professional fees of approximately \$6.2 million primarily related to various on-going legal matters, including a review of our stock option grants, and process improvement projects.

**Research and development.** The decrease in research and development expense was primarily attributable to lower personnel costs of approximately \$5.2 million due to a decrease in incentive compensation, which is consistent with current business performance, and higher capitalization of compensation costs for development personnel offset by an increase in employee severance costs in connection with the closure of development studios in the current period. The decrease in research and development costs was also due to a decrease in production expenses of approximately \$2.1 million which reflects additional product development costs in the comparable prior period related to titles that had not yet reached technological feasibility.

A substantial portion of our research and development costs are capitalized once software development projects reach technological feasibility, which is relatively early in the development process, and subsequently amortized as cost of goods sold. However, amounts earned under our internal royalty program continue to be expensed as incurred in cost of goods sold. During fiscal 2006, incentive compensation directly related to the completion and release of our titles has been capitalized as software development costs and will subsequently be amortized as cost of goods sold upon release of the title.

**Impairment of intangibles and long-lived assets.** In the three and nine months ended July 31, 2006, we recorded an impairment charge of \$8.1 million related to goodwill and fixed assets at our Joytech subsidiary, the manufacturer and distributor of video game accessories, which operates within our publishing segment. The impairment charges reflect a decline in the fair value of Joytech's business resulting from continued competition and a decline in the price and sales volume of current generation accessories due to weaker market conditions and the ongoing transition to next generation hardware platforms. Additional impairment charges of approximately \$6.7 million were related to the write-off of certain trademarks, acquired intangibles and fixed assets. These write-offs were based on management's assessment of the future value of these assets including future business prospects and estimated cash flows to be derived from these assets.

**Provision (benefit) for income taxes.** Income tax benefit was \$0.6 million and income tax expense of \$2.7 million for the nine months ended July 31, 2006 and 2005, respectively. The income tax expense was primarily attributable to our net loss for the fiscal 2006 period offset by a valuation allowance of approximately \$59.5 million that was recorded to reduce our deferred tax assets. The valuation allowance was recorded primarily due to uncertainty regarding the realization of deferred tax assets attributable to net operating loss carryforwards.

The effective tax rate for the comparable period in fiscal 2005 was impacted by additional reserves recorded for product returns primarily related to our North American retail inventory of *Grand Theft Auto: San Andreas*.

The estimated annual effective tax rate, excluding the impact of the valuation allowance, was a benefit of 33.4% for the nine months ended July 31, 2006, compared to an estimated effective tax rate for the comparable period in fiscal 2005, which was an expense of 14.0%. The higher estimated annual effective tax rate, excluding the impact of the valuation allowance, in fiscal 2006 was primarily attributable to forecasted losses in higher tax rate jurisdictions. The lower effective tax rate for the comparable period in fiscal 2005 was attributable to a higher proportion of forecasted earnings in lower tax rate jurisdictions primarily due to additional reserves recorded in for product returns primarily related to our North American retail inventory of *Grand Theft Auto: San Andreas*.

We adopted SFAS 123(R) on November 1, 2005, which requires, among other items, the recognition of stock option expense in the results of operations. As a result of the adoption of SFAS 123(R), the income tax effects of compensatory stock options are included in the computation of the income tax expense (benefit), and deferred tax assets and liabilities, subject to certain prospective adjustments to stockholders' equity for the differences between the income tax effects of expenses recognized in the results of operations and the related amounts deducted for income tax purposes. Prior to our adoption of

SFAS 123(R) the tax benefits relating to the income tax deductions for compensatory stock options were recorded directly to stockholders equity.

We are regularly audited by domestic and foreign taxing authorities. Audits may result in tax assessments in excess of amounts claimed and the payment of additional taxes. We believe that our tax positions comply with applicable tax law, and that we have adequately provided for reasonably foreseeable tax assessments.

**Net income (loss).** For the nine months ended July 31, 2006, net loss was \$170.9 million as compared to net income of \$16.5 million for the nine months ended July 31, 2005 resulting from the changes referred to above.

**Diluted net income (loss) per share.** Diluted net loss per share for the nine months ended July 31, 2006 of \$2.41, compared to diluted net income per share of \$0.23 for the nine months ended July 31, 2005, principally due to the net loss for the period and increase in the weighted average common shares outstanding.

