

MAJESCO ENTERTAINMENT CO  
Form 10-Q/A  
February 01, 2007

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UNITED STATES  
SECURITIES AND EXCHANGE COMMISSION  
WASHINGTON, D.C. 20549

FORM 10-Q/A

(Amendment No. 1)

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

For the quarterly period ended July 31, 2006  
Majesco Entertainment Company

Commission File No. 000-51128

(Exact name of registrant as specified in its charter)

DELAWARE  
(State or Other Jurisdiction of  
Incorporation or Organization)

606-1529524  
(I.R.S. Employer  
Identification No.)

160 Raritan Center Parkway, Edison, NJ 08837  
(Address of principal executive offices)

REGISTRANT'S TELEPHONE NUMBER, INCLUDING AREA CODE: (732) 225-8910

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(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            No

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

Large accelerated filer                      Accelerated filer                      Non-accelerated filer

Indicate by check mark whether the registrant is a shell company (as defined in Rule 12b-2 of the Exchange Act).

Yes            No

As of January 30, 2007, there were 23,445,219 shares of the Registrant's common stock outstanding.

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MAJESCO ENTERTAINMENT COMPANY AND SUBSIDIARY  
July 31, 2006 QUARTERLY REPORT ON FORM 10-Q  
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EXPLANATORY NOTE

Majesco Entertainment Company hereby files this Amendment No. 1 to its Quarterly Report on Form 10-Q for the quarterly period ended July 31, 2006, solely to reclassify certain customer allowances in its Condensed Consolidated Statement of Operations in accordance with EITF 01-9 "Accounting for Consideration Given by a Vendor to a Customer (Including a Reseller of the Vendors Products)".

The impact of the adjustment was to: reduce net revenues and gross profit by \$267 and \$3,092 (in thousands) for the three and nine months ended July 31, 2006, respectively; and decrease sales and marketing expenses and total expenses by \$267 and \$3,092 (in thousands) for the three and nine months ended July 31, 2006, respectively.

The reclassifications have no impact on operating loss, net loss, or net loss attributable to common shareholders per share for the period reported. The Company has reflected the reclassification in the annual and quarterly results contained in its annual financial statements filed on Form 10-K on January 29, 2007.

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MAJESCO ENTERTAINMENT COMPANY AND SUBSIDIARY  
 CONDENSED CONSOLIDATED BALANCE SHEET (RESTATED)  
 (in thousands, except share amounts)

	July 31, 2006 (unaudited)	October 31, 2005
<b>ASSETS</b>		
Current assets		
Cash and cash equivalents	\$ 3,612	\$ 2,407
Due from factor	618	—
Other receivables	642	—
Income taxes receivable	551	826
Inventory — principally finished goods	3,689	8,058
Capitalized software development costs and prepaid license fees	4,056	17,278
Prepaid expenses	558	508
Total current assets	13,726	29,077
Property and equipment — net	758	862
Other assets	71	142
Total assets	\$ 14,555	\$ 30,081
<b>LIABILITIES AND STOCKHOLDERS' EQUITY</b>		
Current liabilities		
Accounts payable and accrued expenses	\$ 10,539	\$ 18,493
Inventory financing payable	208	—
Due to factor	—	6,343
Advances from customers	307	484
Total current liabilities	11,054	25,320
Stockholders' equity:		
Common stock — \$.001 par value; 250,000,000 shares authorized; 22,408,410 and 22,242,476 issued and outstanding at July 31, 2006 and October 31, 2005, respectively	22	22
Additional paid in capital	93,303	92,158
Accumulated deficit	(89,859)	(87,388)
Accumulated other comprehensive income (loss)	35	(31)
Total stockholders' equity	3,501	4,761
Total liabilities and stockholders' equity	\$ 14,555	\$ 30,081

See accompanying notes

MAJESCO ENTERTAINMENT COMPANY AND SUBSIDIARY  
CONDENSED CONSOLIDATED STATEMENT OF OPERATIONS (RESTATED)  
(in thousands, except share amounts)

	Three Months Ended July 31,		Nine Months Ended July 31,	
	2006	2005	2006	2005
	(Note 1A)		(Note 1A)	
	(unaudited)			
Net revenues	\$ 12,363	\$ 4,565	\$ 45,186	\$ 55,139
Cost of sales				
Product costs	5,461	5,002	20,550	30,358
Software development costs and license fees	2,784	15,748	9,056	21,587
	8,245	20,750	29,606	51,945
Gross profit (loss)	4,118	(16,185)	15,580	3,194
Operating expenses				
Research and development	556	721	1,953	2,517
Selling and marketing	2,159	8,479	8,484	17,594
General and administrative	3,061	3,822	8,021	8,922
(Gain) loss from settlement of liabilities and other	(1,410)	1,439	(4,507)	1,439
Loss on impairment of software development costs	—	6,115	2,375	6,115
Severance	—	1,360	—	1,360
Write-off of accounts receivable	—	322	—	322
Depreciation and amortization	84	188	347	765
	4,450	22,446	16,673	39,034
Operating loss	(332)	(38,631)	(1,093)	(35,840)
Other costs and expenses				
Interest expense and financing costs, net	392	241	1,378	1,502
Loss on foreign exchange contract	—	—	—	48
Loss before income taxes	(724)	(38,872)	(2,471)	(37,390)
Benefit for income taxes	—	(1,329)	—	(736)
Net loss	(724)	(37,543)	(2,471)	(36,654)
Fair value charge for warrants exercised at a discount	—	—	—	1,100
Net loss attributable to common stockholders	\$ (724)	\$ (37,543)	\$ (2,471)	\$ (37,754)
Net income (loss) attributable to common stockholders per share:				
Basic	\$ (.03)	\$ (1.69)	\$ (.11)	\$ (1.87)
Diluted	\$ (.03)	\$ (1.69)	\$ (.11)	\$ (1.87)
Weighted average shares outstanding				
Basic	22,408,410	22,231,075	22,345,021	20,162,747
Diluted	22,408,410	22,231,075	22,345,021	20,162,747

See accompanying notes

MAJESCO ENTERTAINMENT COMPANY AND SUBSIDIARY  
 CONDENSED CONSOLIDATED STATEMENT OF CASH FLOWS  
 (dollars in thousands)

