

Activision Blizzard, Inc.

Form 10-Q

November 10, 2008

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## **UNITED STATES**

**SECURITIES AND EXCHANGE COMMISSION**

Washington, D.C. 20549



# FORM 10-Q

(Mark one)

x

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

**For the Quarterly Period Ended September 30, 2008**



OR

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

For the transition period from \_\_\_\_\_ to \_\_\_\_\_

Commission File Number 1-15839

**ACTIVISION BLIZZARD, INC.**

(Exact name of registrant as specified in its charter)

**Delaware**

(State or other jurisdiction of  
incorporation or organization)

**95-4803544**

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

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

(Address of principal executive offices)

**90405**

(Zip Code)

**(310) 255-2000**

(Registrant's telephone number, including area code)

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

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

Large Accelerated Filer  Accelerated Filer  Non-accelerated filer  (Do not check if a smaller reporting company)

Smaller reporting company

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



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The number of shares of the registrant's Common Stock outstanding as of October 31, 2008 was 1,324,390,741.

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**ACTIVISION BLIZZARD, INC. AND SUBSIDIARIES**

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**EXPLANATORY NOTE**

*On July 9, 2008, a business combination by and among Activision, Inc., Sego Merger Corporation, a wholly-owned subsidiary of Activision, Inc., Vivendi S.A., ( Vivendi ) VGAC LLC, a wholly-owned subsidiary of Vivendi S.A., and Vivendi Games, Inc., a wholly-owned subsidiary of VGAC LLC, was consummated. As a result of the consummation of the business combination, Activision, Inc. was renamed Activision Blizzard, Inc. For accounting purposes, the business combination is treated as a reverse acquisition, with Vivendi Games, Inc. deemed to be the acquirer. The historical financial statements of Activision Blizzard, Inc. prior to July 9, 2008 are those of Vivendi Games, Inc. (see Note 1 of consolidated financial statement for more details).*

**CAUTIONARY STATEMENT**

*This Quarterly Report on Form 10-Q contains, or incorporates by reference, certain forward-looking statements within the meaning of the Private Securities Litigation Reform Act of 1995. Such statements consist of any statement other than a recitation of historical fact and include, but are not limited to, (1) projections of revenues, expenses, income or loss, earnings or loss per share, cash flow projections or other financial items; (2) statements of our plans and objectives, including those relating to product releases; (3) statements of future economic performance; and (4) statements of assumptions underlying such statements. We generally use words such as anticipate, believe, could, estimate, expect, forecast, future, intend, may, outlook, plan, positioned, potential, project, remain, scheduled, set to, subject to, to be, upcoming, will, and other similar expressions to help identify forward-looking statements. These forward-looking statements are subject to business and economic risk, reflect management's current expectations, estimates and projections about our business, and are inherently uncertain and difficult to predict. Our actual results could differ materially. The forward-looking statements contained herein speak only as of the date on which they were made, and we disclaim any obligation to update any forward-looking statements to reflect events or circumstances after the date of this Quarterly Report. Risks and uncertainties that may affect our future results include, but are not limited to the following: sales of Activision Blizzard's titles, shifts in consumer spending trends, the impact of the current macroeconomic environment, the seasonal and cyclical nature of the interactive game market, Activision Blizzard's ability to predict consumer preferences among competing hardware platforms, declines in software pricing, product returns and price protection, product delays, retail acceptance of Activision Blizzard's products, adoption rate and availability of new hardware and related software, industry competition, rapid changes in technology and industry standards, protection of proprietary rights, litigation against Activision Blizzard, maintenance of relationships with key personnel, customers, vendors and third-party developers, domestic and international economic, financial and political conditions and policies, foreign exchange rates, integration of recent acquisitions and the identification of suitable future acquisition opportunities, Activision Blizzard's success in integrating the operations of Activision and Vivendi Games in a timely manner, or at all, and the combined company's ability to realize the anticipated benefits and synergies of the transaction to the extent, or in the timeframe, anticipated, as well as the other risk factors included in Part II, Item 1A of our Quarterly Report on Form 10-Q for the quarter ended June 30, 2008. Except as otherwise noted (including in connection with the review and presentation of results of operations for the quarter ended September 30, 2008), all references to we, us, our, Activision Blizzard or the Company in the following discussion and analysis mean Activision Blizzard, Inc. and its subsidiaries.*

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**Part I. FINANCIAL INFORMATION**

**Item 1. Financial Statements**

**ACTIVISION BLIZZARD, INC. AND SUBSIDIARIES**

**CONSOLIDATED BALANCE SHEETS**

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(Amounts in millions, except share data)

	September 30, 2008 (Unaudited)	December 31, 2007 (As Adjusted)
<b>Assets</b>		
Current assets:		
Cash and cash equivalents	\$ 2,842	\$ 62
Short-term investments	94	3
Accounts receivable, net of allowances of \$96 million and \$94 million at September 30, 2008 and December 31, 2007, respectively	316	104
Inventories	377	21
Software development	226	25
Intellectual property licenses	10	9
Deferred income taxes	228	143
Intangible assets, net	51	
Other current assets	57	23
<b>Total current assets</b>	<b>4,201</b>	<b>390</b>
Long-term investments	86	
Software development	20	51
Intellectual property licenses		8
Property and equipment, net	168	129
Deferred income taxes	80	24
Other assets	21	6
Intangible assets, net	1,462	7
Trade name	433	53
Goodwill	7,270	203
<b>Total assets</b>	<b>\$ 13,741</b>	<b>\$ 871</b>
<b>Liabilities and Shareholders' Equity</b>		
Current liabilities:		
Accounts payable	\$ 338	\$ 49
Deferred revenues	206	197
Accrued expenses and other liabilities	557	274
<b>Total current liabilities</b>	<b>1,101</b>	<b>520</b>
Deferred income tax, net	696	
Other liabilities	169	111
<b>Total liabilities</b>	<b>1,966</b>	<b>631</b>
Shareholders' equity:		
Common stock, \$.000001 par value, 2,400,000,000 shares authorized, 1,323,628,497 shares issued and outstanding at September 30, 2008 and 590,618,180 shares issued and outstanding at December 31, 2007		
Additional paid-in capital	12,165	490
Net payable to Vivendi and affiliated companies		77
Accumulated deficit	(403)	(367)
Accumulated other comprehensive income	13	40
<b>Total shareholders' equity</b>	<b>11,775</b>	<b>240</b>
<b>Total liabilities and shareholders' equity</b>	<b>\$ 13,741</b>	<b>\$ 871</b>

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





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**ACTIVISION BLIZZARD, INC. AND SUBSIDIARIES**

**CONSOLIDATED STATEMENTS OF OPERATIONS**

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(Unaudited)

(Amounts in millions, except per share data)

	For the three months ended September 30,		For the nine months ended September 30,	
	2008	2007 (As Adjusted)	2008	2007 (As Adjusted)
<b>Net revenues</b>				
Product sales	\$ 413	\$ 98	\$ 553	\$ 246
Subscription, licensing, and other revenues	298	228	834	650
<b>Total net revenues</b>	<b>711</b>	<b>326</b>	<b>1,387</b>	<b>896</b>
<b>Costs and expenses</b>				
Cost of sales product costs	279	31	350	95
Cost of sales software royalties and amortization	50	5	88	14
Cost of sales intellectual property licenses	36	1	45	5
Cost of sales massively, multiplayer, online game	43	40	123	146
Product development	200	117	414	327
Sales and marketing	142	46	220	105
Restructuring costs	61		61	(1)
General and administrative	94	29	172	71
<b>Total costs and expenses</b>	<b>905</b>	<b>269</b>	<b>1,473</b>	<b>762</b>
Operating income (loss)	(194)	57	(86)	134
Investment income (loss), net	24	(2)	28	(5)
Income (loss) before income tax provision (benefit)	(170)	55	(58)	129
Income tax provision (benefit)	(62)	7	(22)	(12)
Net income (loss)	\$ (108)	\$ 48	\$ (36)	\$ 141
Net income (loss) per share				
Basic and diluted	\$ (0.08)	\$ 0.08	\$ (0.04)	\$ 0.24
Number of shares used in computation				
Basic and diluted	1,271	591	816	591

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



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**ACTIVISION BLIZZARD, INC. AND SUBSIDIARIES**

**CONSOLIDATED STATEMENTS OF CASH FLOWS**

**(Unaudited)**  
**(Amounts in millions)**

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	For the nine months ended September 30,	
	2008	2007 (As Adjusted)
Cash flows from operating activities:		
Net income (loss)	\$ (36)	\$ 141
Adjustments to reconcile net income (loss) to net cash provided by operating activities:		
Deferred income taxes	(109)	(24)
Depreciation and amortization	144	45
Impairment charges	24	
Loss on disposal of property and equipment		1
Amortization and write-offs of capitalized software development costs and intellectual property licenses (1)	120	15
Stock-based compensation expense (2)	47	77
Tax benefit associated with employee stock options	2	
Excess tax benefits from stock option exercises	(17)	
Changes in operating assets and liabilities, net of impact of acquisitions:		
Accounts receivable	224	125
Inventories	(135)	(3)
Software development and intellectual property licenses	(119)	(71)
Other assets	(11)	(3)
Deferred revenues	10	88
Accounts payable	108	(10)
Accrued expenses and other liabilities	(127)	(73)
Net cash provided by operating activities	125	308
Cash flows from investing activities:		
Capital expenditures	(24)	(46)
Cash acquired through the business combination, net of cash payments to effect acquisitions	1,137	
Increase in restricted cash	(35)	1
Net cash provided by (used in) investing activities	1,078	(45)
Cash flows from financing activities:		
Proceeds from issuance of common stock to employees	19	
Repurchase of stock through tender offer	(2)	
Return of capital to Vivendi	(79)	
Issuance of additional common stock related to the business combination	1,731	
Net cash transfers to Vivendi and affiliated companies	(79)	(294)
Excess tax benefits from stock option exercises	17	
Net cash provided by (used in) financing activities	1,607	(294)
Effect of exchange rate changes on cash	(30)	3
Net increase (decrease) in cash and cash equivalents	2,780	(28)
Cash and cash equivalents at beginning of period	62	68
Cash and cash equivalents at end of period	\$ 2,842	\$ 40

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

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

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





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For the Nine Months ended September 30, 2008

(Unaudited)

(Amounts in millions)

	Common Stock Shares	Common Stock Amount	Additional Paid-In Capital	Net Payable to Vivendi	Accumulated Deficit	Accumulated Other Comprehensive Income (Loss)	Total Shareholders' Equity
<b>Balance at December 31, 2007 (As Adjusted)</b>	<b>591</b>	<b>\$</b>	<b>\$ 490</b>	<b>\$ 77</b>	<b>\$ (367)</b>	<b>\$ 40</b>	<b>\$ 240</b>
Settlement of payable to Vivendi (see Note 18)			(2)	(77)			(79)
Components of comprehensive loss:							
Net loss					(36)		(36)
Unrealized depreciation on short-term investments, net of taxes						(2)	(2)
Foreign currency translation adjustment						(25)	(25)
Total comprehensive loss							(63)
Tender offer (see Note 1)			(2)				(2)
Issuance of additional common stock related to the business combination (see Note 1)	126		1,731				1,731
Issuance of common stock pursuant to employee stock options, restricted stock rights, employee stock purchase plans, and warrants	5		19				19
Stock-based compensation expense related to employee stock options, restricted stock rights, and employee stock purchase plans			42				42
Preliminary purchase consideration upon the business combination (see Note 4)	602		9,964				9,964
Tax benefit associated with employee stock options			2				2
Return of capital to Vivendi (see Note 18)			(79)				(79)
<b>Balance at September 30, 2008</b>	<b>1,324</b>	<b>\$</b>	<b>\$ 12,165</b>	<b>\$</b>	<b>\$ (403)</b>	<b>\$ 13</b>	<b>\$ 11,775</b>

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

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**ACTIVISION BLIZZARD, INC. AND SUBSIDIARIES**

**Notes to Consolidated Financial Statements**

(Unaudited)

**1. Background and basis of presentation**

*Business Combination*

We consummated our previously announced business combination (the *Business Combination*) pursuant to the Business Combination Agreement (the *Business Combination Agreement*), dated as of December 1, 2007, by and among Activision, Inc., SeGO Merger Corporation, a wholly-owned subsidiary of Activision, Inc., Vivendi S.A. (*Vivendi*), VGAC LLC, a wholly-owned subsidiary of Vivendi (*VGAC*), and Vivendi Games, Inc., a wholly-owned subsidiary of VGAC (*Vivendi Games*). Upon the closing of the Business Combination, which occurred on July 9, 2008, Activision, Inc. was renamed Activision Blizzard, Inc. (*Activision Blizzard*). Activision Blizzard continues to operate as a public company traded on the NASDAQ under the ticker symbol ATVI. Activision Blizzard now conducts the combined business operations of Activision, Inc. and Vivendi Games including its subsidiary, Blizzard Entertainment, Inc. (*Blizzard*). In connection with the Business Combination, we issued approximately 717 million shares of common stock to VGAC including 126 million shares of common stock purchased by Vivendi for approximately \$1.7 billion. Immediately following the consummation of the Business Combination, VGAC owned approximately 54% of Activision Blizzard's issued and outstanding common stock. While Activision, Inc. was the surviving entity in this Business Combination, because the transaction is treated as a reverse acquisition, Vivendi Games is deemed to be the acquirer for accounting purposes. Accordingly, Activision Blizzard applied purchase accounting to the assets and liabilities of Activision, Inc. as of July 9, 2008. Also, for all Exchange Act filings following consummation of the Business Combination, the historical financial statements of Activision Blizzard for periods prior to the consummation of the Business Combination will be those of Vivendi Games. Activision, Inc.'s businesses were included in Activision Blizzard's financial statements for all periods subsequent to the consummation of the Business Combination only.

In accordance with the terms of the Business Combination Agreement, on July 16, 2008, Activision Blizzard commenced a tender offer to purchase up to 293 million shares of its common stock at a price of \$13.75 per share. The tender offer expired on August 13, 2008. We purchased 171,832 shares of our common stock as a result of the tender offer. These shares were accounted for using the treasury method and were retired and cancelled.

Upon consummation of the Business Combination, the senior unsecured credit agreement with Vivendi (as lender) became effective upon terms substantially similar to those previously disclosed in Note 21 of the consolidated financial statements included in Activision, Inc.'s Annual Report on Form 10-K for the fiscal year ended March 31, 2008. Under that credit agreement, we have access to funds for general corporate purposes as previously disclosed (see Note 16 for details).

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### *Basis of Presentation*

The accompanying unaudited Consolidated Financial Statements as of September 30, 2008 and for the three and nine month periods ended September 30, 2008 and 2007 include the accounts of Activision Blizzard, Inc. and its subsidiaries ( Activision Blizzard or we ). The information furnished is unaudited and the adjustments included consist of only normal recurring adjustments that, in the opinion of management, are necessary to provide a fair statement of the results for the interim periods presented.

The accompanying unaudited Consolidated Financial Statements should be read in conjunction with Vivendi Games, Inc. and its subsidiaries ( Vivendi Games ) audited Consolidated Financial Statements for the year ended December 31, 2007 included in our Form 8-K as filed with the Securities and Exchange Commission ( SEC ) on November 5, 2008. The selection of footnote disclosures appearing in this Quarterly Report on Form 10-Q are those deemed necessary in order to update and make current the financial disclosures presented in the Vivendi Games audited financial statements for the year ended December 31, 2007.

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

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2. **Accounting changes**

*Comparative period* Following the consummation of the Business Combination, the historical financial statements of Activision Blizzard for periods prior to the consummation of the Business Combination are those of Vivendi Games. Activision, Inc.'s businesses were included in Activision Blizzard's financial statements for all periods subsequent to the consummation of the Business Combination only.

*Change in Segment Presentation* In conjunction with the Business Combination, we changed the manner in which senior management assesses the operating performance of, and allocates resources to, its operating segments. As a result, we operate four business segments: (i) Blizzard Entertainment, Inc. and its subsidiaries publishing of traditional games and online subscription-based games in the massively multiplayer online game ( MMOG ) category ( Blizzard ), (ii) Activision Publishing - publishing interactive entertainment software and peripherals which includes certain studios, assets, and titles previously included in Vivendi Games Sierra Entertainment prior to the Business Combination ( Activision ), (iii) Activision Blizzard Distribution - distribution of interactive entertainment software and hardware products ( Distribution ) (these three business segments form Activision Blizzard s core operations) and (iv) Activision Blizzard s non-core exit operations. Activision Blizzard s non-core exit operations represent legacy Vivendi Games divisions or business units that the Company has begun to exit or wind down as part of our restructuring and integration efforts as a result of the Business Combination, but do not meet the criteria for separate reporting of discontinued operations. In accordance with the provisions of Statement of Financial Standards, No. 131, Disclosures about Segments of an Enterprise and Related Information, ( SFAS No. 131 ), all prior period segment information has been restated, when practical, to conform to this new financial statement presentation (see Note 14 for details).

