Activision Blizzard, Inc.
Form 10-Q
November 07, 2012
Table of Contents

UNITED STATES

SECURITIES AND EXCHANGE COMMISSION

Washington, D.C. 20549

FORM 10-Q

(Mark one)

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

For the Quarterly Period Ended September 30, 2012

OR

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

For the transition period from to

Commission File Number 1-15839

ACTIVISION BLIZZARD, INC.

(Exact name of registrant as specified in its charter)

Delaware (State or other jurisdiction of incorporation or organization)	**95-4803544** (I.R.S. Employer Identification No.)
3100 Ocean Park Boulevard, Santa Monica, CA (Address of principal executive offices)	**90405** (Zip Code)

(310) 255-2000
(Registrant s telephone number, including area code)

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

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 (§232.405 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 x No o

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

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

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

The number of shares of the registrant s Common Stock outstanding at October 31, 2012 was 1,112,704,853.

Table of Contents

ACTIVISION BLIZZARD, INC. AND SUBSIDIARIES

Table of Contents

Table of Contents

CAUTIONARY STATEMENT

This Quarterly Report on Form 10-Q contains, or incorporates by reference, certain forward-looking statements within the meaning of the Private Securities Litigation Reform Act of 1995. Such statements consist of any statement other than a recitation of historical fact and include, but are not limited to: (1) projections of revenues, expenses, income or loss, earnings or loss per share, cash flow or other financial items; (2) statements of our plans and objectives, including those relating to product releases; (3) statements of future financial or operating performance; and (4) statements of assumptions underlying such statements. Activision Blizzard, Inc. (Activision Blizzard) generally uses words such as outlook, forecast, will, could, should, would, to be, plans, believes, may, expects, intends, anticipates, estimate, future, positioned, potential, project, remain, scheduled, set to, subject to, upcoming and other similar expressions to help identify forward-looking statements. Forward-looking statements are subject to business and economic risk, reflect management s current expectations, estimates and projections about our business, and are inherently uncertain and difficult to predict. Our actual results could differ materially from expectations stated in forward-looking statements. Risks and uncertainties that may affect our future results include, but are not limited to, sales levels of Activision Blizzard s titles, the impact of the current macroeconomic environment and market conditions within the video game industry, increasing concentration of titles, shifts in consumer spending trends, Activision Blizzard s ability to predict consumer preferences, including interest in specific genres such as first-person action and massively multiplayer online games and preferences among competing hardware platforms, maintenance of relationships with key personnel, customers, licensees, licensors, vendors, and third-party developers, including the ability to attract, retain and develop key personnel and developers that can consistently create high quality hit titles, the seasonal and cyclical nature of the interactive entertainment market, changing business models including digital delivery of content, competition including from used games and other forms of entertainment, possible declines in software pricing, product returns and price protection, product delays, adoption rate and availability of new hardware (including peripherals) and related software, rapid changes in technology and industry standards, litigation risks and associated costs, protection of proprietary rights, counterparty risks relating to customers, licensees, licensors and manufacturers, domestic and international economic, financial and political conditions and policies, foreign exchange rates and tax rates, potential challenges associated with geographic expansion, and the other factors identified in Risk Factors included in Part II, Item 1A of our Annual Report on Form 10-K for the year ended December 31, 2011 and in our other periodic filings with the Securities and Exchange Commission (the SEC). The forward-looking statements contained herein are based upon information available to us as of the date of this Quarterly Report on Form 10-Q and we assume no obligation to update any such forward-looking statements. Although these forward-looking statements are believed to be true when made, they may ultimately prove to be incorrect. These statements are not guarantees of our future performance and are subject to risks, uncertainties and other factors, some of which are beyond our control and may cause actual results to differ materially from current expectations.

Activision Blizzard s names, abbreviations thereof, logos, and product and service designators are all either the registered or unregistered trademarks or trade names of Activision Blizzard. All other product or service names are the property of their respective owners.

Table of Contents

ACTIVISION BLIZZARD, INC. AND SUBSIDIARIES

CONDENSED CONSOLIDATED BALANCE SHEETS

(Unaudited)

(Amounts in millions, except share data)

	At September 30, 2012	At December 31, 2011
Assets		
Current assets:		
Cash and cash equivalents	$ 2,909	$ 3,165
Short-term investments	455	360
Accounts receivable, net of allowances of $230 million and $300 million at September 30, 2012 and December 31, 2011, respectively	200	649
Inventories, net	291	144
Software development	164	137
Intellectual property licenses	13	22
Deferred income taxes, net	497	507
Other current assets	173	396
Total current assets	4,702	5,380
Long-term investments	19	16
Software development	156	62
Intellectual property licenses	4	12
Property and equipment, net	148	163
Other assets	12	12
Intangible assets, net	80	88
Trademark and trade names	433	433
Goodwill	7,107	7,111
Total assets	$ 12,661	$ 13,277
Liabilities and Shareholders Equity		
Current liabilities:		
Accounts payable	$ 253	$ 390
Deferred revenues	847	1,472
Accrued expenses and other liabilities	455	694
Total current liabilities	1,555	2,556
Deferred income taxes, net	60	55
Other liabilities	163	174
Total liabilities	1,778	2,785
Commitments and contingencies (Note 11)		
Shareholders equity:		
Common stock, $0.000001 par value, 2,400,000,000 shares authorized, 1,112,157,484 and 1,133,391,371 shares issued at September 30, 2012 and December 31, 2011, respectively		
Additional paid-in capital	9,418	9,616
Retained earnings	1,539	948
Accumulated other comprehensive income (loss)	(74)	(72)
Total shareholders equity	10,883	10,492
Total liabilities and shareholders equity	$ 12,661	$ 13,277

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

Table of Contents

ACTIVISION BLIZZARD, INC. AND SUBSIDIARIES

CONDENSED CONSOLIDATED STATEMENTS OF OPERATIONS

(Unaudited)

(Amounts in millions, except per share data)