CASH FLOWS FROM OPERATING ACTIVITIES	Nine Months Ended July 31,	
	2006	2005
	(unaudited)	
Net loss	\$ (2,471)	\$ (36,654)
Adjustments to reconcile net loss to net cash provided by (used in) operating activities		
Depreciation and amortization	347	765
Impairment of software development costs	2,375	6,115
Non-cash compensation expense	1,020	1,341
Loss (gain) on settlement of liabilities and other gains	(4,507)	1,439
Write-off of accounts receivable.		322
Amortization of software development costs and prepaid license fees.	9,056	13,992
Changes in operating assets and liabilities		
Decrease (increase) in due from factor — net	(6,961)	8,333
Increase in other receivables	(642)	—
Decrease (increase) in inventory	4,369	(9)
Decrease (increase) in capitalized software development costs and prepaid license fees	1,791	(36,200)
Decrease in income tax receivable	275	—
Increase in prepaid expenses and other	(50)	(2,959)
Decrease in other assets	9	126
(Decrease) in accounts payable and accrued expenses.	(3,321)	(3,643)
Decrease in advances from customers	(177)	(589)
Net cash provided by (used in) operating activities	1,113	(47,621)
CASH FLOWS FROM INVESTING ACTIVITIES		
Purchases of property and equipment	(182)	(349)
Net cash used in investing activities	(182)	(349)
CASH FLOWS FROM FINANCING ACTIVITIES		
Net proceeds from secondary offering	—	41,898
Net proceeds from exercise of warrants at discount	—	6,482
Net proceeds from exercise of warrants	—	12,108
Inventory financing	208	(6,536)
Net cash provided by investing activities	208	53,952
Effect of exchange rates on cash and cash equivalents	66	127
Net increase in cash	1,205	6,109
Cash and cash equivalents — beginning of period	2,407	4,170
Cash and cash equivalents — end of period	\$ 3,612	\$ 10,279

## SUPPLEMENTAL SCHEDULE OF NON CASH INVESTING AND FINANCING ACTIVITIES

Fair value charge for warrants exercised at discount	—	\$ 1,100
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CASH FLOWS FROM OPERATING ACTIVITIES	Nine Months Ended July 31,	
	2006	2005
	(unaudited)	
Issuance of common stock as a dividend on the preferred stock	—	\$ 1,261
Accounts payable settled through the issuance of common stock	\$ 125	—
See accompanying notes		

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## 1. PRINCIPAL BUSINESS ACTIVITY AND BASIS OF PRESENTATION

Majesco Entertainment Company and subsidiary (“Majesco” or “Company”) is a provider of interactive entertainment products. The Company’s offerings include video game software and other digital entertainment products.

Majesco’s products provide it with opportunities to capitalize on the large and growing installed base of interactive entertainment platforms and an increasing number of interactive entertainment enthusiasts. The Company sells its products directly and through resellers primarily to U.S. retail chains, including Best Buy, GameStop/Electronics Boutique, Circuit City, Target, Toys “R” Us and Wal-Mart. Majesco also sells products internationally through partnerships with international publishers. The Company has developed retail and distribution network relationships over its more than 20-year history.

Majesco provides offerings for most major interactive entertainment hardware platforms, including Nintendo’s Game Boy Advance, or GBA, DS, Micro and GameCube, Sony’s PlayStation 2, or PS2, and PlayStation Portable, or PSP, Microsoft’s Xbox and the personal computer, or PC.

The Company’s offerings include video game software and other digital entertainment products. The Company’s operations involve similar products and customers worldwide. The products are developed and sold domestically and internationally. The Company is centrally managed and the chief operating decision makers, the chief executive and other officers, use consolidated 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. Sales for the Company in the United States were \$11.1 million or 88% and \$39.7 million or 82% for the three and nine month periods ended July 31, 2006, respectively. Sales in Europe were \$1.5 million or 12% and \$8.5 million or 18% for the three and nine month periods ended July 31, 2006, respectively. During the same periods last year, there were no material sales in Europe.

The accompanying financial statements have been prepared assuming that the Company will continue as a going concern. The Company has suffered losses that raise substantial doubt about its ability to continue as a going concern. Management's plan in regard to these matters is also described below. The financial statements do not include any adjustments that might result from the outcome of this uncertainty.

As of July 31, 2006, assuming continued availability of funding at previous levels by the current factor or alternative sources, management believes that there will be sufficient capital resources from operations and financing arrangements for the next twelve months in order to meet our requirements for: development, production, marketing, purchases of equipment, and the acquisition of intellectual property rights for future products.

However, in the event that the Company is unable to generate the level of operating revenues in the business plan, the Company will be required to reduce operating expenditures or obtain additional sources of financing. There can be no assurance that additional sources of financing will be available on acceptable terms, if at all. If no additional sources of financing are available, it could create a material adverse effect on future operating prospects.

The accompanying interim 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 results of operations for interim periods are not necessarily indicative of results to be expected for the entire fiscal year or any other period. The balance sheet at October 31, 2005 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 consolidated financial statements should be read in conjunction with the Company's consolidated financial statements and notes for the year ended October 31, 2005 filed on Form 10-K on February 1, 2006.

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The statements contained in this Report on Form 10-Q, that are not purely historical, are forward-looking information and statements within the meaning of Section 27A of the Securities Act of 1933 and Section 21E of the Securities Exchange Act of 1934. These include statements regarding our expectations, intentions, or strategies regarding future matters. All forward-looking statements included in this document are based on information available to us on the date hereof. It is important to note that our actual result could differ materially from those projected in such forward-looking statements contained in this Form 10-Q. The forward-looking statements contained herein are based on current expectations that involve numerous risks and uncertainties. Assumptions relating to the foregoing involve judgments regarding among other things, our ability to secure financing or investment for capital expenditures, future economic and competitive market conditions, and future business decisions. All these matters are difficult or impossible to predict accurately, many of which may be beyond our control. Although we believe that the assumptions underlying our forward-looking statements are reasonable, any of the assumptions could be inaccurate and, therefore, there can be no assurance that the forward-looking statements included in this Form 10-Q will prove to be accurate.

#### NOTE 1A – RESTATEMENT

As a result of a review of customer allowances issued during the year ended October 31, 2006, the company reclassified certain customer allowances in accordance with EITF 01-9 “Accounting for Consideration Given by a Vendor to a Customer (Including a Reseller of the Vendors Products)”.

The impact of the adjustment was to reduce net revenues and gross profit and decrease sales and marketing expenses reported for the quarter ended July 31, 2006.

The reclassifications have no impact on operating loss, net loss, or net loss attributable to common shareholders per share for the period reported. The adjustment has no impact on the financial statements contained in its annual report filed on Form 10-K on January 29, 2007.

The table below summarizes the impact on operating results for the three and nine months ended July 31, 2006.

	Three Months Ended July 31, 2006			Nine Months Ended July 31, 2006		
	As		difference	As		difference
	Previously Reported	As Restated		Previously Reported	As Restated	
Net revenues	\$ 12,630	\$ 12,363	\$ 267	\$ 48,278	\$ 45,186	\$ 3,092
Gross profit	\$ 4,385	\$ 4,118	\$ 267	\$ 18,672	\$ 15,580	\$ 3,092
Selling and marketing	\$ 2,426	\$ 2,159	\$ 267	\$ 11,576	\$ 8,484	\$ 3,092
Total operating expense	\$ 4,717	\$ 4,450	\$ 267	\$ 19,765	\$ 16,673	\$ 3,092
Operating loss	\$ (332)	\$ (332)	No change	\$ (1,093)	\$ (1,093)	No change
Net loss	\$ (724)	\$ (724)	No change	\$ (2,471)	\$ (2,471)	No change

## 2. SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES

**Stock Based Compensation.** In December 2004, the Financial Accounting Standards Board (“FASB”) issued Statement of Financial Accounting Standards No. 123 (R) (revised 2004), “Share-Based Payment” which revised Statement of Financial Accounting Standards No. 123, “Accounting for Stock-Based Compensation”. This statement supersedes Opinion No. 25, “Accounting for Stock Issued to Employees.” The revised statement addresses the accounting for share-based payment transactions with employees and other third parties, eliminates the ability to account for share-based compensation transactions using APB 25 and requires that the compensation costs relating to such transactions be recognized in the statement of operations. The revised statement has been implemented by the Company effective November 1, 2005.

