ELECTRONIC ARTS INC
Form 10-Q
February 06, 2007

Table of Contents

UNITED STATES
SECURITIES AND EXCHANGE COMMISSION
WASHINGTON, D.C. 20549
FORM 10-Q

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

For the Quarterly Period Ended December 31, 2006

OR

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

For the Transition Period from __________ to__________

Commission File No. 0-17948

ELECTRONIC ARTS INC.

(*Exact name of registrant as specified in its charter*)

Delaware	**94-2838567**
(State or other jurisdiction of incorporation or organization)	*(I.R.S. Employer Identification No.)*
209 Redwood Shores Parkway Redwood City, California	**94065**
(Address of principal executive offices)	*(Zip Code)*

(650) 628-1500

(Registrant s telephone number, including area code)

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

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 þ Accelerated filer o Non-accelerated filer o

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

As of February 1, 2007, there were 310,042,832 shares of the Registrant s Common Stock, par value $0.01 per share, outstanding.

ELECTRONIC ARTS INC.
FORM 10-Q
FOR THE PERIOD ENDED DECEMBER 31, 2006
Table of Contents

		Page
Part I FINANCIAL INFORMATION		
Item 1.	Condensed Consolidated Financial Statements (Unaudited)	
	Condensed Consolidated Balance Sheets as of December 31, 2006 and March 31, 2006	3
	Condensed Consolidated Statements of Operations for the Three and Nine Months Ended December 31, 2006 and 2005	4
	Condensed Consolidated Statements of Cash Flows for the Nine Months Ended December 31, 2006 and 2005	5
	Notes to Condensed Consolidated Financial Statements	6
	Report of Independent Registered Public Accounting Firm	30
Item 2.	Management s Discussion and Analysis of Financial Condition and Results of Operations	31
Item 3.	Quantitative and Qualitative Disclosures About Market Risk	56
Item 4.	Controls and Procedures	59
Part II OTHER INFORMATION		
Item 1.	Legal Proceedings	60
Item 1A.	Risk Factors	60
Item 6.	Exhibits	68
Signature		69
Exhibit Index		70

EXHIBIT 15.1
EXHIBIT 31.1
EXHIBIT 31.2
EXHIBIT 32.1
EXHIBIT 32.2

Table of Contents

PART I FINANCIAL INFORMATION

Item 1. Condensed Consolidated Financial Statements (Unaudited)
ELECTRONIC ARTS INC. AND SUBSIDIARIES
CONDENSED CONSOLIDATED BALANCE SHEETS

(Unaudited) (In millions, except par value data)	December 31, 2006	March 31, 2006 (a)
ASSETS		
Current assets:		
Cash and cash equivalents	$ 1,199	$ 1,242
Short-term investments	1,212	1,030
Marketable equity securities	235	160
Receivables, net of allowances of $228 and $232, respectively	551	199
Inventories	72	61
Deferred income taxes, net	92	86
Other current assets	170	234
Total current assets	3,531	3,012
Property and equipment, net	451	392
Investments in affiliates	6	11
Goodwill	730	647
Other intangibles, net	221	232
Other assets	104	92
TOTAL ASSETS	$ 5,043	$ 4,386
LIABILITIES, MINORITY INTEREST AND STOCKHOLDERS EQUITY		
Current liabilities:		
Accounts payable	$ 170	$ 163
Accrued and other current liabilities	851	654
Deferred net revenue	75	52
Total current liabilities	1,096	869
Deferred income taxes, net	6	29
Other liabilities	63	68
Total liabilities	1,165	966
Commitments and contingencies (See Note 9)		
Minority interest		12

Stockholders equity:		
Preferred stock, $0.01 par value. 10 shares authorized		
Common stock, $0.01 par value. 1,000 shares authorized; 310 and 305 shares issued and outstanding, respectively	3	3
Paid-in capital	1,345	1,081
Retained earnings	2,342	2,241
Accumulated other comprehensive income	188	83
Total stockholders equity	3,878	3,408
TOTAL LIABILITIES, MINORITY INTEREST AND STOCKHOLDERS EQUITY	$ 5,043	$ 4,386

See accompanying Notes to Condensed Consolidated Financial Statements.

(a) Derived from audited financial statements.

Table of Contents

ELECTRONIC ARTS INC. AND SUBSIDIARIES
CONDENSED CONSOLIDATED STATEMENTS OF OPERATIONS

(Unaudited) (In millions, except per share data)	Three Months Ended December 31, 2006	Three Months Ended December 31, 2005	Nine Months Ended December 31, 2006	Nine Months Ended December 31, 2005
Net revenue	$ 1,281	$ 1,270	$ 2,478	$ 2,310
Cost of goods sold	470	502	977	937
Gross profit	811	768	1,501	1,373
Operating expenses:				
Marketing and sales	165	147	350	329
General and administrative	91	58	222	160
Research and development	330	206	783	571
Amortization of intangibles	7	1	20	3
Acquired in-process technology	1		3	
Restructuring charges	2	9	12	9
Total operating expenses	596	421	1,390	1,072
Operating income	215	347	111	301
Interest and other income, net	25	20	69	49
Income before provision for income taxes and minority interest	240	367	180	350
Provision for income taxes	84	106	83	93
Income before minority interest	156	261	97	257
Minority interest	4	(2)	4	(5)
Net income	$ 160	$ 259	$ 101	$ 252
Net income per share:				
Basic	$ 0.52	$ 0.86	$ 0.33	$ 0.83
Diluted	$ 0.50	$ 0.83	$ 0.32	$ 0.80
Number of shares used in computation:				
Basic	309	301	307	304
Diluted	319	311	316	315

See accompanying Notes to Condensed Consolidated Financial Statements.

Table of Contents

ELECTRONIC ARTS INC. AND SUBSIDIARIES
CONDENSED CONSOLIDATED STATEMENTS OF CASH FLOWS

(Unaudited) (In millions)	Nine Months Ended December 31, 2006	2005
OPERATING ACTIVITIES		
Net income	$ 101	$ 252
Adjustments to reconcile net income to net cash provided by operating activities:		
Depreciation and amortization	110	68
Stock-based compensation	105	1
Minority interest	(4)	5
Realized net losses on investments and sale of property and equipment	1	
Tax benefit from exercise of stock options		117
Acquired in-process technology	3	
Change in assets and liabilities:		
Receivables, net	(338)	(243)
Inventories	(7)	(11)
Other assets	63	(35)
Accounts payable	1	50
Accrued and other liabilities	125	32
Deferred net revenue	23	23
Net cash provided by operating activities	183	259
INVESTING ACTIVITIES		
Capital expenditures	(118)	(87)
Proceeds from sale of marketable equity securities		4
Purchase of investment in affiliates	(1)	(2)
Proceeds from sale of investment in affiliate		2
Proceeds from maturities and sales of short-term investments	911	948
Purchase of short-term investments	(1,088)	(347)
Acquisition of subsidiaries, net of cash acquired	(94)	(3)
Other investing activities	2	(2)
Net cash provided by (used in) investing activities	(388)	513
FINANCING ACTIVITIES		
Proceeds from sales of common stock through employee stock plans and other plans	133	151
Excess tax benefit from stock-based compensation	27	
Repayment of note assumed in connection with acquisition	(14)	
Repurchase and retirement of common stock		(709)

Net cash provided by (used in) financing activities	146	(558)
Effect of foreign exchange on cash and cash equivalents	16	(22)
Increase (decrease) in cash and cash equivalents	(43)	192
Beginning cash and cash equivalents	1,242	1,270
Ending cash and cash equivalents	1,199	1,462
Short-term investments	1,212	1,094
Ending cash, cash equivalents and short-term investments	$ 2,411	$ 2,556
Supplemental cash flow information:		
Cash paid during the period for income taxes	$ 46	$ 23
Non-cash investing activities:		
Change in unrealized gains (losses) on investments, net	$ 80	$ 37

See accompanying Notes to Condensed Consolidated Financial Statements.

ELECTRONIC ARTS INC. AND SUBSIDIARIES
NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS
(Unaudited)

(1) DESCRIPTION OF BUSINESS AND BASIS OF PRESENTATION

We develop, market, publish and distribute interactive software games that are playable by consumers on home video game consoles (such as the Sony PlayStation® 3, Microsoft Xbox 360 and Nintendo Wii), personal computers, mobile platforms (including cellular handsets and handheld game players such as the PlayStation® Portable (PSP) and the Nintendo DS) and online (over the Internet and other proprietary online networks). Some of our games are based on content that we license from others (e.g., Madden NFL Football, The Godfather and FIFA Soccer), and some of our games are based on our own wholly-owned intellectual property (e.g., The Sims, Need for Speed and BLACK). Our goal is to publish titles with mass-market appeal, which often means translating and localizing them for sale in non-English speaking countries. In addition, we also attempt to create software game franchises that allow us to publish new titles on a recurring basis that are based on the same property. Examples of this franchise approach are the annual iterations of our sports-based products (e.g., Madden NFL Football, NCAA® Football and FIFA Soccer), wholly-owned properties that can be successfully sequeled (e.g., The Sims, Need for Speed and Battlefield) and titles based on long-lived literary and/or movie properties (e.g., Lord of the Rings and Harry Potter).

The Condensed Consolidated Financial Statements are unaudited and reflect all adjustments (consisting only of normal recurring accruals unless otherwise indicated) that, in the opinion of management, are necessary for a fair presentation of the results for the interim periods presented. The preparation of these Condensed Consolidated Financial Statements requires management to make estimates and assumptions that affect the amounts reported in these Condensed Consolidated Financial Statements and accompanying notes. Actual results could differ materially from those estimates. The results of operations for the current interim periods are not necessarily indicative of results to be expected for the current year or any other period.

These Condensed Consolidated Financial Statements should be read in conjunction with the Consolidated Financial Statements and Notes thereto included in our Annual Report on Form 10-K for the fiscal year ended March 31, 2006, as filed with the United States Securities and Exchange Commission (SEC) on June 12, 2006.

(2) FISCAL YEAR AND FISCAL QUARTER

Our fiscal year is reported on a 52 or 53-week period that ends on the Saturday nearest March 31. As a result, fiscal 2006 contained 53 weeks with the first quarter containing 14 weeks. Our results of operations for the fiscal years ending March 31, 2007 and 2006 contain the following number of weeks:

Fiscal Years Ended	Number of Weeks	Fiscal Period End Date
March 31, 2007	52 weeks	March 31, 2007
March 31, 2006	53 weeks	April 1, 2006

Our results of operations for the three and nine months ended December 31, 2006 and 2005 contained the following number of weeks:

Fiscal Period	Number of Weeks	Fiscal Period End Date
Three months ended December 31, 2006	13 weeks	December 30, 2006
Nine months ended December 31, 2006	39 weeks	December 30, 2006
Three months ended December 31, 2005	13 weeks	December 31, 2005
Nine months ended December 31, 2005	40 weeks	December 31, 2005

For simplicity of disclosure purposes, all fiscal periods are referred to as ending on a calendar month end.

(3) STOCK-BASED COMPENSATION

Adoption of SFAS No. 123(R)

In December 2004, the Financial Accounting Standards Board (FASB) issued Statement of Financial Accounting Standard (SFAS) No. 123 (revised 2004) (SFAS No. 123(R)), *Share-Based Payment* . SFAS No. 123(R) requires that the cost resulting from all share-based payment transactions be recognized in the financial statements using a fair-value-based method. In March 2005, the SEC released Staff Accounting Bulletin (SAB) No. 107, *Share-Based Payment* , which provides the views of the staff regarding the interaction between SFAS No. 123(R) and certain SEC rules and regulations for public companies. SFAS No. 123(R) replaces SFAS No. 123, *Accounting for Stock-Based Compensation* , as amended, supersedes Accounting Principles Board (APB) No. 25, *Accounting for Stock Issued to Employees* , and amends SFAS No. 95, *Statement of Cash Flows* .

We adopted SFAS No. 123(R) as of April 1, 2006 and have applied the provisions of SAB No. 107 to our adoption of SFAS No. 123(R). SFAS No. 123(R) requires companies to estimate the fair value of share-based payment awards on the date of grant using an option-pricing model. We elected to use the modified prospective transition method of adoption which requires that compensation expense be recognized in the financial statements for all awards granted after the date of adoption as well as for existing awards for which the requisite service has not been rendered as of the date of adoption. Accordingly, prior periods are not restated for the effect of SFAS No. 123(R).

Prior to April 1, 2006, we accounted for stock-based awards to employees using the intrinsic value method in accordance with APB No. 25 and adopted the disclosure-only provisions of SFAS No. 123, as amended. Also, as required by SFAS No. 148, *Accounting for Stock-Based Compensation Transition and Disclosure* , we provided pro forma net income (loss) and net income (loss) per share disclosures for stock-based awards as if the fair-value-based method defined in SFAS No. 123 had been applied.

Valuation and Expense Recognition. Upon adoption of SFAS No. 123(R), we began to recognize compensation costs for stock-based payment transactions to employees based on their grant-date fair value over the service period for which such awards are expected to vest. The fair value of restricted stock units is determined based the quoted price of our common stock on the date of grant. The fair value of stock options and stock purchase rights granted pursuant to our employee stock purchase plan is determined using the Black-Scholes valuation model, which was the same model we previously used for the pro forma information required under SFAS No. 123. The determination of fair value is affected by our stock price as well as assumptions regarding subjective and complex variables such as expected employee exercise behavior and our expected stock price volatility over the expected term of the award. Generally, our assumptions are based on historical information and judgment is required to determine if historical trends may be indicators of future outcomes. The Black-Scholes valuation model requires us to estimate the following key assumptions:

Risk-free interest rate. The risk-free interest rate is based on U.S. Treasury yields in effect at the time of grant for the expected term of the option.

Expected volatility. We use our historical stock price volatility and consider the implied volatility computed based on the price of short-term options publicly traded on our common stock for our expected volatility assumption.

Expected term. The expected term represents the weighted-average period the stock options are expected to remain outstanding. The expected term is determined based on historical exercise behavior, post-vesting termination patterns, options outstanding and future expected exercise behavior.

Expected dividends.

The assumptions used in the Black-Scholes valuation model to value our option grants and employee stock purchase plan were as follows:

	Stock Option Grants		Employee Stock Purchase Plan	
	Three Months Ended December 31, 2006	Nine Months Ended December 31, 2006	Three Months Ended December 31, 2006	Nine Months Ended December 31, 2006
Risk-free interest rate	4.5 - 4.6%	4.5 - 5.1%	4.7 - 5.1%	3.7 - 5.1%
Expected volatility	32 - 43%	32 - 46%	33 - 35%	30 - 36%
Weighted-average volatility	35%	35%	35%	33%
Expected term	4.2 years	4.2 years	6-12 months	6-12 months
Expected dividends	None	None	None	None

Prior to our adoption of SFAS No. 123(R), we valued our stock options based on the multiple-award valuation method and recognized the expense using the accelerated approach over the requisite service period. In conjunction with our adoption of SFAS No. 123(R), we changed our method of recognizing our stock-based compensation expense for post-adoption grants to the straight-line approach over the requisite service period; however, we continue to value our stock options based on the multiple-award valuation method.

As required by SFAS No. 123(R), employee stock-based compensation expense recognized in the three and nine months ended December 31, 2006 was calculated based on awards ultimately expected to vest and has been reduced for estimated forfeitures. In subsequent periods, if actual forfeitures differ from those estimates, an adjustment to stock-based compensation expense will be recognized at that time.

The following table summarizes stock-based compensation expense resulting from stock options, restricted stock, restricted stock units and our employee stock purchase plan included in our Condensed Consolidated Statements of Operations (in millions):

	Three Months Ended December 31,		Nine Months Ended December 31,	
	2006	2005	2006	2005
Cost of goods sold	$	$	$ 1	$
Marketing and sales	5		14	
General and administrative	10		30	
Research and development	20		60	1
Stock-based compensation expense	35		105	1
Benefit from income taxes	(7)		(22)	
Stock-based compensation expense, net of tax	$ 28	$	$ 83	$ 1

As of December 31, 2006, the total unrecognized compensation cost related to stock options was $173 million and is expected to be recognized over the weighted-average service period of 1.5 years. As of December 31, 2006, the total unrecognized compensation cost related to restricted stock and restricted stock units was $81 million and is expected to be recognized over the weighted-average service period of 2.5 years.

The adoption of SFAS No. 123(R), using the fair value method, had the following effect on our pre-tax income, net income, and basic and diluted net income per share as compared to what would have been reported under APB No. 25 using the intrinsic value method, which was the method used prior to our adoption (in millions, except per share data):

	Three Months Ended December 31, 2006			Nine Months Ended December 31, 2006		
	Fair Value Method	Intrinsic Value Method	Impact of Change	Fair Value Method	Intrinsic Value Method	Impact of Change
Income before provision for income taxes and minority interest	$ 240	$ 264	$ (24)	$ 180	$ 264	$ (84)
Net income	$ 160	$ 169	$ (9)	$ 101	$ 158	$ (57)
Net income per share:						
Basic	$ 0.52	$ 0.55	$ (0.03)	$ 0.33	$ 0.51	$ (0.18)
Diluted	$ 0.50	$ 0.53	$ (0.03)	$ 0.32	$ 0.50	$ (0.18)

APIC Pool. In November 2005, the FASB issued FASB Staff Position (FSP) No. Financial Accounting Standard (FAS) 123(R)-3, *Transition Election Related to Accounting for the Tax Effects of Share-Based Payment Awards* . The FASB allows for a practical exception in calculating the additional paid-in capital pool (APIC pool) of excess tax benefits upon adoption that is available to absorb tax deficiencies recognized subsequent to the adoption of SFAS No. 123(R). For employee stock-based compensation awards that are outstanding upon adoption of SFAS No. 123(R), the alternative transition method provides a simplified method to establish the beginning balance of the APIC pool related to the tax effects of employee stock-based compensation. It also provides a simplified method to determine the subsequent impact on the APIC pool and Condensed Consolidated Statements of Cash Flows for the tax effects of employee stock-based compensation awards. We elected to adopt the alternative transition method provided in FSP No. FAS 123(R)-3 for calculating the tax effects of stock-based compensation pursuant to SFAS No. 123(R).

Cash Flow Impact. Prior to our adoption of SFAS No. 123(R), cash retained as a result of tax deductions relating to stock-based compensation was presented in operating cash flows along with other tax cash flows. SFAS No. 123(R) requires a classification change in the statement of cash flows. As a result, tax benefits relating to excess stock-based compensation deductions, which had been included in operating cash flow activities, are now presented as financing cash flow activities (total cash flows remain unchanged).

Summary of Plans and Plan Activity

Stock Option Plans

Our 2000 Equity Incentive Plan (the Equity Plan) allows us to grant options to purchase our common stock, restricted stock, restricted stock units and stock appreciation rights to our employees, officers and directors. Pursuant to the Equity Plan, incentive stock options may be granted to employees and officers and non-qualified options may be granted to employees, officers and directors, at not less than 100 percent of the fair market value on the date of grant. We also have options outstanding that were granted under (1) the Criterion Software Limited Approved Share Option Scheme (the Criterion Plan), which we assumed in connection with our acquisition of Criterion, and (2) the JAMDAT Mobile Inc. Amended and Restated 2000 Stock Incentive Plan and the JAMDAT Mobile Inc. 2004 Equity Incentive Plan (collectively, the JAMDAT Plans), which we assumed in connection with our acquisition of JAMDAT. Options granted under the Equity Plan generally expire ten years from the date of grant and are generally exercisable as to 24 percent of the shares after 12 months, and then ratably over 38 months. All options granted under the Criterion Plan were exercisable as of March 31, 2005 and expire in January 2012. Certain assumed options granted under the JAMDAT Plans have acceleration rights upon the occurrence of various triggering events. Otherwise, the terms of the JAMDAT Plans are similar to our Equity Plan.

