

MAJESCO ENTERTAINMENT CO
Form 10-Q
March 19, 2007

UNITED STATES
SECURITIES AND EXCHANGE COMMISSION

WASHINGTON, D.C. 20549

FORM 10-Q

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

For the quarterly period ended January 31, 2007

Commission File No. 000-51128

Majesco Entertainment Company

(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

(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 March 14, 2007, there were 23,837,426 shares of the Registrant's common stock outstanding.

MAJESCO ENTERTAINMENT COMPANY AND SUBSIDIARY

January 31, 2007 QUARTERLY REPORT ON FORM 10-Q

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

	January 31, 2007 (unaudited)	October 31, 2006
ASSETS		
Current assets		
Cash and cash equivalents	\$ 3,916	\$ 3,794
Due from factor	1,088	1,189
Accounts and other receivables	1,489	3,103
Inventory – principally finished goods	3,287	2,438
Capitalized software development costs and prepaid license fees	1,360	1,489
Prepaid expenses	637	2,226
Total current assets	11,777	14,239
Property and equipment – net	695	701
Other assets	71	71
Total assets	\$ 12,543	\$ 15,011
LIABILITIES AND STOCKHOLDERS' EQUITY		
Current liabilities		
Accounts payable and accrued expenses	\$ 10,443	\$ 10,911
Inventory financing payable	579	1,390
Advances from customers	320	961
Total current liabilities	11,342	13,262
Stockholders' equity:		
Common stock – \$.001 par value; 250,000,000 shares authorized; 23,982,791 and 23,427,462 issued and outstanding at January 31, 2007 and October 31, 2006, respectively	24	23
Additional paid in capital	94,928	94,529
Accumulated deficit	(93,680)	(92,754)
Accumulated other comprehensive loss	(71)	(49)
Total stockholders' equity	1,201	1,749
Total liabilities and stockholders' equity	\$ 12,543	\$ 15,011

See accompanying notes

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

Three Months Ended
January 31,

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	2007	2006
	(Unaudited)	
Net revenues	\$ 14,495	\$ 21,638
Cost of sales		
Product costs	8,177	9,553
Software development costs and license fees	1,815	4,119
	9,992	13,672
Gross profit	4,503	7,966
Operating expenses		
Research and development	608	768
Selling and marketing	1,731	4,456
General and administrative	2,273	2,374
Loss on impairment of software development costs	—	2,375
Depreciation and amortization	73	135
	4,685	10,108
Operating loss	(182)	(2,142)
Other costs and expenses		
Interest expense and financing costs, net	744	445
Loss before income taxes	(926)	(2,587)
Benefit for income taxes	—	—
Net loss	\$ (926)	\$ (2,587)
Net loss per share:		
Basic and diluted	\$ (0.04)	\$ (0.12)
Weighted average shares outstanding		
Basic and diluted	23,627,419	22,257,631
See accompanying notes		

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

	Three Months Ended January 31,	
	2007	2006
	(unaudited)	
CASH FLOWS FROM OPERATING ACTIVITIES		
Net loss	\$ (926)	\$ (2,587)
Adjustments to reconcile net loss to net cash provided by (used in) operating activities		
Depreciation and amortization	73	135
Impairment of software development costs	—	2,375

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Non-cash compensation expense	400	135
Gain on settlement of liabilities and other gains	(31)	—
Amortization of software development costs and prepaid license fees	849	—
Changes in operating assets and liabilities		
Decrease (increase) in due from factor – net	101	(11,552)
Decrease in other receivables	1,614	—
(Increase) decrease in inventory	(849)	726
(Increase) decrease in capitalized software development costs and prepaid license fees	(719)	9,315
Decrease in income tax receivable	—	275
Decrease (increase) in prepaid expenses and other	1,589	(327)
(Decrease) increase in accounts payable and accrued expenses.	(438)	405
(Decrease) in advances from customers	(641)	(213)
Net cash provided by (used in) operating activities	1,022	(1,313)
CASH FLOWS FROM INVESTING ACTIVITIES		
Purchases of property and equipment	(67)	(141)
Net cash used in investing activities	(67)	(141)
CASH FLOWS FROM FINANCING ACTIVITIES		
Inventory financing	(811)	1,953
Net cash (used in) provided by financing activities	(811)	1,953
Effect of exchange rates on cash and cash equivalents	(22)	34
Net increase in cash	122	533
Cash and cash equivalents – beginning of period	3,794	2,407
Cash and cash equivalents – end of period	\$ 3,916	\$ 2,940
SUPPLEMENTAL SCHEDULE OF NON CASH INVESTING AND FINANCING ACTIVITIES		
Accounts payable settled through the issuance of common stock, classified as a mandatorily redeemable liability	\$ 365	—
Cash paid for interest	\$ 781	\$ 445