The implementation of FAS No. 123 (R) has resulted in charges of \$404,000 and \$858,000 for three and nine-month periods ended July 31, 2006, respectively

There is no impact on the basic or diluted earnings per share reported on the statement of operations. For the 2005 fiscal year the Company accounted for its employee incentive stock option

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plans using the intrinsic value method in accordance with the recognition and measurement principles of Accounting Principles Board Opinion No. 25, “Accounting for Stock Issued to Employees.” Had the Company determined compensation expenses based on the fair value at the grant dates for those awards consistent with the method of SFAS 123, the Company’s net (loss) per share would have increased to the following pro forma amounts:



	Three Months Ended July 31, 2005	Nine Months Ended July 31, 2005
(in thousands, except per share amounts)		
Net income (loss) — as reported	\$ (37,543)	\$ (36,654)
Add: total stock based employee compensation expense determined under intrinsic value based methods for all awards	124	682
Less: stock based employee compensation determined under fair value based method net of income tax effect	(419)	(1,463)
Net income (loss) — pro forma	\$ (37,838)	\$ (37,435)
Net income (loss) attributable to common stockholders per share:		
Basic and diluted net loss per share as reported	\$ (1.69)	\$ (1.87)
Pro forma basic and diluted basic loss per share	\$ (1.70)	\$ (1.91)

The fair value of each option grant is estimated on the date of grant using the Black-Scholes option-pricing model with the following assumptions:

	July 31, 2006	July 31, 2005
Risk free annual interest rate	4.30%	2.71% to 3.85%
Expected volatility	90%	30% to 90%
Expected life	5 years	5 years
Assumed dividends	None	None

Effective November 1, 2005, the Company adopted FAS No. 123 (R) utilizing the modified prospective method. FAS No. 123 (R) requires the recognition of stock-based compensation expense in the financial statements.

Under the modified prospective method, the provisions of FAS No. 123 (R) apply to all awards granted or modified after the date of adoption. In addition, the unrecognized expense of awards not yet vested at the date of adoption, determined under the original provisions of FAS 123, “Accounting for Stock Based Compensation”, shall be recognized in net earnings in the periods after the date of adoption. Stock based compensation consists primarily of stock options. Stock options are granted to employees at exercise prices equal to the fair market value of the Company’s stock at the dates of grant. Stock options generally vest over three years and have a term of seven years. Compensation expense for stock options is recognized on a straight line basis over the period for each separately vesting stock option award.

The fair value for options issued was estimated at the date of grant using a Black-Scholes option-pricing model. The risk free rate was derived from the U.S. Treasury yield curve in effect at the time of the grant. The volatility factor was determined based on a study done by an independent securities valuation firm. The Black-Scholes option-pricing model was developed for use in estimating the fair value of traded options that have no vesting restrictions and are fully transferable. In addition, option-pricing models require the input of highly subjective assumptions including the expected stock price volatility. Because the Company’s employee stock options have characteristics significantly different from those of traded options and because changes in the subjective input assumptions can materially affect the fair value estimate, in management’s opinion the existing models do not necessarily provide a reliable single measure of the fair value of its employee stock options.

A summary of the status of the Company's options for the nine months ended July 31, 2006 is as follows:

	Shares	Weighted Average Exercise Price	Remaining Life	Aggregate Intrinsic Value
Balance at beginning of period	1,820,550	\$ 8.45	6.4	—
Granted	215,000	\$ 1.47	6.3	—
Cancelled or Expired	(585,256)	\$ 7.30	5.7	—
Exercised	—	—	—	—
Outstanding at end of period	1,450,294	\$ 6.44	5.7	—
Exercisable at end of period	482,360	\$ 8.74	5.4	—

A summary of the status of the Company's nonvested shares as of July 31, 2006, and changes during the nine months ended July 31, 2006 is presented below:

	Number of Shares	Weighted- Average Fair Value at Grant Date	Weighted- Average Remaining Contractual Term (in years)
Non-vested shares at October 31, 2005	1,581,260	\$ 4.51	6.4
Options granted	215,000	\$ 1.07	6.3
Options vested	(317,969)	\$ 2.83	5.6
Options forfeited or expired	(510,357)	\$ 3.78	5.7
Non-vested shares at July 31, 2006	967,934	\$ 3.01	5.8

As of July 31, 2006, there was approximately \$2.9 million of unrecognized compensation cost related to non-vested stock option awards, which is expected to be recognized over a remaining weighted-average vesting period of 1.7 years.

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 period. Among the more significant estimates included in these financial statements are the estimated customer allowances, the valuation of inventory and the recoverability of advance payments for software development costs and intellectual property licenses. Actual results could differ from those estimates.

Earnings/(Loss) per share. Basic earnings/(loss) per common share is computed by dividing the net loss applicable to common stockholders by the weighted-average number of shares of common stock outstanding for the period. Diluted and basic earnings/(loss) per common share for the three month period ended July 31, 2006, and the nine month periods ended July 31, 2006 and 2005 are the same because the impact of the conversion or exercise, as applicable, of the warrants (2,070,687 at July 31, 2006 and 2005) and stock options (1,450,294 and 950,907 at July 31, 2006 and 2005, respectively) would be antdilutive.

Recent accounting pronouncements. In June 2006 the FASB issued interpretation No. 48, "Accounting for Uncertainty in Income Taxes — an Interpretation of FASB Statement No. 109" ("FIN 48"). FIN 48 clarifies the accounting for uncertainty in income taxes recognized in a company's financial statements in accordance with SFAS No. 109, "Accounting for Income Taxes." FIN 48 prescribes a recognition threshold and measurement attribute for the financial statement recognition and measurement of a tax position taken or expected to be taken in a tax return. FIN 48 is effective for fiscal years beginning after December 15, 2006. We are currently reviewing this new standard to determine its effects, if any, on our results of operations or financial position. The Company does not believe that any other recently issued, but not yet effective accounting standards will have a material effect on the Company's consolidated financial position, results of operations or cash flows.

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### 3. DUE FROM FACTOR

Due from (to) factor consists of the following:

	July 31, 2006 (in thousands)	October 31, 2005 (in thousands)
Outstanding accounts receivable sold to factor	\$ 7,313	\$ 4,842
Less: allowance	(2,716)	(9,551)
Advances from factor	(3,979)	(1,634)
	\$ 618	\$ (6,343)

The following table sets forth the adjustments to the price protection and other customer sales incentive allowances included as a reduction of the amounts due from factor:

	Nine Months Ended July 31, (in thousands)	
	2006	2005
Balance — beginning of period	\$ (9,551)	\$ (4,860)
Add: provision	(2,231)	(12,711)
Less: amounts charged against allowance	9,066	6,773

Balance — end of period \$ (2,716)      \$ (10,798)

#### 4. OTHER RECEIVABLES

Other receivables consist of \$0.5 million of legal fees due from insurance carriers and \$0.1 of royalties receivables.