	For the Three Months Ended September 30, 2012	For the Three Months Ended September 30, 2011	For the Nine Months Ended September 30, 2012	For the Nine Months Ended September 30, 2011
Net revenues				
Product sales	$ 536	$ 369	$ 2,208	$ 2,197
Subscription, licensing, and other revenues	305	385	880	1,151
Total net revenues	841	754	3,088	3,348
Costs and expenses				
Cost of sales product costs	146	138	633	650
Cost of sales online subscriptions	56	59	178	181
Cost of sales software royalties and amortization	19	24	107	133
Cost of sales intellectual property licenses	10	16	37	69
Product development	131	133	407	390
Sales and marketing	131	115	346	264
General and administrative	121	104	413	333
Restructuring		3		24
Total costs and expenses	614	592	2,121	2,044
Operating income	227	162	967	1,304
Investment and other income (expense), net	1	3	4	7
Income before income tax expense	228	165	971	1,311
Income tax expense	2	17	176	325
Net income	$ 226	$ 148	$ 795	$ 986
Earnings per common share				
Basic	$ 0.20	$ 0.13	$ 0.70	$ 0.84
Diluted	$ 0.20	$ 0.13	$ 0.70	$ 0.84
Weighted-average shares outstanding				
Basic	1,109	1,140	1,113	1,151
Diluted	1,114	1,148	1,118	1,160
Dividends per common share	$	$	$ 0.18	$ 0.165

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

Table of Contents

ACTIVISION BLIZZARD, INC. AND SUBSIDIARIES

CONDENSED CONSOLIDATED STATEMENTS OF COMPREHENSIVE INCOME

(Unaudited)

(Amounts in millions)

	For the Three Months Ended September 30, 2012	2011	For the Nine Months Ended September 30, 2012	2011
Net income	$ 226	$ 148	$ 795	$ 986
Other comprehensive income:				
Foreign currency translation adjustment	49	(58)	(3)	(18)
Unrealized gains on investments, net of deferred income taxes of $1 million for the three and nine months ended September 30, 2012 and $0 million and $1 million for the three and nine months ended September 30, 2011, respectively	1		1	2
Other comprehensive income	$ 50	$ (58)	$ (2)	$ (16)
Comprehensive income	$ 276	$ 90	$ 793	$ 970

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

Table of Contents

ACTIVISION BLIZZARD, INC. AND SUBSIDIARIES

CONDENSED CONSOLIDATED STATEMENTS OF CASH FLOWS

(Unaudited)

(Amounts in millions)

	For the Nine Months Ended September 30, 2012	2011
Cash flows from operating activities:		
Net income	$ 795	$ 986
Adjustments to reconcile net income to net cash provided by operating activities:		
Deferred income taxes	20	124
Depreciation and amortization	69	77
Loss on disposal of property and equipment		1
Amortization and write-off of capitalized software development costs and intellectual property licenses (1)	123	151
Stock-based compensation expense (2)	83	61
Excess tax benefits from stock option exercises	(4)	(21)
Changes in operating assets and liabilities:		
Accounts receivable, net	450	516
Inventories, net	(145)	(96)
Software development and intellectual property licenses	(218)	(181)
Other assets	228	170
Deferred revenues	(639)	(1,268)
Accounts payable	(141)	(117)
Accrued expenses and other liabilities	(252)	(301)
Net cash provided by operating activities	369	102
Cash flows from investing activities:		
Proceeds from maturities of available-for-sale investments	305	603
Payment of contingent consideration		(3)
Purchases of available-for-sale investments	(382)	(325)
Capital expenditures	(46)	(47)
Decrease in restricted cash	(22)	(18)
Net cash (used in) provided by investing activities	(145)	210
Cash flows from financing activities:		
Proceeds from issuance of common stock to employees	25	39
Repurchase of common stock	(315)	(524)
Dividends paid	(204)	(194)
Excess tax benefits from stock option exercises	4	21
Net cash used in financing activities	(490)	(658)
Effect of foreign exchange rate changes on cash and cash equivalents	10	3
Net decrease in cash and cash equivalents	(256)	(343)
Cash and cash equivalents at beginning of period	3,165	2,812
Cash and cash equivalents at end of period	$ 2,909	$ 2,469

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

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

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

Table of Contents

ACTIVISION BLIZZARD, INC. AND SUBSIDIARIES

CONDENSED CONSOLIDATED STATEMENT OF CHANGES IN SHAREHOLDERS EQUITY

For the Nine Months Ended September 30, 2012

(Unaudited)

(Amounts in millions)

	Common Stock		Additional Paid-In Capital	Treasury Stock		Retained Earnings	Accumulated Other Comprehensive Income (Loss)	Total Shareholders Equity
	Shares	**Amount**		**Shares**	**Amount**			
Balance at December 31, 2011	**1,133**	**$**	**$ 9,616**		**$**	**$ 948**	**$ (72)**	**$ 10,492**
Net income						795		795
Other comprehensive income							(2)	(2)
Issuance of common stock pursuant to employee stock options and restricted stock rights	5		25					25
Stock-based compensation expense related to employee stock options and restricted stock rights			92					92
Dividends ($0.18 per common share) (See Note 10)						(204)		(204)
Shares repurchased (See Note 10)				(26)	(315)			(315)
Retirement of treasury shares	(26)		(315)	26	315			
Balance at September 30, 2012	**1,112**	**$**	**$ 9,418**		**$**	**$ 1,539**	**$ (74)**	**$ 10,883**

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

Table of Contents

ACTIVISION BLIZZARD, INC. AND SUBSIDIARIES

Notes to Condensed Consolidated Financial Statements

(Unaudited)

1. Description of business and basis of consolidation and presentation

Description of Business

Activision Blizzard, Inc. is a worldwide online, personal computer (PC), video game console, handheld and mobile device game publisher. The terms Activision Blizzard, the Company, we, us, and our are used to refer collectively to Activision Blizzard, Inc. and its subsidiaries. We maintain significant operations in the United States, Canada, the United Kingdom, France, Germany, Ireland, Italy, Sweden, Spain, the Netherlands, Australia, South Korea and China.

The common stock of Activision Blizzard is traded on The NASDAQ Stock Market under the ticker symbol ATVI. Vivendi S.A. (Vivendi) owned approximately 61% of Activision Blizzard s outstanding common stock at September 30, 2012.

Currently, we operate under three operating segments:

Activision Publishing, Inc.

Activision Publishing, Inc. (Activision) is a leading international developer and publisher of interactive entertainment. Activision develops games based on both internally-developed and licensed intellectual property. Activision markets and sells games we develop and, through our affiliate label program, games developed by certain third-party publishers. We sell games both through retail channels and by digital download. Activision currently offers games that operate on the Sony Computer Entertainment, Inc. (Sony) PlayStation 3 (PS3), Nintendo Co. Ltd. (Nintendo) Wii (Wii), and Microsoft Corporation (Microsoft) Xbox 360 (Xbox 360) console systems; the Nintendo Dual Screen handheld game systems; the PC; and Apple iOS devices and other handheld and mobile devices.

Blizzard Entertainment, Inc.