Table of Contents

The following table summarizes our stock option activity for the nine months ended December 31, 2006:

	Options (in thousands)	Weighted-Average Exercise Price	Weighted-Average Remaining Contractual Term (in years)	Aggregate Intrinsic Value (in millions)
Outstanding as of March 31, 2006	40,882	$ 40.02		
Activity for the nine months ended December 31, 2006:				
Granted	4,167	51.16		
Exercised	(4,023)	29.37		
Forfeited, cancelled or expired	(2,212)	52.90		
Exchange Program (cancelled)	(1,776)	64.92		
Outstanding as of December 31, 2006	37,038	$ 40.47	6.6	$ 447

Additional stock option-related information as of December 31, 2006:

	Options (in thousands)	Weighted-Average Exercise Price	Weighted-Average Remaining Contractual Term (in years)	Aggregate Intrinsic Value (in millions)
Outstanding	37,038	$ 40.47	6.6	$ 447
Vested and expected to vest	35,115	$ 39.72	6.5	$ 445
Exercisable	22,311	$ 31.91	5.2	$ 432

A total of 15 million shares were available for grant under our Equity Plan as of December 31, 2006, of which no more than 13 million shares were eligible for grant in the form of restricted stock or restricted stock units.

The aggregate intrinsic value represents the total pre-tax intrinsic value based on our closing stock price as of December 31, 2006 which would have been received by the option holders had all option holders exercised their options as of that date. We issue new common stock from our authorized shares upon the exercise of stock options.

The weighted-average grant-date fair value of stock options granted during the three and nine months ended December 31, 2006 was $19.14 and $17.82, respectively. The weighted-average grant-date fair value of stock options granted during the three and nine months ended December 31, 2005 was $15.65 and $16.23, respectively. The total intrinsic value of options exercised during the three and nine months ended December 31, 2006 was $38 million and $96 million, respectively. The total intrinsic value of options exercised during the three and nine months ended December 31, 2005 was $96 million and $154 million, respectively. The total fair value (determined at the grant date) of shares vested during the three and nine months ended December 31, 2006 was $18 million and $72 million, respectively. The total fair value (determined at the grant date) of shares vested during the three and nine months ended December 31, 2005 was $32 million and $99 million, respectively.

The following table summarizes outstanding and exercisable options as of December 31, 2006:

	Options Outstanding				Options Exercisable		
Range of Exercise Prices	Number of Shares (in thousands)	Weighted-Average Remaining Contractual Term (in years)	Weighted-Average Exercise Price	Potential Dilution	Number of Shares (in thousands)	Weighted-Average Exercise Price	Potential Dilution
$ 0.53 - $14.99	3,608	1.71	$ 11.33	1.2%	3,600	$ 11.35	1.2%
15.00 - 24.99	4,422	4.17	23.13	1.4%	4,419	23.13	1.4%
25.00 - 34.99	7,844	5.44	30.12	2.5%	7,617	30.09	2.4%
35.00 - 44.99	2,132	7.17	42.41	0.7%	1,321	42.28	0.4%
45.00 - 54.99	12,812	8.50	50.92	4.1%	3,593	49.21	1.2%
55.00 - 65.93	6,220	8.47	60.54	2.0%	1,761	60.73	0.6%
$ 0.53 - $65.93	37,038	6.59	$ 40.47	11.9%	22,311	$ 31.91	7.2%

Potential dilution is computed by dividing the options in the related range of exercise prices by the shares of common stock issued and outstanding as of December 31, 2006 (310 million shares).

Restricted Stock Units and Restricted Stock

We grant restricted stock units and restricted stock (collectively referred to as restricted stock rights) under our Equity Plan to employees worldwide. Restricted stock units entitle holders to receive shares of common stock at the end of a specified period of time. Upon vesting, the equivalent number of common shares are typically issued net of tax withholdings. Restricted stock is issued and outstanding upon grant; however, restricted stock award holders are restricted from selling the shares until they vest. Upon vesting, we will typically withhold shares to satisfy tax withholding requirements. Restricted stock rights are subject to forfeiture and transfer restrictions. Vesting for restricted stock rights are based on continued employment of the holder. If the vesting conditions are not met, unvested restricted stock rights will be forfeited. Generally, our restricted stock right grants vest according to one of the following vesting schedules:

100 percent after one year;

Three-year vesting with 25 percent cliff vesting at the end of each of the first and second years, and 50 percent cliff vesting at the end of the third year; or

Four-year vesting with 25 percent cliff vesting at the end of each year.

The following table summarizes our restricted stock right activity for the nine months ended December 31, 2006:

	Restricted Stock Rights (in thousands)	Weighted-Average Grant Date Fair Value
Balance as of March 31, 2006	655	$ 52.21
Activity for the nine months ended December 31, 2006:		
Granted	1,113	52.89
Exchange Program (granted)	444	54.22
Vested	(43)	54.03

Forfeited	(82)		52.43
Balance as of December 31, 2006	2,087	$	52.95

The weighted-average grant date fair value of restricted stock rights is based on the quoted market value of our common stock on the date of grant. The weighted-average fair value of restricted stock rights granted during the three and nine months ended December 31, 2006 was $55.57 and $52.89, respectively. The weighted-average fair value of restricted stock rights granted during the three and nine months ended December 31, 2005 was $56.51 and $54.35, respectively. The total fair value of

Table of Contents

restricted stock rights vested during the three and nine months ended December 31, 2006 was less than $1 million and $2 million, respectively. There were no restricted stock rights vested during the three and nine months ended December 31, 2005.

At our Annual Meeting of Stockholders, held on July 27, 2006, our stockholders approved amendments to the Equity Plan to (1) increase by 11 million shares the limit on the total number of shares underlying awards of restricted stock and restricted stock units that may be granted under the Equity Plan from 4 million to 15 million shares, and (2) to limit the number of shares subject to options surrendered and cancelled in the Exchange Program that will again become available for issuance under the Equity Plan to 7 million plus the number of shares necessary for the issuance of the restricted stock rights to be granted in connection with the Exchange Program.

Exchange Program

At our Annual Meeting of Stockholders, held on July 27, 2006, our stockholders approved a voluntary program (the Exchange Program) to permit our eligible employees to exchange certain outstanding stock options that were significantly underwater (that is, the exercise price is greater than the trading price of our common stock) for a lesser number of shares of restricted stock rights to be granted under the Equity Plan. The Exchange Program commenced on August 16, 2006 and ended on September 15, 2006.

The Exchange Program was open to all of our employees who were employed by us on August 16, 2006 and were still an employee on the date on which the tendered options were cancelled and restricted stock rights were granted except (1) our named executive officers identified in our 2006 Annual Proxy Statement, (2) members of our Board of Directors, and (3) employees who resided in China, Belgium and Denmark due to restrictions arising under the local laws of those countries.

Option grants that had an exercise price per share equal to or greater than the threshold price were considered eligible options . The threshold price was $61.66, which represented 125 percent of the five-business day average closing price of our common stock prior to August 16, 2006, as reported on the NASDAQ Global Select Market, which was $49.324. Due to local tax law restrictions, U.K. approved options granted under the U.K Sub-Plan of the 2000 Plan approved by the U.K. HM Revenue & Customs on May 2, 2001 (U.K. Approved Options) were not eligible for exchange. However, options held by eligible employees other than U.K. Approved Options and that otherwise met the requirements for eligibility were eligible for exchange. Excluded from the offer were any option grants for fewer than five shares.

Eligible options exchanged under the program were cancelled in exchange for restricted stock rights following the expiration of the offer. For restricted stock rights issued in exchange for unvested options, compensation expense is recorded based on the grant-date fair value of the options tendered over their remaining original vesting period of those options. Restricted stock rights issued in connection with the Exchange Program vest over a period of up to three years.

The Exchange Program resulted in options to purchase approximately 1,776,000 shares of our common stock being exchanged for approximately 444,000 shares of restricted stock rights. In connection with the Exchange Program, a net total of 1,332,000 shares of common stock were returned to the Equity Plan for future issuance.

Employee Stock Purchase Plan

Since September 1991, we have offered our employees the ability to participate in an employee stock purchase plan. Pursuant to our current plan, the 2000 Employee Stock Purchase Plan (ESPP), eligible employees may authorize payroll deductions of up to 10 percent of their compensation to purchase shares at 85 percent of the lower of the fair market value of the common stock on the date of commencement of the offering or on the last day of the six-month purchase period.

At our Annual Meeting of Stockholders, held on July 27, 2006, our stockholders approved an amendment to the ESPP to increase the number of shares authorized under the ESPP by 1.5 million. As of December 31, 2006, we had 3 million shares of common stock reserved for future issuance under the ESPP.

Information related to stock issuances under the ESPP are as follows:

	Nine Months Ended December 31, 2006	
	2006	2005
Number of shares issued (in thousands)	370	316
Exercise prices for purchase rights	$ 43.10	$ 42.31 to 47.95
Estimated weighted-average fair value of purchase rights	$ 17.30	$ 16.13

We issue new common stock out of the ESPP s pool of authorized shares. The fair value above was estimated on the date of grant using the Black-Scholes option-pricing model assumptions described in this note under the headings Adoption of SFAS No. 123(R) and Pre-SFAS No. 123(R) Pro Forma Accounting Disclosures .

Pre-SFAS No. 123(R) Pro Forma Accounting Disclosures

Prior to the adoption of SFAS No. 123(R), we accounted for stock-based awards to employees using the intrinsic value method in accordance with APB No. 25 and adopted the disclosure-only provisions of SFAS No. 123, as amended.

Had compensation cost for our stock-based compensation plans been measured based on the estimated fair value at the grant dates in accordance with the provisions of SFAS No. 123, as amended, we estimate that our reported net income and net income per share would have been the pro forma amounts indicated below. The fair value of each option grant is estimated on the date of grant using the Black-Scholes option-pricing model. The following weighted-average assumptions were used for grants made under our stock-based compensation plan during the three and nine months ended December 31, 2005:

	Three Months Ended December 31, 2005	Nine Months Ended December 31, 2005
Risk-free interest rate	4.3%	4.0%
Expected volatility	32%	34%
Expected term of stock options (in years)	3.2	3.3
Expected term of employee stock purchase plan (in months)	6	6
Expected dividends	None	None

Our calculations were based on a multiple-award valuation method and forfeitures were recognized when they occurred.

(In millions, except per share data)	Three Months Ended December 31, 2005	Nine Months Ended December 31, 2005
Net income:		
As reported	$ 259	$ 252
Deduct: Total stock-based employee compensation expense determined under fair-value-based method for all awards, net of related tax effects	(20)	(71)
Add: Stock-based employee compensation expense included in reported net income, net of related tax effects		1
Pro forma	$ 239	$ 182
Net income per share:		
As reported basic	$ 0.86	$ 0.83
Pro forma basic	$ 0.79	$ 0.60

As reported diluted	$	0.83	$	0.80
Pro forma diluted	$	0.77	$	0.58

Table of Contents

(4) BUSINESS COMBINATIONS

Digital Illusions C.E. and Mythic Entertainment, Inc.

The following table summarizes the preliminary allocation of assets acquired and liabilities assumed in connection with the acquisitions of Mythic Entertainment, Inc. (Mythic) and the remaining minority interest of Digital Illusions C.E. (DICE) for the nine months ended December 31, 2006 (in millions):

	DICE	Mythic	Total
Current assets	$	$ 15	$ 15
Property and equipment, net		1	1
Other long-term assets		1	1
Acquired in-process technology	1	2	3
Goodwill	21	62	83
Finite-lived intangibles	4	22	26
Liabilities	(2)	(27)	(29)
Minority interest	8		8
Total consideration	$ 32	$ 76	$ 108

Digital Illusions C.E.

Based in Sweden, DICE develops games for PCs and video game consoles. In 2003 we acquired (1) approximately 1,911,403 shares of Class B common stock representing a 19 percent equity interest in DICE, and (2) a warrant to acquire an additional 2,327,602 shares of to-be-issued Class A common stock at an exercise price of SEK 43.23. Prior to our tender offer in the fourth quarter of fiscal 2005, we accounted for our Class B common stock investment in DICE under the equity method of accounting, as prescribed by APB No. 18, *The Equity Method of Accounting for Investments in Common Stock* . Separately, the warrant was recognized at a cost of $5 million as of March 31, 2006 and was included in investments in affiliates in our Condensed Consolidated Balance Sheets.

On January 27, 2005, we completed a tender offer by acquiring 3,235,053 shares of Class A common stock at a price of SEK 61 per share, representing 32 percent of the outstanding Class A common stock of DICE. During the tender offer period and through the end of fiscal 2005, we acquired, through open market purchases at an average price of SEK 60.33, an additional 1,190,658 shares of Class A common stock, representing approximately 12 percent of the outstanding Class A common stock of DICE. During the first three months and last two weeks of fiscal 2006, we acquired, through open market purchases at an average price of SEK 63.07, an additional 1,071,152 shares of Class A common stock, representing approximately 10 percent of the outstanding Class A common stock of DICE. Accordingly, on a cumulative basis as of March 31, 2006, we owned approximately 73 percent of DICE on an undiluted basis (excluding the warrant discussed above). As a result, we have included the assets, liabilities and results of operations of DICE in our Condensed Consolidated Financial Statements since January 27, 2005. The percent of DICE stock that we did not own was reflected as minority interest on our Condensed Consolidated Financial Statements from January 27, 2005 until the acquisition date of the remaining minority interest in October 2006. DICE s products were primarily sold through co-publishing agreements with us and our transactions with DICE were recorded on an arm s length basis.

In October 2006, the remaining minority interest in DICE was acquired for a total of $27 million in cash, including transaction costs. In connection with the acquisition of the remaining minority interest of DICE, the warrant was reclassified to goodwill for this wholly owned subsidiary. We expect further adjustments to our purchase price allocation, including the allocation of goodwill, as a result of the acquisition of the remaining minority interest of DICE.

Except for acquired in-process technology, which is discussed below, the acquired finite-lived intangible assets are being amortized on a straight-line basis over estimated lives ranging from one to four years. The intangible assets that make up that amount as of December 31, 2006 include:

	Gross Carrying Amount (in millions)	Weighted-Average Useful Life (in years)
Developed and Core Technology	$ 4	2
Trade Name	2	4
Total Finite-Lived Intangibles	$ 6	3

During the nine months ended December 31, 2006, we recorded $21 million of goodwill, none of which is tax deductible.

The acquired in-process technology was expensed in our Condensed Consolidated Statements of Operations upon consummation of the acquisition, and in each period we increased our ownership percentage. Acquired in-process technology includes the value of products in the development stage that are not considered to have reached technological feasibility or have alternative future use.

We expect to finalize the preliminary purchase price allocation during the three months ended March 31, 2007.

Mythic Entertainment, Inc.

On July 24, 2006, we acquired all outstanding shares of Mythic for an aggregate purchase price of $76 million in cash, including transaction costs. Based in Fairfax, Virginia, Mythic is a developer and publisher of massively multiplayer online role-playing games. The results of operations of Mythic and the estimated fair market values of the acquired assets and assumed liabilities have been included in our Condensed Consolidated Financial Statements since the date of acquisition. Except for acquired in-process technology, which is discussed below, the acquired finite-lived intangible assets are being amortized on a straight-line basis over estimated lives ranging from three to five years. The intangible assets that make up that amount as of the date of the acquisition include:

	Gross Carrying Amount (in millions)	Weighted-Average Useful Life (in years)
Developed and Core Technology	$ 15	4
Trade Name	6	5
Subscribers and Other Intangibles	1	5
Total Finite-Lived Intangibles	$ 22	4

We recorded $62 million of goodwill, none of which is tax deductible and we expensed $2 million of acquired in-process technology in our Condensed Consolidated Statements of Operations upon consummation of the acquisition.

We expect to finalize the preliminary purchase price allocation during the three months ended March 31, 2007.

Table of Contents

(5) GOODWILL AND OTHER INTANGIBLE ASSETS

Goodwill information is as follows (in millions):

	As of March 31, 2006	Goodwill Acquired	Purchase Accounting Adjustments [1]	Effects of Foreign Currency Translation	As of December 31, 2006
Goodwill	$ 647	$ 83	$ (4)	$ 4	$ 730

[1] During the three months ended June 30, 2006, we finalized the purchase price allocation including the allocation of goodwill related to our acquisition of JAMDAT Mobile Inc. (JAMDAT). As a result, we reduced goodwill and the liability balance assumed from JAMDAT by $4 million.

Finite-lived intangibles consisted of the following (in millions):

	As of December 31, 2006			
	Gross Carrying Amount	Accumulated Amortization	Other	Other Intangibles, Net
Developed and Core Technology	$ 180	$ (54)	$	$ 126
Carrier Contracts and Related	85	(15)		70
Trade Name	44	(23)		21
Subscribers and Other Intangibles	16	(11)	(1)	4
Total	$ 325	$ (103)	$ (1)	$ 221

	As of March 31, 2006			
	Gross Carrying Amount	Accumulated Amortization	Other	Other Intangibles, Net
Developed and Core Technology	$ 160	$ (31)	$	$ 129
Carrier Contracts and Related	85	(2)		83
Trade Name	36	(21)		15
Subscribers and Other Intangibles	15	(9)	(1)	5
Total	$ 296	$ (63)	$ (1)	$ 232

Amortization of intangibles for the three and nine months ended December 31, 2006 was $14 million (of which $7 million was recognized as cost of goods sold) and $40 million (of which $20 million was recognized as cost of goods sold), respectively. Amortization of intangibles for the three and nine months ended December 31, 2005 was $3 million (of which $2 million was recognized as cost of goods sold) and $8 million (of which $5 million was recognized as cost of goods sold), respectively. Finite-lived intangible assets are amortized using the straight-line method over the lesser of their estimated useful lives or the agreement terms, typically from two to twelve years. As of December 31, 2006 and March 31, 2006, the weighted-average remaining useful life for finite-lived intangible assets was approximately 6.4 years and 7.2 years, respectively.

As of December 31, 2006, future amortization of finite-lived intangibles that will be recorded in cost of goods sold and operating expenses is estimated as follows (in millions):

Fiscal Year Ending March 31,	
2007 (remaining three months)	$ 14
2008	51
2009	40
2010	33
2011	29
Thereafter	54
Total	$ 221

(6) RESTRUCTURING AND ASSET IMPAIRMENT CHARGES

Restructuring and asset impairment information as of December 31, 2006 was as follows (in millions):

	Fiscal 2006 International Publishing Reorganization			Fiscal 2006 Restructuring	Fiscal 2004, 2003 and 2002 Restructurings	
	Workforce	Facilities-related	Other	Workforce	Facilities-related	Total
Balances as of March 31, 2005	$	$	$	$	$ 10	$ 10
Charges to operations	3	8	3	10		24
Charges utilized in cash	(2)		(1)	(7)	(5)	(15)
Adjustments to operations					2	2
Balances as of March 31, 2006	$ 1	$ 8	$ 2	$ 3	$ 7	$ 21
Charges to operations	8	1	3			12
Charges utilized in cash	(9)		(5)	(2)	(3)	(19)
Balances as of December 31, 2006	$	$ 9	$	$ 1	$ 4	$ 14

All restructuring charges recorded subsequent to December 31, 2002, were recorded in accordance with SFAS No. 146, *Accounting for Costs Associated with Exit or Disposal Activities*. We generally expense restructuring costs as they are incurred and accrue costs associated with certain facility closures at the time we exit the facility. Adjustments to our restructuring reserves are made in future periods, if necessary, based upon then-current events and circumstances.

Fiscal 2006 International Publishing Reorganization

In November 2005, we announced plans to establish an international publishing headquarters in Geneva, Switzerland. Through the quarter ended September 30, 2006, we relocated certain employees to our new facility in Geneva, closed certain facilities in the U.K., and made other related changes in our international publishing business.

Since the inception of the restructuring plan, through December 31, 2006, we have incurred restructuring charges of approximately $26 million, of which $11 million was for employee-related expenses, $9 million for the closure of certain U.K. facilities, and $6 million in other costs in connection with our international publishing reorganization. The restructuring accrual of $9 million as of December 31, 2006 is expected to be utilized by March 2017. This accrual is included in other accrued expenses presented in Note 8 of the Notes to Condensed Consolidated Financial

Statements.

In fiscal 2007, we expect to incur between $15 million and $20 million of restructuring costs in connection with our international publishing reorganization. Overall, including charges incurred through December 31, 2006, we expect to incur between $40 million and $45 million of restructuring costs, substantially all of which will result in cash expenditures by 2017. These restructuring costs will consist primarily of employee-related relocation assistance (approximately $25 million), facility exit costs (approximately $11 million), as well as other reorganization costs (approximately $6 million).

