

MAJESCO ENTERTAINMENT CO

Form 10-Q

September 10, 2012

**UNITED STATES**

**SECURITIES AND EXCHANGE COMMISSION**

**WASHINGTON, D.C. 20549**

**FORM 10-Q**

**QUARTERLY REPORT**

**PURSUANT TO SECTION 13 OR 15(d) OF THE**

**SECURITIES EXCHANGE ACT OF 1934**

**For the quarterly period ended July 31, 2012**

**Commission File No. 000-51128**

**Majesco Entertainment Company**

(Exact name of registrant as specified in its charter)

DELAWARE                      06-1529524  
(State or Other Jurisdiction of (I.R.S. Employer  
Incorporation or Organization) Identification No.)

**160 Raritan Center Parkway, Edison, NJ 08837**

(Address of principal executive offices)

Registrant's Telephone Number, Including Area Code: **(732) 225-8910**

(Former Name, Former Address and Former Fiscal Year, if Changed Since Last Report)

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 R No ☒

Indicate by check mark whether the registrant has submitted electronically and posted on its corporate Web site, if any, every Interactive Data File required to be submitted and posted pursuant to Rule 405 of Regulation S-T (232.4.05 of this chapter) during the preceding 12 months (or for such shorter period that the registrant was required to submit and post such files). Yes R 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 ☐ Smaller reporting company ☐  
(Do not check if a smaller reporting company)

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

As of September 4, 2012, there were 41,849,154 shares of the Registrant's common stock outstanding.

**MAJESCO ENTERTAINMENT COMPANY AND SUBSIDIARY**

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**PART I. FINANCIAL INFORMATION****Item 1. Financial Statements****MAJESCO ENTERTAINMENT COMPANY AND SUBSIDIARY****CONDENSED CONSOLIDATED BALANCE SHEETS****(In thousands, except share amounts)**

|   | <b>July 31,<br/>2012<br/>(unaudited)</b> | <b>October 31,<br/>2011</b> |
|---|--|-----------------------------|
| <b>ASSETS</b>   |  |                             |
| Current assets:   |  |                             |
| Cash and cash equivalents   | \$ 27,292                                | \$ 13,689                   |
| Due from factor, net  | -  | 937                         |
| Accounts and other receivables, net   | 3,347                                    | 3,143                       |
| Inventory, net  | 6,052                                    | 11,605                      |
| Advance payments for inventory  | 1,465                                    | 5,975                       |
| Capitalized software development costs and license fees, net  | 7,667                                    | 12,564                      |
| Prepaid expenses and other current assets   | 599                                      | 3,071                       |
| Total current assets  | 46,422                                   | 50,984                      |
| Property and equipment, net   | 1,029                                    | 1,184                       |
| Other assets  | 159                                      | 209                         |
| Total assets  | \$ 47,610                                | \$ 52,377                   |
| <b>LIABILITIES AND STOCKHOLDERS' EQUITY</b>   |  |                             |
| Current liabilities:  |  |                             |
| Accounts payable and accrued expenses   | \$ 14,591                                | \$ 20,313                   |
| Inventory financing payable   | -  | 1,238                       |
| Advances from customers and deferred revenue  | 227                                      | 5,642                       |
| Due to factor   | 650                                      | -                           |
| Warrant liability   | 363                                      | -                           |
| Total current liabilities   | 15,831                                   | 27,193                      |
| Warrant liability   | -  | 1,949                       |
| Commitments and contingencies   |  |                             |
| Stockholders' equity:   |  |                             |
| Common stock — \$.001 par value; 250,000,000 shares authorized; 41,364,549 and 41,307,349 shares issued and outstanding at July 31, 2012 and October 31, 2011, respectively | 41                                       | 41                          |
| Additional paid-in capital  | 120,496                                  | 119,222                     |

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|  |           |           |
|--|-----------|-----------|
| Accumulated deficit                        | (88,159 ) | (95,501 ) |
| Accumulated other comprehensive loss       | (599 )    | (527 )    |
| Net stockholders' equity                   | 31,779    | 23,235    |
| Total liabilities and stockholders' equity | \$ 47,610 | \$ 52,377 |

See accompanying notes

**MAJESCO ENTERTAINMENT COMPANY AND SUBSIDIARY****CONDENSED CONSOLIDATED STATEMENTS OF OPERATIONS****(Unaudited, in thousands, except share amounts)**

|   | <b>Three Months Ended</b> |            | <b>Nine months Ended</b> |            |
|---|---------------------------|------------|--------------------------|------------|
|   | <b>July 31</b>            |            | <b>July 31</b>           |            |
|   | 2012                      | 2011       | 2012                     | 2011       |
| Net revenues  | \$9,145                   | \$19,545   | \$105,725                | \$100,154  |
| Cost of sales   |                           |            |                          |            |
| Product costs   | 2,632                     | 8,577      | 35,563                   | 42,681     |
| Software development costs and license fees   | 2,997                     | 3,015      | 31,461                   | 16,237     |
|   | 5,629                     | 11,592     | 67,024                   | 58,918     |
| Gross profit  | 3,516                     | 7,953      | 38,701                   | 41,236     |
| Operating costs and expenses  |                           |            |                          |            |
| Product research and development  | 1,912                     | 1,947      | 5,890                    | 5,150      |
| Selling and marketing   | 2,684                     | 2,313      | 16,356                   | 11,952     |
| General and administrative  | 2,392                     | 2,484      | 8,088                    | 8,089      |
| Loss on impairment of software development costs and license fees – cancelled games | -                         | 150        | 1,219                    | 1,512      |
| Depreciation and amortization   | 141                       | 121        | 448                      | 223        |
|   | 7,129                     | 7,015      | 32,001                   | 26,926     |
| Operating income (loss)   | (3,613)                   | ) 938      | 6,700                    | 14,310     |
| Other expenses (income)   |                           |            |                          |            |
| Interest and financing costs, net   | 102                       | 123        | 765                      | 1,077      |
| Change in fair value of warrant liability   | (594)                     | ) (1,258)  | ) (1,586)                | ) 2,085    |
| Income (loss) before income taxes   | (3,121)                   | ) 2,073    | 7,521                    | 11,148     |
| Income taxes  | (34)                      | ) 184      | 179                      | 421        |
| Net income (loss)   | \$(3,087)                 | ) \$1,889  | \$7,342                  | \$10,727   |
| Net income (loss) per share:  |                           |            |                          |            |
| Basic   | \$(0.08)                  | ) \$0.05   | \$0.18                   | \$0.28     |
| Diluted   | \$(0.08)                  | ) \$0.05   | \$0.18                   | \$0.27     |
| Weighted average shares outstanding:  |                           |            |                          |            |
| Basic   | 39,893,133                | 38,803,090 | 39,883,365               | 38,165,521 |
| Diluted   | 39,893,133                | 41,318,806 | 41,016,631               | 39,827,022 |

See accompanying notes

**MAJESCO ENTERTAINMENT COMPANY AND SUBSIDIARY****CONDENSED CONSOLIDATED STATEMENTS OF CASH FLOWS****(Unaudited, in thousands)**

|   | <b>Nine months Ended</b> |             |
|---|--------------------------|-------------|
|   | <b>July 31,</b>          |             |
|   | <b>2012</b>              | <b>2011</b> |
| <b>CASH FLOWS FROM OPERATING ACTIVITIES</b>                                       |                          |             |
| Net income  | \$ 7,342                 | \$ 10,727   |
| Adjustments to reconcile net income to net cash provided by operating activities: |                          |             |
| Depreciation and amortization   | 448                      | 223         |
| Change in fair value of warrant liability   | (1,586 )                 | 2,085       |
| Non-cash compensation expense   | 1,301                    | 1,064       |
| Provision for price protection  | 3,211                    | 2,380       |
| Amortization of capitalized software development costs and license fees           | 11,103                   | 3,467       |
| Loss on impairment of software development costs and license fees                 | 1,219                    | 1,512       |
| Provision for excess inventory  | 27                       | 1,612       |
| Changes in operating assets and liabilities, net of acquisition:                  |                          |             |
| Due from/to factor  | (2,500 )                 | (2,786 )    |
| Accounts and other receivables, net   | 631                      | (1,987 )    |
| Inventory   | 5,526                    | 2,199       |
| Capitalized software development costs and license fees                           | (7,378 )                 | (9,420 )    |
| Advance payments for inventory  | 4,467                    | 4,888       |
| Prepaid expenses and other assets   | 2,472                    | 261         |
| Accounts payable and accrued expenses   | (5,769 )                 | 753         |
| Advances from customers and deferred revenue                                      | (5,367 )                 | (376 )      |
| Net cash provided by operating activities   | 15,147                   | 16,602      |
| <b>CASH FLOWS FROM INVESTING ACTIVITIES</b>                                       |                          |             |
| Purchases of property and equipment   | (244 )                   | (396 )      |
| Purchase of assets of Quick Hit, Inc., net of acquired cash                       | -                        | (800 )      |
| Net cash used in investing activities   | (244 )                   | (1,196 )    |
| <b>CASH FLOWS FROM FINANCING ACTIVITIES</b>                                       |                          |             |
| Repayment of inventory financing  | (1,237 )                 | (5,557 )    |
| Proceeds from exercise of warrants  | -                        | 1,824       |
| Restricted shares withheld for employee taxes                                     | (27 )                    | -           |
| Net cash used in financing activities   | (1,264 )                 | (3,733 )    |
| Effect of exchange rates on cash and cash equivalents                             | (36 )                    | (3 )        |
| Net increase in cash and cash equivalents   | 13,603                   | 11,670      |
| Cash and cash equivalents — beginning of period                                   | 13,689                   | 8,004       |
| Cash and cash equivalents — end of period   | \$ 27,292                | \$ 19,674   |
| <b>SUPPLEMENTAL SCHEDULE OF NON-CASH INVESTING AND FINANCING ACTIVITIES</b>       |                          |             |
| Landlord-provided leasehold improvements  | \$ -                     | \$ 163      |

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|  |        |          |
|--|--------|----------|
| Warrant liability reclassified to additional paid-in capital upon exercise | \$ -   | \$ 1,042 |
| SUPPLEMENTAL CASH FLOW INFORMATION   |        |          |
| Cash paid during the year for interest and financing costs                 | \$ 715 | \$ 1,078 |
| Cash paid during the year for income taxes                                 | \$ 565 | \$ -     |

See accompanying notes



## **MAJESCO ENTERTAINMENT COMPANY AND SUBSIDIARY**

### **NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS**

**(Unaudited, in thousands, except share and per-share amounts)**

#### **1. PRINCIPAL BUSINESS ACTIVITY AND BASIS OF PRESENTATION**

The accompanying financial statements present the financial results of Majesco Entertainment Company and Majesco Europe Limited, its wholly-owned subsidiary, (“Majesco” or the “Company”) on a consolidated basis.