Blizzard Entertainment, Inc. (Blizzard) is a leader in the subscription-based massively multi-player online role-playing game (MMORPG) category in terms of both subscriber base and revenues generated through its World of Warcraft® franchise, which it develops, hosts and supports. Blizzard also develops, markets and sells role-playing action and strategy PC-based computer games, including games in the multiple-award winning Diablo® and StarCraft® franchises. In addition, Blizzard maintains a proprietary online-game related service, Battle.net®. Blizzard distributes its products and generates revenues worldwide through various means, including: subscriptions (which consist of fees from individuals playing *World of Warcraft*, prepaid cards and other value-added service revenues such as realm transfers, faction changes, and other character customizations within *World of Warcraft* gameplay); retail sales of physical boxed products; online download sales of PC products; and licensing of software to third-party or related party companies that distribute *World of Warcraft*, *StarCraft® II* and *Diablo III*.

Activision Blizzard Distribution

Activision Blizzard Distribution (Distribution) consists of operations in Europe that provide warehousing, logistical and sales distribution services to third-party publishers of interactive entertainment software, our own publishing operations, and manufacturers of interactive entertainment hardware.

Basis of Consolidation and Presentation

Activision Blizzard prepared the accompanying unaudited condensed consolidated financial statements in accordance with the rules and regulations of the Securities and Exchange Commission for interim reporting. As permitted under those rules and regulations, certain notes or other information that are normally required by accounting principles generally accepted in the United States of America (U.S. GAAP) have been condensed or omitted if they substantially duplicate the disclosures contained in the annual audited consolidated financial statements. The year-end condensed balance sheet data was derived from audited financial statements but does not include all disclosures required by U.S. GAAP. The unaudited condensed consolidated financial statements should be read in conjunction with the audited consolidated financial statements and notes thereto included in our Annual Report on Form 10-K for the year ended December 31, 2011. In the opinion of management, all adjustments (consisting of normal recurring accruals) considered necessary for fair statement of our financial position and results of operations in accordance with U.S. GAAP have been included in the accompanying unaudited condensed consolidated financial statements.

Table of Contents

The accompanying consolidated financial statements include the accounts and operations of the Company. All intercompany accounts and transactions have been eliminated. The consolidated financial statements have been prepared in conformity with U.S. GAAP. The preparation of the consolidated financial statements in conformity with U.S. GAAP requires management to make estimates and assumptions that affect the amounts reported in the consolidated financial statements and accompanying notes. Actual results could differ from these estimates and assumptions.

The Company considers events or transactions that occur after the balance sheet date, but before the financial statements are issued, to provide additional evidence relative to certain estimates or to identify matters that require additional disclosures.

Results of Adjustment

We identified through our internal processes that, in previous years, we erroneously over-recognized revenue for a country in our Europe region. We performed an evaluation under SEC Staff Accounting Bulletin No. 108 and concluded the effect of this error was immaterial to prior years financial statements as well as the projected full-year 2012 financial statements. As such, during the nine months ended September 30, 2012, we recorded an adjustment to reduce net revenues and operating income by $11 million in our consolidated statements of operations, and similarly reduced net revenues and income from operations before income tax expenses in our Blizzard segment, Europe region, and online subscriptions as presented in footnote 7 of the notes to the condensed consolidated financial statements by $11 million. There was no impact to operating cash flows. The adjustment increased the deferred revenues on our consolidated balance sheet and represents a correction of an error. The $11 million adjustment related to prior periods as follows: (i) approximately $1 million for the quarter ended March 31, 2012; (ii) approximately $1 million for each quarter of 2011 (totaling approximately $4 million for the year ended December 31, 2011); (iii) $2 million for the year ended December 31, 2010; and (iv) approximately $4 million for periods prior to the year ended December 31, 2010. Net income decreased by approximately $9 million, or less than $0.01 earnings per basic and diluted share, as a result of recording this adjustment.

2. Inventories, net

Our inventories, net consist of the following (amounts in millions):

	At September 30, 2012		At December 31, 2011	
Finished goods	$	180	$	116
Purchased parts and components		111		28
Inventories, net	$	291	$	144

Table of Contents

3. Intangible assets, net

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

	At September 30, 2012			
	Estimated useful lives	Gross carrying amount	Accumulated amortization	Net carrying amount
Acquired definite-lived intangible assets:				
License agreements	3 - 10 years	$ 88	$ (84)	$ 4
Internally-developed franchises	11 - 12 years	309	(233)	76
Acquired indefinite-lived intangible assets:				
Activision trademark	Indefinite	386		386
Acquired trade names	Indefinite	47		47
Total		$ 830	$ (317)	$ 513

	At December 31, 2011			
	Estimated useful lives	Gross carrying amount	Accumulated amortization	Net carrying amount
Acquired definite-lived intangible assets:				
License agreements	3 - 10 years	$ 88	$ (82)	$ 6
Game engines	2 - 5 years	32	(32)	
Internally-developed franchises	11 - 12 years	309	(227)	82
Distribution agreements	4 years	18	(18)	
Acquired indefinite-lived intangible assets:				
Activision trademark	Indefinite	386		386
Acquired trade names	Indefinite	47		47
Total		$ 880	$ (359)	$ 521

Amortization expense of intangible assets was $3 million and $7 million for the three and nine months ended September 30, 2012, respectively. Amortization expense of intangible assets was $7 million and $22 million for the three and nine months ended September 30, 2011, respectively.

At September 30, 2012, future amortization of definite-lived intangible assets is estimated as follows (amounts in millions):

2012 (remaining three months)	$ 27
2013	28
2014	13
2015	7
2016	3
Thereafter	2

Total	$	80

4. Income taxes

The income tax expense of $2 million for the three months ended September 30, 2012 reflected an effective tax rate of 0.8%, which differed from the effective tax rate of 10.7% for the three months ended September 30, 2011 primarily due to a tax benefit resulting from a federal income tax audit settlement allocated to us in the three months ended September 30, 2012 by a subsidiary of Vivendi S.A. (Vivendi), as further discussed below. The effective tax rate of 0.8% for the three months ended September 30, 2012 differed from the statutory rate of 35.0% primarily due to the tax benefit resulting from the federal income tax audit settlement, foreign income taxes levied at relatively lower rates, the geographic mix of our income, and recognition of California research and development credits and federal domestic production deductions. The federal research credit expired on December 31, 2011 and, as of September 30, 2012, an extension of the credit had not been signed into law, so we have excluded the benefit from this tax credit in our income tax calculation for the three months ended September 30, 2012.

Table of Contents

For the nine months ended September 30, 2012, the tax rate was based on our projected annual effective tax rate for 2012, and also included certain discrete tax items recorded during the period. Our tax expense of $176 million for the nine months ended September 30, 2012 reflected an effective tax rate of 18.1%, which differed from the effective tax rate of 24.8% for the nine months ended September 30, 2011 primarily due to the tax benefit resulting from the federal income tax audit settlement allocated to us in the three months ended September 30, 2012.

