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ABOUT OUR BUSINESS

We are a developer, publisher and distributor of interactive entertainment software for the leading hardware platforms in the home video game market. We currently publish titles for Sony's PlayStation and PlayStation 2, Nintendo 64, Nintendo Game Boy Color, and personal computers ("PCs") in most interactive software genres, including childrens, action, adventure, driving, fighting, puzzle, role playing, simulation, sports and strategy. Our customers include Wal-Mart, Toys "R" Us, Electronics Boutique, Target, Kmart Stores, Babbages Etc., Best Buy, Kay Bee Toys, other national and regional retailers, discount store chains and specialty retailers.

Our games are based on intellectual property licensed from third parties or created internally. We continually seek to identify and develop titles based upon entertainment projects (such as movies and television programs), sports and entertainment personalities, popular sports and trends or concepts that have high public visibility or recognition or that reflect the trends of popular culture. Our games are developed both internally and under contract with independent developers. Other than games that we release on CD-ROM for use on PCs, all of our products consist of cartridges, CD-ROMs and DVDs manufactured for us by Nintendo and Sony.

In the year ended December 31, 2000, our net sales increased to $347.0 million from $303.5 million in 1999, $216.7 million in 1998 and $90.2 million in 1997. During the year ended December 31, 2000, our net income was $18.2 million, as compared to our 1999 net income of $31.3 million. This change in net income reflects the impact of a platform transition year and an increase in development and overhead costs as we prepare for the next generation of console systems.

We are a Delaware corporation that was incorporated in 1997. We were formerly incorporated in New York in 1989 under the name Trinity Acquisition Corporation, which changed its name in 1990 to T.HQ, Inc. through a merger with T.HQ, Inc., a California corporation. Our principal executive offices are located at 27001 Agoura Road, Calabasas Hills, California 91301, and our telephone number is (818) 871-5000. Our web site is at www.thq.com.

THE INTERACTIVE ENTERTAINMENT INDUSTRY AND TECHNOLOGY

The home interactive game market consists both of (i) cartridge-based, CD-ROM-based and DVD-ROM based software for use solely on dedicated hardware systems, and (ii) software distributed on CD-ROMs for use on PCs. Until 1996, most software for dedicated platforms was sold in cartridge form. Since then, CD-ROMs and DVD-ROMs have become increasingly popular because they have substantially greater data storage capacity and lower manufacturing costs than cartridges.

The first modern platform was introduced by Nintendo in 1985 using "8-bit" technology. "Eight-bit" means that the central processing unit, or "chip," on which the software operates is capable of processing data in 8-bit units. Subsequent advances in technology have resulted in continuous increases in the processing power of the chips that power both the platforms and PCs. As the technology of the hardware has advanced, the software designed for the platforms has similarly advanced, with faster and more complex images, more lifelike animation and sound effects and more intricate scenarios. The larger data storage capacity of DVD-ROMs and other disk media for systems such as the Sony PlayStation 2 and the yet to be released Microsoft Xbox and the Nintendo Gamecube enables them to provide richer content and longer play. This new generation of systems is based primarily on 128-bit technology, however, the 32-bit and 64-bit technology platforms are still providing markets for software.

The following table sets forth the year in which each of the manufacturers' platforms, for which we have published titles and technology, released in the United States:

Manufacturer	Product Name	Date of U.S. Introduction	Technology
Nintendo	NES	1985	8-bit
Nintendo	Game Boy	1989	8-bit (portable)
Sega	Game Gear	1991	8-bit (portable)
Sega	Genesis	1989	16-bit
Nintendo	SNES	1991	16-bit
Sega	Saturn	1995	32-bit
Sony	PlayStation	1995	32-bit
Nintendo	Nintendo 64	1996	64-bit
Nintendo	Game Boy Color	1998	16-bit (portable)
Sega	Dreamcast	1999	128-bit
Sony	PlayStation 2	2000	128-bit

Sony launched the successor to the PlayStation, the PlayStation 2, in the U.S. market in October 2000. Nintendo has plans to launch the handheld Game Boy Advance platform in the summer of 2001, as well as another new console platform in the fall of 2001 called the Gamecube. Microsoft has also announced a new platform, Xbox, scheduled to debut in the fall of 2001. We have indicated that we will publish for these new platforms. Software for the new platforms requires different standards of design and technology to fully exploit their capabilities. The introduction of new platforms also requires that game developers devote substantial additional resources to product design and development.