*Change in Accounting Principles* In the current quarter, the Company changed the manner in which it recognizes revenue associated with sales of The Burning Crusade expansion pack, released in January 2007 for its massively, multi-player, online game, World of Warcraft. Prior to the Business Combination, Vivendi Games determined that the sale of an expansion pack was a separate deliverable with standalone value apart from the World of Warcraft license and the subscription to the online game. Pursuant to Emerging Issues Task Force No. 00-21 Revenue Arrangements with Multiple Deliverables ( EITF No. 00-21 ), Vivendi Games recognized revenue from the sale of an expansion pack upon delivery because it had standalone value and there was objective and reliable evidence of fair value for the subscription service. As a result of the consummation of the Business Combination the Company changed its weighting of the factors considered in determining if sales of The Burning Crusade expansion pack have standalone value. After considering the intended functionality of the expansion pack and the necessity of the World of Warcraft license and subscription service to the functionality of the expansion pack, the Company determined that it is preferable to conclude that the expansion packs do not have standalone value and to account for fees from sales of expansion packs over the remaining estimated useful life of the customer. This method recognizes revenue over the period during which the customer is expected to utilize the intended full functionality of the expansion pack. The Company believes that it is preferable to recognize revenue from sales of expansion packs over the estimated remaining useful life of the customer, because this is consistent with the accounting for the World of Warcraft license and the evolution of accounting for on-line enabled video games in the console industry. In accordance with Statement of Financial Accounting Standards (SFAS) No. 154, Accounting Changes and Error Corrections ( SFAS No. 154 ), this change has been applied retrospectively to our consolidated financial statements for all prior periods.

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*In addition to the above, the Company also identified certain ancillary fees charged to World of Warcraft subscribers that had been recognized immediately rather than deferred over the estimated remaining subscription life. Accordingly, the Company has also retrospectively adjusted subscription revenues for the year ended December 31, 2007, and such adjustments are immaterial to all periods presented.*



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*As a result of the changes, cost of sales and amortization of capitalized software costs were also impacted, as cost of sales and software amortization are recognized in relation to the related revenues. We filed a Form 8-K with the SEC on November 5, 2008 which summarizes the effect of the changes to prior periods. The effects of these changes to the numbers in this Form 10-Q were as follows (amounts in millions):*



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	Three months ended September 30, 2007			
	As Reported	As Adjusted	Effect of Change	As Adjusted (Reclassified)
<b>Consolidated Statement of Operations:</b>				
Product sales	\$ 73	\$ 106	\$ 33	\$ 98
Subscription, licensing and other revenues	221	220	(1)	228
Cost of sales product costs	70	72	2	31
Cost of sales software royalties and amortization	1	3	2	5
<b>Operating income</b>	29	57	28	57
Income (loss) before income tax provision (benefit)	27	55	28	55
Income tax provision (benefit)	(4)	7	11	7
Net income	\$ 31	\$ 48	\$ 17	\$ 48
Net income per share				
- Basic and diluted	\$ 0.05	\$ 0.08	\$ 0.03	\$ 0.08

	Nine months ended September 30, 2007			
	As Reported	As Adjusted	Effect of Change	As Adjusted (Reclassified)
<b>Consolidated Statement of Operations:</b>				
Product sales	\$ 339	\$ 284	\$ (55)	\$ 246
Subscription, licensing and other revenues	624	613	(11)	650
Cost of sales product costs	239	234	(5)	95
Cost of sales software royalties and amortization	8	7	(1)	14
<b>Operating income (loss)</b>	193	133	(60)	134
Income (loss) before income tax provision (benefit)	189	129	(60)	129
Income tax provision (benefit)	12	(12)	(24)	(12)
Net income (loss)	\$ 177	\$ 141	\$ (36)	\$ 141
Net income per share				
- Basic and diluted	\$ 0.30	\$ 0.24	\$ (0.06)	\$ 0.24

	December 31, 2007			
	As Reported	As Adjusted	Effect of Change	As Adjusted (Reclassified)
<b>Consolidated Balance Sheets:</b>				
Software development	\$ 1	\$ 1	\$	\$ 25
Deferred income taxes	127	143	16	143
Deferred revenues	137	190	53	197
Accrued expenses and other liabilities	374	362	(12)	274
Accumulated deficit	(343)	(367)	(24)	(367)

	Nine months ended September 30, 2007			
	As Reported	As Adjusted	Effect of Change	As Adjusted (Reclassified)
<b>Consolidated Statement of Cash Flows:</b>				
Net income (loss)	\$ 177	\$ 141	\$ (36)	\$ 141
Adjustments to reconcile net income to net cash provided by operating activities:				
Deferred income taxes		(24)	(24)	(24)

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Amortization and write-offs of capitalized software development costs and intellectual property licenses	8	7	(1)	15
Changes in operating assets and liabilities:				
Deferred revenues	8	83	75	88
Accrued expenses and other liabilities	44	30	(14)	(73)

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*As adjusted (reclassified) reflects certain reclassification adjustments made to prior periods to be consistent with the current period presentation. There is no change on retained earnings as of January 1, 2007 as a result of the change in accounting principle.*

*Stock Split* - In July 2008, the Board of Directors approved a two-for-one split of our outstanding common shares effected in the form of a stock dividend ( the split ). The split was paid September 5, 2008 to shareholders of record as of August 25, 2008. The par value of our common stock was maintained at the pre-split amount of \$.000001 per share. The Consolidated Financial Statements and Notes thereto, including all share and per share data, have been restated as if the split had occurred as of the earliest period presented.

*Reclassifications* - Certain reclassifications have been made to prior year financial statements to conform to the current period presentation.

3. **Summary of significant accounting policies**

*Significant Accounting Assumptions and Estimates*

*The preparation of financial statements in conformity with US GAAP requires management to make estimates and assumptions that affect the reported amounts of assets and liabilities and the disclosure of gain or loss contingencies at the date of the financial statements and the reported amounts of revenues and expenses during the reporting period. Actual results could differ from those estimates and assumptions.*

*Principles of Consolidation*

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*The Consolidated Financial Statements include the accounts of Activision Blizzard, Inc., a Delaware corporation, and its wholly-owned subsidiaries. All intercompany accounts and transactions have been eliminated in consolidation.*



*Cash, Cash Equivalents, and Investments*

Cash and cash equivalents include cash, money markets, and short-term investments with original maturities of not more than 90 days.

Short-term investments generally mature between three and thirty months. Investments with maturities beyond one year may be classified as short-term based on their liquid nature and because such securities represent the investment of cash that is available for current operations. All other investments that are not classified as short-term are classified as long-term investments. All of our investments are classified as available-for-sale and are carried at fair market value with unrealized appreciation (depreciation) reported, net of taxes, as a component of accumulated other comprehensive income (loss) in shareholders' equity. The specific identification method is used to determine the cost of securities disposed with realized gains and losses reflected in investment income, net.

*Restricted Cash - Compensating Balances*

We have restricted cash of \$87 million as of September 30, 2008 and \$3 million as of December 31, 2007. Most of the restricted cash as of September 30, 2008 relates to the standby letter of credit required by one of our inventory manufacturers to qualify for payment terms on our inventory purchases. Under the terms of this arrangement, we are required to maintain with the issuing bank a compensating balance, restricted as to use, of not less than the sum of the available amount of the letter of credit plus the aggregate amount of any drawings under the letter of credit that have been honored thereunder but not reimbursed. Restricted cash is included in short-term investments.

*Financial Instruments*

The estimated fair values of financial instruments have been determined using available market information and valuation methodologies described below. However, considerable judgment is required in interpreting market data to develop the estimates of fair value. Accordingly, the estimates presented herein may not be indicative of the amounts that we could realize in a current market exchange. The use of different market assumptions or valuation methodologies may have a material effect on the estimated fair value amounts.

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The carrying amount of cash and cash equivalents, accounts receivable, accounts payable, and accrued expenses are a reasonable approximation of fair value due to their short-term nature. Short-term investments are carried at fair value with fair values estimated based on quoted market prices. Long-term investments are comprised of student loan backed taxable auction rate securities (see note 13 for details).

We account for derivative instruments in accordance with Statement of Financial Accounting Standards ( SFAS ) No. 133, Accounting for Derivative Instruments and Hedging Activities , SFAS No. 138, Accounting for Certain Derivative Instruments and Certain Hedging Activities , an amendment of SFAS No. 133 and SFAS No. 149, Amendment of Statement 133 on Derivative Instruments and Hedging Activities . SFAS No. 133, 138, and 149 require that all derivatives, including foreign exchange contracts, be recognized in the balance sheet in other assets or liabilities at their fair value.

We utilize forward contracts in order to reduce financial market risks. These instruments are used to hedge foreign currency exposures of underlying assets, liabilities, or cash flows. Our accounting policies for these instruments are based on whether they meet the criteria for designation as hedging transactions. Changes in fair value of derivatives that are designated as cash flow hedges, are highly effective, and qualify as hedging instruments, are recorded in other comprehensive income, if any, until the underlying hedged item is recognized in earnings. Any ineffective portion of a derivative's change in fair value is immediately recognized in earnings. Changes in fair value of derivatives that do not qualify as hedging instruments are recorded in earnings. The fair value of foreign currency contracts is estimated based on the prevailing exchange rate of the various hedged currencies as of the end of the period.

*Software Development Costs and Intellectual Property Licenses*

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

We account for software development costs in accordance with Statement of Financial Accounting Standards No. 86, Accounting for the Costs of Computer Software to Be Sold, Leased, or Otherwise Marketed, (SFAS No. 86). Software development costs are capitalized once the technological feasibility of a product is established and such costs are determined to be recoverable. Technological feasibility of a product encompasses both technical design documentation and game design documentation. Significant management judgments and estimates are utilized in the assessment of when technological feasibility is established. For products where proven technology exists, this may occur early in the development cycle. Technological feasibility is evaluated on a product-by-product basis. Prior to a product's release, we expense, as part of cost of sales software royalties and amortization, capitalized costs when we believe such amounts are not recoverable. Capitalized costs for those products that are cancelled or abandoned are charged to product development expense in the period of cancellation. Amounts related to software development which are not capitalized are charged immediately to product development expense.

Commencing upon product release, capitalized software development costs are amortized to cost of sales software royalties and amortization based on the ratio of current revenues to total projected revenues for the specific product, generally resulting in an amortization period of six months or less.

Intellectual property license costs represent license fees paid to intellectual property rights holders for use of their trademarks, copyrights, software, technology, music or other intellectual property or proprietary rights in the development of our products. Depending upon the agreement with the rights holder, we may obtain the rights to use acquired intellectual property in multiple products over multiple years, or alternatively, for a single product. Prior to the related product's release, we expense, as part of cost of sales intellectual property licenses, capitalized intellectual property costs when we believe such amounts are not recoverable. Capitalized intellectual property costs for those products that are cancelled or abandoned are charged to product development expense in the period of cancellation.

Commencing upon the related product's release, capitalized intellectual property license costs are amortized to cost of sales intellectual property licenses based on the ratio of current revenues for the specific product to total projected revenues for all products in which the licensed property will be utilized. As intellectual property license contracts may extend for multiple years, the amortization of capitalized intellectual property license costs relating to such contracts may extend beyond one year.

We evaluate the future recoverability of capitalized software development costs and intellectual property licenses on a quarterly basis. For products that have been released in prior periods, the primary evaluation criterion is actual title performance. For products that are scheduled to be released in future periods, recoverability is evaluated based on the expected performance of the specific products to which the costs relate or in which the licensed trademark or copyright is

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to be used. Criteria used to evaluate expected product performance include: historical performance of comparable products developed with comparable technology; orders for the product prior to its release; and, for any sequel product, estimated performance based on the performance of the product on which the sequel is based. Further, as many of our intellectual property licenses extend for multiple products over multiple years, we also assess the recoverability of capitalized intellectual property license costs based on certain qualitative factors, such as the success of other products and/or entertainment vehicles utilizing the intellectual property, whether there are any future planned theatrical releases or television series based on the intellectual property, and the rights holder's continued promotion and exploitation of the intellectual property.

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

*Inventories*

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Inventories are valued at the lower of cost (first-in, first-out or weighted average) or market.

### *Long-Lived Assets*

*Property and Equipment.* Property and equipment are recorded at cost. Depreciation and amortization are provided using the straight-line method over the shorter of the estimated useful lives or the lease term: buildings, 25 to 33 years; computer equipment, office furniture and other equipment, 2 to 5 years; leasehold improvements, the shorter of 5 years or the life of the lease. When assets are retired or disposed of, the cost and accumulated depreciation thereon are removed and any resulting gains or losses are included in the accompanying consolidated statements of operations.

*Goodwill and Other Indefinite-Lived Assets.* We account for goodwill using the provisions of Statement of Financial Accounting Standards No. 142, *Goodwill and Other Intangible Assets* ( SFAS No. 142 ). Under SFAS No. 142, goodwill is considered to have an indefinite life, and is carried at cost. In addition acquired trade names were assessed as indefinite lived assets because there is no foreseeable limit on the period of time over which they are expected to contribute cash flows. Goodwill and acquired trade names are not amortized but are subject to an annual test for impairment and in between annual tests when events or circumstances indicate that the carrying value may not be recoverable.

*Amortizable Intangible Assets.* Intangible assets subject to amortization are carried at cost less accumulated amortization. Amortizable intangible assets consist of internally developed franchises, acquired developed software, acquired game engines, favorable leases and distribution agreements, and other intangibles related primarily to licensing activities and retail customer relationships. Intangible assets subject to amortization are amortized over the estimated useful life in proportion to the pattern in which the economic benefits are consumed. Long-lived assets including amortizable intangible assets are reviewed for impairment in accordance with Statement of Financial Accounting Standards No. 144, *Accounting for the Impairment or Disposal of Long-lived Assets* ( SFAS No. 144 ) whenever events or changes in circumstances indicate that the carrying amount of such assets may not be recoverable. Determination of recoverability is based on an estimate of undiscounted future cash flows resulting from the use of the asset and its eventual disposition. Measurement of any impairment loss for long-lived assets and amortizable intangible assets is based on the amount by which the carrying value exceeds the fair value of the asset.

### *Revenue Recognition*

#### *Product sales*

We recognize revenue from the sale of our products upon the transfer of title and risk of loss to our customers, and once any performance obligations have been completed. Certain products are sold to customers with a street date (the earliest date these products may be sold by retailers). For these products we recognize revenue on the later of the street date or the



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sale date. Revenue from product sales is recognized after deducting the estimated allowance for returns and price protection.

Some of our software products provide limited online features at no additional cost to the consumer. Generally, we consider such features to be incidental to the overall product offering and an inconsequential deliverable. Accordingly, we recognize revenue related to products containing these limited online features upon the transfer of title and risk of loss to our customer. In instances where online features or additional functionality is considered a substantive deliverable in addition to the software product, we take this into account when applying our revenue recognition policy. This evaluation is performed for each software product together with any online transactions, such as electronic downloads of titles of product add-ons when it is released. When we determine that a software title contains online functionality that constitutes a more-than-inconsequential separate service deliverable in addition to the product, principally because of its importance to game play, we consider that our performance obligations for this title extend beyond the sale of the game. Vendor-specific objective evidence of fair value ( VSOE ) does not exist for the online functionality, as we do not separately charge for this component of the title. As a result, we recognize all of the revenue from the sale of the title ratably over an estimated service period. In addition, we defer the costs of sales for this title to match revenues. Cost of sales includes: manufacturing costs, software royalties and amortization, and intellectual property licenses.

We recognize revenues for the massively, multiplayer, online game *World of Warcraft*, its expansion packs and other ancillary services in accordance with Staff Accounting Bulletin No. 101, Revenue Recognition in Financial Statements, ( SAB No. 101 ), as amended by Staff Accounting Bulletin No. 104, Revenue Recognition ( SAB No. 104 ).

We consider the *World of Warcraft* boxed product including expansion packs and other ancillary revenues as a single deliverable with the total arrangement consideration combined and recognized ratably as revenue over the estimated customer life beginning upon activation of the software and delivery of the services. Revenues attributed to the sale of *World of Warcraft* boxed software and related expansion packs are classified as product sales and revenues attributable to subscription and other ancillary services are classified as subscription, licensing and other revenues.

With respect to online transactions, such as electronic downloads of titles or product add-ons that do not include a more-than-inconsequential separate service deliverable, revenue is recognized when the fee is paid by the online customer to purchase online content and we are notified by the online retailer that the product has been downloaded. In addition, persuasive evidence of an arrangement must exist and collection of the related receivable must be probable.

Sales incentives or other consideration given by us to our customers are accounted for in accordance with EITF Issue 01-09, Accounting for Consideration Given by a Vendor to a Customer (Including a Reseller of the Vendor's Products). In accordance with EITF Issue 01-09, sales incentives and other consideration that are considered adjustments of the selling price of our products, such as rebates and product placement fees, are reflected as reductions to revenue. Sales incentives and other consideration that represent costs incurred by us for assets or services received, such as the appearance of our products in a customer's national circular ad, are reflected as sales and marketing expenses.

*Subscription Revenues*

Subscription revenues are recognized in accordance with SAB No. 101, as amended by SAB No. 104. Subscription revenues are derived from *World of Warcraft*, a game that is playable through Blizzard's servers on a subscription-only basis. After the first month of free usage that is



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included with the boxed software, the *World of Warcraft* end user may enter into a subscription agreement for additional access. Subscription revenues received are deferred and recognized as subscription revenues ratably over the subscription period. Revenue from the sale of prepaid cards, sold through retail outlets and other stores, is deferred and recognized as subscription revenue ratably beginning when the cards are first activated. Revenue from Internet gaming rooms in Asia is recognized upon usage of the time packages sold. Ancillary revenues associated with subscriptions are recognized ratably over the estimated customer life.

### *Licensing Revenues*

Third-party licensees in China and Taiwan distribute and host Blizzard's *World of Warcraft* game in their respective countries under license agreements with Blizzard. The licensees paid certain minimum, non-refundable, generally recoupable guaranteed royalties when entering into the licensing agreements. Upon receipt of the recoupable advances, we defer their recognition and recognize the revenues in subsequent periods as these advances are recouped by the licensees. As the licensees pay additional royalties above and beyond those initially advanced, we recognize these additional royalties as revenues based on activation of the underlying prepaid time by the end users.