As previously disclosed, on July 9, 2008, a business combination (the Business Combination) occurred amongst Vivendi, the Company and certain of their respective subsidiaries pursuant to which Vivendi Games, Inc. (Vivendi Games), then a member of the consolidated U.S. tax group of Vivendi s subsidiary, Vivendi Holdings I Corp. (VHI), became a subsidiary of the Company. As a result of the business combination, the favorable tax attributes of Vivendi Games, Inc. carried forward to the Company. In late August 2012, VHI settled a federal income tax audit with the Internal Revenue Service (IRS) for the tax years ended December 31, 2002, 2003, and 2004. In connection with the settlement agreement, VHI s consolidated federal net operating loss carryovers were adjusted and allocated to various companies that were part of its consolidated group during the relevant periods. This allocation resulted in a $132 million federal net operating loss allocation to Vivendi Games. In September 2012, the Company filed an amended tax return for its December 31, 2008 tax year to utilize these additional federal net operating losses allocated as a result of the aforementioned settlement, resulting in the recording of a one-time tax benefit of $46 million. Prior to the settlement, and given the uncertainty of the VHI audit, the Company had insufficient information to allow it to record or disclose any information related to the audit until the quarter ended September 30, 2012.

The overall effective income tax rate for the year could be different from the effective tax rate for the three and nine months ended September 30, 2012 and will be dependent, in part, on our profitability for the remainder of the year. In addition, our effective income tax rates for the remainder of 2012 and future periods will depend on a variety of factors, such as changes in the mix of income by tax jurisdiction, applicable accounting rules, applicable tax laws and regulations, and rulings and interpretations thereof, developments in tax audits and other matters, and variations in the estimated and actual level of annual pre-tax income or loss. Further, the effective tax rate could fluctuate significantly on a quarterly basis and could be adversely affected by the extent that income (loss) before income tax expenses (benefit) is lower than anticipated in foreign regions where taxes are levied at relatively lower statutory rates and/or higher than anticipated in the United States where taxes are levied at relatively higher statutory rates.

The IRS is currently examining the Company s federal tax returns for the 2009 tax year. The Company also has several state and non-U.S. audits pending. Vivendi Games is no longer subject to U.S. federal income tax examinations for tax years before 2004 or state examinations for tax years before 2000. Although the final resolution of the Company s global tax disputes is uncertain, based on current information, in the opinion of the Company s management, the ultimate resolution of these matters are not expected to have a material adverse effect on the Company s consolidated financial position, liquidity or results of operations. However, an unfavorable resolution of the Company s global tax disputes could have a material adverse effect on the Company s business and results of operations in an interim period in which the matters are ultimately resolved.

5. Software development and intellectual property licenses

The following table summarizes the components of our capitalized software development costs and intellectual property licenses (amounts in millions):

	At September 30, 2012	At December 31, 2011

Internally developed software costs	$	168	$	115
Payments made to third-party software developers		152		84
Total software development costs	$	320	$	199
Intellectual property licenses	$	17	$	34

Amortization, write-offs and impairments of capitalized software development costs and intellectual property licenses are comprised of the following (amounts in millions):

Table of Contents

	Three months ended September 30, 2012	Three months ended September 30, 2011	Nine months ended September 30, 2012	Nine months ended September 30, 2011
Amortization of capitalized software development costs and intellectual property licenses	$ 22	$ 28	$ 121	$ 158
Write-offs and impairments			8	

6. Fair value measurements

Financial Accounting Standards Board (FASB) literature regarding fair value measurements for financial and non-financial assets and liabilities establishes a three-level fair value hierarchy that prioritizes the inputs used to measure fair value. This hierarchy requires entities to maximize the use of observable inputs and minimize the use of unobservable inputs. The three levels of inputs used to measure fair value are as follows:

- Level 1 Quoted prices in active markets for identical assets or liabilities.

- Level 2 Observable inputs other than quoted prices included in Level 1, such as quoted prices for similar assets or liabilities in active markets or other inputs that are observable or can be corroborated by observable market data.

- Level 3 Unobservable inputs that are supported by little or no market activity and that are significant to the fair value of the assets or liabilities. This includes certain pricing models, discounted cash flow methodologies and similar techniques that use significant unobservable inputs.

We measure the fair value of certain assets on a non-recurring basis, generally annually or when events or changes in circumstances indicate that the carrying amount of the assets may not be recoverable.

For the nine-month period ended September 30, 2012, there were no impairment charges related to assets that are measured on a non-recurring basis.

The tables below segregate all financial assets and liabilities that are measured at fair value on a recurring basis and non-financial assets and liabilities that are not subject to recurring fair value measurement into the most appropriate level within the fair value hierarchy based on the inputs used to determine the fair value on September 30, 2012 and December 31, 2011 (amounts in millions):

	September 30,	Fair Value Measurements at September 30, 2012 Using	Balance Sheet

	2012	Quoted Prices in Active Markets for Identical Assets (Level 1)	Significant Other Observable Inputs (Level 2)	Significant Unobservable Inputs (Level 3)	Classification
Recurring fair value measurements:					
Money market funds	$ 2,774	$ 2,774	$	$	Cash and cash equivalents
U.S. treasuries and government agency securities	417	417			Short-term investments
Auction rate securities (ARS)	19			19	Long-term investments
Foreign exchange contract derivatives	3		3		Other current assets
Total recurring fair value measurements	$ 3,213	$ 3,191	$ 3	$ 19	

Table of Contents

	December 31, 2011	Fair Value Measurements at December 31, 2011 Using Quoted Prices in Active Markets for Identical Assets (Level 1)	Significant Other Observable Inputs (Level 2)	Significant Unobservable Inputs (Level 3)	Total Gains (Losses)	Balance Sheet Classification
Recurring fair value measurements:						
Money market funds	$ 2,869	$ 2,869	$	$		Cash and cash equivalents
U.S. treasuries with original maturities of three months or less	2	2				Cash and cash equivalents
U.S. treasuries and government agency securities	344	344				Short-term investments
ARS	16			16		Long-term investments
Total recurring fair value measurements	$ 3,231	$ 3,215	$	$ 16		
Non-recurring fair value measurements:						
Goodwill (a)	$ 7,111	$	$	$ 7,111	$ (12)	
Total non-recurring fair value measurements	$ 7,111	$	$	$ 7,111	$ (12)	

(a) During our annual impairment review of goodwill performed as of December 31, 2011, we identified and recorded an impairment of $12 million in our Distribution segment. The decrease in fair value of the reporting unit was primarily due to the decrease of forecasted revenue from our Distribution segment in view of the industry trend towards digital distribution.