### Liquidity and Capital Resources

Our primary cash requirements are to fund the development and marketing of our products. We satisfy our working capital requirements primarily through cash flow from operations. At July 31, 2006, we had working capital of \$284.9 million as compared to working capital of \$365.9 million at October 31, 2005.

Cash and cash equivalents increased for the nine months ended July 31, 2006 as follows:

(thousands of dollars)	Nine months ended July 31,	
	2006	2005
Cash provided by operating activities	\$ 84,362	\$ 111,939
Cash used in investing activities	(18,791 )	(81,213 )
Cash provided by financing activities	2,950	14,912
Effects of exchange rates on cash and cash equivalents	3,414	(5,378 )
Net increase (decrease) in cash and cash equivalents	\$ 71,935	\$ 40,260

**Operating Activities.** Net cash provided by operating activities for the nine months ended July 31, 2006 was \$84.4 million compared to \$111.9 million for the nine months ended July 31, 2005. The decrease is primarily due to the net loss in the current period, adjusted for non-cash items including amortization and write-offs of software development costs. Net cash provided by operating activities in the current period also reflects an increase in accrued expenses and approximately \$51.0 million of cash received related to various agreements to provide online content, in-game advertising and licensing of our intellectual property.

**Investing Activities.** Net cash used in investing activities for the nine months ended July 31, 2006 was \$18.8 million compared to \$81.2 million for the nine months ended July 31, 2005. Net cash used in the current period primarily reflects the purchase of fixed assets partially offset by net cash acquired in the acquisition of Firaxis. The prior year period primarily reflects the acquisitions of Visual Concepts and Kush, Gaia and the intellectual property of *Civilization*.

**Financing Activities.** Net cash provided by financing activities for the nine months ended July 31, 2006 was \$3.0 million as compared to \$14.9 million for the nine months ended July 31, 2005. The decrease was primarily attributable to lower proceeds from the exercise of stock options. The prior period also reflects the repurchase of our common stock at an aggregate cost of \$15.0 million.





### Significant Balance Sheet Changes

*Accounts receivable:* The decrease of \$99.8 million in net accounts receivable from October 31, 2005 to July 31, 2006, was primarily due to lower net revenues in the current period and is consistent with the seasonal fluctuations of our business. Our allowances, which include doubtful accounts, returns, price concessions, rebates and other sales allowances, increased to \$82.5 million at July 31, 2006 from \$69.9 million at October 31, 2005 and increased as a percentage of receivables to 45.7% at July 31, 2006 from 26.1% at October 31, 2005. The increase in the allowance is due to weaker market conditions and the ongoing transition to next generation hardware platforms.

As of July 31, 2006, the receivable balances from our five largest retail customers accounted for approximately 47.7% of our gross receivable balance. Wal-Mart, GameStop and Best Buy accounted for approximately 13.2%, 12.8 and 11.0%, respectively, of our gross receivable balance. Generally, we have been able to collect our receivables in the ordinary course of business.

We do not hold any collateral to secure payment from customers and our domestic receivables are not covered by insurance. However, from time to time we purchase insurance from financial institutions on our receivables, with certain limits, to help protect us from loss in the event of a customer's bankruptcy or insolvency.

We are subject to credit risks, particularly in the event that any of the receivables represent a limited number of retailers. If we are unable to collect our accounts receivable as they become due, it could adversely affect our liquidity and working capital position and we would be required to increase our provision for doubtful accounts.

*Inventories:* The decrease of \$53.0 million in inventories from October 31, 2005 to July 31, 2006 was primarily due to a decrease in distribution inventories and is consistent with the decrease in trade accounts payable. The lower inventories balance was also consistent with lower seasonal inventory level requirements.

*Prepaid taxes and taxes receivable:* The increase of prepaid taxes and taxes receivable from October 31, 2005 to July 31, 2006 was primarily attributable to an increase in carry-back claims anticipated for fiscal 2006.

*Deferred revenue:* We have entered into various agreements to provide online content, in-game advertising and licensing of our intellectual property. Deferred revenue as of July 31, 2006 is \$50.0 million. To the extent that we have not performed the obligations required under the agreements, cash received is accounted for as deferred revenue.