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With respect to license agreements that provide customers the right to make multiple copies in exchange for guaranteed amounts, revenue is recognized upon delivery of a master copy. Per copy royalties on sales that exceed the guarantee are recognized as earned. In addition, persuasive evidence of an arrangement must exist and collection of the related receivable must be probable.

*Other revenues*

Other revenues primarily include ancillary sales of non-software related products. It includes licensing activity of intellectual property other than software (such as characters) to third-parties. Revenue is recorded upon receipt of licensee statements, or upon the receipt of cash, provided the license period has begun.

*Allowances for Returns, Price Protection, Doubtful Accounts, and Inventory Obsolescence*

We closely monitor and analyze the historical performance of our various titles, the performance of products released by other publishers, and the anticipated timing of other releases in order to assess future demands of current and upcoming titles. Initial volumes shipped upon title launch and subsequent reorders are evaluated to ensure that quantities are sufficient to meet the demands from the retail markets, but at the same time are controlled to prevent excess inventory in the channel. We benchmark units to be shipped to our customers using historical and industry data.

We may permit product returns from, or grant price protection to, our customers under certain conditions. In general, price protection refers to the circumstances when we elect to decrease the wholesale price of a product by a certain amount and, when granted and applicable, allows customers a credit against amounts owed by such customers to us with respect to open and/or future invoices. The conditions our customers must meet to be granted the right to return products or price protection include, among other things, compliance with applicable payment terms, and consistent delivery to us of inventory and sell-through reports. We may also consider other factors, including the facilitation of slow-moving inventory and other market factors. Management must make estimates of potential future product returns and price protection related to current period product revenue. We estimate the amount of future returns and price protection for current period product revenue utilizing historical experience and information regarding inventory levels and the demand and acceptance of our products by the end consumer. The following factors are used to estimate the amount of future returns and price protection for a particular title: historical performance of titles in similar genres; historical performance of the hardware platform; historical performance of the franchise; console hardware life cycle; sales force and retail customer feedback; industry pricing; weeks of on-hand retail channel inventory; absolute quantity of on-hand retail channel inventory; our warehouse on-hand inventory levels; the title's recent sell-through history (if available); marketing trade programs; and competing titles. The relative importance of these factors varies among titles depending upon, among other items, genre, platform, seasonality, and sales strategy. Significant management judgments and estimates must be made and used in connection with establishing the allowance for returns and price protection in any accounting period. Based upon historical experience we believe our estimates are reasonable. However, actual returns and price protection could vary materially from our allowance estimates due to a number of reasons including, among others, a lack of consumer acceptance of a title, the release in the same period of a similarly themed title by a competitor, or technological obsolescence due to the emergence of new hardware platforms. Material differences may result in the amount and timing of our revenue for any period if factors or market conditions change or if management makes different judgments or utilizes different estimates in determining the allowances for returns and price protection. For example, a 1% change in our September 30, 2008 allowance for returns and price protection would impact net revenues by \$2 million.

Similarly, management must make estimates of the uncollectibility of our accounts receivable. In estimating the allowance for doubtful accounts, we analyze the age of current outstanding account balances, historical bad debts, customer concentrations, customer creditworthiness,

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current economic trends, and changes in our customers' payment terms and their economic condition, as well as whether we can obtain sufficient credit insurance. Any significant changes in any of these criteria would affect management's estimates in establishing our allowance for doubtful accounts.

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

### *Shipping and Handling*

Shipping and handling costs, which consist primarily of packaging and transportation charges incurred to move finished goods to customers, are included in cost of sales product costs.

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*Income Taxes*



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We account for income taxes using Statement of Financial Accounting Standards No. 109, Accounting for Income Taxes ( SFAS No. 109 ). Under SFAS No. 109, income taxes are accounted for under the asset and liability method. Deferred tax assets and liabilities are recognized for the future tax consequences attributable to differences between the financial statement carrying amounts of existing assets and liabilities and their respective tax bases and operating loss and tax credit carryforwards. Deferred tax assets and liabilities are measured using enacted tax rates expected to apply to taxable income in the years in which those temporary differences are expected to be recovered or settled. The effect on deferred tax assets and liabilities of a change in tax rates is recognized in income in the period that includes the enactment date.

### *Foreign Currency Translation*



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The functional currencies of our foreign subsidiaries are their local currencies. All assets and liabilities of our foreign subsidiaries are translated into U.S. dollars at the exchange rate in effect at the end of the period, and revenue and expenses are translated at average exchange rates during the period. The resulting translation adjustments are reflected as a component of accumulated other comprehensive income (loss) in shareholders equity.

*Earnings (Loss) Per Common Share*





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Basic earnings (loss) per share is computed by dividing income available to common shareholders by the weighted average number of common shares outstanding for all periods. Diluted earnings per share is computed by dividing income available to common shareholders by the weighted average number of common shares outstanding, increased by common stock equivalents. Common stock equivalents are calculated using the treasury stock method and represent incremental shares issuable upon exercise of our outstanding options and warrants. However, potential common shares are not included in the denominator of the diluted earnings per share calculation when inclusion of such shares would be anti-dilutive, such as in a period in which a net loss is recorded. Earnings (loss) per share for periods prior to the Business Combination are retrospectively adjusted to reflect the number of split adjusted shares received by Vivendi, former parent company of Vivendi Games.

### *Stock-Based Compensation*



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We account for stock-based compensation in accordance with Statement of Financial Accounting Standards No. 123 (revised 2004), Share-Based Payment ( SFAS No. 123R ). SFAS No. 123R requires companies to estimate the fair value of share-based payment awards on the measurement date using an option-pricing model. The value of the portion of the award that is ultimately expected to vest is recognized as expense over the requisite service periods in our Consolidated Statement of Operations.

Stock-based compensation expense recognized during the period is based on the value of the portion of share-based payment awards that is ultimately expected to vest during the period. Stock-based compensation expense recognized in our Consolidated Statement of Operations for the three and nine months ended September 30, 2008 included compensation expense for share-based payment awards granted by Activision, Inc. prior to, but not yet vested as of July 9, 2008, based on the revalued fair value estimated as of July 9, 2008 (see note 17), and compensation expense for the share-based payment awards granted subsequent to July 9, 2008 based on the grant date fair value estimated in accordance with the provisions of SFAS No. 123R. Stock-based compensation expense recognized in the Consolidated Statement of Operations is based on awards ultimately expected to vest and has been reduced for estimated forfeitures. SFAS No. 123R requires forfeitures to be estimated at the time of grant and revised, if necessary, in subsequent periods if actual forfeitures differ from those estimates.

We estimate the value of employee stock options on the date of grant using a binomial-lattice model (see Note 17). Our determination of fair value of share-based payment awards on the date of grant using an option-pricing model is affected by our stock price as well as assumptions regarding a number of highly complex and subjective variables. These variables include, but are not limited to, our expected stock price volatility over the term of the awards, and actual and projected employee stock option exercise behaviors.

Prior to the Business Combination, Vivendi Games had equity incentive plans that are equity-settled and cash-settled. Equity-settled award includes stock options and restricted shares plans from Vivendi, and the cash-settled award includes stock appreciation rights and restricted stock units from Vivendi, and the Blizzard Equity Plan ( BEP ). In accordance with SFAS No. 123R, for cash-settled awards, the Company recorded a liability and recognized changes in fair value of the liability that occur during the period as compensation cost over the requisite service period. Changes in the fair value of the liability that occur after the end of the requisite service period are compensation cost of the period in which the changes occur. Any differences between the amount for which the liability is settled and its fair value at the settlement date as estimated in accordance with SFAS No. 123R is an adjustment of compensation cost in the period of settlement.

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**4. Acquisitions**

*Reverse acquisition*

The Business Combination (see Note 1) is accounted for as a reverse acquisition under the purchase method of accounting. For this purpose, Vivendi Games was deemed to be the accounting acquirer and Activision, Inc. was deemed to be the accounting acquiree.

The preliminary purchase price of Activision, Inc. consists of the following items (amounts in millions):

Fair market value of Activision, Inc.'s outstanding common stock immediately prior to the Business Combination at the closing price	\$	9,102
Fair value of Activision, Inc.'s existing vested and unvested stock awards at the closing price*		861
Transaction expenses		1
<b>Total consideration</b>	<b>\$</b>	<b>9,964</b>

\* The fair value of the existing vested and unvested stock award is comprised of the following (amounts in millions):

Fair value of Activision, Inc. existing vested stock awards	\$	713
Fair value of Activision, Inc. unvested stock awards		296
Less: Unearned stock-based compensation		(148)
	<b>\$</b>	<b>861</b>

The fair value of Activision, Inc.'s stock awards was determined using fair value of Activision, Inc.'s common stock of \$15.04 per share, which is the closing price as of July 9, 2008 a binomial-lattice model and the following assumptions: (a) varying volatility ranging from 42.38% to 51.50%, (b) a risk free interest rate of 3.97%, (c) an expected life ranging from approximately 3.22 years to 4.71 years, (d) risk adjusted stock return of 8.89%, and (e) an expected dividend yield of 0.0%.

The Company's allocation of the preliminary purchase price of Activision, Inc. is as follows (amounts in millions):

	<b>Amount</b>
Working capital, excluding inventories	\$ 1,194
Inventories	221
Property and equipment	64
Deferred tax asset	62
Other long term assets	128

**Estimated useful  
life**

Intangible assets:

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License agreements	3 - 10 years	207
Developed software	Less than 1 year	68
Game engines	2 - 5 years	128
Internally developed franchises	5 - 12 years	1,124
Retail customer relationships	Less than 1 year	40
Favorable leases	1 - 2 years	5
Distribution agreements	4 years	17
Activision trade name	Indefinite	386
Goodwill	Indefinite	7,085
Long term liabilities		(24)
Deferred tax liability		(741)
<b>Total consideration</b>		<b>\$ 9,964</b>

Goodwill arises from the Business Combination due to the acquired work force of Activision, Inc., and the expected synergies from the Business Combination. The following table presents the gross and net balances, and accumulated amortization of the components of our purchased amortizable intangible assets acquired in the Business Combination as of September 30, 2008 (amounts in millions):

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	Gross	Accumulated Amortization	Net
License agreements	\$ 207	\$ (8)	\$ 199
Developed software	68	(21)	47
Game engines	128	(6)	122
Internally developed franchises	1,124	(16)	1,108
Retail customer relationships	40	(36)	4
Favorable leases	5	(1)	4
Distribution agreements	17	(1)	16
<b>Total</b>	<b>\$ 1,589</b>	<b>\$ (89)</b>	<b>\$ 1,500</b>

Intangibles and goodwill are not tax deductible. The estimated future after-tax decreases to net income from the amortization of the finite-lived intangible assets are the following amounts (amounts in millions):

Year ending December 31,	Amount
2008 (remaining three months)	\$ 222
2009	284
2010	198
2011	141
2012	119
Thereafter	536

The following table summarizes unaudited pro forma financial information assuming the Business Combination (see Note 1) had occurred at the beginning of the periods presented. This pro forma financial information is for informational purposes only and does not reflect any operating efficiencies or inefficiencies which may result from the Business Combination and therefore is not necessarily indicative of results that would have been achieved had the businesses been combined during the periods presented (amounts in millions, except per share data).

	For the three months ended September 30,		For the nine months ended September 30,	
	2008	2007	2008	2007
Pro forma net revenues	\$ 764	\$ 644	\$ 2,698	\$ 2,022
Pro forma net loss	(121)	(9)	(166)	(103)
Pro forma net loss per share - basic and diluted	(0.09)	(0.01)	(0.13)	(0.08)

*Freestyle Games, Ltd.*

On September 11, 2008, we completed an acquisition of Freestyle Games, Ltd., a premier United Kingdom based video game developer specializing in music based games. The acquisition is expected to be immaterial to current year earnings (loss) per share and cash flow. Additionally, pro forma Consolidated Statements of Operations for this acquisition are not shown, as they would not differ materially from reported results.





Table of Contents**5. Inventories**

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

	September 30, 2008		December 31, 2007	
Finished goods	\$	353	\$	19
Purchased parts and components		24		2
	\$	377	\$	21

**6. Goodwill**

The changes in the carrying amount of goodwill by reportable segments, (see Notes 2 and 14 for details) for the nine months ended September 30, 2008 are as follows (amounts in millions):

	Blizzard	Activision	Distribution	Activision Blizzard s Core Operations	Activision Blizzard s Non-core Exit Operations	Total
Balance as of December 31, 2007	\$ 178	\$	\$	\$ 178	\$ 25	\$ 203
Goodwill acquired during the period		7,080	12	7,092		7,092
Re-assigned goodwill		7		7	(7)	
Issuance of contingent consideration					6	6
Impairment charge (see Note 10)					(16)	(16)
Tax benefit credited to goodwill		(15)		(15)		(15)
Balance as of September 30, 2008	\$ 178	\$ 7,072	\$ 12	\$ 7,262	\$ 8	\$ 7,270

Goodwill acquired during the period represents goodwill of \$7.1 billion related to the acquisition of Activision, Inc. (see Note 4). As a result of the Business Combination, goodwill affected by the reorganization/integration was reassigned to the reporting units affected using a relative fair value approach. The tax benefit credited to goodwill represents the tax deduction resulting from the exercise of stock options that were outstanding and vested at the consummation of the Business Combination and included in the purchase price of Activision, Inc. to the extent that the tax deduction does not exceed the fair value of those options.

**7. Intangible assets**

Intangible assets consist of the following (amounts in millions):

			September 30, 2008			
	Estimated Useful Lives	Gross carrying amount	Accumulated amortization	Impairment charge (See Note 10)		Net
Acquired definite-lived intangible assets:						
License agreements	3-10 years	\$ 207	\$ (8)	\$	\$	199
Developed software	1-2 years	283	(233)			50
Game engines	2-5 years	136	(6)			130
Internally developed franchises	11-12 years	1,124	(16)			1,108
Retail customer relationships	Less than 1 year	40	(36)			4
Favorable leases	1-4 years	5	(1)			4
Distribution agreements	4 years	17	(1)			16
Other intangibles	0-2 years	14	(12)			2
Acquired indefinite-lived intangible assets:						
Activision trademark	Indefinite	386				386
Acquired trade names	Indefinite	52		(5)		47
<b>Total</b>		<b>\$ 2,264</b>	<b>\$ (313)</b>	<b>\$ (5)</b>	<b>\$</b>	<b>1,946</b>

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	Estimated Useful Lives	Gross carrying amount	December 31, 2007		
			Accumulated amortization	Impairment charge	Net
Acquired definite-lived intangible assets:					
Developed software	2 yrs	\$ 215	\$ (210)	\$	\$ 5
Other intangibles	0-2 yrs	14	(11)		3
Acquired indefinite-lived intangible assets:					
Acquired trade names	Indefinite	52			52
Total		\$ 281	\$ (221)	\$	\$ 60

**Amortization expense of intangible assets for the three and nine months ended September 30, 2008 was \$90 million and \$92 million, respectively. Amortization expense of intangible assets for the three and nine months ended September 30, 2007 was \$1 million and \$3 million, respectively.**

## 8. Income Taxes

The income tax benefit of \$62 million for the three months ended September 30, 2008 reflects our effective income tax rate benefit for the quarter of 36.5%. The significant items that generate the variance between our effective rate for the three-months ended September 30, 2008 and our statutory rate of 35% were the result of the state income taxes provided, net of federal benefit, foreign income taxes, goodwill impairment and California research and development tax credits.

For the nine months ended September 30, 2008 our effective tax rate benefit of 37.9% differs from the effective tax rate benefit of 9.3% for the nine months ended September 30, 2007. The difference is due to the recognition of the California Research and Development tax credit and IRC 199 Domestic Production Deduction in the third quarter of 2008 and tax benefits from net operating losses surrendered at September 30, 2007.

The income tax benefit of \$12 million for the nine months ended September 30, 2007 reflects our effective income tax rate benefit of 9.3%, which differs from our effective tax rate benefit of 30% for the year ended December 31, 2007 due to the recognition of research and development tax credits in the fourth quarter of 2007 and the release of additional valuation allowance on deferred tax assets and net operating losses surrendered when compared to those estimated at September 30, 2007, as a result of meeting the more likely than not recognition criteria in the fourth quarter of 2007.

We adopted the provisions of Financial Accounting Standards Board Interpretation No. 48 Accounting for Uncertainty in Income Taxes (FIN 48) an interpretation of SFAS No. 109 on January 1, 2007. At December 31, 2007, we had \$14 million of unrecognized tax benefits. As a result of the Business Combination, an additional \$74 million of unrecognized tax benefits was added, resulting in a balance of \$88 million at September 30, 2008. It is reasonably possible there will be an \$11 million decrease of our unrecognized tax benefits within the next twelve months due to the completion of certain income tax audits.



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We recognize interest and penalties related to uncertain tax positions in income tax expense. As of September 30, 2008, we had approximately \$1 million of accrued interest related to uncertain tax positions. For the nine months ended September 30, 2008, we recorded approximately \$1 million of interest expense related to uncertain tax positions.