See accompanying notes

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1. PRINCIPAL BUSINESS ACTIVITY AND BASIS OF PRESENTATION

Majesco Entertainment Company, together with its wholly owned UK 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 Wii, 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 \$12.5 million or 86% and \$17.4 million or 81% for the three month periods ended January 31, 2007 and 2006, respectively. Sales in Europe were \$2.0 million or 14% and \$4.2 million or 19% for the three month periods ended January 31, 2007 and 2006, respectively.

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. The financial statements do not include any adjustments that might result from the outcome of this uncertainty.

As of January 31, 2007, management believes that there will be sufficient capital resources from operations and existing financing arrangements to meet the Company's requirements for: development, production, marketing, purchases of equipment, and the acquisition of intellectual property rights for future products for the next twelve months. However, in the event that the Company is unable to generate the level of operating revenues in its business plan, the Company will be required to reduce operating expenditures or obtain additional sources of financing to continue operations. 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 of the Company.

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, 2006 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, 2006 filed on Form 10-K on January 29, 2007.

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

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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.

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 \$400,000 and \$135,000 for the three month periods ended January 31, 2007 and 2006, respectively.

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 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 January 31, 2007 and 2006, are the same because the impact of the conversion or exercise, as applicable, of the warrants (2,220,687 at January 31, 2007 and 2006) and stock options (1,509,872 and 1,979,023 at January 31, 2007 and 2006, respectively) would be antidilutive.

3. DUE FROM FACTOR

Due from (to) factor consists of the following:

	January 31, 2007 (in thousands)	October 31, 2006 (in thousands)
Outstanding accounts receivable sold to factor	\$ 9,308	\$ 14,384
Less: allowance	(3,310)	(4,047)
Advances from factor	(4,910)	(9,148)
	\$ 1,088	\$ 1,189

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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:

	Three Months Ended January 31,	
	2007	2006
	(in thousands)	
Balance – beginning of period	\$ (4,047)	\$ (9,551)
Add: provision	(352)	(1,279)
Less: amounts charged against allowance	1,089	4,808
Balance – end of period	\$ (3,310)	\$ (6,022)

4. PREPAID EXPENSES

The following table presents the major components of prepaid expenses:

	January 31, 2007	October 31, 2006
	(in thousands)	(in thousands)
Advance payments for inventory	\$ 343	\$ 1,934
Other (less than 5% of total assets)	294	292
	\$ 637	\$ 2,226

5. ACCOUNTS AND OTHER RECEIVABLES

The following table presents the major components of prepaid expenses:

	January 31, 2007	October 31, 2006
	(in thousands)	(in thousands)
Accounts receivable	\$ 182	\$ 2,370
Legal fee reimbursements due from insurance carriers	1,307	733
	\$ 1,489	\$ 3,103

6. ACCOUNTS PAYABLE AND ACCRUED EXPENSES

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

January	October
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	31, 2007	31, 2006
Accounts payable – trade	\$ 5,047	\$ 4,992
Accrued expenses:		
Royalties – including accrued minimum guarantees	3,337	3,233
Salaries and other compensation	392	499
Sales commissions	216	406
Settlement payable in common stock	365	—
Other accruals	1,086	1,781
	\$ 10,443	\$ 10,911

On November 16, 2005 Papaya Studio Corporation instituted legal proceedings against the Company for \$1.9 million in the Central District Court of California alleging breach of contract. On January 29, 2007, we entered into a settlement agreement with regard to all claims relating to this litigation. Under the terms of the settlement agreement, we agreed to pay Papaya a total of \$200,000 of cash in installments over a period of 90 days. In addition, as part of the settlement, we issued 238,562 shares of our common stock with a fair value of \$365,000 to Papaya's President and sole