#### 5. ACCOUNTS PAYABLE AND ACCRUED EXPENSES

Accounts payable and accrued expenses consist of the following (in thousands):

	July 31, 2006	October 31, 2005
Accounts payable — trade	\$ 5,212	\$ 9,563
Accrued expenses:		
Royalties — including accrued minimum guarantees	3,077	5,634
Salaries and other compensation	975	1,481
Sales commissions	209	467
Professional fees	496	311
Other accruals	570	1,037
	\$ 10,539	\$ 18,493

#### 6. CONTINGENCIES AND COMMITMENTS

##### Commitments

At July 31, 2006, the Company had open letters of credit aggregating \$1.7 million under the Company's purchase order assignment arrangements for inventory to be delivered during the subsequent quarter.

At July 31, 2006 the Company was committed under agreements with certain developers for future milestone and license fee payments aggregating \$0.5 million, \$0.2 million of which are payable through October 31, 2006. Milestone payments represent scheduled installments due to the Company's developers based upon the developers providing the Company certain deliverables, as predetermined in the Company's contracts. The milestone payments generally represent advances against royalties to the developers. These payments will be used to reduce future royalties due to the developers from sales of the Company's videogames.

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The Company has entered into "at will" employment agreements with certain key executives. These employment agreements include provisions for, among other things, annual compensation, bonus arrangements and stock option grants. These agreements also contain provisions related to severance terms and change of control provisions.

##### Contingencies

In July 2006 the Company finalized and adopted an employee incentive plan that provides for cash payments aggregating \$0.8 million to \$2.2 million if the Company achieves certain adjusted net income targets for the year ending October 31, 2006. The Company has accrued \$0.4 million under the plan as of July 31, 2006.

On December 2, 2005, a vendor filed a complaint against the Company in the Supreme Court of the State of New York, County of New York, alleging breach of contract and failure to pay in connection with services rendered and seeking approximately \$2.6 million in damages and costs, including attorney's fees. On May 31, 2006 the Company entered into a settlement agreement with the vendor settling all claims relating to the action. Under the terms of the settlement agreement, the Company agreed to pay the vendor a total of \$750 thousand as follows: \$200 thousand upon execution of the settlement agreement, \$175 thousand thirty days thereafter, and \$375 thousand sixty days thereafter, in full settlement of all claims and liabilities between the parties relating to this action. The Company also agreed to indemnify and hold harmless the vendor for certain claims relating to the services performed by the vendor on our behalf. All payments have been made to the vendor under the settlement agreement.

On November 16, 2005, one of the Company's service providers instituted legal proceedings against the Company for \$1.9 million in the United States District Court for the Central District of California alleging breach of contract. The Company believes that the claims are without merit and intends to vigorously defend this action.

In July 2005, four purported class action complaints were filed against the Company and several current and former directors and officers of the Company in the United States District Court for the District of New Jersey. On September 12, 2005, a fifth purported class action complaint was filed in the same court on behalf of a class of individuals who purchased shares of the Company common stock in the Company's January 26, 2005 offering of six million shares of common stock (the "Offering"). The complaint named as defendants the Company, current and former officers of the Company, and certain financial institutions who served as underwriters with respect to the Offering.

On October 11, 2005, the Court consolidated the five cases and appointed a Lead Plaintiff. On December 14, 2005, the Lead Plaintiff filed an Amended Consolidated Complaint, which is now the operative Complaint. The Complaint names the following as defendants: the Company, Carl Yankowski, Jan E. Chason, Jesse Sutton, Joseph Sutton, Morris Sutton, Laurence Aronson, F. Peter Cuneo, James Halpin, Louis Lipschitz, Marc Weisman, RBC Capital Markets Corporation, JMP Securities LLC, Harris Nesbitt & Corp., Wedbush Morgan Securities Inc., and Goldstein Golub Kessler LLP.

The Complaint alleges that the Registration Statement and Prospectus filed with the SEC in connection with the Company's Offering and certain of the Company's press releases and other public filings contained material misstatements and omissions about the Company's financial condition and prospects as well as its products. The lead Plaintiff asserts a claim under Section 11 of the Securities Act against all the defendants on behalf of investors who purchased in the Offering. It asserts a Section 12(a)(2) claim against the Company and the financial institutions who served as underwriters in connection with the Offering, and a Section 15 control person claim against defendants Carl Yankowski, Jan Chason, Jesse Sutton, Joseph Sutton, and Morris Sutton (the "Defendants"). Lead Plaintiff also asserts a claim under Section 10(b) of the Exchange Act and Rule 10b-5 promulgated there under against the Company and the Defendants and a claim under Section 20(a) of the Exchange Act against the Defendants. The Complaint seeks damages in an unspecified amount. The proposed class period for the Exchange Act claims is December 8, 2004 through September 12, 2005. We will vigorously contest the action.

The Company is party to other routine claims and suits brought by the Company and against the Company in the ordinary course of business, including disputes arising over contractual claims and collection matters. In the opinion of management, after consultation with legal counsel, the outcome of such routine claims will not have a material adverse effect on the Company's business, financial condition, and results of operations or liquidity. However, the costs and other effects of pending or future litigation, governmental investigations, legal and administrative cases and proceedings (whether civil or criminal), settlements, judgments and investigations, claims and changes in those matters (including the matters described above), and developments or assertions by or against the Company relating to intellectual property rights and intellectual property licenses, could have a material adverse effect on the Company's business, financial condition, and results of operations or liquidity.

#### 7. RELATED PARTIES

The Company receives printing and packaging services from a business of which the brother of Morris Sutton, the Company's Chairman Emeritus, is a principal. During the three and nine month periods ended July 31, 2006 the Company was charged \$0.2 million and \$1.0 million compared to \$0.4 million and \$2.1 million for the three and nine month periods ended July 31, 2005. These charges are included in product costs in the accompanying consolidated statement of operations. Such charges are, to the Company's knowledge, on terms no less favorable to what the Company could receive from providers of similar services.

The Company receives marketing services from a business which is owned by one of its directors. During the three and nine month periods ended July 31, 2006, the Company was charged \$2,500 and \$12,100 compared to \$33,221 and \$133,924 for the three and nine month periods ended July 31, 2005. These charges are included in selling and marketing costs in the accompanying consolidated statement of operations. Such charges are, to the Company's knowledge, on terms no less favorable to what the Company could receive from providers of similar services.

#### 8. STOCKHOLDERS EQUITY

During the nine month period ended July 31, 2006 the Company recorded the following activity as increases to additional paid in capital: \$67,000 representing the fair value of 49,492 shares of restricted common stock issued to non-employee directors; \$858,000 of stock option expense related to the adoption of FAS No. 123 (R), \$93,000 representing one-half of the fair value of a warrant to purchase 150,000 shares of common stock issued to a consultant, and \$125,000 related to the issuance of 116,442 shares of common stock in payment of accounts payable. The warrant issued to the consultant vests one half based on services delivered in July of 2006, and one half based on services delivered during the fourth quarter of 2006.