*Loan Facilities:* In August 2005, we entered into a credit agreement with JPMorgan Chase Bank, N.A. ( JPMorgan ). The JPMorgan credit agreement provided for borrowings of up to \$50.0 million through the expiration of the agreement on August 23, 2006. We had no borrowings under the credit agreement and we were in compliance with all financial and other covenants at July 31, 2006. We did not renew our credit agreement with JPMorgan.

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In May 2006, our United Kingdom subsidiary renewed its credit facility agreement with Lloyds TSB Bank plc ( Lloyds ) under which Lloyds agreed to make available borrowings of up to approximately \$23.0 million. Advances under the credit facility bear interest at the rate of 1.25% per annum over the bank's base rate, and are guaranteed by us. Available borrowings under the agreement are reduced by the amount of outstanding guarantees. The facility expires on March 31, 2007. We had no outstanding guarantees and no borrowings under this facility as of July 31, 2006.

**Stock Split:** In April 2005, we effected a three-for-two stock split in the form of a stock dividend. Accordingly, all share and per share data in the accompanying unaudited condensed consolidated financial statements and notes thereto give retroactive effect to the stock split.

**Legal and Accounting Expenses:** We have incurred and may continue to incur significant legal, accounting and other professional fees and expenses in connection with pending regulatory and litigation matters.

Based on our currently proposed operating plans and assumptions, we believe that projected cash flow from operations and available cash resources, including amounts available under our line of credit, will be sufficient to satisfy our cash requirements for the foreseeable future. If our projected cash flow and available cash is insufficient to fund our operations or if our plans and assumptions change or prove to be inaccurate, we may be required to seek additional financing or curtail our diversification activities.

### Contractual Obligations and Contingent Liabilities and Commitments

A summary of annual minimum contractual obligations and commitments as of July 31, 2006 is as follows:

Fiscal years ending October 31,	Licensing and Marketing	Software Development	Operating Leases	Distribution	Total
Remainder of 2006	\$ 34,738	\$ 21,669	\$ 5,321	\$ 1,327	\$ 63,055
2007	60,046	28,771	16,643	1,293	106,753
2008	53,201	9,547	15,021		77,769
2009	53,959	16	14,539		68,514
2010	53,967		13,082		67,049
Thereafter	100,280		35,504		135,784
Total	\$ 356,191	\$ 60,003	\$ 100,110	\$ 2,620	\$ 518,924

**Licensing and Marketing Agreements:** Our license expense consists primarily of payments made to licensors for intellectual property rights under agreements which expire at various times through December 2012. As of July 31, 2006, we have minimum guaranteed licensing and marketing commitments of \$356.2 million of which \$2.9 million are recorded in our condensed consolidated balance sheet as the licensor does not have any significant performance obligation. Minimum guaranteed licensing and marketing commitments primarily reflect our agreements with major sports leagues and players' associations.

**Software Development Agreements:** Our payments made to third-party developers include contractual advances and royalty payments under agreements which expire at various times through November 2008. Assuming performance by third-party developers, we have aggregate outstanding commitments of \$60.0 million under various software development agreements at July 31, 2006. We have also established an internal royalty program pursuant to which we pay royalties to certain of our development personnel based on product sales. Royalties earned under our internal royalty program are expensed as incurred.

**Lease Commitments:** Our offices and warehouse facilities are occupied under non-cancelable operating leases expiring at various times from October 2006 to September 2014. We also lease certain furniture, equipment and automobiles under non-cancelable leases expiring through July 2010. Future minimum



rental payments for fiscal 2006 are \$5.3 million and aggregate minimum rental payments through applicable lease expirations are \$100.1 million.

*Distribution Agreements:* We periodically enter into distribution agreements to purchase various software games. These agreements, which expire at various dates through July 2007, require remaining aggregate minimum guaranteed payments of \$2.6 million at July 31, 2006.

*Contingent Consideration:* In November 2005, in connection with the acquisition of Firaxis, we agreed to make additional payments of \$11.3 million based on future product sales, of which approximately \$10.0 million will be recorded as additional purchase price and \$1.3 million will be recorded as employee compensation expense.

In fiscal 2005, in connection with the acquisition of Irrational, we agreed to make additional payments of \$2.0 million to the former owners of Irrational based on the delivery of products. We anticipate making a payment of \$1.0 million related to these contingent payments within the next twelve months and \$1.0 million in fiscal 2008 due to the expected timing of product releases. Additionally, in fiscal 2005, in connection with the acquisition of Visual Concepts and Kush Games, we agreed to make additional payments of approximately \$1.4 million to SEGA based on the commercial release of products. The additional payments to SEGA are expected to be made in fiscal 2006.