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shareholder. In addition, to the extent \$365,000 in proceeds from sales of these shares over a period of 10-12 months, subject to certain trading limitations, is not realized, we will pay the difference between the proceeds received from sales of the shares and \$365,000. No shares have been sold as of January 31, 2007. Accordingly, the Company recorded the \$365,000 fair value of the stock as a liability January 31, 2007 because cash settlement may be required based on events outside the control of the Company. The amount will be reclassified to paid in capital as the shares are sold and the proceeds realized by the holder in accordance with the agreement. In addition, as part of the settlement, we transferred to Papaya ownership of any video game assets developed by Papaya under the contract that was the subject of this litigation.

7. CONTINGENCIES AND COMMITMENTS

Commitments

At January 31, 2007, the Company had open letters of credit aggregating \$0.9 million under the Company's purchase order assignment arrangements for inventory to be delivered during the subsequent quarter.

At January 31, 2007 the Company was committed under agreements with certain developers for future milestone and license fee payments aggregating \$1.5 million, \$1.4 million of which are payable through October 31, 2007. 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.

Effective January 1, 2007, upon his resignation, the Company entered into a transition agreement with Morris Sutton, its former Chairman Emeritus, under which he will provide services as a consultant for a two year period. The agreement provides for a monthly retainer of \$29,175 and a commission equal to 2% of sales to certain specified accounts.

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 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

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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.

On October 10, 2006, Trinad Capital Master Fund, Ltd., a shareholder of our common stock, filed a complaint 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. The current or former officers and directors named as defendants in the complaint are Morris Sutton, Jesse Sutton, Joseph Sutton and Carl Yankowski. The Complaint also named the Company’s outside auditors, Goldstein Golub Kessler LLP, as a defendant. Goldstein Golub Kessler LLP has since been voluntarily dismissed without prejudice. The allegations in the Complaint are similar to those in the Amended Consolidated Complaint filed in the In re: Majesco Securities Litigation putative class action discussed above. The Complaint alleges three causes of action: (1) a claim under Section 10(b) of the Exchange Act (and Rule 10b-5 promulgated thereunder) against all the named defendants; (2) a claim under Section 20(a) of the Exchange Act against Morris Sutton, Jesse Sutton and Joseph Sutton; and (3) a common law fraud claim against Morris Sutton, Jesse Sutton, Joseph Sutton and Carl Yankowski. Trinad seeks compensatory damages of no less than \$10 million. This amount is sought

with respect to each claim. In connection with the fraud claim, Trinad also seeks \$10 million in punitive damages.

On November 2, 2006, Trinad Capital Master Fund, Ltd., filed a complaint, purportedly on behalf of the Company, against certain current or former directors of the Company in the United States District Court for the District of New Jersey. The individuals named as defendants in the complaint are Morris Sutton, Jesse Sutton, Joseph Sutton, Louis Lipschitz and Laurence Aronson. The complaint also names the Company as a nominal defendant. The complaint alleges that, from late 2004 through the filing date, defendants breached their fiduciary duties which caused damage to the Company. The complaint does not specify the amount of damages sought.

The Company at times may be a 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.

8. RELATED PARTIES

The Company receives printing and packaging services from a business of which the brother of Morris Sutton, the Company's former Chairman Emeritus, and uncle of Jesse Sutton, the Company's interim Chief Executive Officer is a principal. During the three month periods ended January 31, 2007 and 2006 the Company was charged \$0.6 million and \$0.4 million, respectively. 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. Morris Sutton resigned from the company on February 27, 2007, becoming a consultant.

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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 arrangements with other publishers. We have developed our retail and distribution network over our 20-year history.

We publish video game software for most major interactive entertainment hardware platforms, including Nintendo's Wii, 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 2006 we revised our business model and shifted 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 (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. We develop, manufacture and market a variety of digital media peripherals and applications including "plug-and-play" video game systems. These products connect directly to a user's television and play pre-installed video games without the need for a dedicated console. We have also published GBA video titles utilizing our video compression technology, enabling users to view up to 90 minutes of color video content with stereo audio on their GBA or DS, using a standard GBA cartridge. We entered into licensing agreements with entertainment industry leaders for GBA Video content.

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 carry lower financial risk associated with the recovery of upfront development and license fees as compared with premium game titles.