#### 9. GAIN ON SETTLEMENT OF LIABILITIES AND OTHER GAINS

During the three month period ended July 31, 2006, the Company recorded a gain on settlement of liabilities consisting of \$1.4 million related to the settlement of accounts payable for marketing and development expenses for less than the invoiced amount.

During the nine month period ended July 31, 2006, the Company recorded a gain on settlement of liabilities of \$4.5 million consisting of \$1.5 million related to negotiated reductions in royalties due for certain video and video game titles, \$0.5 million gain on the sale of rights to certain video game titles, and a \$2.5 million gain on the settlement of accounts payable for legal, marketing and development expenses for less than the originally invoiced amount.

#### 10. SUBSEQUENT EVENT

On August 3, 2006 the company issued an aggregate of 1,156,028 shares of restricted common stock to certain key executives and employees under the 2004 Employee, Director and Consultant Incentive Plan. One half of the shares vest on the second anniversary of the grant date, and the remaining half vest on the third anniversary of the grant date.

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

Overview

We are a provider of interactive entertainment products. We sell our products primarily to large retail chains, specialty retail stores, video game rental outlets and distributors. We also sell our products internationally through distribution agreements with international publishers. We have developed our retail and distribution network relationships over our 20-year history.

We publish video game software for most major interactive entertainment hardware platforms, including Nintendo's Game Boy Advance, or GBA, DS, Micro and GameCube, Sony's PlayStation 2, or PS2, and PlayStation Portable, or PSP™, Microsoft's Xbox and the personal computer, or PC.

Our video game titles are targeted at various demographics at a range of price points, from lower-priced "value" titles to more expensive "premium" titles. In some instances, these titles are based on licenses of well-known properties, and in other cases based on original properties. We collaborate and enter into agreements with content providers and video game development studios for the creation of our video games.

Majesco Sales Inc. was incorporated in 1986 under the laws of the State of New Jersey. On December 5, 2003, Majesco Sales Inc. completed a reverse merger with Majesco Holdings Inc (formerly, ConnectivCorp) then a publicly traded company with no active operations. Majesco Holdings Inc. was incorporated in 1998 under the laws of the State of Delaware. As a result of the merger, Majesco Sales Inc. became a wholly-owned subsidiary and the sole operating business of the public company. On April 4, 2005, Majesco Sales Inc. was merged into Majesco Holdings Inc., and Majesco Holdings Inc. changed its name to Majesco Entertainment Company.

During the second half of fiscal 2005, we had several major developments that ultimately led us to revise our business model and shift our product strategy away from capital intensive premium console games to a focus on lower-cost games for both console and handheld systems. We believe this strategy will allow us to capitalize on our strengths and expertise while reducing some of the cost and risk associated with publishing a large number of premium console titles. We continue to publish titles for popular handheld systems such as the GBA, DS and PSP. We also intend to publish software for Nintendo's WII console (expected to be released in late 2006) as we believe this platform allows us to develop games within our cost parameters, while enabling us to reach the "mass market" consumer. In addition, we will continue to opportunistically look for titles to publish on the PC and other home console systems.

Net Revenues. Our revenues are derived from the following types of offerings:

- Games. Our video games consist of "premium" titles and "value" titles for console and handheld video game systems. Premium titles are higher-priced video games that typically involve greater development and marketing costs. We work with third-party development studios to develop our own proprietary titles and we also license rights to well-known properties from third parties. Value titles are typically sold at suggested retail prices below \$20 and typically involve comparatively lower development and marketing costs than our premium titles; and
- Other digital entertainment products. Our GBA Video titles utilize compression technology

that enables users to view up to 90 minutes of color video content with stereo audio on their GBA or DS, using a standard GBA cartridge and with no additional hardware required. We enter into licensing agreements with entertainment industry leaders for GBA Video content. In addition, we develop, manufacture and market a variety of digital media peripherals and applications including a stand-alone TV Arcade “plug-and-play” video game system which consists of a firmware-enabled joystick that connects directly to a user’s television and plays pre-installed video games without the need for a dedicated console.

Our revenues are recognized net of reserves for price protection and other allowances.

**Cost of Sales.** Cost of sales consists of product costs and amortization of software development costs and license fees. A significant component of our cost of sales is product costs. These are

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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. Commencing upon the related product’s release, capitalized software development and intellectual property license costs are amortized to cost of sales.

**Gross Profit.** Gross Profit is the excess of net revenues over product costs and amortization of software development and license fees. Our gross profit is directly affected by the mix of revenues from our premium handheld versus value titles. The excess of net revenues over product costs has the potential to be substantially higher from publishing premium titles given the relatively lower manufacturing costs and higher sales prices. However, development and license fees incurred to produce premium 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. Our value titles are generally characterized as having lower gross profit margin potential than premium titles as a result of their lower sales price, and lower financial risk associated with the recovery of upfront development and license fees associated with premium game titles.

**Product Research and Development Expenses.** Product research and development expenses relate principally to our cost of supervision of the third-party developers of our video games and other products, testing new products and conducting quality evaluations during the development cycle. Costs incurred are employee-related, may include equipment and are not allocated to cost of sales. Although there can be no assurance, we anticipate that, with our focus now on low-cost handheld game and value products, expenditures for product research and development will decrease.

**Selling and Marketing Expenses.** Selling and marketing expenses consist of marketing and promotion expenses, the cost of shipping products to customers and related employee costs. A large component of this expense relates to marketing and promotion expenses, which includes certain customer marketing allowances. We anticipate that our focus now on low-cost handheld game and value products, will result in decreased sales and marketing expense.

**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. We expect to continue to incur increased costs related to the currently pending shareholder class action lawsuits, as well as for consultants in connection with our required



compliance with recently enacted regulations regarding corporate governance and accounting. Under our revised business plan we expect a decrease in certain general and administrative expenses as a result of decreased headcount and related expenses.

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

**(Benefit)Provision for Income Taxes.** For the year ended 2005, we incurred a loss and recognized the availability for income tax purposes of a carryback of such losses to the prior year. Utilization of our net operating loss 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 net operating loss carryforwards before utilization. Since the Company has a history of losses, a full valuation allowance has been established under the provisions of SFAS No. 109 and the company intends to maintain a valuation allowance for its net operating loss carryforwards until sufficient positive evidence exists to support its reversal.

### Critical Accounting Policies

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.

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

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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 the understanding of our financial results. The impact and any associated risks related to these policies on our business operations is discussed throughout management’s discussion and analysis of financial condition and results of operations where such policies affect our reported and expected financial results.

**Revenue Recognition.** We recognize revenue upon the shipment of our product when title and risk of loss are transferred and persuasive evidence of an arrangement exists. In order to recognize revenue, we must not have any continuing obligations and it must also be probable that we will collect the accounts receivable. Revenues, including sales to resellers and distributors, are recognized when these conditions are met.

For those agreements which provide customers with the right to multiple copies in exchange for guaranteed minimum royalty amounts, revenue is recognized at delivery of the product master or the first copy since we have no continuing obligations including requirements for duplication. Royalties on sales that exceed the guaranteed minimum are recognized as earned.