On July 9, 2008, Activision Blizzard entered into a Tax Sharing Agreement (the "Tax Sharing Agreement") with Vivendi. The Tax Sharing Agreement generally governs Activision Blizzard's and Vivendi's respective rights, responsibilities and obligations with respect to the ordinary course of business taxes. Under the Tax Sharing Agreement, with certain exceptions, Activision Blizzard generally is responsible for the payment of U.S. and certain non-U.S. income taxes that are required to be paid to tax authorities on a stand-alone Activision Blizzard basis. In the event that Activision Blizzard joins Vivendi in the filing of a group tax return, Activision Blizzard will pay its share of the tax liability for such group tax return to Vivendi, and Vivendi will pay the tax liability for the entire group to the appropriate tax authority. Vivendi will indemnify Activision Blizzard for any tax liability imposed upon it due to Vivendi's failure to pay any group tax liability. Activision Blizzard will indemnify Vivendi for any tax liability imposed on Vivendi (or any of its subsidiaries) due to Activision Blizzard's failure to pay any taxes it owes under the Tax Sharing Agreement.

**9. Software Development Costs and Intellectual Property Licenses**

As of September 30, 2008, capitalized software development costs included \$180 million of internally developed software costs and \$66 million of payments made to third-party software developers. As of December 31, 2007, capitalized software development costs included \$1 million of internally developed software costs and \$75 million of payments made to third-party software developers. Capitalized intellectual property licenses were \$10 million and \$17 million as of September 30, 2008 and December 31, 2007, respectively. Amortization and write-offs of capitalized software development costs and intellectual property licenses for the three and nine months ended September 30, 2008 and 2007 was \$81 million and \$1 million, \$120 million and \$15 million, respectively.

**10. Restructuring**

**The Company has implemented an organizational restructuring as a result of the Business Combination described in Note 1. This organizational restructuring is to integrate different operations to create the streamlined organization of Activision Blizzard.**

**The primary goals of the organizational restructuring were to rationalize the title portfolio and consolidate certain corporate functions so as to realize the synergies of the Business Combination.**

**Since the consummation of the Business Combination, the Company has commenced the organizational restructuring activities, focusing first on North American staff, redundant premises and related redundant equipment assets. We have communicated to the North America, Canada, and Australia redundant employees and ceased use of certain offices under operating lease contracts. Impairment of goodwill and other intangibles and write-offs of prepaid royalties and intellectual licenses were also recorded as a result. The following table details the amount of restructuring reserves included in accrued expenses and other liabilities in the Consolidated Balance Sheets at September 30, 2008 (amounts in millions):**

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	Severance(1)	Facilities costs(1)	Asset write-downs(2)	Contract termination costs(1)	Total
Balance as of December 31, 2007	\$	\$	\$	\$	\$
Original restructuring charges (charges to expenses)	32	2	24	3	61
Utilization (cash paid or otherwise settled)	(9)		(24)	(2)	(35)
Balance at September 30, 2008	\$ 23	\$ 2	\$	\$ 1	\$ 26

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(1) Accounted for in accordance with Statement of Financial Accounting Standards 146, Accounting for Costs Associated with Exit or Disposal Activities ( SFAS No. 146 ).

(2) Accounted for in accordance with SFAS No. 144 and SFAS No. 142.

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Utilization represents the amount of cash paid to settle restructuring liabilities incurred (\$9 million of severance and \$2 million of contract termination costs) and non-cash asset write-down charges of which \$3 million relates to fixed assets disposal, \$5 million relates to impairment of acquired trade name, and \$16 million relates to impairment of goodwill.

The total restructuring reserve balance as of September 30, 2008 and the net restructuring charges for the three and nine months periods then ended are presented below by reporting segments (amounts in millions):

	Ending balance September 30, 2008	Restructuring charges Three months ended September 30, 2008	Nine months ended September 30, 2008
Activision	\$	\$ 1	\$ 1
Blizzard			
Distribution			
Activision Blizzard's core operations		1	1
Activision Blizzard's non-core exit operations	26	60	60
Total	\$ 26	\$ 61	\$ 61

For the next nine months, we anticipate incurring between \$75 million and \$100 million of additional before tax restructuring charges, and after tax cash restructuring charges between \$45 million and \$60 million relating to the Business Combination. Overall, including charges incurred through September 30, 2008, we expect to incur cash and non-cash before tax restructuring charges between \$135 million and \$160 million by June 30, 2009 with an after tax cash impact between \$70 million and \$90 million. The after tax cash charges are expected to consist primarily of employee-related severance cash costs (approximately \$55 million), facility exit cash costs (approximately \$25 million) and cash contract terminations (approximately \$10 million). Separately, these restructuring charges are expected to be partially offset by approximately between \$30 million and \$50 million of cash proceeds from asset disposals and cash after tax benefits related to the streamlining of the Vivendi Games title portfolio.

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

### *Comprehensive Income (loss)*

The components of comprehensive income (loss) for the three and nine months ended September 30, 2008 and 2007 were as follows (amounts in millions):

	Three months ended September 30,		Nine months ended September 30,	
	2008	2007	2008	2007
Net income (loss)	\$ (108)	\$ 48	\$ (36)	\$ 141

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Other comprehensive income (loss):							
Foreign currency translation adjustment	(26)		7		(25)		2
Unrealized depreciation on short-term investments, net of taxes	(2)				(2)		
Other comprehensive income (loss)	(28)		7		(27)		2
Comprehensive income (loss)	\$	(136)	\$	55	\$	(63)	\$ 143



Table of Contents*Accumulated Other Comprehensive Income (Loss)*

For the nine months ended September 30, 2008 the components of accumulated other comprehensive income (loss) were as follows (amounts in millions):

	Foreign currency	Unrealized appreciation (depreciation) on investments	Accumulated other comprehensive income
Balance as of December 31, 2007	\$ 40	\$ 40	\$ 40
Other comprehensive loss	(25)	(2)	(27)
Balance as of September 30, 2008	\$ 15	\$ (2)	\$ 13

Other comprehensive income (loss) is presented net of tax benefits related to unrealized depreciation on our investments for the nine months ended September 30, 2008. Income taxes were not provided for foreign currency translation items as these are considered indefinite investments in non-U.S. subsidiaries.

**12. Investment Income (Loss), Net**

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

	Three months ended September 30,		Nine months ended September 30,	
	2008	2007	2008	2007
Interest income (expense), net	\$ 17	\$ (2)	\$ 22	\$ (3)
Net realized gain on investments	4		4	
Net unrealized gain (loss) on foreign exchange contracts	3		2	(2)
Investment income (loss), net	\$ 24	\$ (2)	\$ 28	\$ (5)

In 2007, Vivendi provided Vivendi Games access to centralized cash management pool from which Vivendi Games was able to borrow or lend on a daily basis at market rates. From the consummation of the Business Combination, we managed our own investment portfolio.

**13. Fair Value Measurements**

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As of January 1, 2008, we adopted Statement of Financial Accounting Standards No. 157 Fair Value Measurements ( SFAS No. 157 ) for financial assets and liabilities. SFAS No. 157 establishes a three-level fair value hierarchy that prioritizes the inputs used to measure fair value. This hierarchy requires entities to maximize the use of observable inputs and minimize the use of unobservable inputs. The three levels of inputs used to measure fair value are as follows:

- Level 1 Quoted prices in active markets for identical assets or liabilities.
- Level 2 Observable inputs other than quoted prices included in Level 1, such as quoted prices for markets that are not active or other inputs that are observable or can be corroborated by observable market data.
- Level 3 Unobservable inputs that are supported by little or no market activity and that are significant to the fair value of the assets or liabilities. This includes certain pricing models, discounted cash flow methodologies and similar techniques that use significant unobservable inputs.

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The table below segregates all financial assets and liabilities that are measured at fair value on a recurring basis (which, for purposes of SFAS No. 157, means they are so measured at least annually) into the most appropriate level within the fair value hierarchy based on the inputs used to determine the fair value at the measurement date. Financial Statement Position FAS 157-2 delayed the effective date for the application of SFAS No. 157 for all nonfinancial assets and liabilities until January 1, 2009, except those that are recognized or disclosed at fair value in the financial statements on a recurring basis (amounts in millions):

	September 30, 2008	Quoted prices in active markets for identical assets (level 1)	Significant other observable inputs (level 2)	Significant unobservable inputs (level 3)
Money market funds	\$ 2,673	\$ 2,673		
Asset-backed securities	7		7	
Auction rate securities	86			86
Total financial assets at fair value	\$ 2,766	\$ 2,673	\$ 7	\$ 86

The following table provides a reconciliation of the beginning and ending balances for our investment in auction rate securities, as these assets are measured at fair value using significant unobservable inputs (Level 3) (amounts in millions):

	Level 3
Balance as of January 1, 2008	\$
Transfers in and/or (out) of Level 3	
Purchases via the business combination	88
Total losses realized/unrealized included in earnings	
Total losses included in other comprehensive income (a)	(2)
Purchases, sales, issuances, and settlements, net	
Interest received	
Balance as of September 30, 2008	\$ 86

(a) Due to uncertainties surrounding the timing of liquidation of our auction rate securities, we classify these instruments as long-term investments in our consolidated balance sheets as of September 30, 2008. Liquidity for these auction rate securities is typically provided by an auction process which allows holders to sell their notes and resets the applicable interest rate at pre-determined intervals, usually every 7 to 35 days. On an industry-wide basis, many auctions have failed, and there is, as yet, no meaningful secondary market for these instruments. Each of the auction rate securities in our investment portfolio as of September 30, 2008 has experienced a failed auction and there is no assurance that future auctions for these securities will succeed. An auction failure means that the parties wishing to sell their securities could not be matched with an adequate volume of buyers. In the event that there is a failed auction, the indenture governing the security requires the issuer to pay interest at a contractually defined rate that is generally above market rates for other types of similar instruments. The securities for which auctions have failed will continue to earn interest at the contractual rate and be auctioned every 7 to 35 days until the auction succeeds, the issuer calls the securities or they mature. As a result, our ability to liquidate and fully recover the carrying value of our auction rate securities in the near term may be limited or not exist.

Consequently, fair value measurements have been estimated using an income-approach model (discounted cash-flow analysis). When estimating the fair value, we consider both observable market data and non-observable factors, including credit quality, duration, insurance wraps, collateral composition, maximum rate formulas, comparable trading instruments, and likelihood of redemption. Significant assumptions used in the analysis include estimates for interest rates, spreads, cash flow timing and amounts, and holding

periods of the securities. Assets measured at fair value using significant unobservable inputs (Level 3) represent approximately 3% of our financial assets measured at fair value on a recurring basis.

Table of Contents**14. Operations by Reportable Segments and Geographic Area**

Our reportable segments are in accordance with our internal organizational structure, the manner in which our operations are reviewed and managed by our Chief Executive Officer, our Chief Operating Decision Maker ( CODM ), the manner in which operating performance is assessed and resources are allocated, and the availability of separate financial information.

Prior to the Business Combination, Vivendi Games managed its business in two main divisions: Blizzard Entertainment and Sierra Entertainment (along with Sierra online and Vivendi Games Mobile). As a result of the Business Combination, we provide our CODM financial information based upon management's new organizational structure.

Based upon our current organizational structure, we operate four business segments: (i) Blizzard Entertainment, Inc. and its subsidiaries publishing of traditional games and online subscription-based games in the MMOG category ( Blizzard ), (ii) Activision Publishing - publishing of interactive entertainment software and peripherals which includes certain studios, assets, and titles previously included in Vivendi Games Sierra Entertainment prior to the Business Combination ( Activision ), (iii) Activision Blizzard Distribution - distribution of interactive entertainment software and hardware products ( Distribution ) (these three business segments form Activision Blizzard's core operations) and (iv) Activision Blizzard's non-core exit operations. Activision Blizzard's non-core exit operations represent legacy Vivendi Games' divisions or business units that the Company has begun to exit or wind down as part of our restructuring and integration efforts as a result of the Business Combination, but do not meet the criteria for separate reporting of discontinued operations. In accordance with the provisions of SFAS No. 131, all prior period segment information has been restated, when practical, to conform to this new financial statement presentation.

The consummation of the Business Combination resulted in Activision and Distribution net revenues, and segment income (loss) from operations being included from the date of the Business Combination but not for prior periods. Also, Activision in prior periods included Vivendi Games titles retained after the Business Combination.

The CODM reviews segment performance exclusive of the impact of the deferral of net revenues and cost of sales, stock-based compensation expense, restructuring expense, amortization of intangible assets and purchase price accounting related adjustments, and integration and transaction costs. Information on the reportable segments and reconciliations of total net revenues and total segment income (loss) from operations to consolidated net revenues and operating income (loss) for the three and nine months ended September 30, 2008 and 2007 are presented below (amounts in millions):

	Three months ended September 30,			
	2008	2007	2008	2007
	Net revenues		Segment income (loss) from operations	
Activision	\$ 364	\$ 43	\$ (26)	\$ (19)
Blizzard	297	249	146	132
Distribution	56		2	
Activision Blizzard's core operations	717	292	122	113
Activision Blizzard's non-core exit operations	6	3	(110)	(40)
Reportable segments total	723	295	12	73

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Reconciliation to consolidated net revenues / operating  
income (loss):

Net effect from deferral of net revenues and cost of sales	(12)	31	(12)	28
Stock-based compensation expense			(26)	(43)
Restructuring expense			(61)	
Amortization of intangible assets and purchase price accounting related adjustments			(90)	(1)
Integration and transaction costs			(17)	
Consolidated net revenues / operating income (loss)	\$	711	\$	326
			\$	(194)
			\$	57

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	Nine months ended September 30,			
	2008	2007	2008	2007
	Net revenues		Segment income (loss) from operations	
Activision	\$ 457	\$ 108	\$ (61)	\$ (79)
Blizzard	866	856	447	447
Distribution	56		3	
Activision Blizzard's core operations	1,379	964	389	368
Activision Blizzard's non-core exit operations	16	9	(251)	(86)
Reportable segments total	1,395	973	138	282
Reconciliation to consolidated net revenues / operating income (loss):				
Net effect from deferral net revenues and cost of sales	(8)	(77)	(7)	(67)
Stock-based compensation expense			(47)	(77)
Restructuring expense			(61)	(1)
Amortization of intangible assets and purchase price accounting related adjustments			(92)	(3)
Integration and transaction costs			(17)	
Consolidated net revenues / operating income (loss)	\$ 1,387	\$ 896	\$ (86)	\$ 134

Total assets as of September 30, 2008 for Activision Blizzard's core operations were \$13.7 billion, of which \$12.9 billion relates to Activision, \$539 million to Blizzard, and \$209 million to Distribution. Total assets as of September 30, 2008 of Activision Blizzard's non-core exit operations were \$47 million. We have not provided total assets as of September 30, 2007 to our CODM comparable data based on the new organizational structure as it is not practical because prior to the Business Combination, Vivendi Games did not maintain accounting records that allocate assets or liabilities for reportable segments.

Geographic information for the three and nine months ended September 30, 2008 and 2007 is based on the location of the selling entity. Revenues from external customers by geographic regions were as follows (amounts in millions):

	Three months ended September 30,		Nine months ended September 30,	
	2008	2007	2008	2007
North America	\$ 295	\$ 147	\$ 591	\$ 422
Europe	348	122	627	374
Asia Pacific	62	54	153	91
Total territory revenues	705	323	1,371	887
Activision Blizzard's non-core exit operations	6	3	16	9
Total consolidated net revenues	\$ 711	\$ 326	\$ 1,387	\$ 896

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

Three months ended September 30,		Nine months ended September 30,	
2008	2007	2008	2007

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MMOG	271	269	828	746
Console	272	16	335	53
Hand-held	81	7	102	21
PC	25	31	50	67
Total platforms revenues	649	323	1,315	887
Distribution	56		56	
Activision Blizzard's non-core exit operations	6	3	16	9
Total consolidated net revenues	\$ 711	\$ 326	\$ 1,387	\$ 896



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We did not have a single external customer that accounted for 10% or more of consolidated net revenues for the three and nine month periods ended September 30, 2008 and 2007.

**15. Computation of Earnings (Loss) Per Share**

On July 9, 2008, Vivendi obtained control of Activision, Inc. through acquisition of the majority of the outstanding common stock of Activision, Inc. For accounting purposes, Vivendi Games is deemed to be the acquirer (reverse acquisition – see note 1). The historical financial statements prior to July 9, 2008, are those of Vivendi Games. Further, earnings (loss) per share for periods prior to the Business Combination are retrospectively adjusted to reflect the number of split adjusted shares received by Vivendi, former parent of Vivendi Games. The following table sets forth the computations of net income (loss) per share on a basic and diluted basis (amounts in millions, except per share data):

	Three months ended September 30,		Nine months ended September 30,	
	2008	2007	2008	2007
<b>Numerator:</b>				
Numerator for basic and diluted earnings (loss) per share – income available to common shareholders	\$ (108)	\$ 48	\$ (36)	\$ 141
<b>Denominator:</b>				
Denominator for basic and diluted earnings (loss) per share - weighted-average common shares outstanding	1,271	591	816	591
<b>Net income (loss) per share</b>				
Basic and diluted	\$ (0.08)	\$ 0.08	\$ (0.04)	\$ 0.24

Equity incentive awards consisting of stock options, restricted stock units and restricted stock with respect to an aggregate of 55 million shares of common stock for the three and nine months ended September 30, 2008, respectively, were not included in the calculation of diluted earnings per share because their effect would be antidilutive. Potential common shares are not included in the denominator of the diluted earnings per share calculation when inclusion of such shares would be anti-dilutive, such as in a period in which a net loss is recorded.