Product Research and Development Expenses. Product research and development expenses relate principally to our cost of supervision of third-party developers of our video games and other products, testing new products and conducting quality assurance evaluations during the development cycle. Costs incurred are employee-related, may include equipment and are not allocated to cost of sales.

Selling and Marketing Expenses. Selling and marketing expenses consist of marketing and promotion expenses, 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.

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. Although there can be no assurance, legal costs incurred in connection with our pending shareholder litigation in excess of related deductibles are expected to be covered under our insurance policies. Therefore, they are not reflected in operating results.

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. 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 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.

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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 products that did not sell through at retail. 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 charge the excess of cost over net realizable value to cost of sales.

Reserves for Price Protection and Other Allowances. 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 generally 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, 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 month periods ended January 31, 2007 and 2006 we provided allowances for future price protection and other allowances of \$0.3 million and \$1.3 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

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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.

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 for the three months ended January 31, 2006 related to development costs for projects which were either canceled, or for which full recoverability was not expected. In the three month periods ended January 31, 2007 and 2006 we charged \$1.8 million and \$4.1 million, respectively, to cost of sales for amortization of software development costs, prepaid license fees and royalties on products which were sold.

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 January 31, 2007 versus three months ended January 31, 2006

Net Revenues. Net revenues for the three months ended January 31, 2007 decreased to \$14.5 million from \$21.6 million in the comparable quarter last year. The \$7.1 million decrease is primarily due to lower revenues due to a shift away from capital intensive premium console games. During 2006 the Company changed its strategy from a focus on premium console games to handheld and console games with lower development, royalty and marketing expense requirements. Revenue for the three months ended January 31, 2006 includes the release of two premium console

games.

Gross(Loss) Profit. Gross profit for the three months ended January 31, 2007 was \$4.5 million compared to a gross profit of \$8.0 million in the same quarter last year. The decrease in gross profit is primarily attributable to the lower net revenues discussed above. Gross profit as a percentage of net sales was 31% for the three months ended January 31, 2007 compared to 37% for the three months ended January 31, 2006.

Product Research and Development Expenses. Research and development costs decreased \$0.2 million to \$0.6 million for the three months ended January 31, 2007 from \$0.8 million for the comparable period in 2006. 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 \$1.7 million for the three months ended January 31, 2007 from \$4.5 million in the same three month period in

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2006. The \$2.8 million decrease is primarily due to a decrease in media and other marketing costs associated with premium games that were launched in the three months ended January 31, 2006. Selling and marketing expense as a percentage of net sales was approximately 12% for the three months ended January 31, 2007, compared to 21% for the same quarter last year. The decline is the result of an overall decrease in media costs related to the premium games.

General and Administrative Expenses. For the three month period ended January 31, 2007 general and administrative expenses were \$2.3 million, a decrease of \$0.1 million from \$2.4 million in the comparable period in 2006. The decrease is primarily due to lower compensation costs. We recorded \$0.4 million and \$0.1 million of stock compensation expense related to the adoption of SFAS 123(R) for the three months ended January 31, 2007 and 2006, respectively.

Operating Loss. Operating loss for the three months ended January 31, 2007 was \$0.2 million, compared to an operating loss \$2.1 million for the three month period ended January 31, 2006. The decrease in operating loss was primarily due to lower revenues discussed above, offset in part by lower selling and marketing expenses related to our shift in product strategy away from higher cost premium console games, and a \$2.4 million impairment charge in 2006.

Interest and Financing Costs, Net. Interest and financing costs increased to \$0.7 million for the three months ended January 31, 2007 from \$0.4 million for the three months ended January 31, 2006. The increase of \$0.3 million is the result of a higher percentage of the Company's inventory purchases being financed through letters of credit and higher borrowing rates.

Income Taxes. For the three months ended January 31, 2007 and 2006, we did not record any income tax benefit because realization of the resulting loss carryforwards can not be assured.

Net Loss. Net loss for the three months ended January 31, 2007 was \$0.9 million, a decrease of \$1.7 million from a net loss of \$2.6 million for the comparable period in 2006.