In March 2005, we renegotiated a \$6.0 million contingent obligation due upon the delivery of the final PC version of *Duke Nukem Forever* through the payment of \$4.3 million and issuance of a promissory note in the principal amount of \$0.5 million. The payment of the promissory note is contingent upon the commercial release of such product prior to December 31, 2006.

In fiscal 2004, in connection with the acquisition of Mobius, we agreed to make additional contingent payments of approximately \$2.0 million based on the delivery of products.

### **Fluctuations in Operating Results and Seasonality**

We have experienced fluctuations in quarterly operating results as a result of the timing of the introduction of new titles; variations in sales of titles developed for particular platforms; market acceptance of our titles; development and promotional expenses relating to the introduction of new titles; sequels or enhancements of existing titles; projected and actual changes in platforms; the timing and success of title introductions by our competitors; product returns; changes in pricing policies by us and our competitors; the accuracy of retailers' forecasts of consumer demand; the size and timing of acquisitions; the timing of orders from major customers; and order cancellations and delays in product shipment. Sales of our titles are also seasonal, with peak shipments typically occurring in the fourth calendar quarter (our fourth and first fiscal quarters) as a result of increased demand for titles during the holiday season. Quarterly comparisons of operating results are not necessarily indicative of future operating results.

### **International Operations**

Net revenues outside of the United States, principally in Canada, the United Kingdom and other countries in Europe, have accounted for a significant portion of our net revenues. For the nine months ended July 31, 2006 and 2005, net revenues earned outside the United States accounted for approximately 39.1% and 40.6%, respectively, of our net revenues. We are subject to risks inherent in foreign trade, including increased credit risks, tariffs and duties, fluctuations in foreign currency exchange rates, shipping delays and international political, regulatory and economic developments, all of which can have a significant impact on our operating results.

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

We are subject to market risks in the ordinary course of our business, primarily risks associated with interest rate and foreign currency fluctuations.

Historically, fluctuations in interest rates have not had a significant impact on our operating results. At July 31, 2006, we had no outstanding variable rate indebtedness.

We transact business in foreign currencies and are exposed to risks resulting from fluctuations in foreign currency exchange rates. Accounts relating to foreign operations are translated into United States dollars using prevailing exchange rates at the relevant quarter end. Translation adjustments are included as a separate component of stockholders' equity. For the nine months ended July 31, 2006, our foreign currency translation adjustment gain was \$5.2 million. Foreign exchange transaction gain for the nine months ended July 31, 2006 was \$1.4 million.

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

##### *Evaluation of disclosure controls and procedures*

The Company maintains disclosure controls and procedures that are designed to ensure that information required to be disclosed in the Company's reports under the Securities Exchange Act of 1934 is recorded, processed, summarized and reported within the time periods specified in the SEC's rules and forms, and that such information is accumulated and communicated to management, as appropriate, to allow timely decisions regarding required disclosure. The Company's management, with participation of the company's Chief Executive Officer and Chief Financial Officer, has conducted an evaluation of the effectiveness of the Company's disclosure controls and procedures (as defined in the Securities Exchange Act of 1934 Rules 13a-15(e) and 15d-15(e)) as of the end of the period covered by this quarterly report on Form 10-Q.

As previously disclosed in our Annual Report on Form 10-K for the fiscal year ended October 31, 2005, the Company determined that, as of October 31, 2005, there were two material weaknesses affecting our internal control over financial reporting and, as a result of those weaknesses, the Company's disclosure controls and procedures were not effective. As described below, the Company has remediated those material weaknesses. Consequently, based on the evaluation described above, the Company's management, including our Chief Executive Officer and Chief Financial Officer, has concluded that, as of July 31, 2006, the Company's disclosure controls and procedures were effective.