We generally sell our products on a no-return basis, although in certain instances, we may provide price protection or other allowances on certain unsold products. Price protection, when granted and applicable, allows customers a partial credit against amounts they owe us with respect to merchandise unsold by them. Revenue is recognized net of estimates of these allowances.

**Inventory.** Inventory, which consists of finished goods, is stated at the lower of cost as determined by the first-in, first-out method, or market. We estimate 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.

**Reserves for Price Protection and Other Allowances.** We derive revenue from the sale of packaged video game software designed for play on consoles such as PlayStation 2, Xbox and GameCube, personal computers, and hand-held game devices, including the GBA, DS and PSP. We generally sell our products on a no-return basis, although in certain instances, we may 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 assets or services received, such as the appearance of our products in a customer's national circular advertisement, are reflected as selling and marketing expenses. We estimate potential future product price protection and other discounts related to current period product revenue. Generally our price protection for premium-priced titles is higher than that needed for our value titles.

Our reserves 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. 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 or 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 reserves, which would impact the net revenues and/or selling and marketing expenses we report. For the three and nine month periods ended July 31, 2006 we provided allowances for future price protection and other

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allowances of \$0.1 million and \$2.2 million, respectively. For the three and nine month periods ended July 31, 2005 we provided allowances for future price protection and other allowances of \$10.1 million and \$12.7 million, respectively. The fluctuations in the provisions reflected our estimates of future price protection based on the factors discussed above. We do not have significant exposure to credit risk as the factor generally buys our receivables without recourse.

**Software development costs and prepaid license fees.** Software development costs include development fees, most often in the form of milestone payments made to independent software developers for development services. Software development costs are capitalized once technological feasibility of a product is established and it is determined that such costs should 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. 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 (prepaid license fees) and a current liability (accrued royalties payable) at the contractual amount upon execution of the contract when no significant performance remains with the licensor. Capitalized software development costs classified as non-current relate to titles for which we estimate the release date to be more than one year from the balance sheet date.

Commencing upon a related product's release, capitalized software development costs and prepaid license fees are amortized to cost of sales based upon the higher of (i) the ratio of current revenue to total projected revenue or (ii) the straight-line method. The amortization period is usually no longer than one year from the initial release of the product. The recoverability of capitalized software development costs and prepaid license fees is evaluated based on the expected performance of the specific products to which the costs relate. The following criteria are used to evaluate expected product performance: historical performance of comparable products using comparable technology; orders for the product prior to its release; and estimated performance of a sequel product based on the performance of the product on which the sequel is based. We recorded an expense of \$2.4 million and \$6.1 million for the nine months ended July 31, 2006 and 2005, respectively, related to development costs for projects which were either canceled, or for which full recoverability was not expected. We also charged \$9.2 million to cost of sales during the nine months ended July 31, 2005 to recognize impairments in the carrying value of games for which orders received were significantly below expectations. In the three and nine month periods ended July 31, 2006 we charged \$2.8 million and \$9.1 million, respectively, to cost of sales for amortization of software development costs, prepaid license fees and royalties on products which were sold, compared to \$6.5 million and \$12.4 million in the comparable periods in 2005.

**Accounting for Stock-Based Compensation.** In December 2004, the FASB issued SFAS No. 123 (revised 2004), "Share Based Payment" ("SFAS 123(R)"). SFAS 123(R) requires all share-based payments to employees, including grants of employee stock options, to be recognized in the financial statements based on their fair values. We adopted SFAS 123(R) on November 1, 2005. SFAS 123(R) permits public companies to adopt its requirements using either the modified prospective or modified retrospective transition method. We have decided to use the modified prospective transition method, which require that compensation cost is recognized for all awards granted, modified or settled after the effective date as well as for all awards granted to employees prior to the effective date that remain unvested as of the effective date.

## Results of operations

Three months ended July 31, 2006 versus three months ended July 31, 2005

**Net Revenues.** Net revenues for the three months ended July 31, 2006 increased to \$12.4 million from \$4.4 million in the comparable quarter last year. The \$8.0 million increase is primarily due to a lower provision for price protection and other allowances, resulting from a higher sell-through percentage at retailers for titles, principally "Jaws Unleashed", released in the three months ended July 31, 2006.

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**Gross(Loss) Profit.** Gross profit for the three months ended July 31, 2006 was \$4.1 million compared to a gross (loss) of (\$16.2) million in the same quarter last year. The increase in gross profit (loss) is primarily attributable to the

higher net revenues discussed above and a \$9.2 million charge to cost of sales during the nine months ended July 31, 2005 to recognize impairments in the carrying value of games for which orders received were significantly below expectations. Gross profit as a percentage of net sales was 33% for the three months ended July 31, 2006.

**Product Research and Development Expenses.** Research and development costs decreased \$0.1 million to \$0.6 million for the three months ended July 31, 2006 from \$0.7 million for the comparable period in 2005. The decrease is principally the result of fewer quality assurance employees due to a reduced number of premium game projects currently in the development cycle.

**Selling and Marketing Expenses.** Total selling and marketing expenses decreased to \$2.2 million for the three months ended July 31, 2006 from \$8.5 million in the same three month period in 2005. The \$6.3 million decrease is primarily due to a decrease in media costs related to premium games that were launched in the three months ended July 31, 2005. Selling and marketing expense as a percentage of net sales was approximately 18% for the three months ended July 31, 2006, compared to 186% for the same quarter last year. The decline is the result of higher revenues in 2006 and an overall decrease in media costs.

**General and Administrative Expenses.** For the three month period ended July 31, 2006 general and administrative expenses were \$3.1 million, a decrease of \$0.7 million from \$3.8 million in the comparable period in 2005. The decrease is primarily due to lower compensation costs and franchise taxes as a result of a lower asset base used to calculate the taxes. For the three months ended July 31, 2006 we recorded \$0.4 million of stock compensation expense related to the adoption of SFAS 123 (R) effective November 1, 2005. For the three months ended July 31, 2005 we recorded a non-cash compensation charge of \$0.4 million, primarily related to a below market stock option grant to our former CEO. The options were subsequently forfeited as part of his severance agreement.

**Other Operating Expenses.** During the three months ended July 31, 2006 we recorded gains on settlement of liabilities of \$1.4 million resulting from the settlement of accounts payable for marketing and development expenses for less than the invoiced amount.

During the three months ended July 31, 2005 we recorded a provision for a loss of \$1.4 million in connection with a proposed settlement with one of our distributors, \$1.4 million of expense related to severance agreements, and \$6.1 million to write-off all capitalized costs related to the development of video games that we had determined would not be commercially viable and for which development was stopped. We do not have significant exposure to credit risk as our factor generally buys our receivables without recourse; however, during the three months ended July 31, 2005, we recorded an accounts receivable write-off of \$0.3 million related to customer bankruptcies.

**Operating Loss.** Operating loss for the three months ended July 31, 2006 was \$0.3 million, compared to a \$38.6 million operating loss for the three month period ended July 31, 2005. The decrease in operating loss was primarily due to higher gross profit and lower selling and marketing expenses related to our shift in product strategy away from higher cost premium console games, and gains on settlement of liabilities.