Liquidity and Capital Resources

Historically, we have met our capital needs through our factoring and purchase order financing arrangements, sales of our common stock, 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

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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 January 31, 2007, management believes that there will be sufficient capital resources from operations and existing financing arrangements to meet our requirements for development, production, marketing, purchases of equipment, and the acquisition of intellectual property rights for future products for the next twelve months. However, in the event that we are unable to generate the level of operating revenues in the business plan, we will be required to reduce operating expenditures or obtain additional sources of financing to continue operations. 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 of the Company.

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 and 2006 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 January 31, 2007 we had open letters of credit aggregating \$0.9 million for inventory purchases to be delivered during the quarter ended April 30, 2007.

We are committed under agreements with certain developers and content providers for milestone and license fee payments aggregating \$1.5 million, \$1.4 million of which are payable through October 31, 2007.

As of January 31, 2007 we were committed under operating leases for office space and equipment for approximately \$1.5 million through July 2009.

Effective January 1, 2007, upon his resignation, we entered into a transition agreement with Morris Sutton, our former Chairman Emeritus under which he will provide services as a consultant for a two year period. The agreement provides for a monthly retainer of \$29,175 and a commission equal to 2% of sales to certain specified accounts.

As previously disclosed, the Company and several of its current and former directors and officers are defendants in securities class action and other stockholder lawsuits. While we intend to vigorously defend ourselves in these actions, we cannot predict the outcome of such suits. Furthermore, while we maintain insurance to cover the costs and expenses of such suits, there can be no assurance that such insurance will be adequate to cover such costs and expenses, or that any award or judgment against the Company will not exceed the limits of such coverage. Any expenses incurred in connection with such litigation not covered by available insurance or any adverse resolution of such litigation could have a material adverse effect on our financial condition.

Cash Flows

Cash and cash equivalents were \$3.9 million at January 31, 2007 compared to \$3.8 million at October 31, 2006.

Operating Cash Flows. Cash provided by (used in) operating activities during the three months ended January 31, 2007 was \$1.0 million compared (\$1.3) million during the same period in the prior year. The \$2.3 million increase in cash provided by operations in 2007 was due primarily to a lower operating loss than the prior year. 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.

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Investing Cash Flows. Cash used in investing activities for the three months ended January 31, 2007 consists primarily of purchases of computer equipment and leasehold improvements necessary to accommodate our infrastructure growth of \$0.1 million.

Financing Cash Flows. Cash used in financing activities in the three months ended January 31, 2007 was \$0.8 million relating to a reduction in outstanding inventory financing. During the three month period ended January 31,

2006 we generated \$2.0 million due to an increase in the inventory financing balance.

Item 3. Quantitative and Qualitative Disclosures about Market Risk

We are exposed to various market risks, including the changes in foreign currency exchange rates and interest rates. Market risk is the potential loss arising from changes in market rates and prices. Foreign exchange contracts used to hedge foreign currency exposure are subject to market risk. We do not enter into derivatives or other financial instruments for trading or speculative purposes. At January 31, 2007 we did not have any foreign exchange contracts.

Item 4. Controls and Procedures

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

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

While we believe our disclosure controls and procedures and our internal control over financial reporting have improved, no system of controls can prevent errors and fraud. A control system, no matter how well designed and operated, can provide only reasonable, not absolute, assurance that the control system's objectives will be met. Further, the design of a control system must reflect the fact that there are resource constraints, and the benefits of controls must be considered relative to their costs. Because of the inherent limitations in all control systems, no evaluation of controls can provide absolute assurance that all control issues and instances of fraud, if any, within our company have been detected. These inherent limitations include the realities that judgments in decision-making can be faulty, and that breakdowns can occur. Controls can also be circumvented by individual acts of some people, by collusion of two or more people, or by management override of the controls. The design of any system of controls is based in part upon certain assumptions about the likelihood of future events, and there can be no assurance that any design will succeed in achieving its stated goals under all potential future conditions. Over time, controls may become inadequate because of changes in conditions or deterioration in the degree of compliance with its policies or procedures. Because of the inherent limitations in a cost-effective control system, misstatements due to error or fraud may occur and not be detected.

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

Based on the evaluation of the effectiveness of our disclosure controls and procedures, our Interim Chief Executive Officer and Chief Financial Officer concluded that our disclosure controls and procedures (as defined in Exchange Act Rules 13a-15(e) and 15d-15(e)) were effective at a reasonable assurance level. There were no changes in our internal control over financial reporting that occurred during our most recent fiscal quarter that materially affected, or that are reasonably likely to materially affect, our internal control over financial reporting.