The Company is a provider of video game products primarily for the casual-game consumer. It sells its products primarily to large retail chains, specialty retail stores, and distributors. It publishes video games for major current generation interactive entertainment hardware platforms, including Nintendo’s DS, DSi, 3DS and Wii, Sony’s PlayStation 3, or PS3, Microsoft’s Xbox 360 and the personal computer, or PC. It also publishes games for digital platforms such as Xbox Live Arcade and PlayStation Network, or PSN, and mobile platforms such as iPhone, iPad and iPod Touch, as well as online platforms such as Facebook and Zynga.com.

The Company’s video game titles are targeted at various demographics at a range of price points. Due to the larger budget requirements for developing and marketing premium console titles for core gamers, the Company focuses on publishing casual games targeting casual-game consumers. In some instances, its titles are based on licenses of well-known properties and, in other cases based on original properties. The Company enters into agreements with content providers and video game development studios for the creation of its video games.

The Company’s operations involve similar products and customers worldwide. These products are developed and sold domestically and internationally. The Company may also enter into agreements with licensees, particularly for sales of its products internationally. The Company is centrally managed and its chief operating decision makers, the chief executive and other officers, use consolidated and other financial information supplemented by sales information by product category, major product title and platform for making operational decisions and assessing financial performance. Accordingly, the Company operates in a single segment.

#### *Geographic regions*

Net revenues by geographic region were as follows:

|               | Three Months Ended July 31, |     |          |     | Nine months Ended July 31, |     |           |     |
|---------------|-----------------------------|-----|----------|-----|----------------------------|-----|-----------|-----|
|               | 2012                        | %   | 2011     | %   | 2012                       | %   | 2011      | %   |
| United States | \$7,169                     | 78  | \$14,214 | 73  | \$80,516                   | 76  | \$91,425  | 91  |
| Europe        | 1,976                       | 22  | 5,331    | 27  | 25,209                     | 24  | 8,729     | 9   |
| Total         | \$9,145                     | 100 | \$19,545 | 100 | \$105,725                  | 100 | \$100,154 | 100 |

The accompanying interim condensed consolidated financial statements of the Company are unaudited, but in the opinion of management, reflect all adjustments, consisting of normal recurring accruals, necessary for a fair presentation of the results for the interim period. Accordingly, they do not include all information and notes required by generally accepted accounting principles for complete financial statements. The Company's financial results are impacted by the seasonality of the retail selling season and the timing of the release of new titles. The results of operations for interim periods are not necessarily indicative of results to be expected for the entire fiscal year. The balance sheet at October 31, 2011 has been derived from the audited financial statements at that date but does not include all of the information and footnotes required by accounting principles generally accepted in the United States of America for complete financial statements. These interim condensed consolidated financial statements should be read in conjunction with the Company's consolidated financial statements and notes thereto for the year ended October 31, 2011 filed with the Securities and Exchange Commission on Form 10-K on January 17, 2012.

## 2. SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES

*Revenue Recognition.* The Company recognizes revenue upon the shipment of its products when: (1) title and the risks and rewards of ownership are transferred; (2) persuasive evidence of an arrangement exists; (3) there are no continuing obligations to the customer; and (4) the collection of related accounts receivable is probable. Certain products are sold to customers with a street date (the earliest date these products may be resold by retailers). Revenue for sales of these products is not recognized prior to their street date. Some of the Company's software products provide limited online features at no additional cost to the consumer. Generally, such features have been considered to be incidental to the Company's overall product offerings and an inconsequential deliverable. Accordingly, the Company does not defer any revenue related to products containing these limited online features. However, in instances where online features or additional functionality is considered a substantive deliverable in addition to the software product, such characteristics will be taken into account when applying the Company's revenue recognition policy.

The Company generally sells its products on a no-return basis, although in certain instances, the Company provides price protection or other allowances on certain unsold products. Price protection, when granted and applicable, allows customers a partial credit against amounts they owe the Company with respect to merchandise unsold by them. Revenue is recognized, and accounts receivable is presented, net of estimates of these allowances.

The Company estimates potential future product price protection and other allowances related to current period product revenue. The Company analyzes historical experience, current sell through of retailer inventory of the Company's products, current trends in the video game market, the overall economy, changes in customer demand and acceptance of the Company's products and other related factors when evaluating the adequacy of price protection and other allowances.

Sales incentives or other consideration given by the Company to customers that are considered adjustments of the selling price of its products, such as rebates and product placement fees, are reflected as reductions of revenue. Sales incentives and other consideration that represent costs incurred by the Company for benefits received, such as the appearance of the Company's products in a customer's national circular ad, are reflected as selling and marketing expenses, in accordance with Accounting Standards Codification ("ASC") 605-50, *Customer Payments and Incentives*.

In addition, some of the Company's software products are sold exclusively as downloads of digital content for which the consumer takes possession of the digital content for a fee. Revenue from product downloads is generally recognized when the download is made available (assuming all other recognition criteria are met).

The Company operates hosted online games in which players can play for free and purchase virtual goods for use in the games. We recognize revenues from the sale of virtual goods as service revenues over the estimated period in which players use the goods in the game. We currently estimate these periods of use to be three to four months. We will periodically assess our estimates for this period of use and future increases or decreases in these estimates will affect our recognized revenues prospectively. We also recognize advertising revenue related to advertising placed on our game sites as ads are served. The Company has not earned significant revenue to date related to its online games.

The Company records revenue for distribution agreements where it is acting as an agent as defined by ASC Topic 605, *Revenue Recognition, Subtopic 45, Principal Agent Considerations*, on a net basis. When the Company enters into license or distribution agreements that provide for multiple copies of games in exchange for guaranteed amounts, revenue is recognized in accordance with the terms of the agreements, generally upon delivery of a master copy, assuming our performance obligations are complete, the license term commences and all other recognition criteria are met, or as per-copy royalties are earned on sales of games.

In certain instances, customers and distributors provide the Company with cash advances on their orders. These advances are then applied against future sales to these customers. Advances are classified as advances from customers and deferred revenue in the accompanying condensed consolidated balance sheet. Included in advances from customers and deferred revenue are \$195 and \$642, as of July 31, 2012 and October 31, 2011, respectively, primarily related to up-front payments received under license agreements for Europe.

*Inventory.* Inventory is stated at the lower of cost as determined by the first-in, first-out method, or market. The Company estimates the net realizable value of slow-moving inventory on a title-by-title basis and charges the excess of cost over net realizable value to cost of sales. Such estimates may change and additional charges may be incurred until the related inventory items are sold.

*Capitalized Software Development Costs and License Fees.* Software development costs include fees in the form of milestone payments made to independent software developers and licensors. Software development costs are capitalized once technological feasibility of a product is established and management expects such costs to be recoverable against future revenues. For products where proven game engine technology exists, this may occur early in the development cycle. Technological feasibility is evaluated on a product-by-product basis. Amounts related to software development that are not capitalized are charged immediately to product research and development costs. Commencing upon a related product's release capitalized costs are amortized to cost of sales based upon the higher of (i) the ratio of current revenue to total projected revenue or (ii) straight-line charges over the expected marketable life of the product.

Prepaid license fees represent license fees to owners for the use of their intellectual property rights in the development of the Company's products. Minimum guaranteed royalty payments for intellectual property licenses are initially recorded as an asset (prepaid license fees) and a current liability (accrued royalties payable) at the contractual amount upon execution of the contract or when specified milestones or events occur and when no significant performance remains with the licensor. Licenses are expensed to cost of sales at the higher of (i) the contractual royalty rate based on actual sales or (ii) an effective rate based upon total projected revenue related to such license. Capitalized software development costs are classified as non-current if they relate to titles for which the Company estimates the release date to be more than one year from the balance sheet date. No such costs are classified as non-current as of July 31, 2012 or October 31, 2011.

The amortization period for capitalized software development costs and prepaid license fees is usually no longer than one year from the initial release of the product. If actual revenues or revised forecasted revenues fall below the initial forecasted revenue for a particular license, the charge to cost of sales may be larger than anticipated in any given quarter. The recoverability of capitalized software development costs and prepaid license fees is evaluated quarterly based on the expected performance of the specific products to which the costs relate. When, in management's estimate, future cash flows will not be sufficient to recover previously capitalized costs, the Company expenses these capitalized costs to "cost of sales-software development costs and license fees," in the period such a determination is made. These expenses may be incurred prior to a game's release for games that have been developed. If a game is cancelled prior to completion of development and never released to market, the amount is expensed to general and administrative expenses. If the Company was required to write off capitalized software development costs and prepaid license fees, due to changes in market conditions or product acceptance, its results of operations could be materially adversely affected.

Costs of developing online free-to-play social games, including payments to third-party developers are expensed as research and development expenses. Revenue from these games is largely dependent on players' future purchasing behavior in the game and currently the Company cannot reliably project that future net cash flows from developed games will exceed related development costs.

Prepaid license fees and milestone payments made to the Company's third party developers are typically considered non-refundable advances against the total compensation they can earn based upon the sales performance of the products. Any additional royalty or other compensation earned beyond the milestone payments is expensed to cost of sales as incurred.

*Estimates.* The preparation of financial statements in conformity with accounting principles generally accepted in the United States of America requires management to make estimates and assumptions that affect the reported amounts of assets and liabilities or 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 periods. Among the more significant estimates included in these financial statements are price protection and customer allowances, the valuation of inventory, the recoverability of advance payments for software development costs and intellectual property licenses, and the valuation allowances for deferred tax benefits. Actual results could differ from those estimates.