**Interest and Financing Costs, Net.** For the three months ended July 31, 2006 interest and financing costs were approximately \$0.4 million, compared to \$0.2 million for the three months ended July 31, 2005, as the impact of higher borrowing rates in 2006 was partially offset by lower borrowings.

**Income Taxes.** For the three months ended July 31, 2006, we did not provide for income taxes because our net operating loss carryforwards exceed our taxable income. We recorded a tax benefit of \$1.3 million for the three months ended July 31, 2005, net of a full valuation allowance against net deferred tax assets recorded in prior periods.

**Net Loss.** Net loss for the three months ended July 31, 2006 was \$0.7 million, a decrease of \$36.9 million from a net loss of \$37.6 million for the comparable period in 2005.

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Nine months ended July 31, 2006 versus nine months ended July 31, 2005

**Net Revenues.** Net revenues for the nine months ended July 31, 2006 decreased to \$45.2 million from \$55.1 million in the comparable period last year. The decrease is reflective of our change in strategy of selling fewer premium games, a general industry weakness as a result of the hardware transition, as well as lower sales of our GBA Video and TV Arcade products in the 2006 period. The decrease was partially offset by international revenues which we did not have in the comparable period last year, and a lower provision for price protection and other allowances, resulting from a higher sell-through percentage at retailers for titles released in 2006.

**Gross Profit.** Gross profit for the nine months ended July 31, 2006 was \$15.6 million compared to a gross profit of \$3.2 million in the first nine months of last year. The increase of \$12.4 million is primarily due to a \$9.2 million charge to cost of sales during the nine months ended July 31, 2005 to recognize impairments in the carrying value of games for which orders received were significantly below expectations, a decrease in provisions for price protection and other allowances, and increased sales in Europe. Gross profit as a percentage of net sales increased to 35% compared to 6% in the prior year.

**Product Research and Development Expenses.** For the nine months ended July 31, 2006 product research and development costs decreased \$0.5 million to \$2.0 million from \$2.5 million in the comparable period in 2005. The decrease is principally attributable to a lower number of quality assurance employees as a result of the fewer number of premium game projects currently in the development cycle.

**Selling and Marketing Expenses.** For the nine months ended July 31, 2006 total selling and marketing expenses were \$8.5 million, a \$9.1 million decrease from \$17.6 million in comparable period last year. The decrease is primarily the result of lower media costs related to premium games launched in the nine months ended July 31, 2005. Selling and marketing as a percentage of net sales decreased to 19% from 32% in the same period in the prior year. We expect selling and marketing to decline as a percentage of net sales as value games require less marketing than premium console games.

**General and Administrative Expenses.** For the nine month period ended July 31, 2006 general and administrative expenses decreased to \$8.0 million from \$8.9 million during the comparable period in 2005. The \$0.9 million decrease is primarily due to lower compensation costs and lower franchise taxes as a result of a lower asset base used to calculate the taxes. For the nine months ended July 31, 2006 we recorded \$0.8 million of stock compensation expense related to the adoption of SFAS 123 (R) effective November 1, 2005. For the nine months ended July 31, 2005 we recorded a non-cash compensation charge of \$1.4 million, primarily related to a below market stock option grant to our former CEO. The options were subsequently forfeited as part of his severance agreement.

**Other Operating Expenses.** During the nine months ended July 31, 2006 we recorded gains on settlement of liabilities of \$4.5 million, consisting of \$1.5 million related to negotiated reductions in royalties due for certain video and video game titles, \$0.5 million gain on the sale of the rights to certain video game titles and a \$2.5 million gain on the settlement of accounts payable for legal, marketing and development expenses for less than the invoiced amount. In addition, we charged operations \$2.4 million to write-off capitalized costs related to games for which development plans were changed such that it is uncertain whether potential value of that development will be realized.

During the nine months ended July 31, 2005 we recorded a provision for a loss of \$1.4 million in connection with a proposed settlement with one of our distributors. We do not have significant exposure to credit risk as our factor generally buys our receivables without recourse; however, during the nine months ended July 31, 2005, we recorded an accounts receivable write-off of \$0.3 million related to customer bankruptcies. In addition, during the nine months ended July 31, 2005 we recorded \$1.4 million of expense related to severance agreements and we charged operations \$6.1 million to write-off all capitalized costs related to the development of video games that we had determined would not be commercially viable and for which development was stopped.

**Operating Loss.** For the nine month period ended July 31, 2006 we generated an operating loss of \$1.1 million, compared to an operating loss of \$35.8 million during the same period in 2005. The

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decrease in operating loss was primarily due to higher gross profit and lower selling and marketing expenses related to our shift in product strategy, a decrease in impairment of software development costs, and gains on settlement of liabilities.

**Interest and Financing Costs, net.** For the nine months ended July 31, 2006 interest and financing costs decreased approximately \$0.1 million to \$1.4 million from \$1.5 million in the same period in 2005. The decrease is primarily attributable to the lower level of borrowing from our factor, partially offset by an increase in borrowing rates.

**Loss on Foreign Exchange Contract.** During the nine months ended July 31, 2005 we recorded a loss of \$48,000 related to a foreign exchange contract. There were no comparable amounts recorded in the 2006 period.

**Income Taxes.** As a result of the availability of loss carryforwards, we have not recorded any provisions for federal or state income taxes in the current period. Federal and state income taxes were provided for at a combined effective rate of 40% in the 2005 period. We recorded a tax benefit of \$0.7 million for the nine months ended July 31, 2005, net of a full valuation allowance against net deferred tax assets recorded in prior periods.

**Net Loss.** For the nine month period ended July 31, 2006, we generated a net loss of \$2.5 million compared to a net loss of \$36.7 million in the same period in 2005. In the nine month period ended July 31, 2005, a \$1.1 million charge related to the fair value of warrants exercised at a discount resulted in a net loss attributable to common stockholders of \$37.8 million.

#### Liquidity and Capital Resources

Historically, we have met our capital needs through our factoring and purchase order financing arrangements, loans from related persons and advances from customers.

We do not have any bank debt. To satisfy our liquidity needs, we factor our receivables. We also utilize purchase order financing through the factor and through a finance company to provide funding for the manufacture of our products. In connection with these arrangements, the finance company and the factor have a security interest in substantially all of our assets.

Under the terms of our factoring agreement, we assign our accounts receivable to the factor. The factor, in its sole discretion, determines whether or not it will accept a receivable based on its assessment of its credit risk. Once a

receivable is accepted by the factor, the factor assumes substantially all of the credit risk associated with the receivable. The factor is required to remit payments to us for the assigned accounts receivable in accordance with the terms of the assigned invoice, regardless of whether the factor receives payment on the receivable, so long as 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 0.5% of invoiced amounts for these credit and collection services.

We utilize purchase order financing arrangements in order to enable us to provide letters of credit necessary for the manufacture of our products. Manufacturers require us to present a letter of credit in order to manufacture the products required under a purchase order. Currently, we utilize letters of credit from a finance company which charges a fee of 3.3% of the purchase order amount for each transaction for 60 days, plus interest at the prime rate, plus one percent per annum for any advances under the financing arrangement. Our factor also 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 under both arrangements if letters of credit remain outstanding in excess of the original time period.