The following tables provide a reconciliation of the beginning and ending balances of our financial assets classified as Level 3 by major categories (amounts in millions) at September 30, 2012 and 2011, respectively:

	Level 3 ARS (a)	Total financial assets at fair value
Balance at January 1, 2012	$ 16	$ 16
Total unrealized gains included in other comprehensive income	3	3
Balance at September 30, 2012	$ 19	$ 19

	Level 3 ARS (a)	Total financial assets at fair value
Balance at January 1, 2011	$ 23	$ 23
Total unrealized gains included in other comprehensive income	2	2

Balance at September 30, 2011	$ 25	$ 25

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

Assets measured at fair value using significant unobservable inputs (Level 3) represent less than 1% of our financial assets measured at fair value on a recurring basis at September 30, 2012.

Foreign Currency Forward Contracts Not Designated as Hedges

We transact business in various currencies other than the U.S. dollar and have significant international sales and expenses denominated in currencies other than the U.S. dollar, subjecting us to currency exchange rate risks. To mitigate our risk from foreign currency fluctuations we periodically enter into currency derivative contracts, primarily swaps and forward contracts with maturities of twelve months or less, with Vivendi as our principal counterparty. We do not hold or purchase any foreign currency contracts for trading or speculative purposes and we do not designate these forward contracts or swaps as hedging instruments. Accordingly, we report the fair value of these contracts in our condensed consolidated balance sheet with changes in fair value recorded in our condensed consolidated statement of operations. The fair value of foreign currency contracts is estimated based on the prevailing exchange rates of the various hedged currencies as of the end of the period.

7. Operating segments and geographic region

Our operating segments are consistent with our internal organizational structure, the manner in which our operations are reviewed and managed by our Chief Executive Officer, who is our Chief Operating Decision Maker (CODM), the manner in which our CODM assesses operating performance and allocates resources, and the availability of separate financial information. We do not aggregate operating segments.

The CODM reviews segment performance exclusive of the impact of the change in deferred net revenues and related cost of sales with respect to certain of our online-enabled games, stock-based compensation expense, restructuring expense, and amortization of intangible assets. The CODM does not review any information regarding total assets on an operating segment basis and, accordingly, no disclosure is made with respect thereto. Please see footnote 1 of the notes to the condensed consolidated financial statements for the description of an adjustment recorded during the nine months ended September 30, 2012 that impacted net revenues and income from operations before income tax expenses in our Blizzard segment, Europe region, and online subscriptions as presented in tables within this footnote.

Information on the operating segments and reconciliations of total segment net revenues and total segment income from operations to consolidated net revenues and income before income tax expense from external customers for the three and nine months ended September 30, 2012 and 2011 are presented below (amounts in millions):

15

Table of Contents

	Three months ended September 30,			
	2012	2011	2012	2011
	Net revenues		Income from operations before income tax expense	
Activision	$ 283	$ 253	$ (14)	$ (36)
Blizzard	414	297	168	120
Distribution	54	77		1
Operating segments total	751	627	154	85
Reconciliation to consolidated net revenues / consolidated income before income tax expense:				
Net effect from deferral of net revenues and related cost of sales	90	127	110	105
Stock-based compensation expense			(34)	(18)
Restructuring				(3)
Amortization of intangible assets			(3)	(7)
Consolidated net revenues / operating income	$ 841	$ 754	227	162
Investment and other income (expense), net			1	3
Consolidated income before income tax expense			$ 228	$ 165

	Nine months ended September 30,			
	2012	2011	2012	2011
	Net revenues		Income from operations before income tax expense	
Activision	$ 928	$ 898	$ (84)	$ 42
Blizzard	1,299	968	629	425
Distribution	166	214		1
Operating segments total	2,393	2,080	545	468
Reconciliation to consolidated net revenues / consolidated income before income tax expense:				
Net effect from deferral of net revenues and related cost of sales	695	1,268	514	943
Stock-based compensation expense			(85)	(61)
Restructuring				(24)
Amortization of intangible assets			(7)	(22)
Consolidated net revenues / operating income	$ 3,088	$ 3,348	$ 967	$ 1,304
Investment and other income (expense), net			4	7
Consolidated income before income tax expense			$ 971	$ 1,311

Geographic information for the three and nine months ended September 30, 2012 and 2011 is based on the location of the selling entity. Net revenues from external customers by geographic region were as follows (amounts in millions):

Table of Contents

	Three months ended September 30, 2012	Three months ended September 30, 2011	Nine months ended September 30, 2012	Nine months ended September 30, 2011
Net revenues by geographic region:				
North America	$ 403	$ 360	$ 1,567	$ 1,687
Europe	333	323	1,220	1,385
Asia Pacific	105	71	301	276
Total consolidated net revenues	$ 841	$ 754	$ 3,088	$ 3,348

Net revenues by platform were as follows (amounts in millions):

	Three months ended September 30, 2012	Three months ended September 30, 2011	Nine months ended September 30, 2012	Nine months ended September 30, 2011
Net revenues by platform:				
Online subscriptions*	$ 226	$ 336	$ 701	$ 1,090
Console	227	277	1,430	1,711
Hand-held	20	19	64	82
PC and Other	314	45	727	251
Total platform net revenues	787	677	2,922	3,134
Distribution	54	77	166	214
Total consolidated net revenues	$ 841	$ 754	$ 3,088	$ 3,348

*Revenue from online subscriptions consists of revenue from all *World of Warcraft* products, including subscriptions, boxed products, expansion packs, licensing royalties, and value-added services, and revenues from *Call of Duty® Elite* memberships.

Long-lived assets by geographic region at September 30, 2012 and December 31, 2011 were as follows (amounts in millions):

	At September 30, 2012	At December 31, 2011
Long-lived assets* by geographic region:		
North America	$ 94	$ 105
Europe	42	46
Asia Pacific	12	12
Total long-lived assets by geographic region	$ 148	$ 163

*The only long-lived assets that we classify by region are our long term tangible fixed assets, which only includes property, plant and equipment assets; all other long term assets are not allocated by location.

We did not have any single external customer that accounted for 10% or more of consolidated net revenues for the three or nine months ended September 30, 2012 and 2011.