*Income (Loss) Per Share.* Basic income (loss) per share of common stock is computed by dividing net income (loss) applicable to common stockholders by the weighted average number of shares of common stock outstanding for the period. Basic income (loss) per share excludes the impact of unvested shares of restricted stock issued as long term incentive awards to directors, officers and employees. Diluted income (loss) per share reflects the potential impact of common stock options and unvested shares of restricted stock and outstanding common stock purchase warrants that have a dilutive effect under the treasury stock method.

*Reclassifications.* For comparability, certain 2011 amounts have been reclassified, where appropriate, to conform to the financial statement presentation used in 2012.

*Commitments and Contingencies.* We are subject to claims and litigation in the ordinary course of our business. We record a liability for commitments and contingencies when the amount is both probable and reasonably estimable.

*Concentrations.* The Company develops and distributes video game software for proprietary platforms under licenses from Nintendo, Sony and Microsoft, which must be periodically renewed. The Company's agreements with these manufacturers also grant them certain control over the supply and manufacturing of the Company's products. In addition, for each of the three and nine months ended July 31, 2012, sales of the Company's Zumba Fitness games accounted for approximately 79% of net revenues, and for the three and nine months ended July 31, 2011, sales of the Company's Zumba Fitness games accounted for approximately 80% and 70% of net revenues, respectively. We license the rights to publish these games from a third party and have rights to publish other Zumba Fitness games. If the new versions are not successful, this may have a significant impact on our results of operations and cash flows.

#### ***Recent Accounting Pronouncements***

*Fair Value* — In May 2011, the FASB issued an update to ASC 820-10, *Measuring Liabilities at Fair Values*. The update to ASC 820-10 clarifies the application of fair value standards in certain circumstances and requires additional disclosures about fair value measurements within Level 3, including sensitivity to changes in unobservable inputs. The update will become effective for the Company on November 1, 2012. The Company is currently evaluating the potential impact of the update on its financial position, results of operations, and cash flows.

*Comprehensive Income* — In June 2011, the FASB issued an update to ASC 220, *Comprehensive Incomes*. The update to ASC 220 establishes standards for the reporting and presentation of comprehensive income. The update will become effective for the Company on November 1, 2012. Adoption of the update is not expected to have a material impact on the Company's financial position, results of operations, and cash flows.

### 3. FAIR VALUE

The table below segregates all financial assets and liabilities that are measured at fair value on a recurring basis into the most appropriate level within the fair value hierarchy based on the inputs used to determine the fair value at the measurement date.

|                             | July 31, 2012 | Quoted prices<br>in active<br>markets<br>for identical<br>assets<br>(level 1) | Significant<br>other<br>observable<br>inputs<br>(level 2) | Significant<br>unobservable<br>inputs<br>(level 3) |
|-----------------------------|---------------|---|---|--|
| Assets:                     |               |   |   |  |
| Money market funds          | \$ 27,048     | \$ 27,048   | \$ —  | \$ —   |
| Bank deposits               | \$ 244        | \$ 244  | \$ —  | \$ —   |
| Total financial assets      | \$ 27,292     | \$ 27,292   | \$ —  | \$ —   |
| Liabilities:                |               |   |   |  |
| Warrant liability           | \$ 363        | \$ —  | \$ —  | \$ 363   |
| Total financial liabilities | \$ 363        | \$ —  | \$ —  | \$ 363   |

The Company has outstanding warrants that may require settlement by transferring assets under certain change of control circumstances. These warrants are classified as liabilities in the accompanying condensed consolidated balance sheets. The warrants have an exercise price of \$2.04 per share and expire in March 2013. The Company measures the fair value of the warrants at each balance sheet date, using the Black-Scholes method, and a gain or loss is recorded in earnings each period as change in fair value of warrants.

Assumptions used to determine the fair value of the warrants were:

|                               | Three Months ended July 31, |               | Nine months ended July 31, |               |
|-------------------------------|-----------------------------|---------------|----------------------------|---------------|
|                               | 2012                        | 2011          | 2012                       | 2011          |
| Estimated fair value of stock | \$1.77-\$2.45               | \$2.45-\$3.75 | \$1.77-\$3.37              | \$0.62-\$3.75 |
| Expected warrant term         | 0.6-0.9 years               | 1.6-1.9 years | 0.6-1.4 years              | 1.6-2.4 years |
| Risk-free rate                | 0.1-0.2 %                   | 0.3-0.6 %     | 0.1-0.2 %                  | 0.3-0.8 %     |
| Expected volatility           | 77.9-79.0 %                 | 77.9-77.9 %   | 77.9-80.1 %                | 73.5-77.9 %   |
| Dividend yield                | 0 %                         | 0 %           | 0 %                        | 0 %           |

A summary of the changes to the Company's warrant liability, as measured at fair value on a recurring basis using significant unobservable inputs (Level 3) for the three and nine months ended July 31, 2012 and 2011 is presented

below:

|   | Three Months ended July 31, |          | Nine months ended July 31, |          |
|---|-----------------------------|----------|----------------------------|----------|
|   | 2012                        | 2011     | 2012                       | 2011     |
| Beginning balance                               | \$ 957                      | \$ 2,551 | \$ 1,949                   | \$ 144   |
| Warrants exercised                              | -                           | (106 )   | -                          | (1,042 ) |
| Total (gain) loss included in net income (loss) | (594 )                      | (1,258 ) | (1,586 )                   | 2,085    |
| Ending balance                                  | \$ 363                      | \$ 1,187 | \$ 363                     | \$ 1,187 |

The carrying value of accounts receivable, accounts payable and accrued expenses, due from/to factor, and advances from customers are reasonable estimates of their fair values because of their short-term maturity.

#### 4. DUE (TO) FROM FACTOR

Due (to) from factor consists of the following:

|  | July 31, October 31, |           |
|--|----------------------|-----------|
|  | 2012                 | 2011      |
| Outstanding accounts receivable sold to factor | \$4,742              | \$ 12,667 |
| Less: allowances                               | (5,383 )             | (6,952 )  |
| Less: advances from factor                     | (9 )                 | (4,778 )  |
|  | \$ (650 )            | \$ 937    |

Outstanding accounts receivable sold to the factor as of July 31, 2012 and October 31, 2011 for which the Company retained credit risk amounted to \$486 and \$2,046, respectively. As of July 31, 2012 and October 31, 2011, allowances for uncollectible accounts amounted to \$178 and \$0, respectively. Allowances include provisions for customer payments and incentives deductible in future periods.



A summary of the changes in price protection and other customer sales incentive allowances included as a reduction of the amounts due from factor is presented below:

|   | <b>Nine months Ended</b> |             |
|---|--------------------------|-------------|
|   | <b>July 31,</b>          |             |
|   | <b>2012</b>              | <b>2011</b> |
| Allowances — beginning of period                    | \$ (6,952 )              | \$ (3,298 ) |
| Provision for price protection                      | (3,211 )                 | (2,392 )    |
| Amounts charged against allowance and other changes | 4,780                    | 1,235       |
| Allowances — end of period                          | \$ (5,383 )              | \$ (4,455 ) |

## 5. ACCOUNTS AND OTHER RECEIVABLES

Accounts and other receivables consist of the following:

|  | <b>July 31,</b> | <b>October 31,</b> |
|--|-----------------|--------------------|
|  | <b>2012</b>     | <b>2011</b>        |
| Royalties receivable                           | \$ 997          | \$ 2,513           |
| Trade accounts receivable                      | 350             | 630                |
| Cooperative advertising expense reimbursements | 2,000           | -                  |
|  | \$ 3,347        | \$ 3,143           |

Sales and marketing expenses in the three and nine months ended July 31, 2012 include accrued reimbursements from vendors of \$238 and \$4,000, respectively, under cooperative advertising agreements.

## 6. INVENTORIES

Inventories consist of the following:

|                          | <b>July 31,</b> | <b>October 31,</b> |
|--------------------------|-----------------|--------------------|
|                          | <b>2012</b>     | <b>2011</b>        |
| Finished goods           | \$ 3,058        | \$ 5,071           |
| Packaging and components | 2,994           | 6,534              |

\$ 6,052    \$ 11,605

## 7. PREPAID EXPENSES AND OTHER CURRENT ASSETS

Prepaid expenses consist of the following:

|                     | <b>July 31,    October 31,</b> |                 |
|---------------------|--------------------------------|-----------------|
|                     | <b>2012</b>                    | <b>2011</b>     |
| Prepaid advertising | \$ 422                         | \$ 2,795        |
| Other               | 177                            | 276             |
|                     | <b>\$ 599</b>                  | <b>\$ 3,071</b> |

## 8. PROPERTY AND EQUIPMENT, NET

Property and equipment, net, consist of the following:

|                          | <b>July 31,    October 31,</b> |                 |
|--------------------------|--------------------------------|-----------------|
|                          | <b>2012</b>                    | <b>2011</b>     |
| Computers and software   | \$3,365                        | \$ 3,201        |
| Furniture and equipment  | 1,260                          | 1,131           |
| Leasehold improvements   | 317                            | 317             |
|                          | 4,942                          | 4,649           |
| Accumulated depreciation | (3,913 )                       | (3,465 )        |
|                          | <b>\$ 1,029</b>                | <b>\$ 1,184</b> |

**9. ACCOUNTS PAYABLE AND ACCRUED EXPENSES**

Accounts payable and accrued expenses consist of the following:

|                                  | <b>July 31,</b> | <b>October 31,</b> |
|----------------------------------|-----------------|--------------------|
|                                  | <b>2012</b>     | <b>2011</b>        |
| Accounts payable-trade           | \$5,111         | \$ 5,994           |
| Royalty and software development | 7,634           | 10,071             |
| Salaries and other compensation  | 1,365           | 3,407              |
| Income taxes payable             | 51              | 423                |
| Other accruals                   | 430             | 418                |
|                                  | <b>\$14,591</b> | <b>\$ 20,313</b>   |

**10. STOCKHOLDERS' EQUITY***Common stock warrants and units*

The following table sets forth the number shares of common stock purchasable under outstanding stock purchase warrants at July 31, 2012 and October 31, 2011:

| Issued in connection with | Issue date        | Expiration date | Exercise Price | July 31, 2012    | October 31, 2011 |
|---------------------------|-------------------|-----------------|----------------|------------------|------------------|
| Equity financing          | September 5, 2007 | March 5, 2013   | \$ 2.04        | 1,110,001        | 1,110,001        |
| Consulting services       | June 14, 2006     | May 31, 2013    | \$ 1.55        | 16,500           | 16,500           |
| Consulting services       | March 29, 2010    | March 28, 2015  | \$ 1.06        | 50,000           | 70,000           |
|                           |                   |                 |                | <b>1,176,501</b> | <b>1,196,501</b> |

In the nine months ended July 31, 2012, 20,000 warrants were exercised on a cashless basis for 12,320 shares. In the nine months ended July 31, 2011, 587,734 warrants were exercised for \$1,199, 74,500 warrants were exercised on a cashless basis for 46,743 shares and 367,733 previously-outstanding units issued in the Company's 2007 sale of stock and units were exercised for \$611. There were no other changes to the status of the Company's outstanding warrants and units in the nine months ended July 31, 2012 or 2011.