**16. Commitments and Contingencies***Credit Facilities*

We have revolving credit facilities with our Centresoft subsidiary located in the UK (the UK Facility ) and our NBG subsidiary located in Germany (the German Facility ). The UK Facility provided Centresoft with the ability to borrow up to GBP 12 million (\$22 million), including issuing letters of credit, on a revolving basis as of September 30, 2008. The UK Facility bore interest at the London Inter-bank Offer Rate ( LIBOR ) plus 2.0% as of September 30, 2008, is collateralized by substantially all of the assets of the subsidiary and will expire in February 2009. The UK Facility contains various covenants that require the subsidiary to maintain specified financial ratios related to, among others, fixed charges. The German Facility provided for revolving loans up to approximately EUR 1 million (\$1 million) as of September 30,

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2008, bore interest at a Eurocurrency rate plus 2.5%, is collateralized by certain of the subsidiary's property and equipment and has no expiration date. No borrowings were outstanding against the UK Facility and the German Facility as of September 30, 2008.

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As of September 30, 2008, we maintained an \$85 million irrevocable standby letter of credit. The standby letter of credit is required by one of our inventory manufacturers to qualify for payment terms on our inventory purchases. Under the terms of this arrangement, we are required to maintain on deposit with the bank a compensating balance, restricted as to use, of not less than the sum of the available amount of the letter of credit plus the aggregate amount of any drawings under the letter of credit that have been honored thereunder but not reimbursed. At September 30, 2008, the \$85 million deposit is included in short-term investments as restricted cash. The letter of credit was undrawn as of September 30, 2008.

As of September 30, 2008, our publishing subsidiary located in the UK maintained a EUR 25 million (\$37 million) irrevocable standby letter of credit. The standby letter of credit is required by one of our inventory manufacturers to qualify for payment terms on our inventory purchases. The standby letter of credit does not require a compensating balance and is collateralized by substantially all of the assets of the subsidiary and expires in February 2009. No borrowings were outstanding as of September 30, 2008.

On April 29, 2008, Activision, Inc. entered a senior unsecured credit agreement with Vivendi (as lender). Borrowings under the agreement became available upon consummation of the Business Combination. As of September 30, 2008, the credit agreement provides for a revolving credit facility of up to \$475 million, bearing interest at LIBOR plus 1.20% per annum. Any unused amount under the revolving credit facility is subject to a commitment fee of 0.42% per annum. No borrowings were outstanding as of September 30, 2008.

### *Commitments*

In the normal course of business, we enter into contractual arrangements with third parties for non-cancelable operating lease agreements for our offices, for the development of products, and for the rights to intellectual property. Under these agreements, we commit to provide specified payments to a lessor, developer or intellectual property holder, as the case may be, based upon contractual arrangements. The payments to third-party developers are generally conditioned upon the achievement by the developers of contractually specified development milestones. Further, these payments to third-party developers and intellectual property holders typically are deemed to be advances and are recoupable against future royalties earned by the developer or intellectual property holder based on the sale of the related game. Additionally, in connection with certain intellectual property rights acquisitions and development agreements, we will commit to spend specified amounts for marketing support for the related game(s) which is to be developed or in which the intellectual property will be utilized. Assuming all contractual provisions are met, the total future minimum commitments for these and other contractual arrangements in place as of September 30, 2008 are scheduled to be paid as follows (amounts in millions):

	Contractual Obligations(1)			
	Facility and Equipment Leases	Developer and IP	Marketing	Total
For the year ending December 31,				
2008 (remaining three months)	\$ 12	\$ 43	\$ 26	\$ 81
2009	40	62	45	147
2010	35	40	4	79
2011	23	17	13	53
2012	21	22		43
Thereafter	64	38		102
<b>Total</b>	<b>\$ 195</b>	<b>\$ 222</b>	<b>\$ 88</b>	<b>\$ 505</b>

(1) We have omitted FIN 48 liabilities from this table due to the inherent uncertainty regarding the timing of potential issue resolution. Specifically, either (a) the underlying positions have not been fully enough developed under audit to quantify at this time or, (b) the years relating to the issues for certain jurisdictions are not currently under audit. As of September 30, 2008, we had \$88 million of unrecognized tax benefits.

*Legal Proceedings*

On February 8, 2008, the Wayne County Employees Retirement System filed a lawsuit challenging the Business Combination in the Delaware Court of Chancery. The suit is a putative class action filed against the parties to the Business Combination Agreement as well as certain current and former members of our Board of Directors. The plaintiff

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alleges, among other things, that our current and former directors named therein failed to fulfill their fiduciary duties with regard to the Business Combination by surrendering the negotiating process to conflicted management, that those breaches were aided and abetted by Vivendi and those of its subsidiaries named in the complaint, and that the preliminary proxy statement filed by the Company on January 31, 2008 contains certain statements that the plaintiff alleges are false and misleading. The plaintiff seeks an order from the court that, among other things, certifies the case as a class action, enjoins the Business Combination, requires the defendants to disclose all material information, declares that the Business Combination is in breach of the directors' fiduciary duties and therefore unlawful and unenforceable, awards the plaintiff and the putative class damages for all profits and special benefits obtained by the defendant in connection with the Business Combination and tender offer, and awards the plaintiff its cost and expense, including attorney's fees.

After various initial motions were filed and ruled upon, on May 8, 2008, the plaintiff filed an amended complaint that, among other things, added allegations relating to a revised preliminary proxy statement filed by the Company on April 30, 2008. Additional motions were then filed, including a motion for preliminary injunction filed by the plaintiff and a motion to dismiss filed by Vivendi and its subsidiaries. On June 24, 2008, the court granted Vivendi and its subsidiaries' motion to dismiss as to them. On July 1, 2008, the court denied plaintiff's motion for preliminary injunction. The Company intends to defend itself vigorously.

In July 2006, individuals and/or entities claiming to be our stockholders filed derivative lawsuits, purportedly on our behalf, against certain current and former members of our Board of Directors as well as several of our current and former officers. Three derivative actions were filed in Los Angeles Superior Court: Vazquez v. Kotick, et al., L.A.S.C. Case No. BC355327 (filed July 12, 2006); Greuer v. Kotick, et al. L.A.S.C. Case No. SC090343 (filed July 12, 2006); and Amalgamated Bank v. Baker, et al., L.A.S.C. Case No. BC356454 (filed August 3, 2006). These actions were consolidated by the court under the caption In re Activision Shareholder Derivative Litigation, L.A.S.C. Master File No. SC090343 (West, J.). Four derivative actions were filed in the United States District Court for the Central District of California: Pfeiffer v. Kotick, et al., C.D. Cal. Case No. CV06-4771 MRP (JTLx) (filed July 31, 2006); Hamian v. Kotick, et al., C.D. Cal. Case No. CV06-5375 MRP (JLTx) (filed August 25, 2006); Abdelnur vs. Kotick et al., C.D. Cal. Case No. CV07-3575 AHM (PJWx) (filed June 1, 2007); and Scarborough v. Kotick et al., C.D. Cal. Case No. CV07-4602 SVW (PLAx) (filed July 18, 2007). These actions were also consolidated, under the caption In re Activision, Inc. Shareholder Derivative Litigation, C.D. Cal. Case No. CV06-4771 MRP (JTLx) (Pfaelzer, J.). The consolidated complaints alleged, among other things, purported improprieties in our issuance of stock options. Plaintiffs sought various relief on our behalf, including damages, restitution of benefits obtained from the alleged misconduct, equitable relief, including an accounting and rescission of option contracts; and various corporate governance reforms. We expect that defense expenses associated with the matters will be covered by our directors and officers insurance, subject to the terms and conditions of the applicable policies.

On July 22, 2008 and July 28, 2008, all claims in the consolidated stock options dating-related shareholder derivative actions pending in the U.S. District Court for the Central District of California and in Los Angeles Superior Court, respectively, were dismissed with prejudice pursuant to the District Court's order finally approving the Stipulation of Settlement entered into by all parties to the actions. In entering into the Stipulation of Settlement, neither we nor any of the settling parties admitted to any liability or wrongdoing. Under the terms of the court-approved Stipulation of Settlement, we are required to adopt, implement and/or maintain certain corporate governance and internal control measures, relating principally to the following: board composition, structure and practices, director independence standards, stock ownership and compensation, and education; shareholder proposal evaluation process; nomination procedures for shareholder-nominated directors; shareholder meeting procedures; executive compensation policies and procedures; insider trading controls; and stock option granting procedures. We agreed to keep these measures in place for a period of three years, subject to certain exceptions. The Stipulation of Settlement also addresses matters relating to the agreements by certain of our current and former directors and officers to reimburse the Company in connection with the receipt of options that required measurement date corrections. In the case of options already exercised, the agreements allowed reimbursement to be made either by cancellation of vested but unexercised options with a value equivalent to the additional exercise price or by payment of additional exercise price. In the case of options not yet exercised, the exercise price to be paid upon future exercise of those options is increased. In the aggregate, settling defendants have elected to cancel options to acquire approximately 800,000 shares of our common stock and have agreed to increases in the exercise prices of approximately 16.1 million options. The modification of these options did not result in any incremental compensation expense. The Stipulation of Settlement also provides for the forgiveness of approximately \$2 million in legal fees previously billed to us by former outside corporate counsel. In addition, the Stipulation of Settlement provides for us to pay \$10 million to plaintiffs' attorneys for their fees and expenses, subject to court approval of such fees and expenses and subject to our reservation of all rights against our directors and officers (D&O) insurers, reinsurers and co-insurers. The Company paid the \$10 million during the current quarter. The Stipulation

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of Settlement also provides that plaintiffs' attorneys will also be entitled to 15% (up to \$750,000) of any payments made by our D&O insurers to the

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Company in connection with the settlement, to the extent such payments constitute reimbursement of amounts above and beyond covered defense costs incurred in connection with the options matters. We have entered into settlement agreements with our first and second level excess D&O insurers (our primary D&O insurer having exhausted its policy limits prior to the parties' entry into the Stipulation of Settlement). We have not yet reached agreements with our third level excess D&O insurer or our D&O insurer providing Side A/Difference in Conditions coverage.

On July 24, 2006, we received a letter of informal inquiry from the SEC requesting certain documents and information relating to our historical stock option grant practices. Thereafter, in early June 2007, the SEC issued a formal order of non-public investigation, pursuant to which it subpoenaed documents from us related to the investigation, and testimony and documents from certain current and former directors, officers and employees of ours. We were recently advised by the SEC Staff in Los Angeles that they have decided to conclude this investigation without recommending any enforcement action.

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

**17. Stock-Based Compensation and Employee Benefit Plans**

*Equity Incentive Plans*

On July 28, 2008, our Board of Directors adopted the Activision 2008 Incentive Plan, subject to shareholder approval, and, on September 24, 2008, that plan was approved by our shareholders and became effective. It was subsequently amended by the Board of Directors (as so amended, the 2008 Plan). The 2008 Plan authorizes the Compensation Committee of our Board of Directors to provide equity-based compensation in the form of stock options, share appreciation rights, restricted stock, restricted stock units, performance shares, performance units and other performance- or value-based awards structured by the Compensation Committee within parameters set forth in the 2008 Plan, including custom awards that are denominated or payable in, valued in whole or in part by reference to, or otherwise based on or related to, shares of our common stock, or factors that may influence the value of our common stock or that are valued based on our performance or the performance of any of our subsidiaries or business units or other factors designated by the Compensation Committee, as well as incentive bonuses, for the purpose of providing incentives and rewards for superior performance to the directors, officers, employees of, and consultants to, Activision Blizzard and its subsidiaries.

While the Compensation Committee has broad discretion to create equity incentives, our equity-based compensation program currently primarily utilizes a combination of options and restricted stock units. Such awards generally have time-based vesting schedules, vesting annually over periods of three to five years, or vest in their entirety on an anniversary of date of grant, subject to possible earlier vesting if certain performance measures are met, and all such awards which are options generally expire ten years from the grant date. Under the terms of the 2008 Plan, the exercise price for the options, must be equal to or greater than the closing price per share of our common stock on the date the award is granted, as reported on the NASDAQ.

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Upon the effective date of the 2008 Plan, we ceased to make awards under the following equity incentive plans (collectively, the Prior Plans ), although such plans will remain in effect and continue to govern outstanding awards: (i) Activision, Inc. 1998 Incentive Plan, as amended; (ii) Activision, Inc. 1999 Incentive Plan, as amended; (iii) Activision, Inc. 2001 Incentive Plan, as amended; (iv) Activision, Inc. 2002 Incentive Plan, as amended; (v) Activision, Inc. 2002 Executive Incentive Plan, as amended; (vi) Activision, Inc. 2002 Studio Employee Retention Incentive Plan, as amended; (vii) Activision, Inc. 2003 Incentive Plan, as amended; and (viii) Activision, Inc. 2007 Incentive Plan.

As of the date it was approved by our shareholders, there were approximately 15 million shares available for issuance under the 2008 Plan. The number of shares of our common stock reserved for issuance under the 2008 Plan may be further increased from time to time by: (i) the number of shares relating to awards outstanding under any Prior Plan that: (a) expire, or are forfeited, terminated or cancelled, without the issuance of shares; (b) are settled in cash in lieu of shares; or (c) are exchanged, prior to the issuance of shares of our common stock, for awards not involving our common stock; and (ii) if the exercise price of any option outstanding under any Prior Plan is, or the tax withholding requirements with respect to any award outstanding under any Prior Plan are, satisfied by withholding shares otherwise then



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deliverable in respect of the award or the actual or constructive transfer to the Company of shares already owned, the number of shares equal to the withheld or transferred shares. As of September 30, 2008, we had approximately 15 million shares of our common stock reserved for future issuance under the 2008 Plan. Shares issued in connection with awards made under the 2008 Plan are generally issued as new stock issuances.

*Modification of Awards through Business Combination*

As a result of the reverse acquisition accounting treatment for the Business Combination, Activision, Inc. previously issued stock options and restricted stock awards granted to employees and directors, and warrants that were outstanding and unvested at the date of the Business Combination, are accounted for as an exchange of awards. The fair value of the outstanding vested and unvested awards was measured on the date of the acquisition, and for unvested awards which require service subsequent to the date of the Business Combination, a portion of the awards' fair value has been allocated to future service and will be recognized over the remaining future requisite service period.

*Restricted Stock Units and Restricted Stock*

We grant restricted stock units and restricted stock (collectively referred to as restricted stock rights) under the 2008 Plan to employees around the world, and we have assumed as a result of the Business Combination the restricted stock rights granted by Activision, Inc. Restricted stock units entitle the holders thereof to receive shares of our common stock at the end of a specified period of time or otherwise upon a specified occurrence. Restricted stock is issued and outstanding upon grant; however, restricted stock holders are restricted from selling the shares until they vest. Upon vesting of restricted stock rights, we may withhold shares otherwise deliverable to satisfy tax withholding requirements. Restricted stock rights are subject to forfeiture and transfer restrictions. Vesting for restricted stock rights is contingent upon the holders' continued employment with us and may be subject to other conditions. If the vesting conditions are not met, unvested restricted stock rights will be forfeited.

The following table summarizes our restricted stock rights activity for the nine months ended September 30, 2008 (amounts in thousands, except per share amount):

	Restricted Stock Rights	Weighted- Average Grant Date Fair Value
Balance as of January 1, 2008		\$
Activity for the nine months ended September 30, 2008:		
Acquired from the Business Combination	7,676	14.91
Granted	2,291	16.48
Vested	(15)	17.07
Forfeited	(9)	20.29
Balance as of September 30, 2008	9,943	\$ 15.26

As of September 30, 2008, \$70 million of total unrecognized compensation cost related to restricted stock rights is expected to be recognized over a weighted-average period of 2.14 years.

*Non-Plan Employee Stock Options*

In connection with prior employment agreements between Activision, Inc. and Robert A. Kotick, our Chief Executive Officer, and Brian G. Kelly, our Co-Chairman, Mr. Kotick and Mr. Kelly were previously granted options to purchase common stock of Activision, Inc. These awards were assumed as a result of the Business Combination and accounted for as an exchange for options to purchase our common stock. As of September 30, 2008, non-plan options to purchase approximately 16 million shares under such grants were outstanding with a weighted-average exercise price of \$1.02.

*Performance Shares*

In connection with the consummation of the Business Combination, on July 9, 2008, Mr. Kotick received a grant of 2,500,000 performance shares, which will vest in 20% increments on each of the first, second, third, and fourth anniversaries of the date of grant, with another 20% vesting on December 31, 2012, the expiration date of Mr. Kotick's employment agreement with the Company, in each case subject to the Company attaining the specified compound annual total shareholder return target for that vesting period. If the Company does not achieve the performance target for a vesting period, no performance shares will vest for that vesting period. If, however, the Company achieves a performance target for a

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subsequent vesting period, then all of the performance shares that would have vested on the previous vesting date will vest on the vesting date where the performance targets were achieved.

The fair value of these shares was determined using a binomial lattice model which takes into consideration, among other factors, the probability of the performance targets being met. As of September 30, 2008, \$20 million of total unrecognized compensation cost related to the performance shares is expected to be recognized over a weighted-average period of approximately 5 years.

*Employee Stock Purchase Plan*

Effective October 1, 2005, the Board of Directors of Activision, Inc. approved the Activision, Inc. Third Amended and Restated 2002 Employee Stock Purchase Plan and the Activision, Inc. Second Amended and Restated 2002 Employee Stock Purchase Plan for International Employees (together, the ESPP). Under the ESPP, up to an aggregate of 4,000,000 shares of Activision, Inc. common stock may be purchased by eligible employees during two six-month offering periods that commence each April 1 and October 1 (the Offering Period). Common stock is purchased by the ESPP participants at a price per share generally equal to 85% of the lower of the fair market value of our common stock on the first day of the Offering Period and the fair market value of our common stock on the purchase date (the last day of the Offering Period). Employees may purchase shares having a value not exceeding 15% of their gross compensation during an Offering Period and are limited to a maximum of \$10,000 in value for any two purchases within the same calendar year. As a result of the Business Combination the offering period in effect at the time of the Business Combination was assumed by us, and on October 1, 2008, employees purchased 262,002 shares of our common stock at a purchase price of \$11.65 per share under the ESPP. The ESPP has been terminated by the Board of Directors and there will be no further purchases thereunder.