Fiscal 2006 Restructuring

During the fourth quarter of fiscal 2006, we aligned our resources with our product plan for fiscal 2007 and strategic opportunities with next-generation consoles, online and mobile platforms. As part of this alignment, we recorded a total pre-tax restructuring charge of $10 million consisting entirely of one-time benefits related to headcount reductions, which are included in restructuring charges in our Condensed Consolidated Statements of Operations. As of December 31, 2006, an aggregate of $9 million in cash has been paid out under the restructuring plan. The remaining restructuring accrual of $1 million is expected to be utilized during our fiscal year ending March 31, 2007. This accrual is included in other accrued expenses presented in Note 8 of the Notes to Condensed Consolidated Financial Statements.

Fiscal 2004, 2003 and 2002 Restructurings

In fiscal 2004, 2003 and 2002, we engaged in various restructurings based on management decisions. As of December 31, 2006, an aggregate of $30 million in cash had been paid out under these restructuring plans. The remaining projected net cash outlay of $4 million is expected to be utilized during our fiscal year ending March 31, 2007. The facilities-related accrued obligation shown above is net of $4 million of estimated future sub-lease income. The restructuring accrual is included in other accrued expenses presented in Note 8 of the Notes to Condensed Consolidated Financial Statements.

(7) ROYALTIES AND LICENSES

Our royalty expenses consist of payments to (1) content licensors, (2) independent software developers, and (3) co-publishing and/or distribution affiliates. License royalties consist of payments made to celebrities, professional sports organizations, movie studios and other organizations for our use of their trademarks, copyrights, personal publicity rights, content and/or other intellectual property. Royalty payments to independent software developers are payments for the development of intellectual property related to our games. Co-publishing and distribution royalties are payments made to third parties for delivery of product.

Royalty-based obligations with content licensors and distribution affiliates are either paid in advance and capitalized as prepaid royalties or are accrued as incurred and subsequently paid. These royalty-based obligations are generally expensed to cost of goods sold generally at the greater of the contractual rate or an effective royalty rate based on expected net product sales. Prepayments made to thinly capitalized independent software developers and co-publishing affiliates are generally in connection with the development of a particular product and, therefore, we are generally subject to development risk prior to the release of the product. Accordingly, payments that are due prior to completion of a product are generally amortized to research and development over the development period as the services are incurred. Payments due after completion of the product (primarily royalty-based in nature) are generally expensed as cost of goods sold.

Our contracts with some licensors include minimum guaranteed royalty payments which are initially recorded as an asset and as a liability at the contractual amount when no performance remains with the licensor. When performance remains with the licensor, we record guarantee payments as an asset when actually paid and as a liability when incurred, rather than recording the asset and liability upon execution of the contract. Minimum royalty payment obligations are classified as current liabilities to the extent such royalty payments are contractually due within the next twelve months. As of December 31, 2006 and March 31, 2006, approximately $5 million and $9 million, respectively, of minimum guaranteed royalty obligations had been recognized.

Each quarter, we also evaluate the future realization of our royalty-based assets as well as any unrecognized minimum commitments not yet paid to determine amounts we deem unlikely to be realized through product sales. Any impairments determined before the launch of a product are charged to research and development expense. Impairments determined post-launch are charged to cost of goods sold. In either case, we rely on estimated revenue to evaluate the future realization of prepaid royalties and commitments. If actual sales or revised revenue estimates fall below the initial revenue estimate, then the actual charge taken may be greater in any given quarter than anticipated. We had no impairments during the three and nine months ended December 31, 2006 and 2005.

Table of Contents

The current and long-term portions of prepaid royalties and minimum guaranteed royalty-related assets, included in other current assets and other assets, consisted of (in millions):

	As of December 31, 2006	As of March 31, 2006
Other current assets	$ 27	$ 76
Other assets	53	55
Royalty-related assets	$ 80	$ 131

At any given time, depending on the timing of our payments to our co-publishing and/or distribution affiliates, content licensors and/or independent software developers, we recognize unpaid royalty amounts due to these parties as either accounts payable or accrued liabilities. The current and long-term portions of accrued royalties, included in accrued and other current liabilities as well as other liabilities, consisted of (in millions):

	As of December 31, 2006	As of March 31, 2006
Accrued and other current liabilities	$ 118	$ 82
Other liabilities	2	7
Royalty-related liabilities	$ 120	$ 89

In addition, as of December 31, 2006, we were committed to pay approximately $1,550 million to content licensors and co-publishing and/or distribution affiliates, but performance remained with the counterparty (i.e., delivery of the product or content or other factors) and such commitments were therefore not recorded in our Condensed Consolidated Financial Statements. See Note 9 of the Notes to Condensed Consolidated Financial Statements.

(8) BALANCE SHEET DETAILS

Inventories

Inventories as of December 31, 2006 and March 31, 2006 consisted of (in millions):

	As of December 31, 2006	As of March 31, 2006
Raw materials and work in process	$ 1	$ 1
Finished goods (including manufacturing royalties)	71	60
Inventories	$ 72	$ 61

Property and Equipment, Net

Property and equipment, net, as of December 31, 2006 and March 31, 2006 consisted of (in millions):

	As of December 31, 2006	As of March 31, 2006
Computer equipment and software	$ 494	$ 418
Buildings	194	127
Leasehold improvements	90	78
Office equipment, furniture and fixtures	65	57
Land	64	57
Warehouse equipment and other	10	11
Construction in progress	19	59
	936	807
Less accumulated depreciation	(485)	(415)
Property and equipment, net	$ 451	$ 392

Depreciation expense associated with property and equipment amounted to $24 million and $70 million for the three and nine months ended December 31, 2006, respectively. Depreciation expense associated with property and equipment amounted to $20 million and $60 million for the three and nine months ended December 31, 2005, respectively.

Accrued and Other Current Liabilities

Accrued and other current liabilities as of December 31, 2006 and March 31, 2006 consisted of (in millions):

	As of December 31, 2006	As of March 31, 2006
Accrued income taxes	$ 285	$ 234
Accrued compensation and benefits	231	122
Other accrued expenses	167	202
Accrued royalties	118	82
Accrued value added taxes	50	14
Accrued and other current liabilities	$ 851	$ 654

Income Taxes

Effective Income Tax Rate for three and nine months ended December 31, 2006

With respect to our projected annual effective income tax rate at the end of each quarter prior to the end of a fiscal year, we are required to make a projection of several items, including our projected mix of full-year income in each jurisdiction in which we operate and the related income tax expense in each jurisdiction. While this projection is always inherently uncertain, until the third quarter of fiscal 2007, our interim projected tax rate for fiscal 2007 was unusually volatile and subject to significantly greater variation.

The tax rate reported for the nine months ended December 31, 2006 is based on our estimated projected annual effective tax rate for fiscal 2007. Our effective income tax rates for the three and nine months ended December 31, 2006 were 34.9 percent and 45.9 percent, respectively. These rates include various adjustments recorded in the three

months ended December 31, 2006 for the reinstatement of the federal research credit, additional income tax benefit resulting from certain intercompany transactions, offset by additional tax expense due to the development of certain tax audit related matters. Without the impact of these adjustments, our effective income tax rates for the three and nine months ended December 31, 2006 would have been 37.3 percent and 49.0 percent, respectively.

Effective Income Tax Rate for three and nine months ended December 31, 2005

During the three months ended December 31, 2005, we adjusted our projected annual effective income tax rate from our previous projection of 28.0 percent to 29.0 percent (in each case, excluding discrete adjustments). As a result, we recognized $4 million (or $0.01 per basic and diluted net income per share) more income tax expense for both the three and nine months ended December 31, 2005 than we would have recognized had this projected annual effective income tax rate remained at 28.0 percent.

During the nine months ended December 31, 2005, our effective income tax rate was 26.5 percent. This rate included various adjustments recorded in the three months ended September 30, 2005 for the resolution of certain tax-related matters with foreign tax authorities, offset by additional income tax provisions resulting from certain intercompany transactions during the three months ended September 30, 2005. The net impact of these adjustments was that we recognized $9 million (or $0.03 per basic and diluted net income per share) less income tax expense for the nine months ended December 31, 2005 than we would have recognized had our projected annual effective income tax rate remained at 29.0 percent.

(9) COMMITMENTS AND CONTINGENCIES

Lease Commitments and Residual Value Guarantees

We lease certain of our current facilities and equipment under non-cancelable operating lease agreements. We are required to pay property taxes, insurance and normal maintenance costs for certain of these facilities and will be required to pay any increases over the base year of these expenses on the remainder of our facilities.

In February 1995, we entered into a build-to-suit lease (Phase One Lease) with a third-party lessor for our headquarters facilities in Redwood City, California (Phase One Facilities). The Phase One Facilities comprise a total of approximately 350,000 square feet and provide space for sales, marketing, administration and research and development functions. In July 2001, the lessor refinanced the Phase One Lease with Keybank National Association through July 2006. The Phase One Lease expires in January 2039, subject to early termination in the event the underlying financing between the lessor and its lenders is not extended. Subject to certain terms and conditions, upon termination of the lease, we may purchase the Phase One Facilities or arrange for the sale of the Phase One Facilities to a third party.

Pursuant to the terms of the Phase One Lease, we have an option to purchase the Phase One Facilities at any time for a purchase price of $132 million. In the event of a sale to a third party, if the sale price is less than $132 million, we will be obligated to reimburse the difference between the actual sale price and $132 million, up to maximum of $117 million, subject to certain provisions of the Phase One Lease, as amended.

On May 26, 2006, the lessor extended its loan financing underlying the Phase One Lease with its lenders through July 2007. We may request, on behalf of the lessor and subject to lender approval, up to two one-year extensions of the loan financing between the lessor and the lender. In the event the lessor s loan financing with the lenders is not extended, we may loan to the lessor approximately 90 percent of the financing, and require the lessor to extend the remainder through July 2009; otherwise the lease will terminate. We account for the Phase One Lease arrangement as an operating lease in accordance with SFAS No. 13, *Accounting for Leases* , as amended.

In December 2000, we entered into a second build-to-suit lease (Phase Two Lease) with Keybank National Association for a five and one-half year term beginning in December 2000 to expand our Redwood City, California headquarters facilities and develop adjacent property (Phase Two Facilities). Construction of the Phase Two Facilities was completed in June 2002. The Phase Two Facilities comprise a total of approximately 310,000 square feet and provide space for sales, marketing, administration and research and development functions. Subject to certain terms and conditions, upon termination of the lease, we may purchase the Phase Two Facilities or arrange for the sale of the Phase Two Facilities to a third party.

Pursuant to the terms of the Phase Two Lease, we have an option to purchase the Phase Two Facilities at any time for a purchase price of $115 million. In the event of a sale to a third party, if the sale price is less than $115 million, we will be obligated to reimburse the difference between the actual sale price and $115 million, up to a maximum of $105 million, subject to certain provisions of the Phase Two Lease, as amended.

Table of Contents

On May 26, 2006, the lessor extended the Phase Two Lease through July 2009 subject to early termination in the event the underlying loan financing between the lessor and its lenders is not extended. Concurrently with the extension of the lease, the lessor extended the loan financing underlying the Phase Two Lease with its lenders through July 2007. We may request, on behalf of the lessor and subject to lender approval, up to two one-year extensions of the loan financing between the lessor and the lender. In the event the lessor s loan financing with the lenders is not extended, we may loan to the lessor approximately 90 percent of the financing, and require the lessor to extend the remainder through July 2009, otherwise the lease will terminate. We account for the Phase Two Lease arrangement as an operating lease in accordance with SFAS No. 13, as amended.

We believe that, as of December 31, 2006, the estimated fair values of both properties under these operating leases exceeded their respective guaranteed residual values.

The two lease agreements with Keybank National Association described above require us to maintain certain financial covenants as shown below, all of which we were in compliance with as of December 31, 2006.

Financial Covenants		Requirement		Actual as of December 31, 2006
Consolidated Net Worth (in millions)		equal to or greater than	$ 2,430	$3,878
Fixed Charge Coverage Ratio		equal to or greater than	3.00	5.28
Total Consolidated Debt to Capital		equal to or less than	60%	6.0%
Quick Ratio	Q1 & Q2	equal to or greater than	1.00	N/A
Q3 & Q4		equal to or greater than	1.75	9.19

Development, Celebrity, League and Content Licenses: Payments and Commitments

The products we produce in our studios are designed and created by our employee designers, artists, software programmers and by non-employee software developers (independent artists or third-party developers). We typically advance development funds to the independent artists and third-party developers during development of our games, usually in installment payments made upon the completion of specified development milestones. Contractually, these payments are generally considered advances against subsequent royalties on the sales of the products. These terms are set forth in written agreements entered into with the independent artists and third-party developers.

In addition, we have certain celebrity, league and content license contracts that contain minimum guarantee payments and marketing commitments that may not be dependent on any deliverables. Celebrities and organizations with whom we have contracts include: FIFA, FIFPRO Foundation, UEFA and FAPL (Football Association Premier League Limited) (professional soccer); NASCAR (stock car racing); National Basketball Association (professional basketball); PGA TOUR and Tiger Woods (professional golf); National Hockey League and NHL Players Association (professional hockey); Warner Bros. (Harry Potter, Batman and Superman); New Line Productions and Saul Zaentz Company (The Lord of the Rings); Red Bear Inc. (John Madden), National Football League Properties and PLAYERS Inc. (professional football); Collegiate Licensing Company (collegiate football, basketball and baseball); Simcoh (Def Jam); Viacom Consumer Products (The Godfather); ESPN (content in EA SPORTS™ games); and Twentieth Century Fox Licensing and Merchandising (The Simpsons). These developer and content license commitments represent the sum of (1) the cash payments due under non-royalty-bearing licenses and services agreements and (2) the minimum guaranteed payments and advances against royalties due under royalty-bearing licenses and services agreements, the majority of which are conditional upon performance by the counterparty.

The following table summarizes our minimum contractual obligations and commercial commitments as of December 31, 2006 (in millions):

	Contractual Obligations			Commercial Commitments	
Fiscal Year Ending March 31,	Leases (1)	Developer/ Licensor Commitments (2)	Marketing	Letter of Credit, Bank and Other Guarantees	Total
2007 (remaining three months)	$ 19	$ 33	$ 7	$ 6	$ 65
2008	54	172	41	1	268
2009	53	191	31		275
2010	35	166	31		232
2011	25	269	31		325
Thereafter	66	724	185		975
Total	$ 252	$ 1,555	$ 326	$ 7	$ 2,140

(1) Lease commitments include contractual rental commitments of $20 million under real estate leases for unutilized office space resulting from our restructuring activities. These amounts, net of estimated future sub-lease income, were expensed in the periods of the related restructuring and are included in our accrued and other current liabilities reported on our Condensed Consolidated Balance Sheets as of December 31, 2006. See Note 6 of the Notes to Condensed

Consolidated Financial Statements.

(2) Developer/licensor commitments include $5 million of commitments to developers or licensors that have been recorded in current and long-term liabilities and a corresponding amount in current and long-term assets in our Condensed Consolidated Balance Sheets as of December 31, 2006 because payment is not contingent upon performance by the developer or licensor.

Legal Proceedings

On September 14, 2006, we received an informal inquiry from the Securities and Exchange Commission requesting certain documents and information relating to our stock option grant practices from January 1, 1997 to the present. We have cooperated to date with all matters related to this request.

We are also subject to claims and litigation arising in the ordinary course of business. We believe that any liability from any reasonably foreseeable disposition of such claims and litigation, individually or in the aggregate, would not have a material adverse effect on our consolidated financial position or results of operations.

Director Indemnity Agreements

We entered into indemnification agreements with the members of our Board of Directors at the time they joined the Board to indemnify them to the extent permitted by law against any and all liabilities, costs, expenses, amounts paid in settlement and damages incurred by the directors as a result of any lawsuit, or any judicial, administrative or investigative proceeding in which the directors are sued or charged as a result of their service as members of our Board of Directors.

(10) COMPREHENSIVE INCOME

SFAS No. 130, *Reporting Comprehensive Income*, requires classifying items of other comprehensive income (loss) by their nature in a financial statement and displaying the accumulated balance of other comprehensive income separately from retained earnings and additional paid-in capital in the equity section of a balance sheet. Accumulated other comprehensive income primarily includes foreign currency translation adjustments, and the net-of-tax amounts for unrealized gains (losses) on investments and unrealized gains (losses) on derivatives designated as cash flow hedges.

The components of comprehensive income for the three and nine months ended December 31, 2006 and 2005 are summarized as follows (in millions):

	Three Months Ended December 31,		Nine Months Ended December 31,	
	2006	2005	2006	2005
Net income	$ 160	$ 259	$ 101	$ 252
Other comprehensive income (loss):				
Change in unrealized gains (losses) on investments, net of tax expense (benefit) of $0, $0, $0 and $5 respectively	30	(16)	80	38
Reclassification adjustment for losses realized on investments in net income, net of tax benefit of $0 for each period			1	
Change in unrealized gains (losses) on derivative instruments, net of tax expense (benefit) of $0, $0, $0 and $1, respectively	(1)		(4)	4
Reclassification adjustment for (gains) losses realized on derivative instrument in net income, net of tax (expense) benefit of $0, $(2), $0 and $(2), respectively	2	(4)	2	(4)
Foreign currency translation adjustments		1	26	(7)
Total other comprehensive income (loss)	31	(19)	105	31
Total comprehensive income	$ 191	$ 240	$ 206	$ 283

The foreign currency translation adjustments are not adjusted for income taxes as they relate to indefinite investments in non-U.S. subsidiaries.

Table of Contents

(11) NET INCOME PER SHARE

The following table summarizes the computations of basic earnings per share (Basic EPS) and diluted earnings per share (Diluted EPS). Basic EPS is computed as net income divided by the weighted-average number of common shares outstanding for the period. Diluted EPS reflects the potential dilution that could occur from common shares issuable through stock-based compensation plans including stock options, restricted stock, restricted stock units, warrants and other convertible securities using the treasury stock method.

	Three Months Ended December 31,		Nine Months Ended December 31,	
(In millions, except per share amounts)	2006	2005	2006	2005
Net income	$ 160	$ 259	$ 101	$ 252
Shares used to compute net income per share:				
Weighted-average common stock outstanding basic	309	301	307	304
Dilutive potential common shares	10	10	9	11
Weighted-average common stock outstanding diluted	319	311	316	315
Net income per share:				
Basic	$ 0.52	$ 0.86	$ 0.33	$ 0.83
Diluted	$ 0.50	$ 0.83	$ 0.32	$ 0.80

Options to purchase 15 million and 16 million shares of common stock were excluded from the above computation of diluted shares for the three and nine months ended December 31, 2006, respectively, as their inclusion would have been antidilutive. For the three and nine months ended December 31, 2006, the weighted-average exercise price of these shares was $55.44 and $56.13 per share, respectively.

Options to purchase 8 million and 7 million shares of common stock were excluded from the above computation of diluted shares for both the three and nine months ended December 31, 2005, respectively, as their inclusion would have been antidilutive. For the three and nine months ended December 31, 2005, the weighted-average exercise price of these shares was $62.88 and $63.68 per share, respectively.

(12) RELATED PARTY TRANSACTION

On June 24, 2002, we hired Warren C. Jenson as our Executive Vice President, Chief Financial and Administrative Officer and agreed to loan him $4 million to be forgiven over four years based on his continuing employment. The loan did not bear interest. On June 24, 2004, pursuant to the terms of the loan agreement, we forgave $2 million of the loan and provided Mr. Jenson approximately $1.6 million to offset the tax implications of the forgiveness. On June 24, 2006, pursuant to the terms of the loan agreement, we forgave the remaining outstanding loan balance of $2 million. No additional funds were provided to offset the tax implications of the forgiveness of the $2 million balance.

(13) SEGMENT INFORMATION

Our reporting segments are based upon: our internal organizational structure; the manner in which our operations are managed; the criteria used by our Chief Executive Officer, our chief operating decision maker, to evaluate segment performance; the availability of separate financial information; and overall materiality considerations.

We manage our business primarily based on geographical performance. Accordingly, our combined global publishing organizations represent our reportable segment, our Publishing segment, due to their similar economic characteristics, products and distribution methods. Publishing refers to the manufacturing, marketing, advertising and distribution of products developed or co-developed by us, or distribution of certain third-party publishers products through our co-publishing and distribution program.