## 11. STOCK BASED COMPENSATION ARRANGEMENTS

The Company issued 39,419 and 71,933 shares of restricted stock during the three and nine months ended July 31, 2012, respectively, and cancelled 16,720 and 27,053 shares of restricted stock during the three and nine months ended July 31, 2012, respectively. The Company issued 284,766 and 614,250 shares of restricted stock during the three and nine months ended July 31, 2011, respectively, and cancelled no shares in either period. The Company values shares of restricted stock at fair value as of the grant date.

The Company did not issue or cancel any options to purchase shares of common stock during the three and nine months ended July 31, 2012. The Company issued options to purchase 100,000 shares of common stock during the three and nine months ended July 31, 2011, and cancelled no options in the periods. The options issued have an exercise price of \$1.64 per share and expire in 2018. The options had a total grant-date fair value of \$95, based on the Black-Scholes model and estimated share-price volatility of 75.2%, estimated life of 4.3 years and a risk-free rate of 1.8%. The Company values options at fair value as of the grant date.

Stock-based compensation amounted to \$438 and \$1,301 in the three and nine months ended July 31, 2012, respectively, and \$436 and \$1,064 in the three and nine months ended July 31, 2011, respectively.

## 12. INCOME TAXES

The federal and state income tax provisions recorded by the Company for the three and nine months ended July 31, 2012 and 2011 reflect the use of available net operating loss ("NOL") carryforwards to offset taxable income. NOL carryforwards available for income tax purposes at July 31, 2012 amounted to approximately \$65,100 for federal income taxes and approximately \$18,000 for certain state income taxes. Due to the Company's history of losses, a valuation allowance sufficient to fully offset NOLs and other deferred tax assets has been established under current accounting pronouncements and this valuation allowance will be maintained until sufficient positive evidence exists to support its reversal. The tax provision reflected in the accompanying condensed consolidated statements of operations represents alternative minimum taxes and certain state taxes.

**13. INCOME (LOSS) PER SHARE**

The table below provides a reconciliation of basic and diluted average shares outstanding used in computing income (loss) per share, after applying the treasury stock method.

|   | Three months ended July 31, |            | Nine months ended July 31, |            |
|---|-----------------------------|------------|----------------------------|------------|
|   | 2012                        | 2011       | 2012                       | 2011       |
| Basic weighted average shares outstanding     | 39,893,133                  | 38,803,090 | 39,883,365                 | 38,165,521 |
| Common stock options                          | -                           | 557,178    | 296,473                    | 368,012    |
| Non-vested portion of restricted stock grants | -                           | 1,432,762  | 622,766                    | 958,477    |
| Warrants                                      | -                           | 525,776    | 214,027                    | 335,012    |
| Diluted weighted average shares outstanding   | 39,893,133                  | 41,318,806 | 41,016,631                 | 39,827,022 |

Options, warrants and restricted shares to acquire 4,172,951 and 1,845,473 shares of common stock were not included in the calculation of diluted earnings (loss) per common share for the three and nine months ended July 31, 2012, respectively, as the effect of their inclusion would be anti-dilutive. Options, warrants and restricted shares to acquire 386,970 and 545,732 shares of common stock were not included in the calculation of diluted earnings per common share for the three and nine months ended July 31, 2011, respectively, as the effect of their inclusion would be anti-dilutive.

**14. COMPREHENSIVE INCOME (LOSS)**

The components of comprehensive income (loss) for the three- and nine-month periods ended July 31, 2012 and 2011 are summarized as follows:

|  | Three Months Ended |          | Nine months Ended |           |
|--|--------------------|----------|-------------------|-----------|
|  | July 31,           |          | July 31,          |           |
|  | 2012               | 2011     | 2012              | 2011      |
| Net income (loss)  | \$ (3,087 )        | \$ 1,889 | \$ 7,342          | \$ 10,727 |
| Other comprehensive income (loss) — foreign currency translation adjustments | (14 )              | (3 )     | (72 )             | (5 )      |
| Total comprehensive income (loss)  | \$ (3,101 )        | \$ 1,886 | \$ 7,270          | \$ 10,722 |

Losses on foreign currency transactions included in net income (loss), including fees and discounts incurred on conversions, amounted to \$15 and \$203 in the three and nine months ended July 31, 2012, respectively. Losses on foreign currency transactions in the three and nine months ended July 31, 2011 were not significant.

## 15. COMMITMENTS AND CONTINGENCIES

### *Infringement claims*

On July 1, 2011, a complaint for patent infringement was filed in the United States District Court for the District of Delaware by Impulse Technology Ltd. ("Impulse") against Microsoft Corporation and certain other game publisher defendants that have released games for Microsoft's Kinect for Xbox 360, including the Company. The complaint, as amended on April 5, 2012, alleges infringement relating to Microsoft's Xbox Kinect hardware, and correspondingly, the Company's Zumba Fitness, Zumba Fitness Rush, Hulk Hogan's Main Event and Jillian Michaels Fitness Adventure games for Xbox 360, of Impulse's patents for certain motion tracking technology. Impulse is seeking injunctive relief and monetary damages in an unspecified amount for the alleged infringement. The Company intends, in conjunction with Microsoft and the other defendants, to defend itself against the claim and has certain third-party indemnity rights from certain developers for costs incurred under a joint representation agreement. The Company cannot currently estimate a potential range of loss if the claim against the Company is successful.

On November 18, 2011, a complaint for patent infringement was filed in the United States District Court for the Northern District of Ohio by Impulse against the Company, Nintendo of America, Inc. and certain other game publisher defendants that have released games for Nintendo's Wii console. The complaint alleges that Wii and correspondingly, our Zumba Fitness 2 and Jillian Michaels Fitness Workout 2009 games, infringe Impulse's patents for certain interactive technology. Impulse is seeking injunctive relief and monetary damages in an unspecified amount for the alleged infringement. The Company intends to defend itself against the claim and has third-party indemnity rights from a developer that may cover a portion of costs to the Company. The Company cannot currently estimate a potential range of loss if the claim against the Company is successful.

The Company at times may be a party to claims and suits in the ordinary course of business. We record a liability when it is both probable that a liability has been incurred and the amount of the loss or range of loss can be reasonably estimated. The Company has not recorded a liability with respect to the matters above. While the Company believes that it has valid defenses with respect to the legal matters pending and intends to vigorously defend the matters above, given the uncertainty surrounding litigation and our inability to assess the likelihood of a favorable or unfavorable outcome, it is possible that the resolution of one or more of these matters could have a material adverse effect on our consolidated financial position, cash flows or results of operations.

*Commitments*

The Company routinely issues purchase orders and enters into short-term commitments in the ordinary course of business. As of July 31, 2012, commitments under development agreements amounted to \$5,124.

**16. PURCHASE OF ASSETS**

On June 3, 2011, the Company acquired certain assets and assumed certain liabilities of Quick Hit, Inc. ("Quick Hit"), a developer and operator of online games. The aggregate purchase price paid was approximately \$837 in cash. The Company also entered into an exclusive license agreement with a senior lender to Quick Hit for the source code to an online interactive football game, with options to extend the license and purchase the game at the end of the license period, including \$125 paid in the fiscal year ended October 31, 2011, \$125 paid in the nine months ended July 31, 2012 and \$60 due in September 2012, if exercised by the Company.

The Quick Hit acquisition was accounted for as a purchase business combination pursuant to ASC 805, Business Combinations. Accordingly, the assets acquired and liabilities assumed were recorded at their estimated fair values and the excess of the purchase price over the fair value of the identifiable assets acquired and the liabilities assumed was recorded as goodwill. In accordance with ASC 805, the following unaudited supplemental pro forma consolidated financial information is provided using historical data of Quick Hit and of the Company, adjusted for the application of the acquisition method of accounting as if the acquisition had occurred on November 1, 2010 for the nine months ended July 31, 2011. The unaudited supplemental unaudited pro forma financial information is not intended to represent or be indicative of the Company's consolidated results of operations that would have been reported had the Quick Hit acquisition been completed as of the dates presented, and should not be taken as a representation of the Company's future consolidated results of operations or financial position. The unaudited pro forma information also does not reflect any operating efficiencies and associated cost savings that the Company may achieve with respect to the combined companies.

|                              | Nine months Ended<br>July 31,<br>2011<br>(unaudited) |
|------------------------------|--|
| Net revenues                 | \$ 100,883   |
| Net income                   | \$ 7,731   |
| Basic net income per share   | \$ 0.20  |
| Diluted net income per share | \$ 0.19  |

**17. RELATED PARTIES**

The Company currently has an agreement with Morris Sutton, the Company's former Chief Executive Officer and father of the Company's Chief Executive Officer, under which he provides services as a consultant. The agreement provides for a monthly retainer of \$13. Under this arrangement, fees earned in the three and nine months ended July 31, 2012 totaled \$38 and \$113, respectively, and fees earned in the three and nine months ended July 31, 2011 totaled \$38 and \$113, respectively.