##### *Management's Remediation Measures*

As previously reported in the Company's Annual Report on Form 10-K for the fiscal year ended October 31, 2005, management determined that, as of October 31, 2005, there were material weaknesses in the Company's internal control over financial reporting relating to (i) ineffective controls over the existence and valuation of its accounts payable related to inventory purchases and (ii) ineffective controls over the accuracy of the amortization of its capitalized software development costs. As reported in the Annual Report for fiscal 2005, the Company initiated a number of changes in its internal controls to remediate these material weaknesses. At July 31, 2006, the following measures to remediate the control deficiencies were implemented:

- The Company developed reports to assist in the analysis of accounts payable related to inventory purchases to ensure there is adequate and timely reconciliation of these accounts.
- The Company has added an additional level of review of the amortization of capitalized software development costs to ensure the accuracy of the information used in this calculation. The Company has also redesigned the reconciliation schedules in this area to make it easier to review.

Based on the implementation of the additional internal controls discussed above and the subsequent testing of those internal controls for a sufficient period of time, management has concluded that the material weaknesses have been remediated and that the Company's disclosures and procedures and internal control over financial reporting are now effective.

*Changes in Internal Control over Financial Reporting*

Other than as described above, there have been no changes in our internal control over financial reporting that occurred during the third quarter ended July 31, 2006 that have materially affected, or are reasonably likely to materially affect, our internal control over financial reporting.

**PART II OTHER INFORMATION**

**Item 1. Legal Proceedings**

In July 2005, we received three purported class action complaints against us and Rockstar Games, two of which were filed in the United States District Court for the Southern District of New York and one such complaint which was filed in the United States District Court, Eastern District of Pennsylvania. On September 8, 2005, another similar complaint was filed in the Circuit Court for the Twentieth Judicial District, St. Clair County, Illinois and then removed to United States District Court for the Southern District of Illinois. The plaintiffs, alleged purchasers of our *Grand Theft Auto: San Andreas* game, allege that we and Rockstar Games engaged in consumer deception, false advertising and common law fraud and were unjustly enriched as a result of the alleged failure of us and Rockstar Games to disclose that *Grand Theft Auto: San Andreas* contained hidden content, which resulted in the game receiving an M rating from the ESRB rather than an AO rating. The complaints seek unspecified damages, declarations of various violations of law and litigation costs. The New York and Pennsylvania actions, together with an action commenced against us and Rockstar Games in the United States District for the Southern District of New York in August 2006, have been consolidated in the Southern District of New York under the caption *In re Grand Theft Auto Video Game Consumer Litigation*, (05-CV-6734 (BSJ)) and the Illinois action has been transferred to the Southern District of New York for coordinated pretrial proceedings pursuant to an Order of Judicial Panel on Multidistrict Litigation. These cases have been consolidated for pretrial proceedings under the caption *In re Grand Theft Auto Video Game Consumer Litigation (No. II)*, 06-MD-1739 (SWK)(MHD). On June 7, 2006 plaintiffs filed a Consolidated and Amended Complaint. On July 31, 2006, we and Rockstar Games filed a Partial Motion to Dismiss those claims brought under the laws of states other than states where the named plaintiffs reside and were purportedly injured. By an Opinion and Order dated October 25, 2006, the Partial Motion to Dismiss was denied. On November 10, 2006 we and Rockstar Games filed a Motion to Deny Certification of the proposed nationwide class. On November 17, 2006 we and Rockstar Games served an answer denying the allegations in the Consolidated and Amended Complaint and asserting various affirmative defenses. On January 24, 2007, the Plaintiffs cross-moved for certification of the proposed nationwide class. Consolidated discovery in these actions is proceeding.

In November 2006, a complaint was filed against us and Rockstar Games in the United States District Court, Eastern District of Pennsylvania, alleging that we and Rockstar Games engaged in consumer deception, were unjustly enriched and in breach of warranty as a result of the alleged failure of us and Rockstar Games to disclose that *Grand Theft Auto: San Andreas* contained hidden content, which resulted in the game receiving an M rating from the ESRB rather than an AO rating. The complaint seeks unspecified damages, declarations of various violations of law and litigation costs. We and Rockstar Games have filed a Notice of Tag-along Action with the Judicial Panel on Multi-District Litigation, requesting that the case be transferred to the Southern District of New York for pretrial consolidation with *In re Grand Theft Auto Video Game Consumer Litigation (No. II)*, 06-MD-1739 (SWK)(MHD). On January 26, 2007, the Judicial Panel on Multidistrict Litigation issued a Conditional Transfer Order, transferring this action to the Southern District of New York for pre-trial consolidation with *In re Grand Theft Auto Video Game Consumer Litigation (No. II)*, 06-MD-1739 (SWK)(MHD).