Table of Contents

The following table summarizes the financial performance of our Publishing segment and a reconciliation of our Publishing segment s profit to our consolidated operating income (in millions):

	Three Months Ended December 31,		Nine Months Ended December 31,	
	2006	2005	2006	2005
Publishing segment:				
Net revenue	$ 1,246	$ 1,266	$ 2,372	$ 2,300
Depreciation and amortization	(6)	(4)	(17)	(15)
Other expenses	(615)	(680)	(1,314)	(1,336)
Publishing segment profit	625	582	1,041	949
Reconciliation to consolidated operating income:				
Other:				
Net revenue	35	4	106	10
Depreciation and amortization	(32)	(18)	(93)	(53)
Other expenses	(413)	(221)	(943)	(605)
Consolidated operating income	$ 215	$ 347	$ 111	$ 301

Publishing segment profit differs from consolidated operating income primarily due to the exclusion of substantially all of our research and development expense as well as certain corporate functional costs that are not allocated to the publishing organizations.

Information about our total net revenue by product line for the three and nine months ended December 31, 2006 and 2005 is presented below (in millions):

	Three Months Ended December 31,		Nine Months Ended December 31,	
	2006	2005	2006	2005
Consoles				
PlayStation 2	$ 400	$ 495	$ 769	$ 916
Xbox 360	172	76	399	76
Xbox	62	152	150	332
Nintendo GameCube	32	69	56	118
PlayStation 3	41		41	
Wii	29		29	
Other Consoles		1		1
Total Consoles	736	793	1,444	1,443
PC	218	148	370	313
Mobility				
PSP	118	120	219	197
Nintendo DS	55	36	77	56
Game Boy Advance	21	35	35	48
Cellular Handsets	35	1	104	4
Total Mobility	229	192	435	305
Co-publishing and Distribution	49	99	130	161
Internet Services, Licensing and Other				
Subscription Services	24	16	55	45
Licensing, Advertising and Other	25	22	44	43
Total Internet Services, Licensing and Other	49	38	99	88
Total Net Revenue	$ 1,281	$ 1,270	$ 2,478	$ 2,310

Information about our operations in North America, Europe and Asia as of and for the three and nine months ended December 31, 2006 and 2005 is presented below (in millions):

	North America	Europe	Asia	Total
Three months ended December 31, 2006				
Net revenue from unaffiliated customers	$ 637	$ 583	$ 61	$ 1,281
Long-lived assets	1,137	254	11	1,402
Three months ended December 31, 2005				
Net revenue from unaffiliated customers	$ 618	$ 577	$ 75	$ 1,270
Long-lived assets	347	201	9	557
Nine months ended December 31, 2006				
Net revenue from unaffiliated customers	$ 1,359	$ 997	$ 122	$ 2,478

Nine months ended December 31, 2005				
Net revenue from unaffiliated customers	$ 1,245	$ 912	$ 153	$ 2,310

Our direct sales to Wal-Mart Stores, Inc. represented approximately 13 percent of total net revenue for both the three and nine months ended December 31, 2006, respectively, and approximately 12 percent and 13 percent of total net revenue for the three and nine months ended December 31, 2005, respectively. Our direct sales to GameStop Corp. represented approximately 10 percent and 12 percent of total net revenue for the three and nine months ended December 31, 2006, respectively, and approximately 11 percent of total net revenue for the three months ended December 31, 2005.

(14) IMPACT OF RECENTLY ISSUED ACCOUNTING STANDARDS

In February 2006, the FASB issued SFAS No. 155, *Accounting for Certain Hybrid Financial Instruments An Amendment of FASB Statements No. 133 and 140* . SFAS No. 155 (1) permits fair value measurement for any hybrid financial instrument that contains an embedded derivative that otherwise would require bifurcation, (2) clarifies that interest-only strips and principal-only strips are not subject to the requirements of SFAS No. 133, *Accounting for Derivative Instruments and Hedging Activities* , (3) establishes a requirement to evaluate interests in securitized financial assets to identify interests that are freestanding derivatives or that are hybrid financial instruments that contain an embedded derivative requiring bifurcation, (4) clarifies that concentrations of credit risk in the form of subordination are not embedded derivatives, and (5) amends SFAS No. 140, *Accounting for Transfers and Servicing of Financial Assets and Extinguishments of Liabilities A Replacement of FASB Statement No. 125* to eliminate the prohibition on a qualifying special-purpose entity from holding a derivative financial instrument that pertains to a beneficial interest other than another derivative financial instrument. SFAS No. 155 is effective for all financial instruments acquired or issued for fiscal years beginning after September 15, 2006. We do not expect the adoption of SFAS No. 155 to have a material impact on our Condensed Consolidated Financial Statements.

In June 2006, the FASB ratified the consensus reached on Emerging Issues Task Force (EITF) Issue No. 06-3, *How Taxes Collected from Customers and Remitted to Governmental Authorities Should Be Presented in the Income Statement (That Is, Gross Versus Net Presentation)* . The scope of EITF Issue No. 06-3 includes any transaction-based tax assessed by a governmental authority that is imposed concurrent with or subsequent to a revenue-producing transaction between a seller and a customer. The scope does not include taxes that are based on gross receipts or total revenues imposed during the inventory procurement process. Gross versus net income statement classification of that tax is an accounting policy decision and a voluntary change would be considered a change in accounting policy requiring the application of SFAS No. 154, *Accounting Changes and Error Corrections* . The following disclosures will be required for taxes within the scope of this issue that are significant in amount: (1) the accounting policy elected for these taxes and (2) the amounts of the taxes reflected gross (as revenue) in the income statement on an interim and annual basis for all periods presented. The EITF Issue No. 06-3 ratified consensus is effective for interim and annual periods beginning after December 15, 2006. We do not expect the adoption of EITF Issue No. 06-3 to have a material impact on our Condensed Consolidated Financial Statements.

In July 2006, the FASB issued FASB Interpretation (FIN) No. 48, *Accounting for Uncertainty in Income Taxes An Interpretation of FASB Statement No. 109* . FIN No. 48 clarifies the accounting for uncertainty in income taxes recognized in financial statements in accordance with SFAS No. 109, *Accounting for Income Taxes* . FIN No. 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 and provides guidance on derecognition, classification, interest and penalties, accounting in interim periods, disclosure, and transition. Under FIN No. 48, the evaluation of a tax position is a two-step process. The first step is a recognition process where we are required to determine whether it is more likely than not that a tax position will be sustained upon examination, including resolution of any related appeals or litigation processes, based on the technical merits of the position. In evaluating whether a tax position has met the more-likely-than-not recognition threshold, it is presumed that the position will be examined by the appropriate taxing authority that has full knowledge of all relevant information. The second step is a measurement process whereby a tax position that meets the more-likely-than-not recognition threshold is calculated to determine the amount of benefit to recognize in the financial statements. FIN No. 48 also requires new tabular reconciliation of the total amounts of unrecognized tax benefits at the beginning and end of the reporting period. The provisions of FIN No. 48 are effective for fiscal years beginning after December 15, 2006. As such, we are required to adopt it in our first quarter of fiscal year 2008. Any changes to our income taxes due to the adoption of FIN No. 48 are treated as the cumulative effect of a change in accounting principle. We are evaluating what impact the adoption of FIN No. 48 will have on our Condensed Consolidated Financial Statements; however, FIN No. 48 could have a material impact on our Condensed Consolidated Financial Statements.

In September 2006, the SEC issued SAB No. 108, *Financial Statements Considering the Effects of Prior Year Misstatements when Quantifying Misstatements in Current Year Financial Statements* . SAB No. 108 provides guidance on how prior year misstatements should be taken into consideration when quantifying misstatements in

current year financial statements for purposes of determining whether the current year s financial statements are materially misstated. The impact of correcting all misstatements, including both the carryover and reversing effects of prior year misstatements, must be quantified on the current year financial statements. When a current year misstatement has been quantified, SAB No. 99, *Financial Statements Materiality* should be applied to determine whether the misstatement is material and should result in an adjustment to the financial statements. SAB No. 108 also discusses the implications of misstatements uncovered upon the application of SAB No. 108 in situations when a registrant has historically been using either the iron curtain approach or the rollover approach as described in the SAB. Registrants electing not to restate prior periods should reflect the effects of initially applying the guidance

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Table of Contents

in Topic 1N in their annual financial statements covering the first fiscal year ending after November 15, 2006. We are evaluating what impact the adoption of SAB No. 108 will have on our Condensed Consolidated Financial Statements.

In September 2006, the FASB issued SFAS No. 157, *Fair Value Measurements*. SFAS No. 157 defines fair value, establishes a framework for measuring fair value in generally accepted accounting principles and expands disclosures about fair value measurements. Fair value refers to the price that would be received to sell an asset or paid to transfer a liability in an orderly transaction between market participants in the market in which the reporting entity transacts. SFAS No. 157 establishes a fair value hierarchy that prioritizes the information used to develop those assumptions. Fair value measurements would be separately disclosed by level within the fair value hierarchy. The provisions of SFAS No. 157 are effective for financial statements issued for fiscal years beginning after November 15, 2007, and interim periods within those fiscal years. We do not expect the adoption of SFAS No. 157 to have a material impact on our Condensed Consolidated Financial Statements.

In October 2006, the FASB issued FSP No. FAS 123(R)-6, *Technical Corrections of FASB Statement No. 123(R)*, which amends various provisions of SFAS No. 123(R). FSP No. FAS 123(R)-6 (1) exempts nonpublic entities from disclosing the aggregate intrinsic value of outstanding fully vested share options (or share units) and share options expected to vest, (2) revises the computation of the minimum compensation cost that must be recognized to comply with paragraph 42 of SFAS No. 123(R), (3) amends paragraph A170 of Illustration 13(e) to indicate that at the date that the illustrative awards were no longer probable of vesting, any previously recognized compensation cost should have been reversed, and (4) amends the definition of short-term inducement to exclude an offer to settle an award. The provisions of FSP No. FAS 123(R)-6 are required to be applied in the first reporting period beginning after October 20, 2006. Retrospective application is required if an entity had been applying Statement 123(R) inconsistent with the guidance in FSP No. FAS 123(R)-6. We do not expect the adoption of FSP No. FAS 123(R)-6 to have a material impact on our Condensed Consolidated Financial Statements.

REPORT OF INDEPENDENT REGISTERED PUBLIC ACCOUNTING FIRM

The Board of Directors and Stockholders
Electronic Arts Inc.:

We have reviewed the accompanying condensed consolidated balance sheet of Electronic Arts Inc. and subsidiaries (the Company) as of December 30, 2006, the related condensed consolidated statements of operations for the three-month and nine-month periods ended December 30, 2006 and December 31, 2005, and the related condensed consolidated statements of cash flows for the nine-month periods ended December 30, 2006 and December 31, 2005. These condensed consolidated financial statements are the responsibility of the Company s management.

We conducted our review in accordance with the standards of the Public Company Accounting Oversight Board (United States). A review of interim financial information consists principally of applying analytical procedures and making inquiries of persons responsible for financial and accounting matters. It is substantially less in scope than an audit conducted in accordance with the standards of the Public Company Accounting Oversight Board (United States), the objective of which is the expression of an opinion regarding the financial statements taken as a whole. Accordingly, we do not express such an opinion.

Based on our review, we are not aware of any material modifications that should be made to the condensed consolidated financial statements referred to above for them to be in conformity U.S. generally accepted accounting principles.

We have previously audited, in accordance with standards of the Public Company Accounting Oversight Board (United States), the consolidated balance sheet of Electronic Arts Inc. and subsidiaries as of April 1, 2006, and the related consolidated statements of operations, stockholders equity and comprehensive income, and cash flows for the year then ended (not presented herein); and in our report dated June 9, 2006, we expressed an unqualified opinion on those consolidated financial statements. In our opinion, the information set forth in the accompanying condensed consolidated balance sheet as of April 1, 2006, is fairly stated, in all material respects, in relation to the consolidated balance sheet from which it has been derived.

KPMG LLP
Mountain View, California
February 6, 2007

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

This Quarterly Report on Form 10-Q contains forward-looking statements within the meaning of the Private Securities Litigation Reform Act of 1995. All statements, other than statements of historical fact, including statements regarding industry prospects and future results of operations or financial position, made in this Quarterly Report on Form 10-Q are forward looking. We use words such as anticipate , believe , expect , intend estimate , (and the negative of any of these terms), future and similar expressions to help identify forward-looking statements. These forward-looking statements are subject to business and economic risk and reflect management s current expectations, and involve subjects that are inherently uncertain and difficult to predict. Our actual results could differ materially. We will not necessarily update information if any forward-looking statement later turns out to be inaccurate. Risks and uncertainties that may affect our future results include, but are not limited to, those discussed in this report under the heading Risk Factors in Part II, Item 1A, as well as in our Annual Report on Form 10-K for the fiscal year ended March 31, 2006 as filed with the Securities and Exchange Commission (SEC) on June 12, 2006 and in other documents we have filed with the SEC.

OVERVIEW

The following overview is a top-level discussion of our operating results as well as some of the trends and drivers that affect our business. Management believes that an understanding of these trends and drivers is important in order to understand our results for the three and nine months ended December 31, 2006, as well as our future prospects. This summary is not intended to be exhaustive, nor is it intended to be a substitute for the detailed discussion and analysis provided elsewhere in this Form 10-Q, including in the remainder of Management s Discussion and Analysis of Financial Condition and Results of Operations , Risk Factors and the Condensed Consolidated Financial Statements and related notes. Additional information can be found in the Business section of our Annual Report on Form 10-K for the fiscal year ended March 31, 2006 as filed with the SEC on June 12, 2006 and in other documents we have filed with the SEC.

About Electronic Arts

We develop, market, publish and distribute interactive software games that are playable by consumers on home video game consoles (such as the Sony PlayStation® 3, Microsoft Xbox 360 and Nintendo Wii), personal computers, mobile platforms (including cellular handsets and handheld game players such as the PlayStation® Portable (PSP) and the Nintendo DS) and online (over the Internet and other proprietary online networks). Some of our games are based on content that we license from others (e.g., Madden NFL Football, The Godfather and FIFA Soccer), and some of our games are based on our own wholly-owned intellectual property (e.g., The Sims, Need for Speed and BLACK). Our goal is to publish titles with mass-market appeal, which often means translating and localizing them for sale in non-English speaking countries. In addition, we also attempt to create software game franchises that allow us to publish new titles on a recurring basis that are based on the same property. Examples of this franchise approach are the annual iterations of our sports-based products (e.g., Madden NFL Football, NCAA® Football and FIFA Soccer), wholly-owned properties that can be successfully sequeled (e.g., The Sims, Need for Speed and Battlefield) and titles based on long-lived literary and/or movie properties (e.g., Lord of the Rings and Harry Potter).

Overview of Financial Results

Total net revenue for the three months ended December 31, 2006 was $1,281 million, up 1 percent as compared to the three months ended December 31, 2005. Net revenue for the three months ended December 31, 2006 was driven by sales of *Need for Speed Carbon*, *FIFA 07*, *The Sims 2 Pets*, *Madden NFL 07*, and *Tiger Woods PGA TOUR® 07*. *Need for Speed Carbon* sold over eight million copies in the quarter.

Net income for the three months ended December 31, 2006 was $160 million as compared to $259 million for the three months ended December 31, 2005. Diluted net income per share for the three months ended December 31, 2006 was $0.50 as compared to $0.83 for the three months ended December 31, 2005.

During the nine months ended December 31, 2006, we generated $183 million of cash from operating activities as compared to $259 million of cash generated for the nine months ended December 31, 2005. The decrease in cash provided by operating activities for the nine months ended December 31, 2006 as compared to the nine months ended December 31, 2005 resulted primarily from an increase of $95 million in the change in net accounts receivable due to

the timing of the collection of our receivables.

Table of Contents

Stock-Based Compensation. Beginning in fiscal 2007, we adopted Statement of Financial Accounting Standard (SFAS) No. 123 (revised 2004) (SFAS No. 123(R)), *Share-Based Payment* , which requires us to recognize the cost resulting from all share-based payment transactions in our financial statements using a fair-value-based method. See Note 3 of the Notes to Condensed Consolidated Financial Statements. The following table summarizes our stock-based compensation expense resulting from stock options, restricted stock, restricted stock units and our employee stock purchase plan included in our Condensed Consolidated Statements of Operations for the three and nine months ended December 31, 2006 and 2005 (in millions):

	Three Months Ended December 31,		Nine Months Ended December 31,	
	2006	2005	2006	2005
Cost of goods sold	$	$	$ 1	$
Marketing and sales	5		14	
General and administrative	10		30	
Research and development	20		60	1
Stock-based compensation expense	35		105	1
Benefit from income taxes	(7)		(22)	
Stock-based compensation expense, net of tax	$ 28	$	$ 83	$ 1

As of December 31, 2006, the total unrecognized compensation cost related to stock options was $173 million and is expected to be recognized over the weighted-average service period of 1.5 years. As of December 31, 2006, the total unrecognized compensation cost related to restricted stock and restricted stock units (collectively referred to as restricted stock rights) was $81 million and is expected to be recognized over the weighted-average service period of 2.5 years.

On September 15, 2006, we completed a stock option exchange program pursuant to which eligible employees were able to exchange certain outstanding stock options that were significantly underwater (that is, the exercise price of the stock option was greater than the trading price of our common stock at that time) for a lesser number of shares of restricted stock rights, which were granted under our 2000 Equity Incentive Plan. In the exchange program, eligible employees exchanged stock options to purchase approximately 1,776,000 shares of our common stock for 444,000 shares of restricted stock rights.

Management s Overview of Historical and Prospective Business Trends

Transition to Next-Generation Consoles. Our industry is cyclical and in the midst of a transition stage heading into the next cycle. Video game platforms have historically had a life cycle of four to six years, which causes the video game software market to be cyclical as well. The current generation of platforms Sony s PlayStation 2, Microsoft s Xbox and the Nintendo GameCube were initially introduced in 2000 and 2001. In November 2005, Microsoft launched the Xbox 360. More recently, Sony introduced the PlayStation 3 in November 2006 in North America and Japan and is expected to launch it in Europe and elsewhere in March 2007. Nintendo introduced the Wii in November 2006 in North America and in December 2006 in Japan and Europe. We refer to Microsoft s Xbox 360, Sony s PlayStation 3 and Nintendo s Wii as next-generation platforms . The release of each of these next-generation platforms has moved the interactive entertainment industry further along the transition into the next cycle. We expect that, as the current generation of platforms reaches the end of its cycle and the installed base of next-generation platforms continues to grow, sales of video games for current-generation platforms will continue to decline as consumers replace their current-generation platforms with next-generation platforms, or defer game software purchases until they are able to purchase a next-generation platform. This decline in current-generation product sales may not be offset by increased sales of products for the new platforms. This pattern is referred to in our industry as a transition to next-generation consoles. During this transition, we intend to continue to develop new titles for certain current-generation video game

consoles while we also continue to make significant investments in the development of products for next-generation consoles. We expect the average selling prices and unit sales of our titles for current-generation consoles to continue to decline as more value-oriented consumers purchase current-generation consoles, a greater number of competitive titles are published at reduced price points, and consumers potentially defer purchases in anticipation of next-generation consoles. Although there can be no assurance, and our actual results could differ materially, in the short-term we expect gross margin pressure as a result of (1) a decrease in average selling prices of titles for current-generation platforms, (2) higher license royalty rates, and (3) amortization of our newly-acquired intangible assets.

We have incurred and expect to continue to incur increased costs during this transition as we have continued to develop and market new titles for certain current-generation video game platforms while also making significant investments in products for the next-generation platforms. Moreover, we expect development costs for next-generation video games to be greater on a per-title basis than development costs for current-generation video games. As we move through the life cycle of current-generation consoles, we will continue to devote significant resources to the development of current-generation titles while at the same time continuing to invest heavily in tools, technologies and titles for the next generation of platforms and technology. We expect our operating results to continue to be volatile and difficult to predict.

Investment in Online. Today, we generate net revenue from a variety of online products and services, including casual games and downloadable content marketed under our Pogo brand, persistent state world games such as *Ultima Online* and *Dark Age of Camelot®,* PC-based downloadable content and online-enabled packaged goods. As the nature of online game offerings expands and evolves, we anticipate long-term opportunities for growth in this area. For example, we expect that consumers will take advantage of the online connectivity of next-generation consoles at a much higher rate than they have on current-generation consoles, allowing more consumers to enhance their gameplay experience through multiplayer activity, community-building and downloading content. We plan to increase the amount of content available for download on the PC and consoles, and to increase the number of PC-based games that can be downloaded electronically. In addition, we plan to expand our casual game offerings internationally and to invest in growing genres such as mid-session games. To further enhance our online offerings, we acquired Mythic Entertainment (Mythic), a developer and publisher of massively multiplayer online role-playing games in July 2006. Although we intend to make significant investments in online products, infrastructure and services and believe that online gameplay will become an increasingly important part of our business in the long term, we do not expect revenue from persistent state world games or online gameplay and distribution to be significant in fiscal 2007.