MSI Entertainment, a company controlled by Morris Sutton, acted as an agent for the Company in sales to a distributor. The titles, for which the Company had no other planned distribution, were paid for in advance by the distributor. In the nine months ended July 31, 2011, the Company paid MSI a fee of \$78 in connection with the sales.

Beginning in 2011, the Company has purchased a portion of its Zumba belt accessories from a second supplier, on terms equivalent to those of its primary supplier. Morris Sutton and another relative of Jesse Sutton, the Company's Chief Executive Officer, earned compensation from the supplier of approximately \$0 and \$446 in the three and nine months ended July 31, 2012, respectively, based on the value of the Company's purchases. No such compensation applied in the three and nine months ended July 31, 2011. In addition, in the three and nine months ended July 31, 2012, the Company purchased \$0 and \$35 of supplies from a company controlled by Morris Sutton.

The Company also has an agreement with a member of its board of directors to provide specified strategic consulting services, in addition to his services as a board member, on a month-to-month basis at a monthly rate of \$10. Under this arrangement, fees earned in the three and nine months ended July 31, 2012 totaled \$30 and \$90, respectively, and fees earned in the three and nine months ended July 31, 2011 totaled \$30 and \$90, respectively.



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

Statements in this quarterly report on Form 10-Q that are not historical facts constitute forward-looking statements that are made pursuant to the safe harbor provisions of Section 21E of the Securities Exchange Act of 1934, or the Exchange Act. These statements relate to future events or our future financial performance and involve known and unknown risks, uncertainties and other factors that may cause our or our industry's actual results, levels of activity, performance or achievements to be materially different from any future results, levels of activity, performance or achievements expressed or implied by these forward-looking statements. Those factors include, among other things, those listed under "Risk Factors" and elsewhere in our annual report on Form 10-K for the fiscal year ended October 31, 2011 and other filings with the Securities and Exchange Commission ("SEC"). In some cases, you can identify forward-looking statements by terminology such as "may," "will," "should," "expects," "plans," "anticipates," "believes," "estimates," "predicts," "potential" or "continue" or the negative of these terms or other comparable terminology. These statements are only predictions. Actual events or results may differ materially. Moreover, neither we nor any other person assume responsibility for the accuracy or completeness of these statements. We are under no duty to update any of the forward-looking statements after the date of this report to conform these statements to actual results. References herein to "we," "us," "our," and the "Company" are to Majesco Entertainment Company.

### **Overview**

We are a provider of video game products primarily for the family oriented, casual-game consumer. We sell our products primarily to large retail chains, specialty retail stores, video game rental outlets and distributors. We publish video games for almost all major current generation interactive entertainment hardware platforms, including Nintendo's DS, DSi and Wii, Sony's PlayStation 3, or PS3, and PlayStation Portable, or PSP, Microsoft's Xbox 360 and the personal computer, or PC. We also publish games for numerous digital platforms such as Xbox Live Arcade and PlayStation Network, or PSN, and mobile platforms such as iPhone, iPad and iPod Touch, as well as online platforms such as Facebook and Zynga.com.

Our video game titles are targeted at various demographics at a range of price points. Due to the larger budget requirements for developing and marketing premium console titles for core gamers, we focus on publishing more casual games targeting casual-game consumers. In some instances, our titles are based on licenses of well known properties and, in other cases based on original properties. We enter into agreements with content providers and video game development studios for the creation of our video games.

Our operations involve similar products and customers worldwide. These products are developed and sold domestically and internationally. The Company is centrally managed and our chief operating decision makers, the chief executive and other officers, use consolidated and other financial information supplemented by sales information by product category, major product title and platform for making operational decisions and assessing financial performance. Accordingly, we operate in a single segment.

*Net Revenues.* Our revenues are principally derived from sales of our video games. We provide video games primarily for the mass market and casual game player. Our revenues are recognized net of estimated provisions for price protection and other allowances.

*Cost of Sales.* Cost of sales consists of product costs and amortization and impairment of software development costs and license fees. A significant component of our cost of sales is product costs. Product costs are comprised primarily of manufacturing and packaging costs of the disc or cartridge media, royalties to the platform manufacturer and manufacturing and packaging costs of peripherals. In cases where we act as a distributor for other publishers products, cost of sales may increase as we acquire products at a higher fixed wholesale price. While the product costs as a percentage of revenue is higher on these products, we do not incur upfront development and licensing fees or resulting amortization of software development costs. Commencing upon the related product's release, capitalized software development and intellectual property license costs are amortized to cost of sales. When, in management's estimate, future cash flows will not be sufficient to recover previously capitalized costs, we expense these capitalized costs to cost of sales — loss on impairment of software development costs and license fees – future releases. These expenses may be incurred prior to a game's release.

*Gross Profit.* Gross profit is the excess of net revenues over product costs and amortization and impairment of software development and license fees. Development and license fees incurred to produce video games are generally incurred up front and amortized to cost of sales. The recovery of these costs and total gross profit is dependent upon achieving a certain sales volume, which varies by title.

*Product Research and Development Expenses.* Product research and development expenses relate principally to our cost of supervision of third party video game developers, testing new products, development of social games and conducting quality assurance evaluations during the development cycle that are not allocated to games for which technological feasibility has been established. Costs incurred are primarily employee-related, may include equipment, and are not allocated to cost of sales.

*Selling and Marketing Expenses.* Selling and marketing expenses consist of marketing and promotion expenses, including television advertising, the cost of shipping products to customers and related employee costs. Credits to retailers for trade advertising are a component of these expenses.

*General and Administrative Expenses.* General and administrative expenses primarily represent employee related costs, including corporate executive and support staff, general office expenses, professional fees and various other overhead charges. Professional fees, including legal and accounting expenses, typically represent the second largest component of our general and administrative expenses. These fees are partially attributable to our required activities as a publicly traded company, such as SEC filings.

*Loss on Impairment of Software Development Costs and License Fees- Cancelled Games.* Loss on impairment of software development costs and license fees — cancelled games consists of contract termination costs, and the write-off of previously capitalized costs, for games that were cancelled prior to their release to market. We periodically review our games in development and compare the remaining cost to complete each game to projected future net cash flows expected to be generated from sales. In cases where we do not expect the projected future net cash flows generated from sales to be sufficient to cover the remaining incremental cash obligation to complete the game, we cancel the game, and record a charge to operating expenses. While we incur a current period charge on these cancellations, we believe we are limiting the overall loss on a game project that is no longer expected to perform as originally expected due to changing market conditions or other factors. Significant management estimates are required in making these assessments, including estimates regarding retailer and customer interest, pricing, competitive game performance, and changing market conditions.

*Interest and Financing Costs.* Interest and financing costs are directly attributable to our factoring and our purchase-order financing arrangements.

*Income Taxes.* Income taxes consists of our provision/(benefit) for income taxes and proceeds from the sale of rights to certain net operating loss carryforwards in the state of New Jersey. Utilization of our net operating loss (“NOL”) carryforwards may be subject to a substantial annual limitation due to the “change in ownership” provisions of the Internal Revenue Code. The annual limitation may result in the expiration of NOL carryforwards before utilization. Due to our history of losses, a valuation allowance sufficient to fully offset our NOL and other deferred tax assets has been established under current accounting pronouncements, and this valuation allowance will be maintained until sufficient positive evidence exists to support its reversal. In fiscal 2012 and 2011, we reversed our valuation allowance to the extent of our NOL used and recorded certain alternative minimum taxes and state taxes.

## **Seasonality and Variations in Interim Quarterly Results**

Our quarterly net revenues, gross profit, and operating income (loss) are impacted significantly by the seasonality of the retail selling season, and the timing of the release of new titles. Sales of our catalog and other products are generally higher in the first and fourth quarters of our fiscal year (ending January 31 and October 31, respectively) due to increased retail sales during the holiday season. Sales and gross profit as a percentage of sales also generally increase in quarters in which we release significant new titles because of increased sales volume as retailers make purchases to stock their shelves and meet initial demand for the new release. These quarters also benefit from the higher selling prices that we are able to achieve early in the product's life cycle. Therefore, sales results in any one quarter are not necessarily indicative of expected results for subsequent quarters during the fiscal year.

### **Critical Accounting Estimates**

Our discussion and analysis of the financial condition and results of operations is based upon our consolidated financial statements, which have been prepared in accordance with accounting principles generally accepted in the United States of America ("GAAP").

The preparation of these consolidated financial statements requires us to make estimates and judgments that affect the reported amounts of assets, liabilities, revenues, and expenses, and related disclosure of contingent assets and liabilities. We base our estimates on historical experience and on various other assumptions that are believed to be reasonable under the circumstances, the results of which form the basis for making judgments about the carrying values of assets and liabilities that are not readily apparent from other sources. Actual results could differ materially from these estimates under different assumptions or conditions.

We have identified the policies below as critical to our business operations and to 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 when such policies affect our reported and expected financial results.

*Revenue Recognition.* We recognize revenue upon the shipment of our product when: (i) risks and rewards of ownership are transferred, (ii) persuasive evidence of an arrangement exists, (iii) we have no continuing obligations to the customer, and (iv) the collection of related accounts receivable is probable. Certain products are sold to customers with a street date (the earliest date these products may be resold by retailers). Revenue for sales of these products is not recognized prior to their street date. Some of our software products provide limited online features at no additional cost to the consumer. Generally, we have considered such features to be incidental to our overall product offerings and an inconsequential deliverable. Accordingly, we do not defer any revenue related to products containing these limited online features. However, in instances where online features or additional functionality is considered a substantive deliverable in addition to the software product, such characteristics will be taken into account when applying our revenue recognition policy. In addition, some of our software products are sold exclusively as downloads of digital content for which the consumer takes possession of the digital content for a fee. Revenue from product downloads is generally recognized when the download is made available (assuming all other recognition criteria are met).



When we enter into license or distribution agreements that provide for multiple copies of games in exchange for guaranteed amounts, revenue is recognized in accordance with the terms of the agreements, generally upon delivery of a master copy, assuming our performance obligations are complete and all other recognition criteria are met, or as per-copy royalties are earned on sales of games.