*BEP*

In 2006, Blizzard implemented the BEP, an equity incentive plan denominated in U.S. dollars. Under the BEP, restricted shares of Blizzard stock and other cash settled awards were granted to certain key executives and employees of Blizzard.

Under the provisions of the BEP and the Business Combination Agreement, the consummation of the Business Combination is deemed a change in control, which automatically triggered cash payments to the beneficiaries for the portion of awards that were vested at the closing date of the Business Combination. Upon closing of the Business Combination, we paid \$106 million under the BEP to employees. The determination of the value of Blizzard shares upon a change in control is equal to the transaction value under the provisions of the BEP. The outstanding non-vested rights became immediately vested upon the closing of the Business Combination, cancelled and extinguished and converted into a new right to receive an amount in cash eighteen months after the closing upon the terms and subject to the conditions set forth in the BEP and in the Business Combination Agreement, including continued employment through the payment date. As of September 30, 2008, unrecognized compensation expense under the BEP was approximately \$24 million which will be recognized over the remaining fifteen months. As of September 30, 2008, other non-current liabilities in the consolidated balance sheet includes approximately \$65 million related to this plan.

*Vivendi Corporate Plan*

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Prior to the Business Combination, Vivendi Games had equity incentive plans that were equity-settled and cash-settled. Equity-settled awards include stock options and restricted share plans from Vivendi, and the cash-settled award includes stock appreciation rights and restricted stock units from Vivendi. There were no new grants from Vivendi during the nine months ended September 30, 2008. During the three and nine month periods ended September 30, 2008 there were no material movements within the components of equity-settled and cash-settled instruments. As of September 30, 2008 and December 31, 2007, we have recorded in our consolidated balance sheets non-current other liabilities of approximately \$10 million and approximately \$33 million, respectively, relating to the Vivendi Corporate Plan.

### *Stock-based Compensation Expense*

The following table sets forth the total stock-based compensation expense (amounts in millions) resulting from stock options, restricted stock rights, ESPP, the BEP, and the Vivendi Corporate Plan included in our Consolidated Statements of Operations in accordance with SFAS No. 123R for the three and nine months ended September 30, 2008, and 2007:

	<b>Three months ended September 30, 2008</b>	<b>Nine months ended September 30, 2008</b>
Cost of sales software royalties and amortization	\$	\$ 1
Product development	7	34
Sales and marketing	4	6
General and administrative	15	6
Stock-based compensation expense before income taxes	26	47
Income tax benefit	(10)	(19)
Total stock-based compensation expense, net of income tax benefit	\$ 16	\$ 28

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	<b>Three months ended September 30, 2007</b>	<b>Nine months ended September 30, 2007</b>
Cost of sales software royalties and amortization	\$ 1	\$ 1
Product development	35	55
Sales and marketing	3	5
General and administrative	3	16
Stock-based compensation expense before income taxes	42	77
Income tax benefit	(17)	(30)
Total stock-based compensation expense, net of income tax benefit	\$ 25	\$ 47

Additionally, stock option expenses are capitalized in accordance with SFAS No. 86, Accounting for the Costs of Computer Software to Be Sold, Leased, or Otherwise Marketed as discussed in Note 1. For the three and nine months ended September 30, 2008, stock-based compensation costs in the amount of \$15 million was capitalized. The following table summarizes stock-based compensation included in our Consolidated Balance Sheets as a component of software development (amounts in millions):

	<b>Software development</b>
Balance as of January 1, 2008	\$
Stock-based compensation expense capitalized during period	15
Amortization of capitalized stock-based compensation expense	
Balance as of September 30, 2008	\$ 15

*Method and Assumptions on Valuation of Stock Options*

Our employee stock options have features that differentiate them from exchange-traded options. These features include lack of transferability, early exercise, vesting restrictions, pre- and post-vesting termination provisions, blackout dates, and time-varying inputs. In addition, some of the options have non-traditional features, such as accelerated vesting upon the satisfaction of certain performance conditions that must be reflected in the valuation. A binomial-lattice model was selected because it is better able to explicitly address these features than closed-form models such as the Black-Scholes model, and is able to reflect expected future changes in model inputs, including changes in volatility, during the option's contractual term.

Consistent with SFAS No. 123R, we have attempted to reflect expected future changes in model inputs during the option's contractual term. The inputs required by our binomial-lattice model include expected volatility, risk-free interest rate, risk-adjusted stock return, dividend yield, contractual term, and vesting schedule, as well as measures of employees' forfeiture, exercise, and post-vesting termination behavior. Statistical methods were used to estimate employee rank-specific termination rates. These termination rates, in turn, were used to model the number of options that are expected to vest and post-vesting termination behavior. Employee rank-specific estimates of Expected Time-To-Exercise (ETTE) were used to reflect employee exercise behavior. ETTE was estimated by using statistical procedures to first estimate the conditional probability of exercise occurring during each time period, conditional on the option surviving to that time period and then using those probabilities to estimate ETTE. The model was calibrated by adjusting parameters controlling exercise and post-vesting termination behavior so that the measures output by the model matched values of these measures that were estimated from historical data. The weighted-average estimated value of employee stock options granted during the three and nine months ended September 30, 2008 was \$6.59 per share, using the binomial-lattice model with the following weighted-average assumptions:

**Employee and director  
options and warrants**

**Employee stock  
purchase plan**

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	For three and nine months ended September 30, 2008	For three and nine months ended September 30, 2008
Expected life (in years)	5.01	0.5
Risk free interest rate	4.03%	1.53%
Volatility	50.61%	35.75%
Dividend yield		
Weighted-average fair value at grant date	\$ 6.59	\$ 3.36

Upon consummation of the Business Combination described in Note 4, and in accordance with the guidance of SFAS No. 123R, the fair value of Activision, Inc.'s stock awards was determined using the fair value of Activision, Inc.'s common stock of \$15.04 per share, which is the closing price as of July 9, 2008 and a binomial-lattice model with the following assumptions: (a) varying volatility ranging from 42.38% to 51.50%, (b) a risk free interest rate of 3.97%, (c) an expected life

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ranging from approximately 3.22 years to 4.71 years, (d) risk adjusted stock return of 8.89%, and (e) an expected dividend yield of 0.0%.

To estimate volatility for the binomial-lattice model, we use methods or capabilities that are discussed in SFAS No. 123R and Staff Accounting Bulletin No. 107, Share-Based Payment (SAB No. 107). These methods include the implied volatility method based upon the volatilities for exchange-traded options on our stock to estimate short-term volatility, the historical method (annualized standard deviation of the instantaneous returns on Activision Blizzard's stock) during the option's contractual term to estimate long-term volatility and a statistical model to estimate the transition or mean reversion from short-term volatility to long-term volatility. Based on these methods, for options granted during the three and nine months ended September 30, 2008, the expected stock price volatility ranged from 46.15% to 51.42%, with a weighted-average volatility of 50.61%.

As is the case for volatility, the risk-free rate is assumed to change during the option's contractual term. Consistent with the calculation required by a binomial lattice model, the risk-free rate reflects the interest from one time period to the next (forward rate) as opposed to the interest rate from the grant date to the given time period (spot rate). Since we do not currently pay dividends and are not expected to pay them in the future, we have assumed that the dividend yield is zero.

The expected life of employee stock options represents the weighted-average period the stock options are expected to remain outstanding and is, as required by SFAS No. 123R, an output by the binomial-lattice model. The expected life of employee stock options depends on all of the underlying assumptions and calibration of our model. A binomial-lattice model can be viewed as assuming that employees will exercise their options when the stock price equals or exceeds an exercise boundary. The exercise boundary is not constant but continually declines as one approaches the option's expiration date. The exact placement of the exercise boundary depends on all of the model inputs as well as the measures that are used to calibrate the model to estimated measures of employees' exercise and termination behavior.

As stock-based compensation expense recognized in the Consolidated Statement of Operations for the three and nine months ended September 30, 2008 is based on awards ultimately expected to vest, it has been reduced for estimated forfeitures. SFAS No. 123R requires forfeitures to be estimated at the time of grant and revised, if necessary, in subsequent periods if actual forfeitures differ from those estimates. Forfeitures were estimated based on historical experience.

*Accuracy of Fair Value Estimates*

We developed the assumptions used in the binomial-lattice model, including model inputs and measures of employees' exercise and post-vesting termination behavior. Our ability to accurately estimate the fair value of share-based payment awards as of the grant date depends upon the accuracy of the model and our ability to accurately forecast model inputs as long as ten years into the future. These inputs include, but are not limited to, expected stock price volatility, risk-free rate, dividend yield, and employee termination rates. Although the fair value of employee stock options is determined in accordance with SFAS No. 123R and SAB No. 107 using an option-pricing model, the estimates that are produced by this model may not be indicative of the fair value observed between a willing buyer/willing seller. Unfortunately, it is difficult to determine if this is the case, because markets do not currently exist that permit the active trading of employee stock option and other share-based instruments.

*Stock Option Activities*

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We have assumed the stock options granted to employees and directors by Activision, Inc. as a result of the Business Combination. Stock option activities for the nine-months ended September 30, 2008 are as follows (amounts in millions, except number of shares in thousands and per share amounts):

	Shares	Weighted-average exercise price	Weighted-average remaining contractual term	Aggregate intrinsic value
Outstanding at January 1, 2008		\$		
Acquired via the Business Combination	96,075	5.76		
Granted	5,612	16.55		
Exercised	(3,646)	5.09		
Forfeited	(286)	4.47		
Outstanding at September 30, 2008	97,755	6.41	6.01	\$ 888,804
Vested and expected to vest at September 30, 2008	91,376	\$ 6.07	5.24	\$ 860,386
Exercisable at September 30, 2008	54,292	\$ 3.36	4.07	\$ 655,429



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The aggregate intrinsic value in the table above represents the total pretax intrinsic value (i.e., the difference between our closing stock price on the last trading day of the period and the exercise price, times the number of shares for options where the exercise price is below the closing stock price) that would have been received by the option holders had all option holders exercised their options on that date. This amount changes based on the fair market value of our stock. Total intrinsic value of options actually exercised was approximately \$43 million for the three and nine months ended September 30, 2008.

As of September 30, 2008, \$123 million of total unrecognized compensation cost related to stock options is expected to be recognized over a weighted-average period of 1.5 years.

Net cash proceeds from the exercise of stock options were \$19 million for the three and nine months ended September 30, 2008. Income tax benefit from stock option exercises was \$17 million for the three and nine months ended September 30, 2008, of which \$15 million and \$2 million was credited to goodwill and additional paid in capital, respectively. In accordance with SFAS No. 123R, we present excess tax benefits from the exercise of stock options, if any, as financing cash flows rather than operating cash flows.

**18. Related Parties Transactions**

*Treasury Related Administration*

Prior to the Business Combination, Vivendi maintained a centralized cash management pool from which Vivendi Games borrowed and loaned cash on a daily basis. Net cash transfers, under the cash pooling agreement, were included in owner's equity as part of net transfers to Vivendi. Vivendi charged Vivendi Games interest on the cumulative net cash transfers and such charges are included in investment income (loss), net in the accompanying consolidated statements of operations. Net interest earned from Vivendi for the three and nine months ended September 30, 2008 was \$- million and \$5 million, respectively. Net interest expense for the three and nine months ended September 30, 2007 was \$2 million and \$3 million, respectively.

In addition, in accordance with the terms of the Business Combination Agreement, Vivendi Games settled its payable to Vivendi S.A. and distributed its excess cash on hand as defined in the Business Combination Agreement immediately prior to the close of the transaction, resulting in cash payments of \$79 million to settle its payable and \$79 million to distribute its excess cash to Vivendi.

Our foreign currency risk policy seeks to reduce risks arising from foreign currency fluctuations. In connection with this, we use derivative financial instruments, primarily currency forward contracts, with Vivendi as our counterparty. As of September 30, 2008 and December 31, 2007, the net notional amount of outstanding forward foreign exchange contracts was approximately \$32 million and \$14 million, respectively. A pre-tax net unrealized gain of approximately \$3 million and \$2 million for the three and nine months ended September 30, 2008, respectively, and a pre-tax net unrealized loss of approximately \$- million and \$2 million for the three and nine months ended September 30, 2007, respectively, resulted from the foreign exchange contracts with Vivendi were recognized in the Consolidated Statement of Operations.

*Others*

Activision Blizzard has entered into various transactions and agreements, including treasury management services, investor agreement, internal group reporting services, credit facilities arrangement (see Note 16 for more details), and music royalties agreements with Vivendi and its subsidiaries and affiliates. None of these services, transactions and agreements with Vivendi and its subsidiaries and affiliates is material to the Consolidated Financial Statements as a whole.

**19. Subsequent event**

On November 5, 2008, we announced that our Board of Directors authorized a stock repurchase program under which we may repurchase up to \$1 billion of our common stock. Under this program, we may repurchase our common stock from time to time on the open market or in private transactions, including structured or accelerated transactions. We will determine the timing and amount of repurchases based on our evaluation of market conditions and other factors. The repurchase program may be suspended or discontinued by the Company at any time.

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

### Overview

The following overview is a top-level discussion of our operating results as well as some of the trends and drivers that affect our business. Management believes that an understanding of these trends and drivers is important in order to understand our results for the quarter ended and nine month period ended September 30, 2008, as well as our future prospects. This summary is not intended to be exhaustive, nor is it intended to be a substitute for the detailed discussion and analysis provided elsewhere in this Form 10-Q, including the remainder of Management's Discussion and Analysis of Financial Condition and Results of Operations, or the Consolidated Financial Statements and related notes.

### *Our Business*

The Activision Blizzard group of companies is a leading international publisher of interactive entertainment software and peripheral products. Through Blizzard, we are the leader in terms of subscriber base and revenues generated in the subscription-based MMOG category. Activision develops video games on various consoles, hand-held platforms and the PC platform through internally developed franchises and license agreements. Our companies currently offer our products primarily in versions that operate on the Sony PlayStation 2 ( PS2 ), Sony PlayStation 3 ( PS3 ), Nintendo Wii ( Wii ), and Microsoft Xbox 360 ( Xbox360 ) console systems, Sony PlayStation Portable ( PSP ), and Nintendo Dual Screen ( NDS ) hand-held devices, and PCs.

Our Activision business involves the development, marketing, and sale of products directly, by license, or through our affiliate label program with certain third-party publishers. Activision's products cover diverse game categories including action/adventure, action sports, racing, role-playing, simulation, first-person action, music, and strategy. Activision's target customer base ranges from casual players to game enthusiasts, and children to adults. During calendar 2008, Activision plans to release *Guitar Hero World Tour*, *Call of Duty: World at War*, and continue to expand its licensed titles such as *Madagascar: Escape 2 Africa*, *Spider-Man: Web of Shadows*, its first James Bond title, *Quantum of Solace*, and several other titles. Activision is currently in development of *Wolfenstein* from id Software, *Marvel Ultimate Alliance 2: Fusion* from Vicarious Visions, *Prototype* from Radical, and *Singularity* from Raven Software, among other titles.

Our Blizzard business involves the development, marketing, sales and support of traditional games and online subscription-based games in the MMOG category. Blizzard is headquartered in Irvine, California and is the development studio and publisher best known as the creator of *World of Warcraft* and the multi award winning *Diablo*, *StarCraft*, and *Warcraft* franchises. Blizzard distributes its products and generates revenues worldwide through various means, including: subscription revenues (which consist of fees from individuals playing *World of Warcraft*, such as prepaid-cards and other ancillary online revenues); retail sales of physical boxed product; and licensing revenues from third-party companies who distribute *World of Warcraft* in China and Taiwan. During calendar 2008, Blizzard plans to release *World of Warcraft Wrath of the Lich King*, the second expansion pack of *World of Warcraft*. Blizzard is currently in development of, among other games, *StarCraft II* and *Diablo*.

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Our distribution business consists of operations in Europe that provide logistical and sales services to third-party publishers of interactive entertainment software, our own publishing operations, and manufacturers of interactive entertainment hardware.

### *Management's Overview of Historical and Prospective Business Trends*

**Console hardware platforms** In 2005, Microsoft released the Xbox 360 and, in 2006, Sony and Nintendo introduced their respective hardware platforms, the PlayStation 3 and Wii. Activision's plan is to continue to build a significant presence on the PS3, the Wii and the Xbox360 by expanding the number of titles released on these platforms and hand-held platforms while continuing to market to the PS2 platform as long as economically attractive given its large installed base.