8. Goodwill

The changes in the carrying amount of goodwill by operating segment for the nine months ended September 30, 2012 are as follows (amounts in millions):

	Activision	Blizzard	Total
Balance at December 31, 2011	$ 6,933	$ 178	$ 7,111
Tax benefit credited to goodwill	(4)		(4)
Balance at September 30, 2012	$ 6,929	$ 178	$ 7,107

The tax benefit credited to goodwill represents the tax deduction resulting from the exercise of stock options that were outstanding and vested at the consummation of the Business Combination and included in the purchase price of the Company, to the extent that the tax deduction did not exceed the fair value of those options. Conversely, to the extent that the tax deduction did exceed the fair value of those options, the tax benefit is credited to additional paid-in capital.

Table of Contents

9. Computation of basic/diluted earnings per common share

The following table sets forth the computation of basic and diluted earnings per common share (amounts in millions, except per share data):

	Three months ended September 30, 2012	Three months ended September 30, 2011	Nine months ended September 30, 2012	Nine months ended September 30, 2011
Numerator:				
Consolidated net income	$ 226	$ 148	$ 795	$ 986
Less: Distributed earnings to unvested stock-based awards that participate in earnings			(4)	(3)
Less: Undistributed earnings allocated to unvested stock-based awards that participate in earnings	(5)	(2)	(12)	(11)
Numerator for basic and diluted earnings per common share - net income available to common shareholders	221	146	779	972
Denominator:				
Denominator for basic earnings per common share - weighted-average common shares outstanding	1,109	1,140	1,113	1,151
Effect of potential dilutive common shares under the treasury stock method:				
Employee stock options	5	8	5	9
Denominator for diluted earnings per common share - weighted-average common shares outstanding plus dilutive effect of employee stock options	1,114	1,148	1,118	1,160
Basic earnings per common share	$ 0.20	$ 0.13	$ 0.70	$ 0.84
Diluted earnings per common share	$ 0.20	$ 0.13	$ 0.70	$ 0.84

Our unvested restricted stock rights, which consist of restricted stock units, restricted stock awards, and performance shares, are considered participating securities since these securities have non-forfeitable rights to dividends or dividend equivalents during the contractual period of the award. Since the unvested restricted stock rights are considered participating securities, we are required to use the two-class method in our computation of basic and diluted earnings per common share. For the three and nine months ended September 30, 2012, on a weighted-average basis, we had outstanding unvested restricted stock rights with respect to 27 million and 23 million shares of common stock, respectively. For both the three and nine months ended September 30, 2011, on a weighted-average basis, we had outstanding unvested restricted stock rights with respect to 17 million shares of common stock.

Potential common shares are not included in the denominator of the diluted earnings per common share calculation when inclusion of such shares would be anti-dilutive. Therefore, options to acquire 24 million and 20 million shares of common stock were not included in the calculation of diluted earnings per common share for the three and nine months ended September 30, 2012, respectively, and options to acquire 23 million and 31 million shares of common stock were not included in the calculation of diluted earnings per common share for the three and nine months ended September 30, 2011, respectively, as the effect of their inclusion in each case would be anti-dilutive.

Table of Contents

10. Capital transactions

Repurchase Program

On February 2, 2012, our Board of Directors authorized a new stock repurchase program under which we may repurchase up to $1 billion of our common stock, on terms and conditions to be determined by the Company, during the period between April 1, 2012 and the earlier of March 31, 2013 and a determination by the Board of Directors to discontinue the repurchase program. For the nine months ended September 30, 2012, we repurchased 4 million shares of our common stock for an aggregate purchase price of $54 million pursuant to that stock repurchase program.

On February 3, 2011, our Board of Directors authorized a stock repurchase program under which we were authorized to repurchase up to $1.5 billion of our common stock, on terms and conditions to be determined by the Company, until March 31, 2012. For the nine months ended September 30, 2012, we repurchased 22 million shares of our common stock for an aggregate purchase price of $261 million pursuant to that stock repurchase program.

Therefore, for the nine months ended September 30, 2012, we repurchased in total 26 million shares of our common stock for an aggregate purchase price of $315 million pursuant to stock repurchase plans authorized in 2011 and 2012.

For the nine months ended September 30, 2011, we repurchased 47 million shares of our common stock for an aggregate purchase price of $524 million pursuant to stock repurchase plans authorized in 2010 and 2011.

Dividend

On February 9, 2012, our Board of Directors declared a cash dividend of $0.18 per common share to be paid on May 16, 2012 to shareholders of record at the close of business on March 21, 2012 and on May 16, 2012, we made a cash dividend payment of $201 million to such shareholders. On June 1, 2012, the Company made dividend equivalent payments of $3 million related to this cash dividend to the holders of restricted stock units.

On February 9, 2011, our Board of Directors approved a cash dividend of $0.165 per common share to be paid on May 11, 2011 to shareholders of record as of March 16, 2011, and on May 11, 2011, we made a cash dividend payment of $192 million to such shareholders. On August 12, 2011, the Company made dividend equivalent payments of $2 million related to this cash dividend to the holders of restricted stock units.

11. Commitments and contingencies

At September 30, 2012, we did not have any significant changes to our commitments since December 31, 2011. See Note 17 of the Notes to Consolidated Financial Statements included in Item 8 of the Annual Report on Form 10-K for the year ended December 31, 2011 for more information regarding our commitments.

Legal Proceedings

The Company is subject to various legal proceedings and claims. FASB Accounting Standards Codification (ASC) Topic 450 governs the disclosure of loss contingencies and accrual of loss contingencies in respect of litigation and other claims. The Company records an accrual for a potential loss when it is probable that a loss will occur and the amount of the loss can be reasonably estimated. When the reasonable estimate of the potential loss is within a range of amounts, the minimum of the range of potential loss is accrued, unless a higher amount within the range is a better estimate than any other amount within the range. Moreover, even if an accrual is not required, the Company provides additional disclosure related to litigation and other claims when it is reasonably possible (*i.e.*, more than remote) that the outcomes of such litigation and other claims include potential material adverse impacts on the Company. The outcomes of legal proceedings and other claims are subject to significant uncertainties, many of which are outside the Company s control. There is significant judgment required in the analysis of these matters, including the probability determination and whether a potential exposure can be reasonably estimated. In making these determinations, the Company, in consultation with outside counsel, examines the relevant facts and circumstances on a quarterly basis assuming, as applicable, a combination of settlement and litigated outcomes and strategies. Moreover, legal matters are inherently unpredictable and the timing of development of factors on which reasonable judgments and estimates can be based can be slow. As such, there can be no assurance that the final outcome of these matters will not materially and adversely affect our business, financial condition, results of operations, or liquidity.

In prior periods, the Company reported on litigation involving former employees at Infinity Ward, as well as Electronic Arts, Inc. As previously disclosed, all parties to these litigation matters reached a settlement of the disputes on May 31, 2012.