*Price Protection and Other Allowances.* We generally sell our products on a no-return basis, although in certain instances, we provide price protection or other allowances on certain unsold products in accordance with industry practices. Price protection, when granted and applicable, allows customers a partial credit with respect to merchandise unsold by them. Revenue is recognized net of estimates of these allowances. Sales incentives and other consideration that represent costs incurred by us for benefits received, such as the appearance of our products in a customer's national circular advertisement, are generally reflected as selling and marketing expenses. We estimate potential future product price protection and other discounts related to current period product revenue. In addition, some of our software products are sold exclusively as downloads of digital content for which the consumer takes possession of the digital content for a fee. Revenue from product downloads is generally recognized when the download is made available (assuming all other recognition criteria are met).

Our provisions for price protection and other allowances fluctuate over periods as a result of a number of factors including analysis of historical experience, current sell-through of retailer inventory of our products, current trends in the interactive entertainment market, the overall economy, changes in customer demand and acceptance of our products and other related factors. 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. However, actual allowances granted could materially exceed our estimates as unsold products in the distribution channels are exposed to rapid changes in consumer preferences, market conditions, technological obsolescence due to new platforms, product updates or competing products. For example, the risk of requests for allowances may increase as consoles pass the midpoint of their lifecycle and an increasing number of competitive products heighten pricing and competitive pressures. While management believes it can make reliable estimates regarding these matters, these estimates are inherently subjective. Accordingly, if our estimates change, this will result in a change in our provisions, which would impact the net revenues and/or selling and marketing expenses we report. Fluctuations in the provisions reflected our estimates of future price protection based on the factors discussed above. We limit our exposure to credit risk by factoring a portion of our receivables to a third party that buys without recourse. For receivables that are not sold without recourse, we analyze our aged accounts receivables, payment history and other factors to make a determination if collection of receivables is likely, or a provision for uncollectible accounts is necessary.

*Capitalized Software Development Costs and License Fees.* Software development costs include development fees, primarily in the form of milestone payments made to independent software developers. Software development costs are capitalized once technological feasibility of a product is established and management expects such costs to be recoverable against future revenues. For products where proven game engine technology exists, this may occur early in the development cycle. Technological feasibility is evaluated on a product-by-product basis. Amounts related to software development that are not capitalized are charged immediately to product research and development costs. Commencing upon a related product's release capitalized software development costs are amortized to cost of sales based upon the higher of (i) the ratio of current revenue to total projected revenue or (ii) straight-line charges over the expected marketable life of the product.

Prepaid license fees represent license fees to holders for the use of their intellectual property rights in the development of our products. Minimum guaranteed royalty payments for intellectual property licenses are initially recorded as an asset (capitalized license fees) and a current liability (accrued royalties payable) at the contractual amount upon execution of the contract or when specified milestones or events occur and when no significant performance commitment remains with the licensor. Licenses are expensed to cost of sales at the higher of (i) the contractual royalty rate based on actual sales or (ii) an effective rate based upon total projected revenue related to such license.

Capitalized software development costs are classified as non-current if they relate to titles for which we estimate the release date to be more than one year from the balance sheet date. No such costs were classified as non-current as of July 31, 2012 and October 31, 2011.

The amortization period for capitalized software development costs and license fees is usually no longer than one year from the initial release of the product. If actual revenues or revised forecasted revenues fall below the initial forecasted revenue for a particular license, the charge to cost of sales may be larger than anticipated in any given quarter. The recoverability of capitalized software development costs and license fees is evaluated quarterly based on the expected performance of the specific products to which the costs relate.

When, in management's estimate, future cash flows will not be sufficient to recover previously capitalized costs, we expense these capitalized costs to cost of sales — loss on impairment of software development costs and license fees — future releases, in the period such a determination is made. These expenses may be incurred prior to a game's release. If a game is cancelled and never released to market, the amount is expensed to operating costs and expenses — loss on impairment of capitalized software development costs and license fees — cancelled games. As of July 31, 2012, the net carrying value of our licenses and software development costs was \$7.7 million. If we were required to write off licenses or software development costs, due to changes in market conditions or product acceptance, our results of operations could be materially adversely affected.

License fees and milestone payments made to our third party developers are typically considered non-refundable advances against the total compensation they can earn based upon the sales performance of the products. Any additional royalty or other compensation earned beyond the milestone payments is expensed to cost of sales as incurred.

We have expensed as research and development all costs associated with the development of social games. We acquired selected assets from Quick Hit, Inc. in June 2011 and have developed and launched games on Facebook. These games have not earned significant revenues to date and we are continuing to evaluate alternatives for future development and monetization. We also added the former development team of Quick Hit, Inc. to enhance our abilities in the development and operation of our social games.

*Inventory.* Inventory is stated at the lower of cost or market. Cost is determined by the first-in, first-out method. We estimate the net realizable value of slow-moving inventory on a title-by-title basis and charge the excess of cost over net realizable value to cost of sales. Some of our inventory items are packaged with accessories, such as basketballs for our anticipated *Baller Beats* game, belts for our *Zumba* games and dolls for our *Babysitting Mama* game. The purchase of these accessories involves longer lead times and minimum purchase amounts, which require us to maintain higher levels of inventory than for other games. Therefore, these items have a higher risk of obsolescence, which we review periodically based on inventory and sales levels.

*Accounting for Stock-Based Compensation.* Stock-based compensation expense is measured at the grant date based on the fair value of the award and is recognized as expense over the vesting period. Determining the fair value of stock-based awards at the grant date requires judgment, including, in the case of stock option awards, estimating expected stock volatility. In addition, judgment is also required in estimating the amount of stock-based awards that are expected to be forfeited. If actual results differ significantly from these estimates, stock-based compensation expense and our results of operations could be materially impacted.

*Commitments and Contingencies.* We record a liability for commitments and contingencies when the amount is both probable and reasonably estimable. We record associated legal fees as incurred.



## Results of Operations

### *Three months ended July 31, 2012 versus three months ended July 31, 2011*

*Net Revenues.* Net revenues for the three months ended July 31, 2012 decreased to \$9.1 million from \$19.5 million in the comparable quarter last year. The decrease is primarily due to lower sales of Zumba Fitness games for the Wii when compared to the same period last year. Net revenues in the European market decreased approximately \$3.4 million from the period a year ago, primarily reflecting the effects of the timing of the launch of our Zumba Fitness products for the Nintendo Wii. The original Zumba Fitness product was released in the second quarter of fiscal 2011. Comparatively, Zumba 2 was released in the first quarter of fiscal 2012. Fiscal 2012 sales of Cooking Mama and other games for the Nintendo DS declined from the prior year, reflecting the later stage of the platform's life cycle. Revenue from *Zumba Fitness* products accounted for approximately 79% and 80% of total revenue in the three months ended July 31, 2012 and 2011, respectively, on a consolidated basis.

The following table sets forth our net revenues by platform:

|                       | Three months Ended July 31, |       |             |       | Nine months Ended July 31, |       |             |       |
|-----------------------|-----------------------------|-------|-------------|-------|----------------------------|-------|-------------|-------|
|                       | 2012                        | %     | 2011        | %     | 2012                       | %     | 2011        | %     |
|                       | (thousands)                 |       | (thousands) |       | (thousands)                |       | (thousands) |       |
| Nintendo Wii          | \$5,539                     | 61 %  | \$ 14,036   | 72 %  | \$65,147                   | 62 %  | \$ 59,794   | 60 %  |
| Microsoft Xbox 360    | 2,153                       | 24 %  | 2,306       | 12 %  | 26,491                     | 25 %  | 20,334      | 20 %  |
| Nintendo DS           | 948                         | 10 %  | 2,249       | 11 %  | 10,142                     | 10 %  | 14,610      | 15 %  |
| Nintendo 3DS          | -                           | - %   | -           | - %   | 1,452                      | 1 %   | -           | - %   |
| Sony Playstation 3    | 119                         | 1 %   | 637         | 3 %   | 809                        | 1 %   | 4,438       | 4 %   |
| Accessories and other | 386                         | 4 %   | 317         | 2 %   | 1,684                      | 1 %   | 978         | 1 %   |
| TOTAL                 | \$9,145                     | 100 % | \$ 19,545   | 100 % | \$105,725                  | 100 % | \$ 100,154  | 100 % |

*Gross Profit.* Gross profit for the three months ended July 31, 2012 was \$3.5 million compared to a gross profit of \$8.0 million in the same quarter last year. The decrease in gross profit was primarily attributable to decreased net revenues for the three months ended July 31, 2012, as discussed above. Gross profit as a percentage of net sales was 38% for the three months ended July 31, 2012, compared to 41% for the three months ended July 31, 2011. The decrease in gross profit as a percentage of sales was primarily due to a lower percentage of sales in Europe.

*Product Research and Development Expenses.* Research and development expenses of \$1.9 million for the three months ended July 31, 2012, were comparable to \$1.9 million of expenses for the same period in 2011, as increased expenses for the development of social games generally offset lower internal costs of other development activities.

*Selling and Marketing Expenses.* Total selling and marketing expenses were approximately \$2.7 million for the three months ended July 31, 2012, compared to \$2.3 million for the three months ended July 31, 2011. The increase was primarily due to increased media advertising, primarily related to the launch of Zumba Rush, and prelaunch activities related to our anticipated Baller Beats game. Included in the three months ended July 31, 2012 are \$0.3 million of reimbursements due from vendors under cooperative advertising arrangements.

*General and Administrative Expenses.* For the three-month period ended July 31, 2012, general and administrative expenses of \$2.4 million were comparable to \$2.5 million in the three-month period ended July 31, 2011.

*Loss on Impairment of Software Development Costs and License Fees – Cancelled Games.* For the three-month period ended July 31, 2012, loss on impairment of software development costs and license fees – cancelled games, amounted to \$0 compared to \$0.2 million in the prior-year period, which reflected the cancelation of certain development projects, including several games for the Sony Move platform. Our games in development are subject to periodic reviews to assess game design and changing market conditions. When we do not expect the projected future net cash flows generated from sales to be sufficient to cover the remaining incremental cash obligation to complete a game, we cancel the game, and record a charge to operating expenses for the carrying amount of the game.