**Business combination and investments** We have engaged in, evaluated, and expect to continue to engage in and evaluate, a wide array of potential strategic transactions, including acquisitions of companies, businesses, intellectual properties, and other assets. During the three months ended September 30, 2008, we consummated our previously announced business combination (the **Business Combination**) pursuant to the Business Combination Agreement (the **Business Combination Agreement**), dated as of December 1, 2007, by and among the Company, SeGO Merger Corporation, a wholly-owned subsidiary of the Company, Vivendi S.A. ( **Vivendi** ), VGAC LLC, a wholly-owned subsidiary of Vivendi ( **VGAC** ), and Vivendi Games, Inc., a wholly-owned subsidiary of VGAC, ( **Vivendi Games** ). Upon the closing of the Business Combination, which occurred on July 9, 2008, Activision, Inc. was renamed Activision Blizzard, Inc. ( **Activision Blizzard** ). Activision Blizzard continues to operate as a public company traded on the NASDAQ under the ticker symbol

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ATVI. Activision Blizzard now conducts the combined business operations of Activision, Inc. and Vivendi Games including Blizzard Entertainment, Inc. ( "Blizzard" ). In connection with the Business Combination, we issued approximately 717 million shares of our common stock to VGAC including 126 million shares of common stock purchased by Vivendi for approximately \$1.7 billion. Immediately following the consummation of the Business Combination, VGAC owned approximately 54% of Activision Blizzard's issued and outstanding common stock. While Activision was the surviving entity in this Business Combination, because the transaction is treated as a reverse acquisition, Vivendi Games is deemed to be the acquirer for accounting purposes. Accordingly, Activision Blizzard applied purchase accounting to the assets and liabilities of Activision as of July 9, 2008. Also, for all Exchange Act filings following consummation of the Business Combination, the historical financial statements of Activision for periods prior to the consummation of the Business Combination are those of Vivendi Games. Activision, Inc. businesses are included in Activision Blizzard's financial statements for all periods subsequent to the consummation of the Business Combination only. See Note 1 to the Consolidated Financial Statements for further information. Also, to further strengthen our development resources and underscoring our commitment to the music-based genre, on September 11, 2008, we acquired Freestyle Games, Ltd., a premier United Kingdom-based video game developer specializing in the music-based genre.

**International operations** Activision focuses on the growth of the European market through developing localized contents for its Guitar Hero franchises and other franchises or titles in terms of contents and packaging. For the Asian market, Blizzard distributes *World of Warcraft* through direct operations and licenses. Blizzard licensed with The 9 to distribute *World of Warcraft* in China and with SoftWorld in Taiwan. Internet game room players and prepaid cards are also very popular in Asia, particularly in South Korea. Recently, Blizzard has licensed Blizzard Entertainment's *StarCraft II*, *Warcraft III: Reign of Chaos*, *Warcraft III: The Frozen Throne*, and Battle.net platform to a company affiliated with NetEase.com, Inc. Blizzard and NetEase have also established a joint venture, which will provide support for the operation of the licensed games and Battle.net platform in China. For the quarter ended September 30, 2008, Blizzard released a Russian language version of *World of Warcraft* in Russia. Also, Blizzard expanded the sale of support for *World of Warcraft* into Russia and Spanish-speaking Latin America.

**Integration and reorganization** Following the Business Combination on July 9, 2008, we have restructured the Vivendi Games businesses to capture cost-synergy to form the streamlined organization of Activision Blizzard. For the remainder for the year 2008 and beyond, we expect to continue to incur a restructuring expense mainly relating to severance payments to interim employees who are currently assisting us to exit our non-core operations and unutilized facilities. We anticipate completely exiting or winding down our non-core operations by June 2009 inclusive of organizational restructuring activities as a result of the Business Combination. For the next nine months, we anticipate incurring between \$75 million and \$100 million of additional before tax restructuring charges, and after tax cash restructuring charges between \$45 million and \$60 million relating to the Business Combination. Overall, including charges incurred through September 30, 2008, we expect to incur cash and non-cash before tax restructuring charges between \$135 million and \$160 million by June 30, 2009 with an after tax cash impact between \$70 million and \$90 million. The after tax cash charges are expected to consist primarily of employee-related severance cash costs (approximately \$55 million), facility exit cash costs (approximately \$25 million) and cash contract terminations (approximately \$10 million). Separately, these restructuring charges are expected to be partially offset by approximately between \$30 million and \$50 million of cash proceeds from asset disposals and cash after tax benefits related to the streamlining of the Vivendi Games title portfolio.

**Console online games** Activision has published games with significant online functionality that constitutes a more-than-inconsequential separate service deliverable in addition to the product, and in which our performance obligations for these titles extends beyond the sale of the game. Vendor-specific objective evidence of fair value ( "VSOE" ) does not exist for these online features, as we do not separately charge for this component of these titles. As a result, we recognize all of the revenue from the sale of these titles ratably over an estimated service period. In addition, we defer the costs of sales of these titles to match revenue.

**MMOG online games** Blizzard will publish the second expansion pack of *World of Warcraft Wrath of the Lich King*, in multiple countries in November 2008. We expect this expansion pack will bring Blizzard new subscribers and expand Blizzard's subscription revenues.

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**Impact of deferral revenues and cost of sales** We anticipate that, in calendar 2008, we will likely defer approximately \$568 million in net revenues and \$199 million in costs of sales from the sale of console and MMOG online games titles into calendar 2009. Since most of these titles are planned for release in the December quarter of calendar 2008, we expect that a majority of revenues and costs of sales for these products will be deferred in the December quarter of calendar 2008, and recognized in calendar year 2009. However, the actual amount of revenues and costs of sales deferred will vary significantly depending upon the timing of the release of these titles and the sales volume of such products.

**Other revenues** Activision is continuing development of online capabilities for its games. Activision will continue to exploit other revenue sources, including downloadable content and in game advertising for its console games, such as *Guitar Hero World Tour*, and GH Tunes as one of the newly added features to the Guitar Hero franchise.

**Economic conditions** We continue to monitor the recent widely reported unfavorable changes in economic conditions including the likely slowdown in consumer spending this holiday season, which may have impacts on our businesses, such as the pricing of our products, purchases by our customers, and credit quality of our receivables.

### **Critical Accounting Policies and Estimates**

We have identified the policies below as critical to our business operations and the understanding of our financial results. The impact and any associated risks related to these policies on our business operations is discussed throughout Management's Discussion and Analysis of Financial Condition and Results of Operations where such policies affect our

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reported and expected financial results. For a detailed discussion of the application of these and other accounting policies, see Note 3 to the Notes to Consolidated Financial Statements included in Item 1. The preparation of financial statements in conformity with US GAAP requires management to make estimates and assumptions that affect the reported amounts of assets and liabilities at the date of the financial statements and the reported amounts of revenues and expenses during the reporting period. Actual results could differ from those estimates.

*Revenue Recognition*





*Product sales*

We recognize revenue from the sale of our products upon the transfer of title and risk of loss to our customers, and once any performance obligations have been completed. Certain products are sold to customers with a street date (the earliest date these products may be sold by retailers). For these products we recognize revenue on the later of the street date or the sale date. Revenue from product sales is recognized after deducting the estimated allowance for returns and price protection.

Some of our software products provide limited online features at no additional cost to the consumer. Generally, we consider such features to be incidental to the overall product offering and an inconsequential deliverable. Accordingly, we recognize revenue related to products containing these limited online features upon the transfer of title and risk of loss to our customer. In instances where online features or additional functionality is considered a substantive deliverable in addition to the software product, we take this into account when applying our revenue recognition policy. This evaluation is performed for each software product together with any online transactions, such as electronic downloads of titles or product add-ons when it is released. When we determine that a software title contains online functionality that constitutes a more-than-inconsequential separate service deliverable in addition to the product, principally because of its importance to game play, we consider our performance obligations for this title extend beyond the sale of the game. Vendor-specific objective evidence of fair value ( VSOE ) does not exist for the online functionality, as we do not separately charge for this component of the title. As a result, we recognize all of the revenue from the sale of the title ratably over an estimated service period. In addition, we defer the costs of sales for this title to match revenues. Cost of sales includes: manufacturing costs, software royalties and amortization, and intellectual property licenses.

We recognize revenues for the massively, multiplayer, online game *World of Warcraft*, its expansion packs and other ancillary services in accordance with Staff Accounting Bulletin No. 101, Revenue Recognition in Financial Statements, ( SAB No. 101 ), as amended by Staff Accounting Bulletin No. 104, Revenue Recognition ( SAB No. 104 ).

We consider the *World of Warcraft* boxed product including expansion packs and other ancillary revenues as a single deliverable with the total arrangement consideration combined and recognized ratably as revenue over the estimated customer life beginning upon activation of the software and delivery of the services. Revenues attributed to the sale of *World of Warcraft* boxed software and related expansion packs are classified as Product Sales and revenues attributable to subscription and other ancillary services are classified as subscription, licensing and other revenues.

With respect to online transactions, such as electronic downloads of titles or product add-ons that do not constitute a more-than-inconsequential separate service deliverable, revenue is recognized when the fee is paid by the online customer to purchase online content and we are notified by the online retailer that the product has been downloaded. In addition, persuasive evidence of an arrangement must exist and collection of the related receivable must be probable.

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

*Subscription Revenues*

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Subscription revenues are recognized in accordance with SAB No. 101, as amended by SAB No. 104. Subscription revenues are derived from *World of Warcraft*, a game that is playable through Blizzard's servers on a subscription-only basis. After the first month of free usage that is included with the boxed software, the *World of Warcraft* end user may enter into a subscription agreement for additional access. Subscription revenues received are deferred and recognized as subscription revenues ratably over the subscription period. Revenue from the sale of prepaid cards, sold through retail outlets and other stores, is deferred and recognized as subscription revenue ratably beginning when the cards are first activated. Revenue from Internet gaming rooms in Asia is recognized upon usage of the time packages sold. Ancillary revenues associated with subscriptions are recognized ratably over the estimated customer life.

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*Licensing Revenues*

Third-party licensees in China and Taiwan distribute and host Blizzard's *World of Warcraft* game in their respective countries under a license agreement with Blizzard. The licensees paid certain minimum, non-refundable, generally recoupable guaranteed royalties when entering into the licensing agreements. Upon receipt of the recoupable advances, we defer their recognition and recognize the revenues in subsequent periods as these advances are recouped by the licensees. As the licensees pay additional royalties above and beyond those initially advanced, we recognize these additional royalties as revenues based on activation of the underlying prepaid time by the end users.

With respect to license agreements that provide customers the right to make multiple copies in exchange for guaranteed amounts, revenue is recognized upon delivery of a master copy. Per copy royalties on sales that exceed the guarantee are recognized as earned. In addition, persuasive evidence of an arrangement must exist and collection of the related receivable must be probable.

*Allowances for Returns, Price Protection, Doubtful Accounts, and Inventory Obsolescence*

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

We may permit product returns from, or grant price protection to, our customers under certain conditions. In general, price protection refers to the circumstances when we elect to decrease the wholesale price of a product by a certain amount and, when granted and applicable, allows customers a credit against amounts owed by such customers to us with respect to open and/or future invoices. The conditions our customers must meet to be granted the right to return products or price protection are, among other things, compliance with applicable payment terms, and consistent delivery to us of inventory and sell-through reports. We may also consider other factors, including the facilitation of slow-moving inventory and other market factors. Management must make estimates of potential future product returns and price protection related to current period product revenue. We estimate the amount of future returns and price protection for current period product revenue utilizing historical experience and information regarding inventory levels and the demand and acceptance of our products by the end consumer. The following factors are used to estimate the amount of future returns and price protection for a particular title: historical performance of titles in similar genres; historical performance of the hardware platform; historical performance of the brand; console hardware life cycle; Activision Blizzard sales force and retail customer feedback; industry pricing; weeks of on-hand retail channel inventory; absolute quantity of on-hand retail channel inventory; our warehouse on-hand inventory levels; the title's recent sell-through history (if available); marketing trade programs; and competing titles. The relative importance of these factors varies among titles depending upon, among other items, genre, platform, seasonality, and sales strategy. Significant management judgments and estimates must be made and used in connection with establishing the allowance for returns and price protection in any accounting period. Based upon historical experience we believe our estimates are reasonable. However, actual returns and price protection could vary materially from our allowance estimates due to a number of reasons including, among others, a lack of consumer acceptance of a title, the release in the same period of a similarly themed title by a competitor, or technological obsolescence due to the emergence of new hardware platforms. Material differences may result in the amount and timing of our revenue for any period if factors or market conditions change or if management makes different judgments or utilizes different estimates in determining the allowances for returns and price protection. For example, a 1% change in our September 30, 2008 allowance for returns and price protection would impact net revenues by \$2 million.

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

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

### *Software Development Costs and Intellectual Property Licenses*

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

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We account for software development costs in accordance with Statement of Financial Accounting Standards No. 86, Accounting for the Costs of Computer Software to Be Sold, Leased, or Otherwise Marketed. ( SFAS No. 86 ) Software development costs are capitalized once the technological feasibility of a product is established and such costs are determined to be recoverable. Technological feasibility of a product encompasses both technical design documentation and game design documentation. Significant management judgments and estimates are utilized in the assessment of when technological feasibility is established. For products where proven technology exists, this may occur early in the development cycle. Technological feasibility is evaluated on a product-by-product basis. Prior to a product's release, we expense, as part of cost of sales software royalties and amortization, capitalized costs when we believe such amounts are not recoverable. Capitalized costs for those products that are cancelled or abandoned are charged to product development expense in the period of cancellation. Amounts related to software development which are not capitalized are charged immediately to product development expense.

Commencing upon product release, capitalized software development costs are amortized to cost of sales software royalties and amortization based on the ratio of current revenues to total projected revenues for the specific product, generally resulting in an amortization period of six months or less.

Intellectual property license costs represent license fees paid to intellectual property rights holders for use of their trademarks, copyrights, software, technology, music or other intellectual property or proprietary rights in the development of our products. Depending upon the agreement with the rights holder, we may obtain the rights to use acquired intellectual property in multiple products over multiple years, or alternatively, for a single product. Prior to the related product's release, we expense, as part of cost of sales intellectual property licenses, capitalized intellectual property costs when we believe such amounts are not recoverable. Capitalized intellectual property costs for those products that are cancelled or abandoned are charged to product development expense in the period of cancellation.

Commencing upon the related product's release, capitalized intellectual property license costs are amortized to cost of sales intellectual property licenses based on the ratio of current revenues for the specific product to total projected revenues for all products in which the licensed property will be utilized. As intellectual property license contracts may extend for multiple years, the amortization of capitalized intellectual property license costs relating to such contracts may extend beyond one year.

We evaluate the future recoverability of capitalized software development costs and intellectual property licenses on a quarterly basis. For products that have been released in prior periods, the primary evaluation criterion is actual title performance. For products that are scheduled to be released in future periods, the recoverability of capitalized software development costs is evaluated based on the expected performance of the specific products to which the costs relate or in which the licensed trademark or copyright is to be used. Criteria used to evaluate expected product performance include: historical performance of comparable products developed with comparable technology; orders for the product prior to its release; and for any sequel product, estimated performance based on the performance of the product on which the sequel is based. As many of our intellectual property licenses extend for multiple products over multiple years, we also assess the recoverability of capitalized intellectual property license costs based on certain qualitative factors, such as the success of other products and/or entertainment vehicles utilizing the intellectual property, whether there are any future planned theatrical releases or television series based on the intellectual property, and the rights holder's continued promotion and exploitation of the intellectual property.

*Significant management judgments and estimates are utilized in the assessment of the recoverability of capitalized costs. In evaluating the recoverability of capitalized costs, the assessment of expected product performance utilizes forecasted sales amounts and estimates of additional costs to be incurred. If revised forecasted or actual product sales are less than, and/or revised forecasted or actual costs are greater than, the original forecasted amounts utilized in the initial recoverability analysis, the net realizable value may be lower than originally estimated in any given quarter, which could result in an impairment charge. Additionally, as noted above, as many of our intellectual property licenses extend for multiple products over multiple years, we also assess the recoverability of capitalized intellectual property license costs based on certain qualitative factors such as the success of other products and/or entertainment vehicles utilizing the intellectual property, whether there are any*

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*future planned theatrical releases or television series based on the intellectual property and the rights holder's continued promotion and exploitation of the intellectual property. Material differences may result in the amount and timing of charges for any period if management makes different judgments or utilizes different estimates in evaluating these qualitative factors.*



*Amortizable Intangible Assets*

Intangible assets subject to amortization are carried at cost less accumulated amortization. Amortizable intangible assets consist of internally developed franchises, acquired developed software, acquired game engines, favorable leases and



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distribution agreements, and other intangibles related primarily to licensing activities and retail customer relationships. Intangible assets subject to amortization are amortized over the estimated useful life in proportion to the pattern in which the economic benefits are consumed, which for some intangibles assets are approximated by using the straight-line method. Long-lived assets including amortizable intangible assets are reviewed for impairment in accordance with Statement of Financial Accounting Standards No. 144, Accounting for the Impairment or Disposal of Long-lived Assets ( SFAS No. 144 ) whenever events or changes in circumstances indicate that the carrying amount of such assets may not be recoverable. Determination of recoverability is based on an estimate of undiscounted future cash flows resulting from the use of the asset and its eventual disposition. Measurement of any impairment loss for long-lived assets and amortizable intangible assets is based on the amount by which the carrying value exceeds the fair value of the asset.

*Stock-based Compensation Expense*

We account for stock-based compensation in accordance with SFAS No. 123R. SFAS No. 123R requires companies to estimate the fair value of share-based payment awards on the measurement date using an option-pricing model. The value of the portion of the award that is ultimately expected to vest is recognized as expense over the requisite service periods in our Consolidated Statement of Operations (see Note 17 to the Consolidated Financial Statements for additional information.)