Significantly Increased Deferred Revenue for Online-Enabled Games. The ubiquity of high-speed Internet access and integration of network connectivity into next-generation game consoles is expected to expand demand for games with online-enabled features. To address this demand, we include online features in many of our PC, PlayStation 3, PlayStation 2, Xbox 360, Xbox, and PSP products, which enable consumers to participate in online communities and play against one another via the Internet. In order to support the online functionality of our games for the PC, PlayStation 2, PlayStation 3 and the PSP, we provide our consumers with access to servers which we maintain. Starting in fiscal 2008, we will no longer be able to objectively determine the fair value of such services which will prevent us from recognizing revenue related to the software already sold and hosting services separately. Therefore, we will be required to recognize revenue from the sale of our online-enabled packaged goods for the PC, PlayStation 2, PlayStation 3 and the PSP over the estimated online service period. We anticipate that, in fiscal 2008, we will likely defer more than $400 million in net revenue from the sale of these online-enabled packaged goods games into fiscal 2009 (currently expected to be recognized over six months).

Expansion of Mobile Platforms. Advances in mobile technology have resulted in a variety of new and evolving platforms for on-the-go interactive entertainment that appeal to a broader demographic of consumers. Our efforts to capitalize on the growth in mobile interactive entertainment are focused in two broad areas packaged goods games for handheld game systems and downloadable games for cellular handsets.

We have developed and published games for a variety of handheld platforms, including the Nintendo Game Boy and Game Boy Advance, for several years. The introductions of the Sony PSP and the Nintendo DS, with their enhanced graphics, deeper gameplay, and online functionality, provide a richer mobile gaming experience for consumers.

We expect sales of games for cellular handsets to become an increasingly important part of our business worldwide. To accelerate our position in this growing segment, in February 2006, we acquired JAMDAT Mobile Inc. (JAMDAT), a global publisher of wireless games and other wireless entertainment applications. As a result of this acquisition, we expect our net revenue from games for cellular handsets to increase significantly in fiscal 2007. Likewise, the acquisition, along with the additional investment required to grow this portion of our business globally, will result in increased development and operating expenses.

As mobile technology continues to evolve and the installed base of both handheld game systems and game-enabled cellular phones likely expands, we anticipate that sales of our titles for mobile platforms for both handhelds and

cellular handsets will become an increasingly important part of our business.

International Expansion. We expect international sales to remain a fundamental part of our business. As part of our international expansion strategy, we may seek to partner with established local companies through acquisitions, joint ventures or other similar

arrangements. We are planning to expand our development and business activities internationally. We believe that in order to succeed internationally, it is important to locally develop content that is specifically directed toward local cultures and consumers. As such, we expect to continue to devote resources to hiring local development talent and expanding our infrastructure outside of North America, most notably, through the expansion and creation of local studio facilities in Asia. In addition, we are in the process of establishing online game marketing, publishing and distribution functions in China and Singapore.

Sales of Hit Titles. Sales of hit titles, several of which were top sellers in a number of countries, contributed significantly to our net revenue. Our top-selling titles across all platforms worldwide during the three months ended December 31, 2006 were *Need for Speed Carbon, FIFA 07, The Sims 2 Pets, Madden NFL 07,* and *Tiger Woods PGA TOUR 07.* Hit titles are important to our financial performance because they benefit from overall economies of scale. We have developed, and it is our objective to continue to develop, many of our hit titles to become franchise titles that can be regularly iterated.

Increasing Licensing Costs. We generate a significant portion of our net revenue and operating income from games based on licensed content such as Madden NFL Football, FIFA Soccer and Harry Potter. We have recently entered into new licenses and renewed older licenses, some of which may contain higher royalty rates or guarantees than similar license agreements we have entered into in the past. We believe these licenses, and the product franchises they support, will continue to be important to our future operations, but the higher costs of these licenses will negatively impact our gross margins.

Foreign Currency Exchange Impact. Net revenue from international sales accounted for approximately 45 percent of our total net revenue during the first nine months of fiscal 2007 and approximately 46 percent of our total net revenue during the first nine months of fiscal 2006. Our international net revenue was primarily driven by sales in Europe and, to a much lesser extent, in Asia. Year-over-year, foreign exchange rates had a favorable impact on our net revenue of $33 million, or 1 percent, for the nine months ended December 31, 2006.

Acquisitions, Investments and Strategic Transactions. We have engaged in, evaluated, and expect to continue to engage in and evaluate, a wide array of potential strategic transactions, including (1) acquisitions of companies, businesses, intellectual properties, and other assets, and (2) investments in new interactive entertainment businesses, such as online and mobile games. In October 2006, the remaining outstanding shares of Digital Illusions C.E. (DICE) were purchased, thereby completing the acquisition of the remaining minority interest of DICE. In July 2006, we acquired Mythic as part of our efforts to accelerate our growth in the massively multiplayer online role-playing market. In fiscal 2006, we acquired JAMDAT as part of our efforts to accelerate our growth in mobile gaming.

CRITICAL ACCOUNTING POLICIES AND ESTIMATES

Our Condensed Consolidated Financial Statements have been prepared in accordance with accounting principles generally accepted in the United States. The preparation of these Condensed Consolidated Financial Statements requires management to make estimates and assumptions that affect the reported amounts of assets and liabilities, contingent assets and liabilities, and revenue and expenses during the reporting periods. The policies discussed below are considered by management to be critical because they are not only important to the portrayal of our financial condition and results of operations but also because application and interpretation of these policies requires both judgment and estimates of matters that are inherently uncertain and unknown. As a result, actual results may differ materially from our estimates.

Revenue Recognition, Sales Returns, Allowances and Bad Debt Reserves

We principally derive revenue from sales of packaged interactive software games designed for play on video game consoles (such as the PlayStation 3, Xbox 360 and Wii), PCs and mobile platforms including handheld game players (such as the Sony PSP, Nintendo DS and Nintendo Game Boy Advance) and cellular handsets. We evaluate the recognition of revenue based on the criteria set forth in Statement of Position (SOP) 97-2, *Software Revenue Recognition* , as amended by SOP 98-9, *Modification of SOP 97-2, Software Revenue Recognition, With Respect to Certain Transactions* and Staff Accounting Bulletin (SAB) No. 101, *Revenue Recognition in Financial Statements* , as revised by SAB No. 104, *Revenue Recognition* . We evaluate revenue recognition using the following basic criteria and recognize revenue when all four of the following criteria are met:

Evidence of an arrangement: Evidence of an agreement with the customer that reflects the terms and conditions to deliver products must be present in order to recognize revenue.

Delivery: Delivery is considered to occur when the products are shipped and risk of loss and reward have been transferred to the customer. For online games and services, revenue is recognized as the service is provided.

Fixed or determinable fee: If a portion of the arrangement fee is not fixed or determinable, we recognize revenue as the amount becomes fixed or determinable.

Collection is deemed probable: At the time of the transaction, we conduct a credit review of each customer involved in a significant transaction to determine the creditworthiness of the customer. Collection is deemed probable if we expect the customer to be able to pay amounts under the arrangement as those amounts become due. If we determine that collection is not probable, we recognize revenue when collection becomes probable (generally upon cash collection).

Determining whether and when some of these criteria have been satisfied often involves assumptions and judgments that can have a significant impact on the timing and amount of revenue we report. For example, for multiple element arrangements, we must make assumptions and judgments in order to: (1) determine whether and when each element has been delivered; (2) determine whether undelivered products or services are essential to the functionality of the delivered products and services; (3) determine whether vendor-specific objective evidence of fair value (VSOE) exists for each undelivered element; and (4) allocate the total price among the various elements we must deliver. Changes to any of these assumptions or judgments, or changes to the elements in a software arrangement, could cause a material increase or decrease in the amount of revenue that we report in a particular period. For example, some of our packaged goods products are sold with online services. Because we are able to determine VSOE for the online services to be delivered, we are able to allocate the total price received from the combined product and online service sale between these two elements and recognize the related revenue separately. However, starting in fiscal 2008, VSOE will not exist for the online services to be delivered and all revenue from these transactions will be recognized over the estimated online service period. Accordingly, this relatively small change (from having VSOE for online hosting services to no longer having VSOE) will have a significant effect on our reported results.

Product revenue, including sales to resellers and distributors (channel partners), is recognized when the above criteria are met. We reduce product revenue for estimated future returns, price protection, and other offerings, which may occur with our customers and channel partners. In certain countries, we have stock-balancing programs for our PC and video game system products, which allow for the exchange of these products by resellers under certain circumstances. It is our general practice to exchange products or give credits rather than to give cash refunds.

In certain countries, from time to time, we decide to provide price protection for both our PC and video game system products. When evaluating the adequacy of sales returns and price protection allowances, we analyze historical returns, current sell-through of distributor and retailer inventory of our products, current trends in the video game market and the overall economy, changes in customer demand and acceptance of our products, and other related factors. In addition, we monitor the volume of sales to our channel partners and their inventories, as substantial overstocking in the distribution channel could result in high returns or higher price protection costs in subsequent periods.

In the future, actual returns and price protections may 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 product returns and/or price protection for our products may continue to increase as the PlayStation 2 console moves through its lifecycle and an increasing number and the aggregated amount of competitive products heighten pricing and competitive pressures. While we believe we can make reliable estimates regarding these matters, these estimates are inherently subjective. Accordingly, if our estimates changed, our returns and price protection reserves would change, which would impact the total net revenue we report. For example, if actual returns and/or price protection were significantly greater than the reserves we have established, our actual results would decrease our reported total net revenue. Conversely, if actual returns and/or price protection were significantly less than our reserves, this would increase our reported total net revenue.

Determining whether a transaction constitutes an online service transaction or a download of a product can be difficult; however, the accounting for these transactions is significantly different. Revenue from product downloads is recognized when the download occurs assuming all other recognition criteria are met. Revenue from online services is recognized as EA s services are rendered. In addition, some of our online services do not have a defined service period. In those situations, we recognize revenue over the estimated service period. Determining the estimated service period is inherently subjective and is subject to regular revision based on historical online usage.

Significant judgment is required to estimate our allowance for doubtful accounts in any accounting period. We determine our allowance for doubtful accounts by evaluating customer creditworthiness in the context of current economic trends and historical experience. Depending upon the overall economic climate and the financial condition of our customers, the amount and timing of our bad debt expense and cash collection could change significantly.

Royalties and Licenses

Our royalty expenses consist of payments to (1) content licensors, (2) independent software developers, and (3) co-publishing and/or distribution affiliates. License royalties consist of payments made to celebrities, professional sports organizations, movie studios and other organizations for our use of their trademarks, copyrights, personal publicity rights, content and/or other intellectual property. Royalty payments to independent software developers are payments for the development of intellectual property related to our games. Co-publishing and distribution royalties are payments made to third parties for delivery of product.

Royalty-based obligations with content licensors and distribution affiliates are either paid in advance and capitalized as prepaid royalties or are accrued as incurred and subsequently paid. These royalty-based obligations are generally expensed to cost of goods sold generally at the greater of the contractual rate or an effective royalty rate based on expected net product sales. Significant judgment is required to estimate the effective royalty rate for a particular contract. Because the computation of effective royalty rates requires us to project future revenue, it is inherently subjective as our future revenue projections must anticipate, for example, (1) the total number of titles subject to the contract, (2) the timing of the release of these titles, (3) the number of software units we expect to sell which can be impacted by a number of variables, including product quality and competition, and (4) future pricing. Determining the effective royalty rate for hit-based titles is particularly difficult due to the inherent risk of such titles. Accordingly, if our future revenue projections change, our effective royalty rates would change, which could impact the royalty expense we recognize. Prepayments made to thinly capitalized independent software developers and co-publishing affiliates are generally in connection with the development of a particular product and, therefore, we are generally subject to development risk prior to the release of the product. Accordingly, payments that are due prior to completion of a product are generally amortized to research and development over the development period as the services are incurred. Payments due after completion of the product (primarily royalty-based in nature) are generally expensed as cost of goods sold.

Our contracts with some licensors include minimum guaranteed royalty payments which are initially recorded as an asset and as a liability at the contractual amount when no performance remains with the licensor. When performance remains with the licensor, we record guarantee payments as an asset when actually paid and as a liability when incurred, rather than recording the asset and liability upon execution of the contract. Minimum royalty payment obligations are classified as current liabilities to the extent such royalty payments are contractually due within the next twelve months. As of December 31, 2006 and March 31, 2006, approximately $5 million and $9 million, respectively, of minimum guaranteed royalty obligations had been recognized.

Each quarter, we also evaluate the future realization of our royalty-based assets as well as any unrecognized minimum commitments not yet paid to determine amounts we deem unlikely to be realized through product sales. Any impairments determined before the launch of a product are charged to research and development expense. Impairments determined post-launch are charged to cost of goods sold. In either case, we rely on estimated revenue to evaluate the future realization of prepaid royalties and commitments. If actual sales or revised revenue estimates fall below the initial revenue estimate, then the actual charge taken may be greater in any given quarter than anticipated. We had no impairments during the three and nine months ended December 31, 2006 and 2005.

Valuation of Long-Lived Assets, including goodwill and other intangible assets

We evaluate both purchased intangible assets and other long-lived assets in order to determine if events or changes in circumstances indicate a potential impairment in value exists. This evaluation requires us to estimate, among other things, the remaining useful lives of the assets and future cash flows of the business. These evaluations and estimates require the use of judgment. Our actual results could differ materially from our current estimates.

Under current accounting standards, we make judgments about the recoverability of purchased intangible assets and other long-lived assets whenever events or changes in circumstances indicate a potential impairment in the remaining value of the assets recorded on our Condensed Consolidated Balance Sheets. In order to determine if a potential impairment has occurred, management makes various assumptions about the future value of the asset by evaluating future business prospects and estimated cash flows. Our future net cash flows are primarily dependent on the sale of products for play on proprietary video game consoles, handheld game players, PCs, and cellular handsets (platforms). The sales of our products are affected by our ability to accurately predict which platforms and which products we

develop will be successful. Also, our revenue and earnings are dependent on our ability to meet our product release schedules. Due to product sales shortfalls, we may not realize the future net cash flows necessary to recover our long-lived assets, which may result in an impairment charge being recorded in the future. There were no impairment charges recorded in the three and nine months ended December 31, 2006 and December 31, 2005.

SFAS No. 142, *Goodwill and Other Intangible Assets* requires at least an annual assessment for impairment of goodwill by applying a fair-value-based test. A two-step approach is required to test goodwill for impairment for each reporting unit. The first step tests for impairment by applying fair value-based tests at the reporting unit level. The second step (if necessary) measures the amount of impairment by applying fair value-based tests to individual assets and liabilities within each reporting unit. Application of the goodwill impairment test requires judgment, including identification of reporting units, assignment of assets and liabilities to reporting units, assignment of goodwill to reporting units, and determination of the fair value of each reporting unit. The fair value of each reporting unit is estimated using a discounted cash flow methodology which requires significant judgment to estimate the future cash flows, determine the appropriate discount rates, growth rates and other assumptions. The determination of fair value for each reporting unit could be materially affected by changes in these estimates and assumptions which could trigger impairment. In fiscal 2006, we completed the first step of the annual goodwill impairment testing as of January 1, 2006 and found no indicators of impairment of our recorded goodwill. We did not recognize an impairment loss on goodwill in fiscal 2006 or 2005. Future impairment tests may result in a charge to earnings and there is a potential for a write-down of goodwill in connection with the annual impairment test.

Stock-Based Compensation

On April 1, 2006, we adopted SFAS No. 123(R) and applied the provisions of SAB No. 107, *Share-Based Payment* , on our adoption of SFAS No. 123(R). SFAS No. 123(R) requires that the cost resulting from all share-based payment transactions be recognized in the financial statements using a fair-value-based method. We elected to use the modified prospective transition method of adoption. SFAS No. 123(R) requires us to measure compensation cost for all outstanding unvested stock-based awards made to our employees and directors based on estimated fair values and recognize compensation over the service period for awards expected to vest. We recognized $35 million and $105 million of stock-based compensation related to employee stock options, restricted stock units, restricted stock awards and our employee stock purchase plan (ESPP) for the three and nine months ended December 31, 2006, respectively. We recognized less than $1 million and $1 million of stock-based compensation related to employee restricted stock units and non-employee stock options during the three and nine months ended December 31, 2005, respectively.

For options and ESPP, we use the Black-Scholes option valuation model to determine the grant date fair value. The Black-Scholes option valuation model requires us to make certain assumptions about the future. The determination of fair value is affected by our stock price as well as assumptions regarding subjective and complex variables such as expected employee exercise behaviors and our expected stock price volatility over the term of the award. Generally, our assumptions are based on historical information and judgment is required to determine if historical trends may be indicators of future outcomes. We estimated the following key assumptions for the Black-Scholes valuation calculation:

Risk-free interest rate. The risk-free interest rate is based on U.S. Treasury yields in effect at the time of grant for the expected term of the option.

Expected volatility. We use our historical stock price volatility and consider the implied volatility computed based on the price of short-term options publicly traded on our common stock for our expected volatility assumption.

Expected term. The expected term represents the weighted-average period the stock options are expected to remain outstanding. The expected term is determined based on historical exercise behavior, post-vesting termination patterns, options outstanding and future expected exercise behavior.

Expected dividends.

As required by SFAS No. 123(R), employee stock-based compensation expense recognized in the three and nine months ended December 31, 2006 was calculated based on awards ultimately expected to vest and has been reduced for estimated forfeitures. Forfeitures are revised, if necessary, in subsequent periods if actual forfeitures differ from those estimates and an adjustment will be recognized at that time.

Changes to our underlying stock price, our assumptions used in the Black-Scholes option valuation calculation and our forfeiture rate as well as future grants of equity could significantly impact compensation expense to be recognized in fiscal 2007 and future periods.

Income Taxes

In the ordinary course of our business, there are many transactions and calculations where the tax law and ultimate tax determination is uncertain. As part of the process of preparing our Condensed Consolidated Financial Statements, we are required to estimate our income taxes in each of the jurisdictions in which we operate prior to the completion and filing of tax returns for such periods. This process requires estimating both our geographic mix of income and our current tax exposures in each jurisdiction where we operate. These estimates involve complex issues, require extended periods of time to resolve, and require us to make judgments, such as anticipating the positions that we will take on tax returns prior to our actually preparing the returns and the outcomes of disputes with tax authorities. We are also required to make determinations of the need to record deferred tax liabilities and the recoverability of deferred tax assets. A valuation allowance is established to the extent recovery of deferred tax assets is not likely based on our estimation of future taxable income in each jurisdiction.

In addition, changes in our business, including acquisitions, changes in our international corporate structure, changes in the geographic location of business functions or assets, changes in the geographic mix and amount of income, as well as changes in our agreements with tax authorities, valuation allowances, applicable accounting rules, applicable tax laws and regulations, rulings and interpretations thereof, developments in tax audit and other matters, and variations in the estimated and actual level of annual pre-tax income can affect the overall effective income tax rate and result in a variance between the projected effective tax rate for any quarter and the final effective tax rate for the fiscal year.

With respect to our projected annual effective income tax rate at the end of each quarter prior to the end of a fiscal year, we are required to make a projection of several items, including our projected mix of full-year income in each jurisdiction in which we operate and the related income tax expense in each jurisdiction. While this projection is inherently uncertain, for fiscal 2007, our projected tax rate is unusually volatile and subject to significantly greater variation.

RESULTS OF OPERATIONS

Our fiscal year is reported on a 52 or 53-week period that ends on the Saturday nearest March 31. As a result, fiscal 2006 contained 53 weeks with the first quarter containing 14 weeks. Our results of operations for the fiscal years ending March 31, 2007 and 2006 contain the following number of weeks:

Fiscal Years Ended	Number of Weeks	Fiscal Period End Date
March 31, 2007	52 weeks	March 31, 2007
March 31, 2006	53 weeks	April 1, 2006

Our results of operations for the three and nine months ended December 31, 2006 and 2005 contained the following number of weeks:

Fiscal Period	Number of Weeks	Fiscal Period End Date
Three months ended December 31, 2006	13 weeks	December 30, 2006
Nine months ended December 31, 2006	39 weeks	December 30, 2006
Three months ended December 31, 2005	13 weeks	December 31, 2005
Nine months ended December 31, 2005	40 weeks	December 31, 2005

For simplicity of disclosure purposes, all fiscal periods are referred to as ending on a calendar month end.