*Operating (Loss) Income.* Operating loss for the three months ended July 31, 2012 was approximately \$3.6 million, compared to operating income of \$0.9 million in the comparable period in 2011, primarily as a result of decreased revenues and gross profits discussed above.

*Change in Fair Value of Warrant Liability.* We have outstanding warrants that contain a provision that may require settlement by transferring assets and are, therefore, recorded at fair value as liabilities. We recorded a gain of \$0.6 million for the three months ended July 31, 2012, reflecting a decrease in the fair value of the warrants primarily based upon the decreased market price of a share of our common stock during the period, compared to a gain of \$1.3 million for the three months ended July 31, 2011, when the decline in the market price of our common stock was

greater.

*Income Taxes.* In the three months ended July 31, 2012 and 2011, our income tax expense was \$0 and \$0.2 million, respectively, which represents our current alternative minimum tax provision and certain state income taxes and reflects the use of available net operating loss carryforwards to offset taxable income. For the three months ended July 31, 2012, we recorded a tax benefit because net losses for this period will be used to offset taxable income of previous quarters.

***Nine months ended July 31, 2012 versus nine months ended July 31, 2011***

*Net Revenues.* Net revenues for the nine months ended July 31, 2012 increased to \$105.7 million from \$100.2 million in the comparable period last year. The increase was primarily due to the release in the current-year period of *Zumba Fitness 2* for the Nintendo Wii and *Zumba Rush* for the Microsoft Xbox, particularly in the European market where net revenues increased to \$25.2 million from \$8.7 million in the same period a year ago. During the nine months ended July 31, 2012, we recorded product sales revenues from the release of Zumba products in Europe under a distribution agreement with a third party. Under this agreement, we retain all rights to manufacture finished products for the European markets and a third party purchases the goods for resale. Additionally, we continued to receive licensing royalties on European distribution of our original Zumba Fitness products released during the twelve months ended October 31, 2011, under a licensing and manufacturing agreement with a third party. Under this agreement, the third party had rights to manufacture and sell the product in certain territories, and we received a royalty based on their sales. Revenue from *Zumba Fitness* products accounted for approximately 79% and 70% of total revenue in the nine months ended July 31, 2012 and 2011, respectively, on a consolidated basis. Revenues in the nine months ended July 31, 2012 also reflected a greater number of new releases in the period compared to the prior year, including *Cooking Mama 4: Kitchen Magic*, *Alvin and the Chipmunks: Chipwrecked*, *Hulk Hogan's Main Event*, and *Twister Mania*. The nine months ended July 31, 2011 reflect the release of *Zumba Fitness* and *Babysitting Mama*.

*Gross Profit.* Gross profit for the nine months ended July 31, 2012 was \$38.7 million compared to a gross profit of \$41.2 million in the same period last year. The decrease in gross profit was primarily attributable to a decrease in our gross profit as a percentage of sales, which offset increased net revenues for the nine months ended July 31, 2012. Gross profit as a percentage of net sales was 37% for the nine months ended July 31, 2012, compared to 41% for the nine months ended July 31, 2011. The decrease in gross profit as a percentage of sales was primarily due to the impact of lower gross margins on our other new releases and to higher license costs and promotional allowances to retailers on our Zumba Fitness products.

*Product Research and Development Expenses.* Research and development expenses increased to \$5.9 million for the nine months ended July 31, 2012, from \$5.2 million for the comparable period in 2011. The increase was primarily due to internal development costs related to our online games business and increased production headcount. The effects of these increases were partially offset by greater third-party development costs of our initial online games prior to our June 2011 acquisition of assets from Quick Hit, Inc., and the addition of their former development team.

*Selling and Marketing Expenses.* Total selling and marketing expenses were approximately \$16.4 million for the nine months ended July 31, 2012, compared to \$12.0 million for the nine months ended July 31, 2011. The increase was primarily due to increased media advertising, primarily related to *Zumba Fitness* and other titles, and to sales commissions and other variable costs associated with increased sales volumes and new releases. The nine months ended July 31, 2012 included the effects of \$4.0 million of reimbursements from vendors under cooperative advertising arrangements.

*General and Administrative Expenses.* For the nine-month period ended July 31, 2012, general and administrative expenses were \$8.1 million, compared to \$8.1 million for the nine-month period ended July 31, 2011, as lower incentive compensation costs were offset by increases in other expenses.

*Loss on Impairment of Software Development Costs and License Fees – Cancelled Games.* For the nine-month period ended July 31, 2012, loss on impairment of software development costs and license fees – cancelled games, amounted to \$1.2 million compared to \$1.5 million in the prior-year period. Our games in development are subject to periodic reviews to assess game design and changing market conditions. When we do not expect the projected future net cash flows generated from sales to be sufficient to cover the remaining incremental cash obligation to complete a game, we cancel the game, and record a charge to operating expenses for the carrying amount of the game. We may cancel games at any stage of development and impairment losses may fluctuate significantly from period to period.

*Operating Income.* Operating income for the nine months ended July 31, 2012 was approximately \$6.7 million, compared to \$14.3 million in the comparable period in 2011, reflecting generally lower gross profit percentages and increased marketing expenses for new releases, including our Zumba products.

*Change in Fair Value of Warrant Liability.* We recorded a gain of \$1.6 million for the nine months ended July 31, 2012, which reflected a decrease in the fair value of the warrants primarily based upon the decreased market price of a share of our common stock during the period, compared to a loss of \$2.1 million recognized in the nine months ended July 31, 2011, which resulted from an increasing share price during the period.

*Income Taxes.* In the nine months ended July 31, 2012 and 2011, our income tax expense was \$0.2 million and \$0.4 million, respectively, which represented our current alternative minimum tax provision and certain state income taxes

and reflected the use of available NOL carryforwards to offset taxable income.

### **Liquidity and Capital Resources**

As of July 31, 2012, our cash and cash equivalents balance was \$27.3 million and funds available to us under our factoring and purchase order financing agreements were \$2.9 million and \$10.0 million, respectively. We expect continued fluctuations in the use and availability of cash due to the seasonality of our business, timing of receivables collections and working capital needs necessary to finance our business.

Our current plan is to fund our operations through product sales. However, our operating results may vary significantly from period to period and we have previously incurred operating losses. We may be required to modify our plan, or seek outside sources of financing, and/or equity sales, if our operating plan and sales targets are not met. There can be no assurance that such funds will be available on acceptable terms, if at all. In the event that we are unable to negotiate alternative financing, or negotiate terms that are acceptable to us, we may be forced to modify our business plan materially, including making reductions in game development and other expenditures. Additionally, we are dependent on our purchase order financing and account receivable factoring agreements to finance our working capital needs, including the purchase of inventory. If the current level of financing was reduced or we fail to meet our operational objectives, it could create a material adverse change in the business.

#### *Factoring and Purchase Order Financing.*

To satisfy our liquidity needs, we factor our receivables. Under our factoring agreement, we have the ability to take cash advances against accounts receivable and inventory of up to \$30.0 million, and the availability of up to \$2.0 million in letters of credit. The factor, in its sole discretion, can reduce the availability of financing at any time. We had no outstanding advances against accounts receivable under our factoring agreement at July 31, 2012. Our balance due to factor at July 31, 2012 is net of customer payments and incentives expected to be settled in future periods. We also utilize financing to provide funding for the manufacture of our products. Under an agreement with a finance company, we have up to \$10.0 million of availability for letters of credit and purchase order financing. In connection with these arrangements, the finance company and the factor have a security interest in substantially all of our assets. We had no outstanding advances for purchase order financing at July 31, 2012.

Under the terms of our factoring agreement, we sell our accounts receivable to the factor. The factor, in its sole discretion, determines whether or not it will accept the credit risk associated with a receivable. If the factor does not accept the credit risk on a receivable, we may sell the accounts receivable to the factor while retaining the credit risk. In both cases we surrender all rights and control over the receivable to the factor. However, in cases where we retain the credit risk, the amount can be charged back to us in the case of non-payment by the customer. The factor is required to remit payments to us for the accounts receivable purchased from us, provided the customer does not have a valid dispute related to the invoice. The amount remitted to us by the factor equals the invoiced amount, adjusted for allowances and discounts we have provided to the customer, less factor charges of 0.45 to 0.5% of the invoiced amount.

In addition, we may request that the factor provide us with cash advances based on our accounts receivable and inventory. The factor may either accept or reject our request for advances at its discretion. Generally, the factor allowed us to take advances in an amount equal to 70% of net accounts receivable, plus 60% of our inventory balance, up to a maximum of \$2.5 million of our inventory balance. Occasionally, the factor allows us to take advances in excess of these amounts for short-term working capital needs. These excess amounts are typically repaid within a 30-day period. At July 31, 2012, we had no excess advances outstanding.

Amounts to be paid to us by the factor for any accounts receivable are offset by any amounts previously advanced by the factor. The interest rate is prime plus 1.5%, annually, subject to a 5.5% floor. In certain circumstances, an additional 1.0% annually is charged for advances against inventory.

Manufacturers require us to present a letter of credit, or pay cash in advance, in order to manufacture the products required under a purchase order. We utilize letters of credit either from a finance company or our factor. The finance company charges 1.5% of the purchase order amount for each transaction for 30 days, plus administrative fees. Our factor provides purchase order financing at a cost of 0.5% of the purchase order amount for each transaction for 30 days. Additional charges are incurred if letters of credit remain outstanding in excess of the original time period and/or the financing company is not paid at the time the products are received. When our liquidity position allows, we will pay cash in advance instead of utilizing purchase order financing. This results in reduced financing and administrative fees associated with purchase order financing.

*Advances from Customers.* On a case by case basis, distributors and other customers have agreed to provide us with cash advances on their orders. These advances are then applied against future sales to these customers. In exchange for these advances, we offer these customers beneficial pricing or other considerations.