PART II. OTHER INFORMATION

Item 1. Legal Proceedings

None

Item 1A. Risk Factors

A description of the risks associated with our business, financial condition, and results of operations is set forth in Part I, Item 1A, of our Annual Report on Form 10-K for the fiscal year ended October 31, 2006. These factors continue to be meaningful for your evaluation of the Company and we urge you to review and consider the risk factors presented in the Form 10-K. There have been no material changes to these risks other than an update to one risk factor as follows, in order to reflect information recently received from Nasdaq:

We may not be able to maintain our listing on the Nasdaq Capital Market.

Our common stock currently trades on the Nasdaq Capital Market. This market has continued listing requirements that we must continue to maintain to avoid delisting. The standards include, among others, minimum bid price requirements and any of: (i) a minimum stockholders' equity of \$2.5 million pursuant to Marketplace Rule 4310(c)(2)(B)(i); (ii) a market value of listed securities of \$35 million pursuant to Marketplace Rule 4310(c)(2)(B)(ii); or (iii) net income from continuing operations of \$500,000 in the most recently completed fiscal year or in the two of the last three fiscal years pursuant to Marketplace Rule 4310(c)(2)(B)(iii). Our results of operations and our fluctuating stock price directly impact our ability to satisfy these listing standards. In the event we are unable to maintain these listing standards, we may be subject to delisting.

On March 16, 2007 (the "Notice Date"), we received notice from Nasdaq with respect to our failure to satisfy these continued listing requirements. For the ten consecutive trading days preceding the Notice Date, the market value of our listed securities had been below \$35 million, failing to satisfy the requirement listed in the above item (ii). In addition, based on that reported in our Form 10-K for the fiscal year ended October 31, 2006, we did not comply with either of the other requirements listed above.

In order to become compliant with the continued listing standards, during the 30 calendar days following the Notice Date (up to April 16, 2007), our market value of listed securities must be \$35 million or more for ten consecutive business days. If we fail to meet this requirement, or to demonstrate to Nasdaq that we comply with one of the other standards discussed above, we will be subject to delisting.

A delisting from Nasdaq would result in our common stock being eligible for listing on the Over-The-Counter Bulletin Board (the "OTCBB"). The OTCBB is generally considered to be a less efficient system than markets such as Nasdaq or other national exchanges because of lower trading volumes, transaction delays and reduced security analyst and news media coverage. These factors could contribute to lower prices and larger spreads in the bid and ask prices for our common stock. Additionally, trading of our common stock on the OTCBB may make us less desirable to institutional investors and may, therefore, limit our future equity funding options and could negatively affect the liquidity of their investment by our stockholders.

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

None

Item 3. Defaults Upon Senior Securities

None

Item 4. Submission of Matters to a Vote of Security Holders

None

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Item 5. Other Information

On March 16, 2007 (the “Notice Date”), we received notice from the Nasdaq Stock Market with respect to our failure to satisfy its continued listing requirements. Under these requirements, in order to continue to trade on Nasdaq, a company must continue to satisfy one of the following three standards: (i) a minimum stockholders’ equity of \$2.5 million pursuant to Marketplace Rule 4310(c)(2)(B)(i); (ii) a market value of listed securities of \$35 million pursuant to Marketplace Rule 4310(c)(2)(B)(ii); or (iii) net income from continuing operations of \$500,000 in the most recently completed fiscal year or in the two of the last three fiscal years pursuant to Marketplace Rule 4310(c)(2)(B)(iii).

For the ten consecutive trading days preceding the Notice Date, the market value of our listed securities had been below \$35 million, failing to satisfy the requirement listed in the above item (ii). In addition, based on that reported in our Form 10-K for the fiscal year ended October 31, 2006, we did not comply with either of the other requirements listed above.

In order to become compliant with the continued listing standards, during the 30 calendar days following the Notice Date (up to April 16, 2007), our market value of listed securities must be \$35 million or more for ten consecutive business days. If we fail to meet this requirement, or to demonstrate to Nasdaq that we comply with one of the other standards discussed above, we will be subject to delisting.

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: March 19, 2007