Beginning in fiscal 2007, we adopted SFAS No. 123(R) and applied the provisions of SAB No. 107 to our adoption of SFAS No. 123(R). We elected to use the modified prospective transition method of adoption which requires that compensation expense be recognized in the financial statements for all awards granted after the date of adoption as well as for existing awards for which the requisite service has not been rendered as of the date of adoption. Accordingly, prior periods are not restated for the effect of SFAS No. 123(R). Prior to our adoption of SFAS No. 123(R), we valued our stock options based on the multiple-award valuation method and recognized the expense using the accelerated approach over the requisite service period. In conjunction with our adoption of SFAS

No. 123(R), we changed our method of recognizing our stock-based compensation expense to the straight-line approach over the requisite service period; however, we continue to value our stock options based on the multiple-award valuation method.

Prior to fiscal 2007, we accounted for stock-based awards to employees using the intrinsic value method in accordance with Accounting Principles Board No. 25, *Accounting for Stock Issued to Employees* and adopted the disclosure-only provisions of SFAS No. 123, *Accounting for Stock-Based Compensation*, as amended. Also, as required by SFAS No. 148, *Accounting for Stock-Based Compensation Transition and Disclosure*, we provided pro forma net income and net income per common share disclosures for stock-based awards as if the fair-value-based method defined in SFAS No. 123 had been applied. As a result, prior periods are not restated for the effect of SFAS No. 123(R). Stock-based compensation expense for the three and nine months ended December 31, 2006 was $35 million and $105 million, respectively. Stock-based compensation expense for the three and nine months ended December 31, 2005 was less than $1 million and $1 million, respectively.

Net Revenue

We principally derive net revenue from sales of packaged interactive software games designed for play on video game consoles (such as the PlayStation 3, PlayStation 2, Xbox 360 and Wii), PCs and handheld game players (such as the Sony PSP, Nintendo DS and Nintendo Game Boy Advance) and cellular handsets. We also derive net revenue from selling services in connection with some of our online games, programming third-party web sites with our game content, allowing other companies to manufacture and sell our products in conjunction with other products, and selling advertisements on our online web pages and in our games.

From a geographical perspective, our total net revenue for the three and nine months ended December 31, 2006 and 2005 was as follows (in millions):

	Three Months Ended December 31,				Increase /	%
	2006		2005		(Decrease)	Change
North America	$ 637	50%	$ 618	49%	$ 19	3%
Europe	583	45%	577	45%	6	1%
Asia	61	5%	75	6%	(14)	(19%)
International	644	50%	652	51%	(8)	(1%)
Total Net Revenue	$ 1,281	100%	$ 1,270	100%	$ 11	1%

	Nine Months Ended December 31,				Increase /	%
	2006		2005		(Decrease)	Change
North America	$ 1,359	55%	$ 1,245	54%	$ 114	9%
Europe	997	40%	912	39%	85	9%
Asia	122	5%	153	7%	(31)	(20%)
International	1,119	45%	1,065	46%	54	5%
Total Net Revenue	$ 2,478	100%	$ 2,310	100%	$ 168	7%

North America

For the three months ended December 31, 2006, net revenue in North America was $637 million, driven primarily by (1) sales of *Need for Speed Carbon*, which was released during the three months ended December 31, 2006, (2) sales

of *Madden NFL 07*, which was released during the second quarter of fiscal 2007, and (3) growth in our cellular handset games business resulting from our acquisition of JAMDAT on February 15, 2006. Overall, net revenue increased $19 million, or 3 percent, as compared to the three months ended December 31, 2005.

The increase in net revenue for the three months ended December 31, 2006, as compared to the three months ended December 31, 2005 was primarily driven by (1) a $51 million increase in catalog[(a)] net revenue, (2) a $26 million increase in cellular handset net revenue, and (3) an $8 million increase in subscription services net revenue. These increases were partially offset by (1) a $48 million decrease in frontline[(b)] net revenue primarily due to lower sales in our Harry Potter franchise as we did not have a title release during the three months ended December 31, 2006 and (2) a $19 million decrease in net revenue from co-publishing and distribution products.

For the nine months ended December 31, 2006, net revenue in North America was $1,359 million, driven primarily by (1) sales of *Madden NFL 07*, *Need for Speed Carbon* and *NCAA® Football 07* and (2) growth in our cellular handset games business resulting from our acquisition of JAMDAT. Overall, net revenue increased $114 million, or 9 percent, as compared to the nine months ended December 31, 2005.

The increase in net revenue for the nine months ended December 31, 2006, as compared to the nine months ended December 31, 2005 was primarily driven by (1) a $79 million increase in cellular handset net revenue and (2) a $67 million increase in catalog net revenue. These increases were partially offset by a $36 million decrease in frontline net revenue.

(a) We refer to catalog net revenue as net revenue derived from an EA Studio SKU (a version of a title designed for play on a particular platform) for consoles, PC, PSP, Nintendo DS, and Game Boy Advance subsequent to the fiscal period in which the SKU was released.

(b) We refer to frontline net revenue as net revenue derived from an EA Studio SKU for consoles, PC, PSP, Nintendo DS, and Game Boy Advance during the fiscal period the SKU was released.

Europe

For the three months ended December 31, 2006, net revenue in Europe was $583 million, driven primarily by sales of *Need for Speed Carbon*, *FIFA 07*, and *The Sims 2 Pets*. Overall, net revenue increased $6 million, or 1 percent, as compared to the three months ended December 31, 2005. We estimate that foreign exchange rates (primarily the Euro and the British pound sterling) increased reported European net revenue by approximately $35 million, or 6 percent, for the three months ended December 31, 2006 as compared to the three months ended December 31, 2005. Excluding the effect of foreign exchange rates, we estimate that European net revenue decreased by approximately $29 million, or 5 percent, for the three months ended December 31, 2006.

The overall increase in net revenue of $6 million for the three months ended December 31, 2006, as compared to the three months ended December 31, 2005 was driven primarily by (1) a $12 million increase in frontline net revenue, (2) a $10 million increase in catalog net revenue, and (3) an $8 million increase in cellular handset net revenue. These increases were partially offset by a $26 million decrease in co-publishing and distribution net revenue.

For the nine months ended December 31, 2006, net revenue in Europe was $997 million, driven primarily by sales of *FIFA 07*, *Need for Speed Carbon*, and *The Sims 2 Pets*. Overall, net revenue increased $85 million, or 9 percent, as compared to the nine months ended December 31, 2005. We estimate that foreign exchange rates (primarily the Euro and the British pound sterling) increased reported European net revenue by approximately $38 million, or 4 percent, for the nine months ended December 31, 2006 as compared to the nine months ended December 31, 2005. Excluding the effect of foreign exchange rates, we estimate that European net revenue increased by approximately $47 million, or 5 percent, for the nine months ended December 31, 2006.

The increase in net revenue for the nine months ended December 31, 2006, as compared to the nine months ended December 31, 2005 was driven primarily by (1) a $67 million increase in catalog net revenue and (2) a $19 million increase in cellular handset net revenue.

Asia

For the three months ended December 31, 2006, net revenue in Asia decreased by $14 million, or 19 percent, as compared to the three months ended December 31, 2005. The decrease in net revenue for the three months ended December 31, 2006 was driven primarily by (1) lower sales of co-publishing and distribution titles of $6 million and (2) a $6 million decrease in frontline net revenue.

For the nine months ended December 31, 2006, net revenue in Asia decreased by $31 million, or 20 percent, as compared to the nine months ended December 31, 2005. The decrease in net revenue for the nine months ended December 31, 2006 was driven primarily by (1) a $21 million decrease in frontline net revenue and (2) a $16 million decrease in co-publishing and distribution net revenue. These decreases were partially offset by an $8 million increase in catalog net revenue. We estimate that changes in foreign exchange rates decreased reported net revenue in Asia by approximately $5 million, or 3 percent, for the nine months ended December 31, 2006. Excluding the effect of foreign exchange rates, we estimate that Asia net revenue decreased by approximately $26 million, or 17 percent, for the nine months ended December 31, 2006 as compared to the nine months ended December 31, 2005.

40

Our total net revenue by product line for the three and nine months ended December 31, 2006 and 2005 was as follows (in millions):

	Three Months Ended December 31, 2006		2005		Increase/ (Decrease)	% Change
Consoles						
PlayStation 2	$ 400	31%	$ 495	39%	$ (95)	(19%)
Xbox 360	172	13%	76	6%	96	126%
Xbox	62	5%	152	12%	(90)	(59%)
PlayStation 3	41	3%			41	N/M
Nintendo GameCube	32	3%	69	5%	(37)	(54%)
Wii	29	2%			29	N/M
Other Consoles			1		(1)	(100%)
Total Consoles	736	57%	793	62%	(57)	(7%)
PC	218	17%	148	12%	70	47%
Mobility						
PSP	118	9%	120	9%	(2)	(2%)
Nintendo DS	55	4%	36	3%	19	53%
Game Boy Advance	21	2%	35	3%	(14)	(40%)
Cellular Handsets	35	3%	1		34	N/M
Total Mobility	229	18%	192	15%	37	19%
Co-publishing and Distribution	49	4%	99	8%	(50)	(51%)
Internet Services, Licensing and Other						
Subscription Services	24	2%	16	1%	8	50%
Licensing, Advertising and Other	25	2%	22	2%	3	14%
Total Internet Services, Licensing and Other	49	4%	38	3%	11	29%
Total Net Revenue	$ 1,281	100%	$ 1,270	100%	$ 11	1%

	Nine Months Ended December 31, 2006		2005		Increase/ (Decrease)	% Change
Consoles						
PlayStation 2	$ 769	31%	$ 916	40%	$ (147)	(16%)
Xbox 360	399	16%	76	3%	323	425%
Xbox	150	6%	332	14%	(182)	(55%)
Nintendo GameCube	56	2%	118	5%	(62)	(53%)
PlayStation 3	41	2%			41	N/M
Wii	29	1%			29	N/M
Other Consoles			1		(1)	(100%)
Total Consoles	1,444	58%	1,443	62%	1	

PC	370	15%	313	14%	57	18%
Mobility						
PSP	219	9%	197	9%	22	11%
Nintendo DS	77	3%	56	2%	21	38%
Game Boy Advance	35	2%	48	2%	(13)	(27%)
Cellular Handsets	104	4%	4		100	N/M
Total Mobility	435	18%	305	13%	130	43%
Co-publishing and Distribution	130	5%	161	7%	(31)	(19%)
Internet Services, Licensing and Other						
Subscription Services	55	2%	45	2%	10	22%
Licensing, Advertising and Other	44	2%	43	2%	1	2%
Total Internet Services, Licensing and Other	99	4%	88	4%	11	13%
Total Net Revenue	$ 2,478	100%	$ 2,310	100%	$ 168	7%

41

PlayStation 2

For the three months ended December 31, 2006, net revenue from sales of titles for the PlayStation 2 was $400 million, driven primarily by sales of *Need for Speed Carbon*, *FIFA 07*, *The Sims 2 Pets*, and *Madden NFL 07*. Overall, PlayStation 2 net revenue decreased $95 million, or 19 percent, compared to the three months ended December 31, 2005. Although we are unable to specifically quantify the impact, we believe the decrease was primarily due to the transition to next-generation consoles.

For the nine months ended December 31, 2006, net revenue from sales of titles for the PlayStation 2 was $769 million, driven primarily by sales of *Madden NFL 07, Need for Speed Carbon*, and *FIFA 07*. Overall, PlayStation 2 net revenue decreased $147 million, or 16 percent, compared to the nine months ended December 31, 2005. Although we are unable to specifically quantify the impact, we believe the decrease was primarily due to the transition to next-generation consoles.

We expect PlayStation 2 related net revenue to continue to decline as consumers increasingly migrate to new platforms.

Xbox 360

The Xbox 360 was launched in North America, Europe and Japan during the three months ended December 31, 2005 and in the rest of Asia during the three months ended March 31, 2006. Net revenue from sales of titles for the Xbox 360 was $172 million for the three months ended December 31, 2006, driven by sales of *Need for Speed Carbon*, *FIFA 07*, and *Tiger Woods PGA TOUR 07*.

For the nine months ended December 31, 2006, net revenue from sales of titles for the Xbox 360 was $399 million driven by sales of *Madden NFL 07*, *Need for Speed Carbon, FIFA 07*, and *NCAA Football 07*.

We expect net revenue from sales of titles for the Xbox 360 to increase as the installed base grows and we release more titles.

Xbox

For the three months ended December 31, 2006, net revenue from sales of titles for the Xbox was $62 million, driven primarily by sales of *Need for Speed Carbon*, *FIFA 07*, and *Madden NFL 07*. Overall, Xbox net revenue decreased $90 million, or 59 percent, as compared to the three months ended December 31, 2005. Although we are unable to specifically quantify the impact, we believe the decrease was primarily due to the transition to next-generation consoles.

For the nine months ended December 31, 2006, net revenue from sales of titles for the Xbox was $150 million, driven primarily by sales of *Madden NFL 07*, *Need for Speed Carbon, NCAA Football 07*, and *FIFA 07*. Overall, Xbox net revenue decreased $182 million, or 55 percent, as compared to the nine months ended December 31, 2005. Although we are unable to specifically quantify the impact, we believe the decrease was primarily due to the transition to next-generation consoles.

We expect Xbox related net revenue to continue to decline as consumers increasingly migrate to new platforms.

Nintendo GameCube

For the three months ended December 31, 2006, net revenue from sales of titles for the Nintendo GameCube was $32 million, driven primarily by sales of *Need for Speed Carbon*, *The Sims 2 Pets*, *FIFA 07*, and *Madden NFL 07*. Overall, Nintendo GameCube net revenue decreased $37 million, or 54 percent, as compared to the three months ended December 31, 2005. Although we are unable to specifically quantify the impact, we believe the decrease was primarily due to the transition to next-generation consoles.

For the nine months ended December 31, 2006, net revenue from sales of titles for the Nintendo GameCube was $56 million, driven primarily by sales of *Madden NFL 07*, *Need for Speed Carbon*, *FIFA 07*, and *The Sims 2 Pets*. Overall, Nintendo GameCube net revenue decreased $62 million, or 53 percent, as compared to the nine months ended December 31, 2005. Although we are unable to quantify the impact, we believe the decrease was primarily due to the transition to next-generation consoles.

We expect Nintendo GameCube related net revenue to continue to decline as consumers increasingly migrate to new platforms.

PlayStation 3

The PlayStation 3 launched in North America and Japan during the three months ended December 31, 2006. Net revenue from sales of titles for the PlayStation 3 was $41 million for the three and nine months ended December 31, 2006, driven by sales of *Madden NFL 07* and *Need for Speed Carbon.*

We expect net revenue from sales of titles for the PlayStation 3 to increase as the installed base grows and we release more titles.

Wii

The Wii launched in North America, Europe and Japan during the three months ended December 31, 2006. Net revenue from sales of titles for the Wii was $29 million for the three and nine months ended December 31, 2006, driven by sales of *Need for Speed Carbon* and *Madden NFL 07.*

We expect net revenue from sales of titles for the Wii to increase as the installed base grows and we release more titles.

PC

For the three months ended December 31, 2006, net revenue from sales of titles for the PC was $218 million driven primarily by sales of titles from The Sims and Battlefield franchises. Overall, PC net revenue increased $70 million, or 47 percent, as compared to the three months ended December 31, 2005. The increase was driven primarily by a $72 million increase in frontline net revenue.

For the nine months ended December 31, 2006, net revenue from sales of titles for the PC was $370 million driven primarily by sales of titles from The Sims and Battlefield franchises. Overall, PC net revenue increased $57 million, or 18 percent, as compared to the nine months ended December 31, 2005. The increase was due to a $48 million increase in catalog net revenue and a $9 million increase in frontline net revenue.

Mobile Platforms

Net revenue from mobile products, which consist of packaged goods games for handheld systems and downloadable games for cellular handsets, increased from $192 million in the three months ended December 31, 2005 to $229 million in the three months ended December 31, 2006. The increase was primarily due to $34 million year-over-year growth in our cellular handset games business resulting from our acquisition of JAMDAT and $19 million increased net revenue from sales of titles for the Nintendo DS. These increases were partially offset by a $14 million decrease in net revenue from titles for the Game Boy Advance.

Net revenue from mobile products increased from $305 million in the nine months ended December 31, 2005 to $435 million in the nine months ended December 31, 2006. The increase was primarily due to a $100 million year-over-year growth in our cellular handset games business resulting from our acquisition of JAMDAT and an increase in net revenue from sales of titles for the PSP and the Nintendo DS totaling $43 million.

Co-Publishing and Distribution

Net revenue from co-publishing and distribution products decreased from $99 million in the three months ended December 31, 2005 to $49 million in the three months ended December 31, 2006. The decrease was primarily due to (1) a $16 million decrease in sales of *Black & White 2*, (2) a $15 million decrease in sales of the Half-Life franchise, and (3) an $8 million decrease in sales of *Resident Evil® 4.*

Net revenue from co-publishing and distribution products decreased from $161 million in the nine months ended December 31, 2005 to $130 million in the nine months ended December 31, 2006. The decrease was primarily due to (1) a $14 million decrease in sales of *Black & White 2* and (2) a $7 million decrease in sales of *Resident Evil 4.*

Cost of Goods Sold

Cost of goods sold for our packaged-goods business consists of (1) product costs, (2) certain royalty expenses for celebrities, professional sports and other organizations and independent software developers, (3) manufacturing royalties, net of volume

discounts and other vendor reimbursements, (4) expenses for defective products, (5) write-offs of post-launch prepaid royalty costs, (6) amortization of certain intangible assets, and (7) operational expenses. Volume discounts are generally recognized upon achievement of milestones and vendor reimbursements are generally recognized as the related revenue is recognized. Cost of goods sold for our online products consists primarily of data center and bandwidth costs associated with hosting our web sites, credit card fees and royalties for use of third-party properties. Cost of goods sold for our web site advertising business primarily consists of ad-serving costs.
Cost of goods sold for the three and nine months ended December 31, 2006 and 2005 were as follows (in millions):

	December 31, 2006	% of Net Revenue	December 31, 2005	% of Net Revenue	% Change	Change as a % of Net Revenue
Three months ended	$470	36.7%	$ 502	39.5%	(6.4%)	(2.8%)
Nine months ended	$977	39.4%	$ 937	40.6%	4.3%	(1.2%)

For the three months ended December 31, 2006, cost of goods sold decreased by 2.8 percentage points as a percentage of total net revenue as compared to the three months ended December 31, 2005. This decrease was primarily due to:

- Lower average product costs as a percentage of total net revenue primarily driven by (1) fewer returns and less price protection taken, or expected to be taken, during the three months ended December 31, 2006 as compared to the three months ended December 31, 2005 and (2) our acquisition of JAMDAT in February 2006 which created a higher mix of cellular handset net revenue in the three months ended December 31, 2006. We estimate average product costs as a percentage of total net revenue decreased by approximately 3 percent in the three months ended December 31, 2006 as compared to the three months ended December 31, 2005; and

- Lower royalty costs of approximately 1 percent as a percentage of total net revenue primarily due to lower co-publishing and distribution royalties for titles in the three months ended December 31, 2006 as compared to the three months ended December 31, 2005.

As a percentage of total net revenue, the decreases above were partially offset by an approximate 1 percent increase in amortization of intangibles during the three months ended December 31, 2006 as compared to the three months ended December 31, 2005 primarily due to our acquisition of JAMDAT.
For the nine months ended December 31, 2006, cost of goods sold decreased by 1.2 percentage points as a percentage of total net revenue as compared to the nine months ended December 31, 2005. This decrease was primarily due to lower average product costs as a percentage of total net revenue primarily driven by (1) fewer returns and less price protection taken, or expected to be taken, during the nine months ended December 31, 2006 as compared to the nine months ended December 31, 2005 and (2) our acquisition of JAMDAT in February 2006 which created a higher mix of cellular handset net revenue in the nine months ended December 31, 2006. We estimate average product costs as a percentage of total net revenue decreased by approximately 3 percent in the nine months ended December 31, 2006 as compared to the nine months ended December 31, 2005.
As a percentage of total net revenue, the decrease in average product costs was partially offset by an estimated 2 percent increase in license royalties during the nine months ended December 31, 2006 as compared to the nine months ended December 31, 2005 primarily due to new license agreements associated with our EA SPORTS titles and from our acquisition of JAMDAT.
Cost of goods sold as a percentage of total net revenue is difficult to predict. In the short-term, we expect gross margin pressure as a result of (1) a decrease in average selling prices of titles for current-generation platforms, (2) higher

license royalty rates, and (3) amortization of our newly-acquired intangible assets.