*Commitments and Contingencies.*

On July 1, 2011, a complaint for patent infringement was filed in the United States District Court for the District of Delaware by Impulse Technology Ltd., (“Impulse”) against Microsoft Corporation and certain other game publisher defendants that have released games for Microsoft’s Kinect for Xbox 360, including the Company. The complaint, as amended on April 5, 2012, alleges infringement relating to Microsoft’s Xbox Kinect hardware, and correspondingly, the Company’s Zumba Fitness, Zumba Fitness Rush, Hulk Hogan’s Main Event and Jillian Michaels Fitness Adventure games for Xbox 360, of Impulse’s patents for certain motion tracking technology. Impulse is seeking injunctive relief and monetary damages in an unspecified amount for the alleged infringement. The Company intends, in conjunction with Microsoft and the other defendants, to defend itself against the claim and has certain third-party indemnity rights from certain developers for costs incurred under a joint representation agreement. The Company cannot currently estimate a potential range of loss if the claim against the Company is successful.

On November 18, 2011, a complaint for patent infringement was filed in the United States District Court for the Northern District of Ohio by Impulse against the Company, Nintendo of America, Inc. and certain other game publisher defendants that have released games for Nintendo’s Wii console. The complaint alleges that Wii and correspondingly, our Zumba Fitness 2 and Jillian Michaels Fitness Workout 2009 games, infringe Impulse’s patents for certain interactive technology. Impulse is seeking injunctive relief and monetary damages in an unspecified amount for the alleged infringement. The Company intends to defend itself against the claim and has third-party indemnity rights from a developer that may cover a portion of costs to the Company. The Company cannot currently estimate a potential range of loss if the claim against the Company is successful.

The Company at times may be a party to claims and suits in the ordinary course of business. We record a liability when it is both probable that a liability has been incurred and the amount of the loss or range of loss can be reasonably estimated. The Company has not recorded a liability with respect to the matters above. While the Company believes that it has valid defenses with respect to the legal matters pending and intends to vigorously defend the matters above, given the uncertainty surrounding litigation and our inability to assess the likelihood of a favorable or unfavorable outcome, it is possible that the resolution of one or more of these matters could have a material adverse effect on our consolidated financial position, cash flows or results of operations.

Commitments under development agreements amounted to \$5.1 million at July 31, 2012. In addition, certain agreements provide for minimum commitments for marketing support.

### **Off-Balance Sheet Arrangements**

As of July 31, 2012, we had no off-balance sheet arrangements.

### **Inflation**

Our management currently believes that inflation has not had, and does not currently have, a material impact on continuing operations.

### **Cash Flows**

Cash and cash equivalents were \$27.3 million as of July 31, 2012 compared to \$13.7 million at October 31, 2011 and \$19.7 million at July 31, 2011. Working capital as of July 31, 2012 was \$30.6 million compared to \$23.8 million at October 31, 2011. Changes in cash and working capital balances reflect operating results as well as significant seasonal factors.

*Operating Cash Flows.* Our principal operating source of cash is sales of our interactive entertainment products. Our principal operating uses of cash are for payments associated with third-party developers of our software, costs incurred to manufacture, sell and market our video games and general and administrative expenses.

For the nine months ended July 31, 2012, we generated approximately \$15.1 million in cash flow from operating activities, compared to \$16.6 million in the same period last year. The decrease in cash provided by operating activities was primarily due to the timing of payments of license fees and recoupment of advances outstanding at the beginning of the period and other working capital changes. Operating income in the current period before amortization of license fees was comparable to the nine months ended July 31, 2011. Noncash amortization of capitalized software development costs amounted to \$11.1 million in the nine months ended July 31, 2012 compared to \$3.5 million in the prior-year period.



*Investing Cash Flows.* Cash used in investing activities for the nine months ended July 31, 2012 amounted to \$0.2 million, compared to \$1.2 million in the nine months ended July 31, 2011, which included \$0.8 million for the purchase of assets from Quick Hit, Inc.

*Financing Cash Flows.* Net cash used in financing activities for the nine months ended July 31, 2012 and 2011 reflected cash used to reduce outstanding borrowings under our purchase order financing agreement for seasonal inventory. Outstanding borrowing at October 31, 2011 was lower than the comparable prior year and, accordingly, cash outflows for repayments declined.

### **Item 3. Quantitative and Qualitative Disclosure about Market Risk**

#### *Market Risk*

We are exposed to certain market risks in the normal course of business, primarily risks associated with fluctuations in foreign currency exchange rates and interest rates.

#### *Foreign Currency Exchange Rate Risk*

We earn certain revenues from transactions denominated in foreign currencies and are exposed to market risk resulting from fluctuations in foreign currency exchange rates, particularly Euros, which may result in gains or losses in our results of operations. Accordingly, our future results could be adversely affected by declines in exchange rates for the Euro. In the nine months ended July 31, 2012, we launched Zumba Fitness 2 and Zumba Rush in Europe and recognized sales revenue to our distributor. Accordingly, our revenue and gross profits from transactions denominated in Euros increased significantly in the period. However, the portion of our total revenue represented by these transactions may fluctuate significantly on a quarterly basis.

We may hedge a portion of our foreign currency risk related to forecasted foreign currency-denominated revenues by entering into foreign exchange forward contracts that reduce, but do not eliminate our risk. During the nine months ended July 31, 2012 and 2011, we did not enter into any foreign exchange forward contracts related to cash flow hedging activities. We do not maintain significant working capital balances denominated in foreign currencies or enter into derivatives or other financial instruments for trading or speculative purposes.

#### *Interest Rate Risk*

To satisfy our liquidity needs, we factor our receivables and periodically utilize financing to provide funding for the manufacture of our products. We had no outstanding advances for purchase order financing at July 31, 2012.

Under the terms of our factoring agreement, we sell our accounts receivable to the factor. The amount remitted to us by the factor equals the invoiced amount, adjusted for allowances and discounts we have provided to the customer, less factor charges of 0.45% to 0.5% of the invoiced amount and the interest rate on advances is generally prime plus 1.5%, annually, subject to a 5.5% floor.

When we utilize letters of credit from our finance company, the finance company charges 1.5% of the purchase order amount for each transaction for 30 days, plus administrative fees. Additional charges are incurred if letters of credit remain outstanding in excess of the original time period and/or the financing company is not paid at the time the products are received.

At July 31, 2012, we had cash and cash equivalents of \$27.3 million in the form of bank deposits and money market funds. Our cash balances fluctuate significantly during the year. However, interest income on cash balances is not expected to be significant to our results of operations.

There have been no significant changes in our exposure to interest rate risk in the current period.

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

Our management, with the participation of our Chief Executive Officer and Chief Financial Officer, has evaluated the effectiveness of our disclosure controls and procedures, as defined in the Securities Exchange Act of 1934 Rule 13a-15(e) and 15d-15(e), as of the end of the period covered by this report.

In designing and evaluating our disclosure controls and procedures, management recognized that any controls and procedures, no matter how well designed and operated, can provide only reasonable assurance of achieving the desired control objectives.

While we believe our disclosure controls and procedures and our internal control over financial reporting are adequate, no system of controls can prevent errors and fraud. A control system, no matter how well designed and operated, can provide only reasonable, not absolute, assurance that the control system's objectives will be met. Further, the design of a control system must reflect the fact that there are resource constraints, and the benefits of controls must be considered relative to their costs. Because of the inherent limitations in all control systems, no evaluation of controls can provide absolute assurance that all control issues and instances of fraud, if any, within our Company have been detected. These inherent limitations include the realities that judgments in decision-making can be faulty, and that breakdowns can occur. Controls can also be circumvented by individual acts of some people, by collusion of two

or more people, or by management override of the controls. The design of any system of controls is based in part upon certain assumptions about the likelihood of future events, and there can be no assurance that any design will succeed in achieving its stated goals under all potential future conditions. Over time, controls may become inadequate because of changes in conditions or deterioration in the degree of compliance with its policies or procedures. Because of the inherent limitations in a cost-effective control system, misstatements due to error or fraud may occur and not be detected.

Subject to the limitations above, management believes that the consolidated financial statements and other financial information contained in this report, fairly present in all material respects our financial condition, results of operations, and cash flows for the periods presented.

Based on the evaluation of the effectiveness of our disclosure controls and procedures, our Chief Executive Officer and Chief Financial Officer concluded that our disclosure controls and procedures (as defined in Exchange Act Rules 13a-15(e) and 15d-15(e)) were effective at a reasonable assurance level.

There were no changes in our internal control over financial reporting that occurred during our most recent fiscal quarter that materially affected, or that are reasonably likely to materially affect, our internal control over financial reporting.

## **PART II. OTHER INFORMATION**

### **Item 1. Legal Proceedings**

There were no new material legal proceedings or material developments to the pending legal proceedings that have been previously reported in Part I, Item 3 of our Annual Report on Form 10-K for the fiscal year ended October 31, 2011.

### **Item 1A. Risk Factors**

A description of the risks associated with our business, financial condition, and results of operations is set forth in Part I, Item 1A, of our Annual Report on Form 10-K for the fiscal year ended October 31, 2011. These factors continue to be meaningful for your evaluation of the Company and we urge you to review and consider the risk factors presented in the Form 10-K. There have been no material changes to these risks.

### **Item 2. Unregistered Sales of Equity Securities and Use of Proceeds**

None.

### **Item 3. Defaults Upon Senior Securities**

None.

### **Item 4. Mine Safety Disclosures**

Not applicable.

**Item 5. Other Information**

None.

**Item 6. Exhibits**

- 31.1 Certification of Principal Executive Officer pursuant to Section 302 of the Sarbanes-Oxley Act of 2002.
- 31.2 Certification of Principal Financial Officer pursuant to Section 302 of the Sarbanes-Oxley Act of 2002.
- 32 Certification of Principal Executive Officer and Principal Financial Officer pursuant to Section 906 of the Sarbanes-Oxley Act of 2002.
- 101.INS XBRL Instance Document.
- 101.SCH XBRL Schema Document.
- 101.CAL XBRL Calculation Linkbase Document.
- 101.LAB XBRL Label Linkbase Document.
- 101.PRE XBRL Presentation Linkbase Document.

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**SIGNATURE**

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

MAJESCO ENTERTAINMENT COMPANY

/s/ Jesse Sutton  
Jesse Sutton  
Chief Executive Officer  
Date: September 10, 2012