In January 2006, the City Attorney for the City of Los Angeles filed a complaint against us and Rockstar Games in the Superior Court of the State of California. The complaint alleges that we and Rockstar Games violated sections of the California Business and Professions Code prohibiting untrue and

misleading statements and unfair competition and that we and Rockstar Games were unjustly enriched as a result of the alleged failure to disclose that *Grand Theft Auto: San Andreas* contained hidden content which should have resulted in the game receiving an Adults Only ( AO ) rating from the ESRB rather than a Mature ( M ) rating. The complaint also alleges that we made misleading statements as to the origin of the hidden content. The complaint seeks injunctive relief, restitution for purchasers of the game and civil fines. The action has been removed to the United States District Court, Central District of California and we moved to dismiss the complaint. The plaintiff has moved to remand the action to state court and the Judicial Panel on Multidistrict Litigation has issued an order transferring the action to the Southern District of New York and the action was consolidated for pre-trial purposes with *In re Grand Theft Auto Video Game Consumer Litigation (No. II)*, 06-MD-1739 (SWK)(MHD).

In February and March 2006, an aggregate of four purported class action complaints were filed against us, our Chief Executive Officer, Chief Financial Officer and former Chief Global Operating Officer in the United States District Court for the Southern District of New York (the New York Actions ) and one such purported class action was filed in the United States District Court for the Eastern District of Michigan (the Michigan Action ). The New York plaintiffs are Max Kaplan, John Fenninger, David Andrews and David Toth and the Michigan plaintiff was The City of Flint and Daniel J. Hall on behalf of The City of Flint Employees Retirement Pension Fund. The complaints allege that the defendants violated Sections 10(b), 20(a) and Rule 10b-5 of the Securities Exchange Act of 1934 ( Exchange Act ) by making or causing us to make untrue statements or failing to disclose in certain press releases and SEC periodic reports that, among other things: *Grand Theft Auto: San Andreas* contained hidden content which should have resulted in the game receiving an Adults Only ( AO ) rating from the ESRB rather than a Mature ( M ) rating; the defendants attempted to bolster sales of *Grand Theft Auto: San Andreas* by concealing the adult content from retailers who refused to carry AO material; our management failed to keep our Board of Directors informed of important issues or failed to do so in a timely fashion; and we were misstating capitalized software development costs and amortization expense and had inadequate internal controls and procedures to ensure accuracy in our reported financial results. The plaintiffs seek to recover unspecified damages and their costs. The plaintiffs in the Michigan Action voluntarily dismissed their complaint without prejudice. On July 12, 2006, the Court entered Orders appointing the New York City Pension Funds as lead plaintiff and directing the filing of a consolidated amended complaint within sixty (60) days. Plaintiffs filed a consolidated and amended complaint on September 11, 2006. The amended complaint added claims for violations of Sections 10(b) and 20(a) of the Exchange Act related to allegedly improper stock option granting practices at the Company. On December 11, 2006, we announced the preliminary results of an internal investigation into our historical stock option granting practices. The preliminary findings showed that there were improprieties in the process of granting and documenting stock options, and that incorrect measurement dates for certain stock option grants were used for financial accounting purposes. We further announced that we will need to restate previous financial statements and that our financial statements between 1997 and April 30, 2006, are not reliable. As a result of these announcements the parties have entered into a stipulation modifying the current scheduling order. Pursuant to the stipulation, all pending deadlines have been stayed pending a decision by plaintiffs as to whether they will file a second amended complaint reflecting our recent announcements.

In January 2006, the St. Clair Shores General Employees Retirement System filed a purported class and derivative action complaint in the Southern District of New York against us, as nominal defendant, and certain of our officers and directors and certain former officers and directors. The factual allegations in this action are similar to the allegations contained in the New York Actions. Plaintiff asserts that certain defendants breached their fiduciary duty by selling their stock while in possession of certain material non-public information and breached their fiduciary duty and violated Section 14(a) and Rule 14a-9 of the Exchange Act by failing to disclose material facts in our 2003, 2004 and 2005 proxy statements in which we solicited approval to increase share availability under our 2002 Stock Option Plan. Plaintiff seeks the return of all profits from the alleged insider trading conducted by the individual defendants who sold our



stock, unspecified compensatory damages with interest and their costs in the action. A motion to stay the action pending the determination of an investigation by the Special Committee was filed with the Court. On October 4, 2006, the Court issued an order granting the motion and staying the proceedings for a period of 150 days from the date of the Order. On January 17, 2007, the plaintiffs moved for an order granting limited relief from the Court's October 4, 2006 stay of the proceedings in order to file an Amended Derivative and Class Action Complaint.