Table of Contents

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

12. Related party transactions

Treasury

Our foreign currency risk management program seeks to reduce risks arising from foreign currency fluctuations. We use derivative financial instruments, primarily currency forward contracts and swaps, with Vivendi as our principal counterparty. The gross notional amount of outstanding foreign exchange swaps were $901 million and $85 million at September 30, 2012 and December 31, 2011, respectively. A pre-tax net unrealized gain of $4 million and a loss of less than $1 million for the three months ended September 30, 2012 and 2011, respectively, resulted from the foreign exchange contracts and swaps with Vivendi and were recognized in the condensed consolidated statements of operations. A pre-tax net unrealized gain of $3 million and a loss of less than $1 million for the nine months ended September 30, 2012 and 2011, respectively, resulted from the foreign exchange contracts and swaps with Vivendi and were recognized in the condensed consolidated statements of operations.

Other

Activision Blizzard has entered into various transactions and agreements, including cash management services, investor agreement, and music royalty agreements with Vivendi and its subsidiaries and other affiliates. None of these services, transactions and agreements with Vivendi and its affiliates is material, either individually or in the aggregate, to the condensed consolidated financial statements as a whole.

13. Recently issued accounting pronouncements

Indefinite-lived intangible assets impairment

In July 2012, the FASB issued an update to the authoritative guidance related to testing indefinite-lived intangible assets for impairment. This update gives an entity the option to first consider certain qualitative factors to determine whether the existence of events and circumstances indicates that it is more likely than not that the fair value of an indefinite-lived intangible asset is less than its carrying amount as a basis for determining whether it is necessary to perform the quantitative impairment test. This update is effective for the indefinite-lived intangible asset impairment test performed for fiscal years beginning after September 15, 2012. Early adoption is permitted. We do not expect that the adoption of this guidance will have a material impact on our consolidated financial statements.

Fair value measurements and disclosures

Effective January 1, 2012, we adopted an update to the accounting rules for fair value measurement. The new accounting principal establishes a consistent definition of fair value in an effort to ensure that the fair value measurement and disclosure requirements between U.S. GAAP and International Financial Reporting Standards (IFRS) are comparable. This update changes certain fair value measurement principles and enhances the disclosure requirements for fair value measurements. This update does not extend the use of fair value accounting, but provides guidance on how it should be applied where its use was already required or permitted by other standards within U.S. GAAP or IFRS. This update is effective for interim and annual periods beginning after December 15, 2011 and is applied prospectively. The adoption of this pronouncement did not have a material impact on the Company s Condensed Consolidated Financial Statements and accompanying disclosures.

Statement of comprehensive income

Effective January 1, 2012, we adopted the FASB issued authoritative guidance on the presentation of comprehensive income. This update requires that all non-owner changes in stockholders equity be presented either in a single continuous statement of comprehensive income or in two separate but consecutive statements. This update does not change the items that must be reported in other comprehensive income or when an item of other comprehensive income must be reclassified to net income. The adoption of this pronouncement did not have a material impact on the Company s Condensed Consolidated Financial Statements and accompanying disclosures.

Table of Contents

Goodwill impairment

Effective January 1, 2012, the Company adopted an update to the authoritative guidance related to goodwill impairment testing. This update gives companies the option to first perform a qualitative assessment to determine whether it is more likely than not that the fair value of a reporting unit is less than its carrying amount before performing the two-step test mandated prior to the update. If, after assessing the totality of events and circumstances, a company determines it is more likely than not that the fair value of a reporting unit is less than its carrying amount, then it must perform the two-step test. Otherwise, a company may skip the two-step test. Companies are not required to perform the qualitative assessment and may, instead proceed directly to the first step of the two-part test. The adoption of this updated guidance did not have a material impact on the Company s Condensed Consolidated Financial Statements.

Table of Contents

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

Business Overview

Activision Blizzard, Inc. is a worldwide online, personal computer (PC), video game console, handheld and mobile device game publisher. The terms Activision Blizzard, the Company, we, us, and our are used to refer collectively to Activision Blizzard, Inc. and its subsidiaries. Based upon our organizational structure, we conduct our business through three operating segments as follows:

Activision Publishing, Inc.

Activision Publishing, Inc. (Activision) is a leading international developer and publisher of interactive software products and content. Activision develops games based on both internally-developed and licensed intellectual property. Activision markets and sells games we develop and, through our affiliate label program, games developed by certain third-party publishers. We sell games both through retail channels and by digital download. Activision currently offers games that operate on the Sony Computer Entertainment, Inc. (Sony) PlayStation 3 (PS3), Nintendo Co. Ltd. (Nintendo) Wii (Wii), and Microsoft Corporation (Microsoft) Xbox 360 (Xbox 360) console systems; the Nintendo Dual Screen (NDS) handheld game systems; the PC; and Apple iOS devices and other handheld and mobile devices.

Blizzard Entertainment, Inc.

Blizzard Entertainment, Inc. (Blizzard) is a leader in the subscription-based massively multi-player online role-playing game (MMORPG) category in terms of both subscriber base and revenues generated through its World of Warcraft® franchise, which it develops, hosts and supports. Blizzard also develops, markets and sells role-playing action and strategy PC-based computer games, including games in the multiple-award winning Diablo® and StarCraft® franchises. In addition, Blizzard maintains a proprietary online-game related service, Battle.net®. Blizzard distributes its products and generates revenues worldwide through various means, including: subscriptions (which consist of fees from individuals playing World of Warcraft, prepaid cards and other value-added service revenues such as realm transfers, faction changes, and other character customizations within World of Warcraft gameplay); retail sales of physical boxed products; online download sales of PC products; and licensing of software to third-party or related party companies that distribute *World of Warcraft*, *StarCraft® II* and *Diablo® III*.

Activision Blizzard Distribution

Activision Blizzard Distribution (Distribution) consists of operations in Europe that provide warehousing, logistical and sales distribution services to third-party publishers of interactive entertainment software, our own publishing operations, and manufacturers of interactive entertainment hardware.

Business Highlights

For the three months ended September 30, 2012, Activision Blizzard had net revenues of $841 million, as compared to net revenues of $754 million in the same period in 2011. For the three months ended September 30, 2012, Activision Blizzard s earnings per diluted share were $0.20, as compared to earnings per diluted share of $0.13 for the same period in 2011.

For the nine months ended September 30, 2012, Activision Blizzard had net revenues of $3.1 billion, as compared to net revenues of $3.3 billion for the same period in 2011, and earnings per diluted share of $0.70, as compared to earnings per diluted share of $0.84 for the same period in 2011.