We estimate the value of employee stock options on the date of grant using a binomial-lattice model. The fair value of a share-based payment as of the grant date estimated by an option pricing model depends upon our future stock price as well as assumptions concerning expected volatility, risk-free interest rate, and risk-adjusted stock return, as well as measures of employees' forfeiture, exercise, and post-vesting termination behavior. Statistical methods were used to estimate employee type specific termination rates. These termination rates, in turn, were used to model the number of options that are expected to vest and post-vesting termination behavior. Employee type specific estimates of ETTE were used to reflect employee exercise behavior. ETTE was estimated by using statistical procedures to first estimate the conditional probability of exercise occurring during each time period, conditional on the option surviving to that time period. These probabilities were then used to estimate ETTE. The model was calibrated by adjusting parameters controlling exercise and post-vesting termination behavior so that the measures output by the model matched values of these measures that were estimated from historical data. The weighted-average estimated value of employee stock options granted during the three months ended September 30, 2008 was \$6.59 per share using the binomial-lattice model with the following weighted-average assumptions:

	<b>Three months ended September 30, 2008</b>
Expected volatility	50.61%
Risk-free interest rate	4.03%
Expected dividends	

To estimate volatility for the binomial-lattice model, we use methods or capabilities that are discussed in SFAS No. 123R and SAB No. 107. These methods included the implied volatility method based upon the volatilities for exchange-traded options on our stock to estimate short-term volatility, the historical method (annualized standard deviation of the instantaneous returns on Activision Blizzard's stock) during the option's contractual term to estimate long-term volatility and a statistical model to estimate the transition or mean reversion from short-term volatility to long-term volatility. Based on these methods, for options granted during the three months ended September 30, 2008, the expected stock price volatility ranged from 46.15% to 51.42%, with a weighted-average volatility of 50.61% for options granted during the quarter ended September 30, 2008.

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As was the case for volatility, the risk-free rate is assumed to change during the option's contractual period. As required by a binomial-lattice model, the risk-free rate reflects the interest from one time period to the next (forward rate) as opposed to the interest rate from the grant date to the given time period (spot rate). Since we do not currently pay dividends and do not currently expect to pay them in the future, we have assumed that the dividend yield is zero.

The expected life of employee stock options represents the weighted-average period the stock options are expected to remain outstanding and is, as required by SFAS No. 123R, output by the binomial-lattice model. The expected life of employee stock options depends on all of the underlying assumptions and calibration of our model. The binomial-lattice model assumes that employees will exercise options when the stock price equals or exceeds an exercise boundary. The exercise boundary is not constant but continually declines as one approaches the option's expiration date. The exact placement of the exercise boundary depends on all of the model inputs as well as the measures that were used to calibrate the model to estimated measures of employees' exercise and termination behavior.

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Stock-based compensation expense recognized in the Consolidated Statement of Operations is based on awards ultimately expected to vest and has been reduced for estimated forfeitures. SFAS No. 123R requires forfeitures to be estimated at the time of grant and revised, if necessary, in subsequent periods if actual forfeitures differ from those estimates.

If factors change and we employ different assumptions in the application of SFAS No. 123R in future periods, the compensation expense that we record under SFAS No. 123R may differ significantly from what we have recorded in the current period.

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**Selected Consolidated Statements of Operations Data**

The following table sets forth certain Consolidated Statements of Operations data for the periods indicated as a percentage of total net revenues and also breaks down net revenues by territory, and platform. (amounts in millions):

	Three months ended September 30,				Nine months ended September 30,							
	2008		2007		2008		2007					
<b>Net Revenues:</b>												
Product sales	\$	413	58%	\$	98	30%	\$	553	40%	\$	246	27%
Subscription, licensing, and other revenues		298	42		228	70		834	60		650	73
Total net revenues		711	100		326	100		1,387	100		896	100
<b>Costs and expenses:</b>												
Cost of sales product costs		279	39		31	9		350	25		95	10
Cost of sales software royalties and amortization		50	7		5	2		88	6		14	2
Cost of sales intellectual property licenses		36	5		1			45	3		5	1
Cost of sales MMOG		43	6		40	12		123	9		146	16
Product development		200	28		117	36		414	30		327	36
Sales and marketing		142	20		46	14		220	16		105	12
Restructuring costs		61	9					61	4		(1)	
General and administrative		94	13		29	9		172	13		71	8
Total costs and expenses		905	127		269	82		1,473	106		762	85
Operating income (loss)		(194)	(27)		57	18		(86)	(6)		134	15
Investment income (loss), net		24	3		(2)	(1)		28	2		(5)	(1)
Income before income tax provision (benefit)		(170)	(24)		55	17		(58)	(4)		129	14
Income tax provision (benefit)		(62)	(9)		7	2		(22)	(1)		(12)	(2)
Net income (loss)	\$	(108)	(15)%	\$	48	15%	\$	(36)	(3)%	\$	141	16%
<b>Net Revenues by Territory:</b>												
North America	\$	295	41%	\$	147	45%	\$	591	43%	\$	422	47%
Europe		348	49		122	37		627	45		374	42
Asia Pacific		62	9		54	17		153	11		91	10
Total territory net revenues		705	99		323	99		1,371	99		887	99
Activision Blizzard's non-core exit operations		6	1		3	1		16	1		9	1
Total net revenues	\$	711	100%	\$	326	100%	\$	1,387	100%	\$	896	100%

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Net Revenues by Platform												
Mix:												
MMOG	\$	271	38%	\$	269	83%	\$	828	60%	\$	746	84%
Console		272	38		16	5		335	24		53	6
Hand-held		81	11		7	2		102	7		21	2
PC		25	4		31	9		50	4		67	7
Total platform net revenues		649	91		323	99		1,315	95		887	99
Distribution:												
Software		39	6					39	3			
Hardware and peripherals		16	2					16	1			
Other		1						1	0			
Total distribution net revenues		56	8					56	4			
Activision Blizzard's non-core exit operations		6	1		3	1		16	1		9	1
Total net revenues	\$	711	100%	\$	326	100%	\$	1,387	100%	\$	896	100%

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	Three months ended September 30,			Nine months ended September 30,		
	2008	2007	Increase/ (Decrease)	2008	2007	Increase/ (Decrease)
<b>Net revenues:</b>						
Activision	\$ 364	\$ 43	\$ 321	\$ 457	\$ 108	\$ 349
Blizzard	297	249	48	866	856	10
Distribution	56		56	56		56
Activision Blizzard's core operations	717	292	425	1,379	964	415
Activision Blizzard's non-core exit operations	6	3	3	16	9	7
Reportable segments total	\$ 723	\$ 295	\$ 428	\$ 1,395	\$ 973	\$ 422
<b>Reconciliation to consolidated net revenues:</b>						
Net effect from deferral net revenues	(12)	31		(8)	(77)	
Consolidated net revenues	\$ 711	\$ 326		\$ 1,387	\$ 896	
<b>Segment income (loss) from operations:</b>						
Activision	\$ (26)	\$ (19)	\$ (7)	\$ (61)	\$ (79)	\$ 18
Blizzard	146	132	14	447	447	
Distribution	2		2	3		3
Activision Blizzard's core operations	122	113	9	389	368	21
Activision Blizzard's non-core exit operations	(110)	(40)	(70)	(251)	(86)	(165)
Reportable segments total	\$ 12	\$ 73	(61)	\$ 138	\$ 282	(144)
<b>Reconciliation to consolidated operating income (loss):</b>						
Net effect from deferral of net revenues and costs of sales	(12)	28		(7)	(67)	
Stock-based compensation expenses	(26)	(43)		(47)	(77)	
Restructuring expenses	(61)			(61)	(1)	
Amortization of intangible assets and purchase price accounting related adjustments	(90)	(1)		(92)	(3)	
Integration and restructuring costs	(17)			(17)		
Total consolidated operating income (loss)	\$ (194)	\$ 57		\$ (86)	\$ 134	

Total reportable segments net revenues increased by \$428 million and \$422 million for the three and nine months ended September 30, 2008, respectively, when compared to the same periods ended September 30, 2007. The increase was mainly attributable to:

- The consummation of the Business Combination, which resulted in revenues from Activision, Inc. being included from the date of the Business Combination but not for prior periods;

- The current quarter release of an affiliated LucasArts title, *Star Wars: The Force Unleashed*, in Europe and Asia Pacific, *The Mummy: Tomb of the Dragon of the Emperor*, and several other value Wii titles releases such as *Little League World Series Baseball 2008*, *Ferrari Challenge Trofeo Pirelli*, and *Rapala Fishing Frenzy*;
- The first six months of calendar 2008 releases of *Spiderwick* and *The Bourne Conspiracy* versus no new releases for the same periods of calendar 2007;
- Activision's catalog sales of *Guitar Hero III: Legends of Rock*, *Guitar Hero: Aerosmith*, *Guitar Hero: On Tour*, *Call of Duty: Modern Warfare* and *Kung Fu Panda* contributed the majority of Activision net revenues for the three months ended September 30, 2008;
- The worldwide number of *World of Warcraft* subscribers increased, which is mainly attributable to the release of the first expansion pack of *World of Warcraft The Burning Crusade* in January 2007 which also led to the higher box sales of *World of Warcraft*, and additional value added services by Blizzard; and
- International net revenues were impacted by a year over year weakening of the U.S. Dollar in relation to GBP, EUR and AUD. We estimate that foreign exchange rates increased reported consolidated net revenues by approximately \$4 million and \$9 million for the three and nine months ended September 30, 2008, respectively.

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For the three and nine months ended September 30, 2007 (which was prior to consummation of the Business Combination), Activision, Inc.'s revenues from its Publishing segment were \$254 million and \$892 million, respectively, and Vivendi Games' revenues from what is now the Company's Activision segment were \$43 million and \$108 million, respectively. For the three and nine months ended September 30, 2008, the Company's Activision segment reported revenues of \$364 million, which does not include \$35 million of revenues recorded by Activision Inc.'s Publishing segment during the period from July 1, 2008 until consummation of the Business Combination of July 9, 2008 and \$1,092 million for the six months ended June 30, 2008. The year-over-year increase in revenue was primarily due to the increased number of skus for Guitar Hero franchises, and the success of *Call of Duty: Modern Warfare*.

For the three and nine months ended September 30, 2007 (which was prior to consummation of the Business Combination), Activision, Inc.'s revenues from its Distribution segment were \$64 million and \$234 million, respectively. For the three and nine months ended September 30, 2008, the Company's Distribution segment reported revenues of \$56 million, which does not include \$18 million of revenues recorded by Activision Inc.'s Distribution segment during the period from July 1, 2008 until consummation of the Business Combination of July 9, 2008 and \$165 million for the six months ended June 30, 2008. The slight increase year-over-year was mainly attributable to a year over year weakening of the U.S. Dollar in relation to Euros. The increase in Activision net revenue contributed to the increase, partially offset by approximately \$2 million due to foreign exchange rates.

Total segment operating income for the three and nine months ended September 30, 2008 were driven by the following:

- The increase in net revenues of Activision Blizzard's core operations as previously noted; and
- The consummation of the Business Combination, which resulted in operating income (losses) from Activision, Inc. being included from the date of the Business Combination but not for prior periods.

Partially offset by

- The segment operating losses from Activision Blizzard's non-core exit operations that the Company has begun to exit or wind down; and
- Write off of capitalized software development costs of totaling \$61 million and \$71 million for the three and nine months ended September 30, 2008, respectively, as a result of the rationalization of our title portfolio.

*Cash Flow Highlights (amounts in millions)*



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	For the nine months ended September 30, 2008	For the nine months ended September 30, 2007	Increase/ (Decrease)
Cash flows provided by operating activities	\$ 125	\$ 308	\$ (183)
Cash flows provided by (used in) investing activities	1,078	(45)	1,123
Cash flows provided by (used in) financing activities	1,607	(294)	1,901

For the nine months ended September 30, 2008, the following major cash activities occurred:

- Activision, Inc. cash and cash equivalents of approximately \$1.1 billion was transferred to Activision Blizzard upon the Business Combination;
- Upon the Business Combination, Vivendi purchased 126 million shares of our common stock for \$1.7 billion, and as specified in the Business Combination Agreement, Activision Blizzard returned capital to Vivendi of approximately \$79 million and settled balances with Vivendi of approximately \$79 million in the financing activities;
- We have received net proceeds from exercises of stock options and ESPP amounting to \$19 million during the current quarter; and
- We have paid the participants in the BEP \$106 million as a result of the Business Combination.

On November 5, 2008, we announced that our Board of Directors authorized a stock repurchase program under which we may repurchase up to \$1 billion of our common stock. Under this program, we may repurchase our common stock from time

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to time on the open market or in private transactions, including structured or accelerated transactions. We will determine the timing and amount of repurchases based on our evaluation of market conditions and other factors. The repurchase program may be suspended or discontinued by the Company at any time.

**Results of Operations Three and Nine Months Ended September 30, 2008 and 2007**

**Special Note** - The consummation of the Business Combination has resulted in financial information of Activision, Inc. being included from the date of the Business Combination (i.e. from July 9, 2008 onwards) but not for prior periods.

*Net Revenues*

We primarily derive revenue from sales of packaged interactive software games designed for play on video game consoles (such as the PS3, PS2, Xbox360, and Wii), PCs, and hand-held game devices (such as the NDS, and PSP) as well as from subscriptions revenues (which consists of fees from individuals playing *World of Warcraft*, and other ancillary online revenues). We also derive revenue from our distribution business in Europe, which provides logistical and sales services to third-party publishers of interactive entertainment software, to our own publishing operations, and to third-party manufacturers of interactive entertainment hardware. The following table shows the three months segments total net revenues (amounts in millions):

	Three months ended September 30,		
	2008	2007	Increase/ (Decrease)
Activision	\$ 364	\$ 43	\$ 321
Blizzard	297	249	48
Distribution	56		56
Activision Blizzard's core operations	717	292	425
Activision Blizzard's non-core exit operations	6	3	3
Reportable segments total	\$ 723	\$ 295	\$ 428
Reconciliation to consolidated net revenues:			
Net effect from deferral net revenues	(12)	31	
Consolidated net revenues	\$ 711	\$ 326	

Segments total net revenues for the three months ended September 30, 2008 increased by \$428 million. The increase was primarily due to:

- The consummation of the Business Combination, which resulted in revenues from Activision, Inc. being included from the date of the Business Combination but not for prior periods;

- Increase in subscription and licensing revenues as a result of the increased number of *World of Warcraft* subscribers, and additional value-added services; and
- Current quarter release of an affiliated LucasArts title, *Star Wars: The Force Unleashed*, in Europe and Asia Pacific, the release of *The Mummy: Tomb of the Dragon Emperor*, several other value Wii title releases, such as *Little League World Series Baseball 2008*, *Ferrari Challenge Trofeo Pirelli*, and *Rapala Fishing Frenzy*, and also the continued momentum of Activision's catalog sales of *Guitar Hero III: Legends of Rock*, *Guitar Hero: Aerosmith*, *Guitar Hero: On Tour*, *Call of Duty: Modern Warfare* and *Kung Fu Panda* which contributed to the current quarter product sales.

The following table shows the nine months segments total net revenues (amounts in millions):

	Nine months ended September 30,		
	2008	2007	Increase/ (Decrease)
Activision	\$ 457	\$ 108	\$ 349
Blizzard	866	856	10
Distribution	56		56
Activision Blizzard's core operations	1,379	964	415
Activision Blizzard's non-core exit operations	16	9	7
Reportable segments total	\$ 1,395	\$ 973	\$ 422
Reconciliation to consolidated net revenues:			
Net effect from deferral net revenues	(8)	(77)	
Consolidated net revenues	\$ 1,387	\$ 896	

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Segment total net revenues for the nine months ended September 30, 2008 increased by \$422 million as compared to the same period of prior year. The increase was mainly due to:

- The consummation of the Business Combination, which resulted in revenues from Activision, Inc. being included from the date of the Business Combination but not for prior periods;
- An increase in product sales from the catalog sales of *Guitar Hero III: Legends of Rock*, *Guitar Hero: Aerosmith*, *Guitar Hero: On Tour*, *Call of Duty: Modern Warfare*, and *Kung Fu Panda*. *Spiderwick* and *The Bourne Conspiracy* also contributed to the product sales for the nine months ended September 30, 2008. This compares to the first nine months of 2007 when product sales were primarily from the boxed sales of *World of Warcraft* and *World of Warcraft The Burning Crusade*, as well as sales from the back catalog franchise of *F.E.A.R.*, and initial sales of the action-strategy game *World in Conflict*; and
- Increase in subscription and licensing revenues due to increase in the number of *World of Warcraft* subscribers, and additional value added services.

The following table details our consolidated net revenues by territory for the three months ended September 30, 2008 and 2007 (amounts in millions):

	Three months ended September			Increase/ (Decrease)
	2008	30, 2007	2007	
Territory net revenues				
North America	\$ 295	\$ 147	\$ 148	
Europe	292	122	170	
Asia Pacific	62	54	8	
Total Territory net revenues	649	323	326	
Distribution net revenues	56		56	
Activision Blizzard's non-core exit operations	6	3	3	
Consolidated net revenues	\$ 711	\$ 326	\$ 385	

Geographically, all regions recorded an increase in net revenues as compared to the same period of prior year. The increase was primarily attributable to the following:

- The consummation of the Business Combination, which resulted in revenues from Activision, Inc. being included from the date of the Business Combination but not for prior periods;

- Back catalog sales of *Guitar Hero III: Legends of Rock*, *Guitar Hero: Aerosmith*, *Guitar Hero: On Tour*, *Call of Duty: Modern Warfare* and *Kung Fu Panda*;
- The release of an affiliated LucasArts title, *Star Wars: The Force Unleashed* in the current quarter in Europe and Asia Pacific; and
- Increase in the number of *World of Warcraft* subscribers, and additional value added services.

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The following table details our consolidated net revenues by territory for the nine months ended September 30, 2008 and 2007 (amounts in millions):

	<b>Nine months ended September 30, 2008</b>	<b>2007</b>	<b>Increase/ (Decrease)</b>
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