In July 2006, Richard Lasky filed a purported derivative action complaint in the Southern District of New York against us, as nominal defendant, and certain of our officers and directors and certain former officers and directors. The complaint alleges violations of federal and state law, including violations of the Sarbanes-Oxley Act of 2002, the Exchange Act, breaches of fiduciary duties, abuse of control, gross mismanagement, waste of corporate assets and unjust enrichment that allegedly occurred between January 2000 and the present. The complaint also asserts claims alleging the defendants breached their fiduciary duties in connection with the granting of stock options to certain officers and directors since 1997. The complaint seeks unspecified damages against all of the individual defendants, reimbursement from certain of the defendants of bonuses or other incentive or equity based compensation paid to them by us during our fiscal year ended October 31, 2003, equitable and other relief relating to the proceeds from certain of the defendants' alleged improper trading activity in our stock, adoption of certain corporate governance proposals and recovery of litigation costs.

On August 22, 2006, a shareholder derivative complaint was filed by Raeda Karadsheh in the United States District Court of the Southern District of New York against us, as nominal defendant, and certain of our current and former officers and directors. The Karadsheh Complaint asserts claims related to our stock option granting practices. On November 22, 2006, the Court entered an Order consolidating the two actions and providing plaintiffs with forty-five (45) days from the date of the Order to file a consolidated complaint. The Plaintiffs filed a consolidated complaint on January 22, 2007. The consolidated complaint focuses exclusively on our historical stock option granting practices.

In January 2006, Todd Veeck filed a complaint in the Court of Chancery of the State of Delaware against us pursuant to 8 DEL. C. § 220 to compel inspection of our books and records in order to investigate possible breaches of fiduciary duties with regard to the creation, development, marketing and sale of our *Grand Theft Auto* line of products. The parties were able to amicably resolve this action, which was dismissed with prejudice on December 11, 2006.

In February 2005, the personal representatives of the Estates of Arnold Strickland, James Crump and Ace Mealer brought an action in the Circuit Court of Fayette County, Alabama against us, Sony Computer Entertainment America Inc. (SCEA), Sony Corporation of America (SCA), Wal-Mart, GameStop and Devin Moore alleging under Alabama's manufacturers' liability and wrongful death statutes that our video games designed, manufactured, marketed and/or supplied to Mr. Moore resulted in copycat violence that caused the death of Messrs. Strickland, Crump and Mealer. The suit seeks damages (including punitive damages) against all of the defendants in excess of \$600 million. Wal-Mart, SCEA and SCA have tendered their defense and requested indemnification from us, and we have accepted such tender. Our motion to dismiss the action was denied and we moved to have certain issues certified for an immediate interlocutory appeal before the Alabama Supreme Court. We also separately pursued a petition to dismiss claims against us and Rockstar Games, for lack of personal jurisdiction. The Alabama Supreme Court declined to accept the interlocutory appeal, but agreed to hear the petition to dismiss the action for lack of personal jurisdiction. Briefing has been completed on such petition, and the matter is now pending before the Supreme Court. In April 2006, the plaintiffs filed a Third Amended Complaint to add a claim for civil conspiracy; we and our co-defendants have moved to dismiss that claim and the motion is pending. In October 2006, the trial court amended a prior Scheduling Order to set (a) a hearing on the admissibility of Plaintiffs' expert opinions for April 6, 2007; (b) completion of all fact and expert discovery by October 12,

2007; (c) mediation for November 8, 2007; and (d) trial (if necessary) to commence no earlier than January 14, 2008.