Marketing and Sales

Marketing and sales expenses consist of personnel-related costs and advertising, marketing and promotional expenses, net of qualified advertising cost reimbursements from third parties.

Table of Contents

Marketing and sales expenses for the three and nine months ended December 31, 2006 and 2005 were as follows (in millions):

	December 31, 2006	% of Net Revenue	December 31, 2005	% of Net Revenue	$ Change	% Change
Three months ended	$165	13%	$ 147	12%	$18	12%
Nine months ended	$350	14%	$ 329	14%	$21	6%

For the three months ended December 31, 2006, marketing and sales expenses increased by $18 million, or 12 percent, as compared to the three months ended December 31, 2005 primarily due to (1) an increase of $10 million in our annual bonus expense, (2) an increase of $5 million in stock-based compensation expense recognized as a result of our adoption of SFAS No. 123(R), and (3) $5 million in additional personnel-related costs resulting from an increase in headcount.

For the nine months ended December 31, 2006, marketing and sales expenses increased by $21 million, or 6 percent, as compared to the nine months ended December 31, 2005 primarily due to (1) an increase of $14 million in stock-based compensation expense recognized as a result of our adoption of SFAS No. 123(R), (2) an increase of $13 million in our annual bonus expense, and (3) $6 million in additional personnel-related costs resulting from an increase in headcount. These increases were partially offset by a decrease of $15 million in our marketing, advertising, promotional and related contracted services as a result of higher advertising spend in the prior year to support our product releases, primarily for our Harry Potter and Burnout franchises.

General and Administrative

General and administrative expenses consist of personnel and related expenses of executive and administrative staff, fees for professional services such as legal and accounting, and allowances for doubtful accounts.

General and administrative expenses for the three and nine months ended December 31, 2006 and 2005 were as follows (in millions):

	December 31, 2006	% of Net Revenue	December 31, 2005	% of Net Revenue	$ Change	% Change
Three months ended	$ 91	7%	$ 58	5%	$33	57%
Nine months ended	$222	9%	$ 160	7%	$62	39%

For the three months ended December 31, 2006, general and administrative expenses increased by $33 million, or 57 percent, as compared to the three months ended December 31, 2005 primarily due to (1) a $12 million increase in our annual bonus expense, (2) a $10 million increase in stock-based compensation expense recognized as a result of our adoption of SFAS No. 123(R), and (3) an increase of $8 million in professional and contracted services in support of our technology infrastructure.

For the nine months ended December 31, 2006, general and administrative expenses increased by $62 million, or 39 percent, as compared to the nine months ended December 31, 2005 due to (1) an increase of $30 million in stock-based compensation expense recognized as a result of our adoption of SFAS No. 123(R), (2) a $12 million increase in our annual bonus expense, and (3) an increase of $9 million in professional and contracted services in support of our technology infrastructure.

Research and Development

Research and development expenses consist of expenses incurred by our production studios for personnel-related costs, contracted services, equipment depreciation and any impairment of prepaid royalties for pre-launch products. Research and development expenses for our online business include expenses incurred by our studios consisting of direct development and related overhead costs in connection with the development and production of our online games. Research and development expenses also include expenses associated with the development of web site content, network infrastructure direct expenses, software licenses and maintenance, and network and management overhead.

Research and development expenses for the three and nine months ended December 31, 2006 and 2005 were as follows (in millions):

	December 31, 2006	% of Net Revenue	December 31, 2005	% of Net Revenue	$ Change	% Change
Three months ended	$330	26%	$ 206	16%	$124	60%
Nine months ended	$783	32%	$ 571	25%	$212	37%

For the three months ended December 31, 2006, research and development expenses increased by $124 million, or 60 percent, as compared to the three months ended December 31, 2005. The increase was primarily due to (1) a $52 million increase in our annual bonus expense, (2) $28 million in additional personnel-related costs, primarily due to an increase in headcount resulting from our acquisitions of JAMDAT and Mythic, and to support development for next-generation consoles, (3) $20 million of stock-based compensation expense recognized as a result of our adoption of SFAS No. 123(R), (4) an increase of $17 million in external development expenses primarily due to a greater number of projects in development as compared to the prior year, and (5) an increase of $10 million in facilities-related expenses in support of our research and development functions worldwide.

For the nine months ended December 31, 2006, research and development expenses increased by $212 million, or 37 percent, as compared to the nine months ended December 31, 2005. The increase was primarily due to (1) a $65 million increase in our annual bonus expense, (2) an increase of $59 million in stock-based compensation expense recognized as a result of our adoption of SFAS No. 123(R), (3) $50 million in additional personnel-related costs, primarily due to an increase in headcount resulting from our acquisitions of JAMDAT and Mythic, and to support development for next-generation consoles, (4) an increase of $32 million in external development expenses primarily due to a greater number of projects in development as compared to the prior year as well as expenses in our cellular handset business resulting from our acquisition of JAMDAT, and (5) an increase of $24 million in facilities-related expenses in support of our research and development functions worldwide.

We expect research and development expenses to increase in absolute dollars for the fourth quarter fiscal 2007 as compared to the fourth quarter of fiscal 2006 primarily as a result of (1) our recognition of stock-based compensation expense and (2) our investment in developing titles for next-generation consoles, online and mobile platforms.

Amortization of Intangibles

Amortization of intangibles for the three and nine months ended December 31, 2006 and 2005 were as follows (in millions):

	December 31, 2006	% of Net Revenue	December 31, 2005	% of Net Revenue	$ Change	% Change
Three months ended	$ 7	1%	$ 1		$ 6	600%
Nine months ended	$20	1%	$ 3		$17	567%

For the three and nine months ended December 31, 2006, amortization of intangibles increased by $6 million and $17 million, respectively, as compared to the three and nine months ended December 31, 2005. These increases were primarily due to the amortization of intangibles related to our acquisition of JAMDAT.

We expect amortization expenses of intangible assets to increase in fiscal 2007 as compared to fiscal 2006 primarily due to the amortization of intangibles related to our JAMDAT and Mythic acquisitions.

Acquired In-process Technology

The acquired in-process technology charges we incurred for the three and nine months ended December 31, 2006 of $1 million and $3 million, respectively, were the result of the acquisitions of Mythic and the remaining minority interest in DICE. Acquired in-process technology charges incurred during the three and nine months ended December 31, 2005 were zero and less than $1 million, respectively. Acquired in-process technology includes the value of products in the development stage that are not considered to have reached technological feasibility or have an alternative future use. Accordingly, upon consummation of the acquisitions of Mythic and the remaining minority interest in DICE, we incurred a charge for the acquired in-process technology

as reflected in our Condensed Consolidated Statements of Operations. See Note 4 of the Notes to Condensed Consolidated Financial Statements.

Restructuring Charges

Restructuring charges for three and nine months ended December 31, 2006 and 2005 were as follows (in millions):

	December 31, 2006	% of Net Revenue	December 31, 2005	% of Net Revenue	$ Change	% Change
Three months ended	$ 2		$ 9	1%	$ (7)	(78%)
Nine months ended	$12		$ 9		$ 3	33%

In November 2005, we announced plans to establish an international publishing headquarters in Geneva, Switzerland. Through our quarter ended September 30, 2006, we relocated certain employees to our new facility in Geneva, closed certain facilities in the U.K., and made other related changes in our international publishing business. During the three months ended December 31, 2006, restructuring charges were approximately $2 million for employee-related expenses. During the nine months ended December 31, 2006, restructuring charges were approximately $12 million, of which $8 million was for employee-related expenses. We incurred restructuring charges of $9 million during the three and nine months ended December 31, 2005, of which $7 million for the closure of certain U.K. facilities.

For the remainder of fiscal 2007, we expect to incur up to $3 million of restructuring costs in connection with our international publishing reorganization. Overall, including charges incurred through December 31, 2006, we expect to incur between $40 million and $45 million of restructuring costs in connection with our international publishing reorganization, substantially all of which will result in cash expenditures by 2017. These restructuring costs will consist primarily of employee-related relocation assistance (approximately $25 million), facility exit costs (approximately $11 million), as well as other reorganization costs (approximately $6 million).

Interest and Other Income, Net

Interest and other income, net, for the three and nine months ended December 31, 2006 and 2005 were as follows (in millions):

	December 31, 2006	% of Net Revenue	December 31, 2005	% of Net Revenue	$ Change	% Change
Three months ended	$25	2%	$ 20	2%	$ 5	25%
Nine months ended	$69	3%	$ 49	2%	$ 20	41%

For the three and nine months ended December 31, 2006, interest and other income, net, increased by $5 million, or 25 percent, and $20 million, or 41 percent, respectively, as compared to the three and nine months ended December 31, 2005. These increases were primarily due to an increase of $9 million and $21 million in the three and nine months ended December 31, 2006, respectively, in interest income as a result of higher yields on our cash, cash equivalent and short-term investment balances in fiscal 2007.

Income Taxes

Income taxes for the three and nine months ended December 31, 2006 and 2005 were as follows (in millions):

	December 31, 2006	Effective Tax Rate	December 31, 2005	Effective Tax Rate	% Change
Three months ended	$84	34.9%	$ 106	29.0%	(21%)
Nine months ended	$83	45.9%	$ 93	26.5%	(11%)

The tax rate reported for the nine months ended December 31, 2006 is based on our estimated projected annual effective tax rate for fiscal 2007. Our effective income tax rates for the three and nine months ended December 31, 2006 were 34.9 percent and 45.9 percent, respectively. These rates include various adjustments recorded in the three months ended December 31, 2006 for the reinstatement of the federal research credit, additional income tax benefit resulting from certain intercompany transactions, offset by additional tax expense due to the development of certain tax audit related matters. Without the impact of these adjustments, our effective income tax rates for the three and nine months ended December 31, 2006 would have been 37.3 percent and 49.0 percent, respectively.

The overall effective income tax rate for the fiscal year could be different from the tax rates in effect for the three and nine months ended December 31, 2006 and will be dependent on our profitability for the remainder of the fiscal year. In addition, our effective income tax rates for the remainder of fiscal 2007 and future periods will depend on a variety of factors, including changes in our business such as acquisitions and intercompany transactions (for example, the acquisition of and intercompany transactions relating to Mythic and DICE), changes in our international corporate structure, changes in the geographic location of business functions or assets, changes in the geographic mix of income, as well as changes in, or termination of, our agreements with tax authorities, valuation allowances, applicable accounting rules, applicable tax laws and regulations, rulings and interpretations thereof, developments in tax audit and other matters. Also, variations in the estimated and actual level of annual pre-tax income can affect the overall effective income tax rate for the remainder of fiscal 2007 and future fiscal periods. We incur certain tax expenses that do not decline proportionately with declines in our consolidated income or increase in consolidated loss. As a result, in absolute dollar terms, our tax expense will have a greater influence on our effective tax rate at lower levels of pre-tax income than higher levels. In addition, at lower levels of pre-tax income or loss, our effective tax rate will be more volatile.

We historically have considered undistributed earnings of our foreign subsidiaries to be indefinitely reinvested and, accordingly, no U.S. taxes have been provided thereon.

In July 2006, the Financial Accounting Standards Board (FASB) issued FASB Interpretation (FIN) No. 48, *Accounting for Uncertainty in Income Taxes An Interpretation of FASB Statement No. 109* . FIN No. 48 clarifies the accounting for uncertainty in income taxes recognized in financial statements in accordance with SFAS No. 109, *Accounting for Income Taxes* . FIN No. 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 and provides guidance on derecognition, classification, interest and penalties, accounting in interim periods, disclosure, and transition. Under FIN No. 48, the evaluation of a tax position is a two-step process. The first step is a recognition process where we are required to determine whether it is more likely than not that a tax position will be sustained upon examination, including resolution of any related appeals or litigation processes, based on the technical merits of the position. In evaluating whether a tax position has met the more-likely-than-not recognition threshold, it is presumed that the position will be examined by the appropriate taxing authority that has full knowledge of all relevant information. The second step is a measurement process whereby a tax position that meets the more-likely-than-not recognition threshold is calculated to determine the amount of benefit to recognize in the financial statements. FIN No. 48 also requires new tabular reconciliation of the total amounts of unrecognized tax benefits at the beginning and end of the reporting period. The provisions of FIN No. 48 are effective for fiscal years beginning after December 15, 2006. As such, we are required to adopt it in our first quarter of fiscal year 2008. Any changes to our income taxes due to the adoption of FIN No. 48 are treated as the cumulative effect of a change in accounting principle. We are evaluating what impact the adoption of FIN No. 48 will have on our Condensed Consolidated Financial Statements; however, FIN No. 48 could have a material impact on our Condensed Consolidated Financial Statements.

Impact of Recently Issued Accounting Standards

In February 2006, the FASB issued SFAS No. 155, *Accounting for Certain Hybrid Financial Instruments An Amendment of FASB Statements No. 133 and 140* . SFAS No. 155 (1) permits fair value measurement for any hybrid financial instrument that contains an embedded derivative that otherwise would require bifurcation, (2) clarifies that interest-only strips and principal-only strips are not subject to the requirements of SFAS No. 133, *Accounting for Derivative Instruments and Hedging Activities* , (3) establishes a requirement to evaluate interests in securitized financial assets to identify interests that are freestanding derivatives or that are hybrid financial instruments that

contain an embedded derivative requiring bifurcation, (4) clarifies that concentrations of credit risk in the form of subordination are not embedded derivatives, and (5) amends SFAS No. 140, *Accounting for Transfers and Servicing of Financial Assets and Extinguishments of Liabilities A Replacement of FASB Statement No. 125* to eliminate the prohibition on a qualifying special-purpose entity from holding a derivative financial instrument that pertains to a beneficial interest other than another derivative financial instrument. SFAS No. 155 is effective for

all financial instruments acquired or issued for fiscal years beginning after September 15, 2006. We do not expect the adoption of SFAS No. 155 to have a material impact on our Condensed Consolidated Financial Statements.

In June 2006, the FASB ratified the consensus reached on Emerging Issues Task Force (EITF) Issue No. 06-3, *How Taxes Collected from Customers and Remitted to Governmental Authorities Should Be Presented in the Income Statement (That Is, Gross Versus Net Presentation)* . The scope of EITF Issue No. 06-3 includes any transaction-based tax assessed by a governmental authority that is imposed concurrent with or subsequent to a revenue-producing transaction between a seller and a customer. The scope does not include taxes that are based on gross receipts or total revenues imposed during the inventory procurement process. Gross versus net income statement classification of that tax is an accounting policy decision and a voluntary change would be considered a change in accounting policy requiring the application of SFAS No. 154, *Accounting Changes and Error Corrections* . The following disclosures will be required for taxes within the scope of this issue that are significant in amount: (1) the accounting policy elected for these taxes and (2) the amounts of the taxes reflected gross (as revenue) in the income statement on an interim and annual basis for all periods presented. The EITF Issue No. 06-3 ratified consensus is effective for interim and annual periods beginning after December 15, 2006. We do not expect the adoption of EITF Issue No. 06-3 to have a material impact on our Condensed Consolidated Financial Statements.

In September 2006, the SEC issued SAB No. 108, *Financial Statements Considering the Effects of Prior Year Misstatements when Quantifying Misstatements in Current Year Financial Statements* . SAB No. 108 provides guidance on how prior year misstatements should be taken into consideration when quantifying misstatements in current year financial statements for purposes of determining whether the current year s financial statements are materially misstated. The impact of correcting all misstatements, including both the carryover and reversing effects of prior year misstatements, must be quantified on the current year financial statements. When a current year misstatement has been quantified, SAB No. 99, *Financial Statements Materiality* should be applied to determine whether the misstatement is material and should result in an adjustment to the financial statements. SAB No. 108 also discusses the implications of misstatements uncovered upon the application of SAB No. 108 in situations when a registrant has historically been using either the iron curtain approach or the rollover approach as described in the SAB. Registrants electing not to restate prior periods should reflect the effects of initially applying the guidance in Topic 1N in their annual financial statements covering the first fiscal year ending after November 15, 2006. We are evaluating what impact the adoption of SAB No. 108 will have on our Condensed Consolidated Financial Statements.

In September 2006, the FASB issued SFAS No. 157, *Fair Value Measurements* . SFAS No. 157 defines fair value, establishes a framework for measuring fair value in generally accepted accounting principles and expands disclosures about fair value measurements. Fair value refers to the price that would be received to sell an asset or paid to transfer a liability in an orderly transaction between market participants in the market in which the reporting entity transacts. SFAS No. 157 establishes a fair value hierarchy that prioritizes the information used to develop those assumptions. Fair value measurements would be separately disclosed by level within the fair value hierarchy. The provisions of SFAS No. 157 are effective for financial statements issued for fiscal years beginning after November 15, 2007, and interim periods within those fiscal years. We do not expect the adoption of SFAS No. 157 to have a material impact on our Condensed Consolidated Financial Statements.

In October 2006, the FASB issued FASB Staff Position (FSP) No. Financial Accounting Standard (FAS)123(R)-6, *Technical Corrections of FASB Statement No. 123(R)* , which amends various provisions of SFAS No. 123(R). FSP No. FAS 123(R)-6 (1) exempts nonpublic entities from disclosing the aggregate intrinsic value of outstanding fully vested share options (or share units) and share options expected to vest, (2) revises the computation of the minimum compensation cost that must be recognized to comply with paragraph 42 of SFAS No. 123(R), (3) amends paragraph A170 of Illustration 13(e) to indicate that at the date that the illustrative awards were no longer probable of vesting, any previously recognized compensation cost should have been reversed, and (4) amends the definition of short-term inducement to exclude an offer to settle an award. The provisions of FSP No. FAS 123(R)-6 are required to be applied in the first reporting period beginning after October 20, 2006. Retrospective application is required if an entity had been applying Statement 123(R) inconsistent with the guidance in FSP No. FAS 123(R)-6. We do not expect the adoption of FSP No. FAS 123(R)-6 to have a material impact on our Condensed Consolidated Financial Statements.

Table of Contents

LIQUIDITY AND CAPITAL RESOURCES

(In millions)	As of December 31, 2006	As of March 31, 2006	Increase / (Decrease)
Cash and cash equivalents	$ 1,199	$ 1,242	$ (43)
Short-term investments	1,212	1,030	182
Marketable equity securities	235	160	75
Total	$ 2,646	$ 2,432	$ 214
Percentage of total assets	52%	55%	

(In millions)	Nine Months Ended December 31, 2006	2005	Increase / (Decrease)
Cash provided by operating activities	$ 183	$ 259	$ (76)
Cash provided by (used in) investing activities	(388)	513	(901)
Cash provided by (used in) financing activities	146	(558)	704
Effect of foreign exchange on cash and cash equivalents	16	(22)	38
Net increase (decrease) in cash and cash equivalents	$ (43)	$ 192	$ (235)

Changes in Cash Flow

During the nine months ended December 31, 2006, we generated $183 million of cash from operating activities as compared to $259 million of cash generated for the nine months ended December 31, 2005. The decrease in cash provided by operating activities for the nine months ended December 31, 2006 as compared to the nine months ended December 31, 2005 resulted primarily from an increase of $95 million in the change in net accounts receivable due to the timing of the collection of our receivables. We expect total cash flow from operating activities to decline in fiscal 2007.

For the nine months ended December 31, 2006, we generated $911 million of cash proceeds from maturities and sales of short-term investments, and $133 million in proceeds from sales of common stock through our stock plans. Our primary use of cash in non-operating activities consisted of (1) $1,088 million used to purchase short-term investments, (2) $118 million in capital expenditures primarily related to investments in our worldwide development tools, technologies and equipment and expansions of our Vancouver and U.K. studios, as well as (3) $94 million for the acquisitions of Mythic and the remaining minority interest in DICE. During the remainder of fiscal 2007, we anticipate making continued capital investments in our studios as well as investments in technologies to support development of products for the next-generation of consoles, online infrastructure and mobile platforms.