MARKETING AND SALES

We are dependent on the popularity of our games based on licensed properties and positive awareness of our original game concepts to attract customers and to obtain shelf space in stores. Our domestic sales activities are directed by our Executive Vice President - North American Publishing, who maintains contact with major retail accounts and manages the activities of our independent sales staff and regional sales representatives.

United States and Canadian Sales. Our games are promoted to retailers by display at trade shows such as the annual Electronic Entertainment Expo (E3). We also conduct print and cooperative retail advertising campaigns for most titles and prepare promotional materials, including product videos, to increase awareness among retailers and consumers.

Our marketing efforts for products released in 2000 included national television, print, radio and Internet advertising and promotional campaigns. Products shipped in 2000 that received television support included *WWF SmackDown!, Power Rangers Lightspeed Rescue, Evil Dead: Hail to the King, Summoner, Rugrats in Paris, MTV Sports: Skateboarding featuring Andy Macdonald, MTV Sports: Pure Ride, WWF SmackDown! 2* and *WWF No Mercy*. Our games were supported by promotions such as trailers, demo discs, over-sized boxes, standees, posters, and pre-sell giveaways at retail; game kiosks at sporting and outdoor events; rebates and contests with national packaged goods companies and fast food restaurants and co-marketing efforts with the hardware manufacturers. Product public relations for 2000 included cover, feature, preview, review and round-up coverage in broadcast, print and online media targeting enthusiast, lifestyle and major mainstream outlets. Additionally, we increased our corporate public relation efforts, establishing relationships with the leading technology and business reporters.

Some of our titles make up a substantial portion of our gross sales. The following includes games that generated more than 10% of our gross sales over the last three years. In 1998, sales for *WCW/NWO Revenge* for the Nintendo 64, *WCW Nitro* for the Sony PlayStation and *WCW vs. NWO* for the Nintendo 64 were 33.7%, 14.0% and 16.2%, of gross sales, respectively. In 1999, sales for *WCW/NWO Thunder* for the Sony PlayStation, *WWF Wrestlemania* for the Nintendo 64 and *Rugrats: Search for Reptar* for the Sony PlayStation were 12.7%, 12.9% and 11.5%, of gross sales, respectively. In 2000, sales for *WWF SmackDown!* on the Sony PlayStation, *WWF SmackDown! 2* also on the Sony PlayStation and *WWF No Mercy* for the Nintendo 64 were 16.9%, 16.0% and 15.5%, of gross sales, respectively.

Foreign Sales. In 2000, we expanded our direct-to-retail operations to include France and Australia. In December 1998, we acquired Rushware (the name was subsequently changed to THQ Entertainment GmbH), a German company that now serves as our distributor and publisher in Germany and other German-speaking countries. When added to our growing operations in the United Kingdom, these activities have increased our proportion of foreign sales. Additionally, we believe that direct-to-retail operations enable us to realize higher margins on our products distributed in these territories than if such products were to continue to be distributed by third parties.

Other Foreign Sales. We distribute our titles in all viable international markets. Other European territories such as Italy, Spain, Asia, Latin America and others are handled by our international offices through strategic distribution relationships whereby we primarily supply finished goods as well as marketing support. While the majority of our sales occur in the territories where we have direct relationships, we can supply a given title in up to sixty countries worldwide.

Revenue Fluctuations and Seasonality. We have experienced, and may continue to experience, significant quarterly fluctuations in net sales and operating results due to a variety of factors. The software market is highly seasonal with sales typically significantly higher during the fourth quarter (due primarily to the increased demand for interactive games during the year-end holiday buying season). Other factors that cause fluctuations include the timing of our release of new titles, the popularity of both new titles and titles released in prior periods, changes in the mix of titles with varying profit margins, the timing of customer orders, the timing of shipments by the manufacturers, fluctuations in the size and rate of growth of consumer demand for software for various platforms, the timing of the introduction of new platforms and the accuracy of retailers' forecasts of consumer demand.

GEOGRAPHIC INFORMATION

We operate in one reportable segment in which we are a developer, publisher and distributor of interactive entertainment software for the leading hardware platforms in the home video game market. The following information sets forth geographic information on our sales for the years ended December 31, 1998, 1999 and 2000:

Sales to Unaffiliated Customers

	For Year Ended		
(In thousands)	1998	1999	2000
United States	$187,583	$228,827	$270,116
United Kingdom	23,881	41,404	44,638
Germany	5,252	33,252	20,442
France	—	—	7,979
Australia	—	—	3,828
Consolidated	$216,716	$303,483	$347,003

The following table presents certain selected consolidated financial data for the years 1996 through 2000. The information presented as of December 31, 1999 and 2000 and for each of the years ended December 31, 1998, 1999 and 2000 have been derived from, and are qualified by reference to, our audited consolidated financial statements included elsewhere herein. Those financial statements have been audited by Deloitte & Touche LLP, independent auditors. The information presented for each of the years ended December 31, 1996 and 1997 were derived from audited financial statements that are not included elsewhere herein.