According to The NPD Group, with respect to North American data, Chart-Track and GfK with respect to European data, and our internal estimates:

- Activision Blizzard was the #1 PC publisher overall in North America and Europe for the three and nine months ended September 30, 2012;
- Activision Publishing s *Skylanders Spyro s Adventure* , including accessory packs and figures, was the #1 best-selling console and handheld game overall in dollars in North America and Europe for the nine months ended September 30, 2012; and
- Blizzard Entertainment s latest expansion pack, *World of Warcraft: Mists of Pandaria*, which launched on September 25, 2012 (in all regions except for China, which launched on October 2, 2012), sold approximately 2.7 million copies in its first week of sales.

Table of Contents

Additionally, during the nine months ended September 30, 2012, Activision Publishing released *Call of Duty: Modern Warfare 3 Content Collection #1*, *Call of Duty: Modern Warfare 3 Content Collection #2, Call of Duty: Modern Warfare 3 Content Collection #3,* and *Call of Duty: Modern Warfare 3 Content Collection #4*. In addition, Activision Publishing released *Transformers: Fall of Cybertron, Angry Birds Trilogy*, *Skylanders Cloud Patrol , Prototype® 2, Battleship®, The Amazing Spider-Man* and *Men In Black: Alien Crisis* . Activision Publishing also released *Ice Age Continental Drift Arctic Games* in Europe and Asia Pacific.

Recent and Upcoming Product Releases

During October, Activision Publishing released several new titles including: *007 Legends* on October 16, 2012; *Skylanders: Giants* , the sequel to its innovative new entertainment property *Skylanders: Spyro s Adventure* , on October 22, 2012; *Cabela s Dangerous Hunts 2013* and *Cabela s Hunting Expeditions* on October 23, 2012; and *Transformers Prime* on October 30, 2012.

On November 13, 2012, Activision Publishing expects to release *Call of Duty: Black Ops II.* Additionally, Activision Publishing expects to release *Wipeout 3* on November 18, 2012 and *Family Guy: Back to the Multiverse* on November 20, 2012.

Management s Overview of Business Trends

We provide our products through both retail channels and digital online delivery methods. Many of our video games that are available through retailers as physical boxed software products such as DVDs are also available by direct digital download over the Internet (both from websites that we own and from others owned by third parties). In addition, we offer players downloadable content as add-ons to our products (*e.g.*, new multi-player content packs), generally for a one-time fee. We also offer subscription-based services for *World of Warcraft*, which are digitally delivered and hosted by Blizzard s proprietary online-game related service, Battle.net. In conjunction with the release of *Call of Duty: Black Ops II*, all of the *Call of Duty Elite* service features for that game will be free; this free service will not include downloadable content packs, which will be sold separately via a discounted season pass bundle and a la carte as individual content packs. Existing *Call of Duty Elite* premium members will continue to enjoy the *Call of Duty Elite* premium membership features for *Call of Duty: Modern Warfare 3* through the end of their subscription period. Digital revenues remain an important part of our business, and we continue to focus on and develop products that can be delivered via digital online channels. The amount of our digital revenues in any period may fluctuate depending, in part, on the timing and nature of our specific product releases.

Conditions in the retail channels of the video games industry have remained challenging for the first nine months of 2012. In the U.S. and Europe, retail sales within the industry experienced a combined overall decrease of approximately 21% for the first nine months of 2012, as compared to the same period in 2011, according to The NPD Group, Chart-Track and GfK. The declines in the U.S. and European retail channels were impacted by fewer releases and catalogue sales in the nine months ended September 30, 2012 as compared to the same period in 2011, as well as price declines over the prior year. In addition, the decline in sales to the retail channel continues to be more pronounced for casual titles on the Nintendo Wii and handheld platforms (down over 34% year-to-date), than titles on high-definition platforms (i.e., Xbox 360 and PS3).

However, the industry s top five titles (including accessory packs and figures) grew 15% for the nine months ended September 30, 2012, as compared to the same period in 2011. This has resulted in the further concentration of revenues in the top titles, particularly for high-definition platforms, which experienced year-over-year growth, while non-premier titles experienced declines. The Company s results have been less impacted by the general declining trends in retail compared to our competitors because of our greater focus on premier top titles and a more focused overall slate of titles.

Table of Contents

Consolidated Statements of Operations Data

The following table sets forth consolidated statements of operations data for the periods indicated in dollars and as a percentage of total net revenues (amounts in millions):

	Three months ended September 30, 2012		Three months ended September 30, 2011		Nine months ended September 30, 2012		Nine months ended September 30, 2011	
Net revenues:								
Product sales	$ 536	64%	$ 369	49%	$ 2,208	72%	$ 2,197	66%
Subscription, licensing, and other revenues	305	36	385	51	880	28	1,151	34
Total net revenues	841	100	754	100	3,088	100	3,348	100
Costs and expenses:								
Cost of sales product costs	146	17	138	18	633	21	650	19
Cost of sales online subscriptions	56	7	59	8	178	6	181	5
Cost of sales software royalties and amortization	19	2	24	3	107	4	133	4
Cost of sales intellectual property licenses	10	1	16	2	37	1	69	2
Product development	131	16	133	18	407	13	390	12
Sales and marketing	131	16	115	15	346	11	264	8
General and administrative	121	14	104	14	413	13	333	10
Restructuring			3				24	1
Total costs and expenses	614	73	592	78	2,121	69	2,044	61
Operating income	227	27	162	22	967	31	1,304	39
Investment and other income (expense), net	1		3		4		7	
Income before income tax expense	228	27	165	22	971	31	1,311	39
Income tax expense	2		17	2	176	5	325	10
Net income	$ 226	27%	$ 148	20%	$ 795	26%	$ 986	29%

Operating Segment Results

Our operating segments are consistent with our internal organizational structure, the manner in which our operations are reviewed and managed by our Chief Executive Officer, who is our Chief Operating Decision Maker (CODM), the manner in which we assess operating performance and allocate resources, and the availability of separate financial information. We do not aggregate operating segments.

Table of Contents

The CODM reviews segment performance exclusive of the impact of the change in deferred net revenues and related cost of sales with respect to certain of our online-enabled games, stock-based compensation expense, restructuring expense, and amortization of intangible assets. The CODM does not review any information regarding total assets on an operating segment basis and, accordingly, no disclosure is made with respect thereto. Information on the operating segments and reconciliations of total segment net revenues and total segment income from operations to consolidated net revenues and income before income tax expense from external customers for the three and nine months ended September 30, 2012 and 2011 are presented below (amounts in millions):