In September 2006, the personal representatives of the Estates of Verlin Posey, Tryone Posey, and Marilea Schmid brought an action in the Second Judicial District of Bernalillo County, New Mexico in Albuquerque against us; Rockstar Games; SCEA; SCA and Cody Posey ( Posey ), alleging under New Mexico's products liability and wrongful death statutes that our video games resulted in copycat violence that caused Posey to shoot and kill his father (Verlin Posey), stepmother (Tryone Posey) and stepsister (Marilea Schmid). At his criminal trial, Posey argued self-defense, and presented extensive testimony of long-term substantial physical abuse by his father. Posey was convicted of manslaughter in his father's death, second degree murder for his stepmother's death, and first degree murder for his stepsister's death. At sentencing in April 2006, the judge concluded that Posey suffered from post-traumatic stress disorder and depression, and had snapped when he committed the killings; rather than sentence Posey to life in prison, the judge sentenced him to a juvenile facility until he turns twenty-one. The suit seeks damages (including punitive damages) against all of the defendants in excess of \$600 million. SCEA and SCA have tendered their defense and requested indemnification from us, and we have accepted such tender. Copies of the Complaint and Summonses were received by us in December 2006; and we moved to dismiss the Complaint on January 19, 2007.

We intend to vigorously defend and seek dismissal of these matters and, with respect to the derivative actions, we have been advised that the individual defendants will vigorously defend such actions. However, we cannot predict the outcome of these matters and, if determined adversely to us, such matters, either singly or in the aggregate, could result in the imposition of significant judgments, fines and/or penalties which could have a material adverse effect on our financial condition, cash flows and results of operations.

We have received notice from the SEC that it is conducting an informal non-public investigation into certain stock option grants made by us from January 1997 to the present. Prior to receiving the notice, we had initiated an internal review of our option grants, led by a committee consisting of independent board members who have retained independent legal counsel and accountants to assist in the review. We and the Special Committee are fully cooperating with the SEC.

We have received grand jury subpoenas issued by the District Attorney of the County of New York requesting production of documents covering various periods beginning on January 1, 1997, including those relating to, among other things: the so-called Hot Coffee scenes in Grand Theft Auto: San Andreas; the work of our Board of Directors, all Board Committees, and the Special Litigation Committee; certain acquisitions entered into by us; billing and payment records relating to Pricewaterhouse Coopers LLC ( PWC ) and the termination of PWC as our auditors; communications to financial analysts and stockholders about acquisitions and financial results; compensation and human resources documents of certain of our directors and employees; stock-based compensation; the SEC's June 2006 inquiry; legal services performed for employees; corporate credit card and expense records of certain individuals; the SEC bar of our former Chief Executive Officer, Ryan Brant; and ethics, securities, and conflict of interest policies and questionnaires. We are fully cooperating and providing the documents and information called for by the subpoenas.

We have also received a request for information from the Internal Revenue Service that includes a request for records relating to the grant and exercise of options and tax deductions taken by us pursuant to Internal Revenue Code Section 162(m) for the period from October 31, 2000 to October 31, 2004. We are fully cooperating and providing the requested documents.

We are also involved in other routine litigation in the ordinary course of business, which in our opinion will not have a material adverse effect on our financial condition, cash flows or results of operations.

**Item 1A. Risk Factors**

There have been no material changes to the Risk Factors disclosed in Item 1A of the Company's Annual Report on Form 10-K for the year ended October 31, 2006, which was filed prior to this quarterly report on Form 10-Q.

**Item 6. Exhibits**

**Exhibits:**

- 31.1 Chief Executive Officer Certification Pursuant to Section 302 of the Sarbanes-Oxley Act of 2002.
- 31.2 Chief Financial Officer Certification Pursuant to Section 302 of the Sarbanes-Oxley Act of 2002.
- 32.1 Chief Executive Officer Certification pursuant to 18 U.S.C. Section 1350, as adopted Pursuant to Section 906 of the Sarbanes-Oxley Act of 2002.
- 32.2 Chief Financial Officer Certification pursuant to 18 U.S.C. Section 1350, as adopted Pursuant to Section 906 of the Sarbanes-Oxley Act of 2002.

**SIGNATURES**

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

**TAKE-TWO INTERACTIVE SOFTWARE, INC.**

Date: February 28, 2007

By:

(Registrant)

/s/ Paul Eibeler

Paul Eibeler

Chief Executive Officer and President

(Principal Executive Officer)

Date: February 28, 2007

By:

/s/ Karl H. Winters

Karl H. Winters

Chief Financial Officer

(Principal Financial Officer)