Cash, cash equivalents, short-term investments and marketable equity securities

The decrease in cash and cash equivalents was primarily due to $1,088 million used to purchase short-term investments and $118 million in capital expenditures, partially offset by $911 million in proceeds received from the maturities and sales of short-term investments and $133 million in proceeds from sales of common stock through our stock plans. Due to our mix of fixed and variable rate securities, our short-term investment portfolio is susceptible to changes in short-term interest rates. As of December 31, 2006, our short-term investments had gross unrealized gains of $1 million, or less than 1 percent of the total in short-term investments, and gross unrealized losses of approximately $2 million, or less than 1 percent of the total in short-term investments. From time to time, we may liquidate some or all of our short-term investments to fund operational needs or other activities, such as capital

expenditures, business acquisitions or stock repurchase programs. Depending on which short-term investments we liquidate to fund these activities, we could recognize a portion, or all, of the gross unrealized gains or losses. Marketable equity securities increased to $235 million as of December 31, 2006, from $160 million as of March 31, 2006, due to an increase in the fair value of our investment in Ubisoft Entertainment.

Receivables, net

Our gross accounts receivable balances were $779 million and $431 million as of December 31, 2006 and March 31, 2006, respectively. The increase in our accounts receivable balance was expected due to higher sales volume in the third quarter of fiscal 2007 as compared to the fourth quarter of fiscal 2006. We expect our accounts receivable balance to decrease during the three months ending March 31, 2007 based on collections and our lower sales volume. Reserves for sales returns, pricing allowances and doubtful accounts decreased slightly in absolute dollars from $232 million as of March 31, 2006 to $228 million as of December 31, 2006. Reserves remained flat at 9 percent as a percentage of trailing nine month net revenue for both December 31, 2006 and March 31, 2006. We believe these reserves are adequate based on historical experience and our current estimate of potential returns, pricing allowances and doubtful accounts.

Inventories

Inventories increased to $72 million as of December 31, 2006, from $61 million as of March 31, 2006 due to our seasonal product release schedule. Other than *Need for Speed Carbon*, no single title represented more than $4 million of inventory as of December 31, 2006.

Other current assets

Other current assets decreased to $170 million as of December 31, 2006, from $234 million as of March 31, 2006, primarily due to a decrease in prepaid royalties and the collection of advertising credits owed to us by our vendors.

Accounts payable

Accounts payable increased to $170 million as of December 31, 2006, from $163 million as of March 31, 2006, primarily due to higher sales volumes and higher related expenditures to support the seasonality of our business in the third quarter of fiscal 2007 as compared to the fourth quarter of fiscal 2006.

Accrued and other current liabilities

Our accrued and other current liabilities increased to $851 million as of December 31, 2006 from $654 million as of March 31, 2006. The increase was primarily due to (1) an increase of $109 million in accrued compensation and benefits, and (2) an increase of $51 million in accrued income taxes.

Deferred income taxes, net

Our long-term net deferred income tax liability decreased to $6 million as of December 31, 2006 from $29 million as of March 31, 2006 primarily due to adjustments related to our amortization of intangibles and stock-based compensation expensed in accordance with SFAS No. 123(R).

Financial Condition

We believe that existing cash, cash equivalents, short-term investments, marketable equity securities and cash generated from operations will be sufficient to meet our operating requirements for at least the next twelve months, including working capital requirements, capital expenditures, and potential future acquisitions or strategic investments. We may choose at any time to raise additional capital to strengthen our financial position, facilitate expansion, pursue strategic acquisitions and investments or to take advantage of business opportunities as they arise. There can be no assurance, however, that such additional capital will be available to us on favorable terms, if at all, or that it will not result in substantial dilution to our existing stockholders.

The loan financing arrangements supporting our Redwood City headquarters leases with Keybank National Association, described in the Off-Balance Sheet Commitments section below, are scheduled to expire in July 2007. Upon expiration of the financing, we may request, on behalf of the lessor and subject to lender approval, up to two one-year extensions of the loan financing between the lessor and the lender. In the event the lessor s loan financing with the lenders is not extended, we may loan to the lessor approximately 90 percent of the financing, and require the lessor to extend the remainder through July 2009, otherwise the leases will terminate. Upon expiration of the leases, we may purchase the facilities for $247 million, or arrange for a sale of the facilities to a third party. In the event of a sale to a third party, if the sale price is less than $247 million, we will be

obligated to reimburse the difference between the actual sale price and $247 million, up to maximum of $222 million, subject to certain provisions of the leases.

As of December 31, 2006, approximately $810 million of our cash, cash equivalents, short-term investments and marketable equity securities that was generated from operations was domiciled in foreign tax jurisdictions. While we have no plans to repatriate these funds to the United States in the short term, if we choose to do so, we would accrue and pay additional taxes in connection with the repatriation.

We have a shelf registration statement on Form S-3 on file with the SEC. This shelf registration statement, which includes a base prospectus, allows us at any time to offer any combination of securities described in the prospectus in one or more offerings up to a total amount of $2 billion. Unless otherwise specified in a prospectus supplement accompanying the base prospectus, we will use the net proceeds from the sale of any securities offered pursuant to the shelf registration statement for general corporate purposes, including for working capital, financing capital expenditures, research and development, marketing and distribution efforts and, if opportunities arise, for acquisitions or strategic alliances. Pending such uses, we may invest the net proceeds in interest-bearing securities. In addition, we may conduct concurrent or other financings at any time.

Our ability to maintain sufficient liquidity could be affected by various risks and uncertainties including, but not limited to, those related to customer demand and acceptance of our products on new platforms and new versions of our products on existing platforms, our ability to collect our accounts receivable as they become due, successfully achieving our product release schedules and attaining our forecasted sales objectives, the impact of competition, economic conditions in the United States and abroad, the seasonal and cyclical nature of our business and operating results, risks of product returns and the other risks described in the Risk Factors section, included in Part II, Item 1A of this report.

Contractual Obligations and Commercial Commitments

Development, Celebrity, League and Content Licenses: Payments and Commitments

The products we produce in our studios are designed and created by our employee designers, artists, software programmers and by non-employee software developers (independent artists or third-party developers). We typically advance development funds to the independent artists and third-party developers during development of our games, usually in installment payments made upon the completion of specified development milestones. Contractually, these payments are generally considered advances against subsequent royalties on the sales of the products. These terms are set forth in written agreements entered into with the independent artists and third-party developers.

In addition, we have certain celebrity, league and content license contracts that contain minimum guarantee payments and marketing commitments that may not be dependent on any deliverables. Celebrities and organizations with whom we have contracts include: FIFA, FIFPRO Foundation, UEFA and FAPL (Football Association Premier League Limited) (professional soccer); NASCAR (stock car racing); National Basketball Association (professional basketball); PGA TOUR and Tiger Woods (professional golf); National Hockey League and NHL Players Association (professional hockey); Warner Bros. (Harry Potter, Batman and Superman); New Line Productions and Saul Zaentz Company (The Lord of the Rings); Red Bear Inc. (John Madden), National Football League Properties and PLAYERS Inc. (professional football); Collegiate Licensing Company (collegiate football, basketball and baseball); Simcoh (Def Jam); Viacom Consumer Products (The Godfather); ESPN (content in EA SPORTS™ games); and Twentieth Century Fox Licensing and Merchandising (The Simpsons). These developer and content license commitments represent the sum of (1) the cash payments due under non-royalty-bearing licenses and services agreements and (2) the minimum guaranteed payments and advances against royalties due under royalty-bearing licenses and services agreements, the majority of which are conditional upon performance by the counterparty.

The following table summarizes our minimum contractual obligations and commercial commitments as of December 31, 2006, and the effect we expect them to have on our liquidity and cash flow in future periods (in millions):

	Contractual Obligations			Commercial Commitments	
Fiscal Year Ending March 31,	Leases (1)	Developer/ Licensor Commitments (2)	Marketing	Letter of Credit, Bank and Other Guarantees	Total
2007 (remaining three months)	$ 19	$ 33	$ 7	$ 6	$ 65
2008	54	172	41	1	268
2009	53	191	31		275
2010	35	166	31		232
2011	25	269	31		325
Thereafter	66	724	185		975
Total	$ 252	$ 1,555	$ 326	$ 7	$ 2,140

(1) See discussion on operating leases in the Off-Balance Sheet Commitments section below for additional information.

(2) Developer/licensor commitments include $5 million of commitments to developers or licensors that have been recorded in current and long-term liabilities and a corresponding amount in current and long-term assets in our Condensed Consolidated Balance Sheets as of December 31, 2006 because payment is not contingent upon performance by the developer or licensor.

Lease commitments include contractual rental commitments of $20 million under real estate leases for unutilized office space resulting from our restructuring activities. These amounts, net of estimated future sub-lease income, were expensed in the periods of the related restructuring and are included in our accrued and other current liabilities reported on our Condensed Consolidated Balance Sheets as of December 31, 2006. See Note 6 of the Notes to Condensed Consolidated Financial Statements.

Related Party Transaction

On June 24, 2002, we hired Warren C. Jenson as our Executive Vice President, Chief Financial and Administrative Officer and agreed to loan him $4 million to be forgiven over four years based on his continuing employment. The loan did not bear interest. On June 24, 2004, pursuant to the terms of the loan agreement, we forgave $2 million of the loan and provided Mr. Jenson approximately $1.6 million to offset the tax implications of the forgiveness. On June 24, 2006, pursuant to the terms of the loan agreement, we forgave the remaining outstanding loan balance of $2 million. No additional funds were provided to offset the tax implications of the forgiveness of the $2 million balance.

Table of Contents

OFF-BALANCE SHEET COMMITMENTS

Lease Commitments and Residual Value Guarantees

We lease certain of our current facilities and equipment under non-cancelable operating lease agreements. We are required to pay property taxes, insurance and normal maintenance costs for certain of these facilities and will be required to pay any increases over the base year of these expenses on the remainder of our facilities.

In February 1995, we entered into a build-to-suit lease (Phase One Lease) with a third-party lessor for our headquarters facilities in Redwood City, California (Phase One Facilities). The Phase One Facilities comprise a total of approximately 350,000 square feet and provide space for sales, marketing, administration and research and development functions. In July 2001, the lessor refinanced the Phase One Lease with Keybank National Association through July 2006. The Phase One Lease expires in January 2039, subject to early termination in the event the underlying financing between the lessor and its lenders is not extended. Subject to certain terms and conditions, upon termination of the lease, we may purchase the Phase One Facilities or arrange for the sale of the Phase One Facilities to a third party.

Pursuant to the terms of the Phase One Lease, we have an option to purchase the Phase One Facilities at any time for a purchase price of $132 million. In the event of a sale to a third party, if the sale price is less than $132 million, we will be obligated to reimburse the difference between the actual sale price and $132 million, up to maximum of $117 million, subject to certain provisions of the Phase One Lease, as amended.

On May 26, 2006, the lessor extended its loan financing underlying the Phase One Lease with its lenders through July 2007. We may request, on behalf of the lessor and subject to lender approval, up to two one-year extensions of the loan financing between the lessor and the lender. In the event the lessor s loan financing with the lenders is not extended, we may loan to the lessor approximately 90 percent of the financing, and require the lessor to extend the remainder through July 2009; otherwise the lease will terminate. We account for the Phase One Lease arrangement as an operating lease in accordance with SFAS No. 13, *Accounting for Leases* , as amended.

In December 2000, we entered into a second build-to-suit lease (Phase Two Lease) with Keybank National Association for a five and one-half year term beginning in December 2000 to expand our Redwood City, California headquarters facilities and develop adjacent property (Phase Two Facilities). Construction of the Phase Two Facilities was completed in June 2002. The Phase Two Facilities comprise a total of approximately 310,000 square feet and provide space for sales, marketing, administration and research and development functions. Subject to certain terms and conditions, upon termination of the lease, we may purchase the Phase Two Facilities or arrange for the sale of the Phase Two Facilities to a third party.

Pursuant to the terms of the Phase Two Lease, we have an option to purchase the Phase Two Facilities at any time for a purchase price of $115 million. In the event of a sale to a third party, if the sale price is less than $115 million, we will be obligated to reimburse the difference between the actual sale price and $115 million, up to a maximum of $105 million, subject to certain provisions of the Phase Two Lease, as amended.

On May 26, 2006, the lessor extended the Phase Two Lease through July 2009 subject to early termination in the event the underlying loan financing between the lessor and its lenders is not extended. Concurrently with the extension of the lease, the lessor extended the loan financing underlying the Phase Two Lease with its lenders through July 2007. We may request, on behalf of the lessor and subject to lender approval, up to two one-year extensions of the loan financing between the lessor and the lender. In the event the lessor s loan financing with the lenders is not extended, we may loan to the lessor approximately 90 percent of the financing, and require the lessor to extend the remainder through July 2009, otherwise the lease will terminate. We account for the Phase Two Lease arrangement as an operating lease in accordance with SFAS No. 13, as amended.

We believe that, as of December 31, 2006, the estimated fair values of both properties under these operating leases exceeded their respective guaranteed residual values.

The two lease agreements with Keybank National Association described above require us to maintain certain financial covenants as shown below, all of which we were in compliance with as of December 31, 2006.

Financial Covenants		Requirement		Actual as of December 31, 2006
Consolidated Net Worth (in millions)		equal to or greater than	$2,430	$3,878
Fixed Charge Coverage Ratio		equal to or greater than	3.00	5.28
Total Consolidated Debt to Capital		equal to or less than	60%	6.0%
Quick Ratio	Q1 & Q2	equal to or greater than	1.00	N/A
Q3 & Q4		equal to or greater than	1.75	9.19

Legal Proceedings

On September 14, 2006, we received an informal inquiry from the Securities and Exchange Commission requesting certain documents and information relating to our stock option grant practices from January 1, 1997 to the present. We have cooperated to date with all matters related to this request.

We are also subject to claims and litigation arising in the ordinary course of business. We believe that any liability from any reasonably foreseeable disposition of such claims and litigation, individually or in the aggregate, would not have a material adverse effect on our consolidated financial position or results of operations.

Director Indemnity Agreements

We entered into indemnification agreements with the members of our Board of Directors at the time they joined the Board to indemnify them to the extent permitted by law against any and all liabilities, costs, expenses, amounts paid in settlement and damages incurred by the directors as a result of any lawsuit, or any judicial, administrative or investigative proceeding in which the directors are sued or charged as a result of their service as members of our Board of Directors.

Table of Contents

Item 3. Quantitative and Qualitative Disclosures About Market Risk

MARKET RISK

We are exposed to various market risks, including changes in foreign currency exchange rates, interest rates, and market prices. Market risk is the potential loss arising from changes in market rates and market prices. We employ established policies and practices to manage these risks. Foreign exchange option and forward contracts are used to hedge anticipated or mitigate some existing exposures subject to foreign exchange risk as discussed below. We have not historically, nor do we currently, hedge our short-term investment portfolio. We do not consider our cash and cash equivalents to be exposed to significant interest rate risk because our cash and cash equivalent portfolio consists of highly liquid investments with original maturities of three months or less. We also do not currently hedge our market price risk relating to our equity investments. We do not enter into derivatives or other financial instruments for trading or speculative purposes.

Foreign Currency Exchange Rate Risk

From time to time, we hedge a portion of our foreign currency risk related to forecasted foreign-currency-denominated sales and expense transactions by purchasing option contracts that generally have maturities of 15 months or less. These transactions are designated and qualify as cash flow hedges. The derivative assets associated with our hedging activities are recorded at fair value in other current assets in our Condensed Consolidated Balance Sheets. The effective portion of gains or losses resulting from changes in fair value of these hedges is initially reported, net of tax, as a component of accumulated other comprehensive income in stockholders equity and subsequently reclassified into net revenue or operating expenses, as appropriate in the period when the forecasted transaction is recorded. The ineffective portion of gains or losses resulting from changes in fair value, if any, is reported in each period in interest and other income, net, in our Condensed Consolidated Statements of Operations. Our hedging programs reduce, but do not entirely eliminate, the impact of currency exchange rate movements in revenue and operating expenses. As of December 31, 2006, we had foreign currency option contracts outstanding with a total fair value of $1 million included in other current assets.

We utilize foreign exchange forward contracts to mitigate foreign currency risk associated with foreign-currency-denominated assets and liabilities, primarily intercompany receivables and payables. The forward contracts generally have a contractual term of approximately one month and are transacted near month-end. Therefore, the fair value of the forward contracts generally is not significant at each month-end. Our foreign exchange forward contracts are not designated as hedging instruments under SFAS No. 133 and are accounted for as derivatives whereby the fair value of the contracts are reported as other current assets or other current liabilities in our Condensed Consolidated Balance Sheets, and gains and losses from changes in fair value are reported in interest and other income, net. The gains and losses on these forward contracts generally offset the gains and losses on the underlying foreign-currency-denominated assets and liabilities, which are also reported in interest and other income, net, in our Condensed Consolidated Statements of Operations.

As of December 31, 2006, we had forward foreign exchange contracts to purchase and sell approximately $425 million in foreign currencies. Of this amount, $403 million represented contracts to sell foreign currencies in exchange for U.S. dollars, $4 million to sell foreign currencies in exchange for British pound sterling and $18 million to purchase foreign currency in exchange for U.S. dollars. The fair value of our forward contracts was immaterial as of December 31, 2006.

The counterparties to these forward and option contracts are creditworthy multinational commercial banks. The risks of counterparty nonperformance associated with these contracts are not considered to be material.

Notwithstanding our efforts to mitigate some foreign currency exchange rate risks, there can be no assurances that our hedging activities will adequately protect us against the risks associated with foreign currency fluctuations. As of December 31, 2006, a hypothetical adverse foreign currency exchange rate movement of 10 percent or 15 percent would result in potential loss in fair value of our option contracts of $1 million in both scenarios. A hypothetical adverse foreign currency exchange rate movement of 10 percent or 15 percent would result in potential losses on our forward contracts of $42 million and $63 million, respectively, as of December 31, 2006. This sensitivity analysis assumes a parallel adverse shift in foreign currency exchange rates, which do not always move in the same direction. Actual results may differ materially.

56

Interest Rate Risk

Our exposure to market risk from changes in interest rates relates primarily to our short-term investment portfolio. We manage our interest rate risk by maintaining an investment portfolio generally consisting of debt instruments of high credit quality and relatively short maturities. Additionally, the contractual terms of the securities do not permit the issuer to call, prepay or otherwise settle the securities at prices less than the stated par value of the securities. Our investments are held for purposes other than trading. Also, we do not use derivative financial instruments in our short-term investment portfolio.

As of December 31, 2006 and March 31, 2006, our short-term investments were classified as available-for-sale and, consequently, recorded at fair market value with unrealized gains or losses resulting from changes in fair value reported as a separate component of accumulated other comprehensive income, net of any tax effects, in stockholders equity. Our portfolio of short-term investments consisted of the following investment categories, summarized by fair value as of December 31, 2006 and March 31, 2006 (in millions):

	As of December 31, 2006	As of March 31, 2006
Commercial paper	$ 518	$ 25
U.S. agency securities	260	575
Corporate bonds	245	178
U.S. Treasury securities	98	212
Asset-backed securities	91	40
Total short-term investments	$ 1,212	$ 1,030

Notwithstanding our efforts to manage interest rate risks, there can be no assurance that we will be adequately protected against risks associated with interest rate fluctuations. At any time, a sharp change in interest rates could have a significant impact on the fair value of our investment portfolio. The following table presents the hypothetical changes in fair value in our short-term investment portfolio as of December 31, 2006, arising from potential changes in interest rates. The modeling technique estimates the change in fair value from immediate hypothetical parallel shifts in the yield curve of plus or minus 50 basis points (BPS), 100 BPS, and 150 BPS.

(In millions)	Valuation of Securities Given an Interest Rate Decrease of X Basis Points			Fair Value as of December 31,	Valuation of Securities Given an Interest Rate Increase of X Basis Points		
	(150 BPS)	(100 BPS)	(50 BPS)	2006	50 BPS	100 BPS	150 BPS
Commercial paper	$ 521	$ 520	$ 519	$ 518	$ 518	$ 517	$ 516
U.S. agency securities	267	264	262	260	257	255	253
Corporate bonds	250	248	246	245	243	241	239
U.S. Treasury securities	102	101	99	98	97	96	95
Asset-backed securities	93	92	92	91	91	90	89
Total short-term investments	$ 1,233	$ 1,225	$ 1,218	$ 1,212	$ 1,206	$ 1,199	$ 1,192