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. Amounts to be paid to us by the factor for any assigned receivable are offset by any amounts previously advanced by the factor. As our needs require, we may request that the factor advance 80% of the eligible receivables and advance 50% of inventory.

As of July 31, 2006, assuming continued availability of funding at previous levels by the current factor or alternative sources, management believes that there will be sufficient capital resources from

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operations and financing arrangements for the next twelve months in order to meet our requirements for development, production, marketing, purchases of equipment, and the acquisition of intellectual property rights for future products.

Although management believes that alternative forms of financing may be available, there can be no assurance that funds will be available on acceptable terms, if at all. While management has already significantly reduced expenditure levels, in the event that we are unable to maintain our current factoring arrangement or negotiate alternative financing, or negotiate terms that are acceptable to us, we may be forced to further materially modify our business plan, including making further reductions in expenditures. Management believes it can make additional reductions if necessary, and that it can operate under the existing level of financing for at least one year. However, if the current level of financing was reduced and the Company was unable to obtain alternative financing, it could have a material effect on future operating prospects.

As a result of recurring losses incurred by us, the report of our independent Registered Public Accounting firm on the financial statements as of October 31, 2005 contained an explanatory paragraph indicating that we may be unable to continue as a going concern.

**Advances From Customers.** On a case by case basis, distributors and other customers have in the past agreed to provide us with cash advances on their orders. These advances were 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. We do not currently have any material commitments with respect to any capital expenditures.

As of July 31, 2006 we had open letters of credit aggregating \$1.7 million for inventory purchases to be delivered during the quarter ended October 31, 2006.

We are committed under agreements with certain developers and content providers for milestone and license fee payments aggregating \$0.5 million, \$0.2 million of which are payable through October 31, 2006.

As of July 31, 2006 we were committed under operating leases for office space and equipment for approximately \$1.5 million through July 2009.

In July 2006 we finalized and adopted an employee incentive plan that provides for cash payments aggregating \$0.8 million to \$2.2 million if we achieve certain adjusted net income targets for the year ending October 31, 2006. We have accrued \$375,000 under the plan as of July 31, 2006.

On December 2, 2005, a vendor filed a complaint against the Company in the Supreme Court of the State of New York, County of New York, alleging breach of contract and failure to pay in connection with services rendered and seeking approximately \$2.6 million in damages and costs, including attorney's fees. On May 31, the Company entered into a settlement agreement with the vendor settling all claims relating to the action. Under the terms of the settlement agreement, the Company agreed to pay the vendor a total of \$750 thousand as follows: \$200 thousand upon execution of the settlement agreement, \$175 thousand thirty days thereafter, and \$375 thousand sixty days thereafter, in full settlement of all claims and liabilities between the parties relating to this action. The Company also agreed to indemnify and hold harmless the vendor for certain claims relating to the services performed by the vendor on our behalf. All payments have been made to the vendor under the settlement agreement.

On November 16, 2005, one of the Company's service providers instituted legal proceedings against the Company for \$1.9 million in the United States District Court for the Central District of California alleging breach of contract. The Company believes that the claims are without merit and intends to vigorously defend this action.

In July 2005, four purported class action complaints were filed against the Company and several current and former directors and officers of the Company in the United States District Court for the District of New Jersey. On September 12, 2005, a fifth purported class action complaint was filed in

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the same court on behalf of a class of individuals who purchased shares of the Company common stock in the Company's January 26, 2005 offering of six million shares of common stock (the "Offering"). The complaint named as defendants the Company, current and former officers of the Company, and certain financial institutions who served as underwriters with respect to the Offering.

On October 11, 2005, the Court consolidated the five cases and appointed a Lead Plaintiff. On December 14, 2005, Lead Plaintiff filed an Amended Consolidated Complaint, which is now the operative Complaint. The Complaint names the following as defendants: the Company, Carl Yankowski, Jan E. Chason, Jesse Sutton, Joseph Sutton, Morris Sutton, Laurence Aronson, F. Peter Cuneo, James Halpin, Louis Lipschitz, Marc Weisman, RBC Capital Markets Corporation, JMP Securities LLC, Harris Nesbitt & Corp., Wedbush Morgan Securities Inc., and Goldstein



Golub Kessler LLP.

The Complaint alleges that the Registration Statement and Prospectus filed with the SEC in connection with the Company's Offering and certain of the Company's press releases and other public filings contained material misstatements and omissions about the Company's financial condition and prospects as well as its products. Lead Plaintiff asserts a claim under Section 11 of the Securities Act against all the defendants on behalf of investors who purchased in the Offering. It asserts a Section 12(a)(2) claim against the Company and the financial institutions who served as underwriters in connection with the Offering, and a Section 15 control person claim against defendants Carl Yankowski, Jan Chason, Jesse Sutton, Joseph Sutton, and Morris Sutton (the "Defendants"). Lead Plaintiff also asserts a claim under Section 10(b) of the Exchange Act and Rule 10b-5 promulgated thereunder against the Company and the Defendants and a claim under Section 20(a) of the Exchange Act against the Defendants. The Complaint seeks damages in an unspecified amount. The proposed class period for the Exchange Act claims is December 8, 2004 through September 12, 2005. We will vigorously contest the action.

We are party to other routine claims and suits brought by us and against us in the ordinary course of business, including disputes arising over contractual claims and collection matters. In the opinion of management, after consultation with legal counsel, the outcome of such routine claims will not have a material adverse effect on our business, financial condition, and results of operations or liquidity. In addition, the costs and other effects of pending or future litigation, governmental investigations, legal and administrative cases and proceedings (whether civil or criminal), settlements, judgments and investigations, claims and changes in those matters (including those matters described above), and developments or assertions by or against the Company relating to intellectual property rights and intellectual property licenses, could have a material adverse effect on the Company's business, financial condition, and results of operations or liquidity.

#### Cash Flows

Cash and cash equivalents were \$3.6 million at July 31, 2006 compared to \$2.4 million at October 31, 2005.

**Operating Cash Flows.** Cash provided by (used in) operating activities during the nine months ended July 31, 2006 was \$1.1 million compared to cash usage of \$(47.6) million during the same period in the prior year. The \$48.7 million decrease in the use of cash in operations in 2006 was due primarily to a decrease in expenditures for capitalized software development costs and prepaid license fees and a decrease in cash used to reduce the amount due from factor. We expect continued volatility 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 and growth objectives.

**Investing Cash Flows.** Cash used in investing activities for the nine months ended July 31, 2006 consists primarily of purchases of computer equipment and leasehold improvements necessary to accommodate our infrastructure growth of \$0.2 million.

**Financing Cash Flows.** Cash provided by financing activities in the nine months ended July 31, 2006 was \$0.2 million relating to inventory financing. During the nine month period ended July 31, 2005 we generated \$54.0 million in cash, primarily as a result of our secondary offering and from proceeds from the exercise of warrants.

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 pursuant to Section 906 of the Sarbanes-Oxley Act of 2002.
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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

Interim Chief Executive Officer

Date: February 1, 2007

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