This selected consolidated financial data should be read in conjunction with "Management's Discussion and Analysis of Financial Condition and Results of Operations" and the Consolidated Financial Statements and Notes thereto included elsewhere herein.

	Years Ended December 31,				
(In thousands, except per share data)	1996	1997	1998	1999	2000
Statement of Operations Data					
Net sales	$50,255	$90,227	$216,716	$303,483	$347,003
Costs and expenses:					
Cost of sales	29,301	48,127	100,019	134,563	140,699
Royalties and project abandonment	8,587	14,763	48,130	48,370	77,550
Product development	1,510	2,930	8,925	15,511	19,151
Selling and marketing	4,444	8,733	20,326	35,440	42,446
Payment to venture partner	—	—	—	6,119	17,707
General and administrative	4,378	5,605	10,107	14,970	19,530
In-process research and development	—	—	7,232	—	—
Total costs and expenses	48,220	80,158	194,739	254,973	317,083
Income from operations	2,035	10,069	21,977	48,510	29,920
Interest income (expense) — net	(315)	472	819	1,109	1,323
Income before income taxes	1,720	10,541	22,796	49,619	31,243
Income taxes	8	1,954	9,343	18,293	13,054
Net income	$ 1,712	$ 8,587	$ 13,453	$ 31,326	$ 18,189
Net income per share — basic	$ .15	$ .53	$ .75	$ 1.65	$ .91
Net income per share — diluted	$ .14	$ .50	$ .63	$ 1.48	$ .84
Shares used in per share calculation — basic	11,298	16,057	17,929	19,040	20,091
Shares used in per share calculation — diluted	12,000	17,179	21,229	21,197	21,568
Balance Sheet Data					
Working capital	$ 9,561	$31,614	$ 48,342	$ 91,860	$110,269
Total assets	$22,904	$56,545	$128,218	$184,057	$229,942
Lines of credit	$ 5,355	$ —	$ 9,909	$ 16,702	$ 15,473
Shareholders' equity	$10,959	$33,842	$ 62,065	$108,306	$132,125

Overview

We develop, publish and distribute interactive entertainment software for the major platforms sold by Nintendo and Sony and for use on PCs. The following table sets forth, for the periods indicated, the percentage of our revenues derived from sales of titles for the platforms indicated:

	Years Ended December 31,		
Platform	1998	1999	2000
Nintendo (excluding Game Boy)	55%	35%	29%
Nintendo Game Boy/Game Boy Color	8%	17%	20%
Sony PlayStation	31%	37%	41%
Sony PlayStation 2	—	—	3%
PC	5%	8%	3%
Other	1%	3%	4%

Our business cycle generally commences with the securing of a license to publish one or more titles based on a property or agreement with a proven developer to create a game based on original content. These licenses typically require an advance payment to the licensor and a guarantee of minimum future royalties. See "Recovery of Prepaid Royalties, Guarantees and Capitalized Development Costs." After obtaining the license, we begin software development for the title. Upon completion of development and approval of the title by the manufacturer, we order products and generally cause a letter of credit to be opened in favor of the manufacturer or obtain a line of credit from the manufacturer. Products are shipped at our expense to a public warehouse in California for domestic distribution or to warehouses in the United Kingdom, Germany, France or Australia for foreign distribution. We then sell directly to our major retail accounts both domestically and in the United Kingdom, Germany, France and Australia. Foreign sales to distributors in other territories are shipped directly to the customers' locations at their expense.

Unfilled sales orders are commonly referred to as "backlog." Since substantially all of our product orders are fulfilled shortly after we receive them, we do not believe that the amount of our unfilled sales orders as of the end of a period is a meaningful indicator of sales in future periods. Accordingly, we do not report the amount of our unfilled sales orders.

On May 24, 1999, December 13, 1999 and August 31, 2000, we completed acquisitions of Pacific Coast Power & Light Company, a California corporation ("PCP&L"), Genetic Anomalies, Inc., a Delaware corporation ("GA") and Volition, Inc., a Delaware corporation ("Volition"), respectively. The acquisitions have been accounted for as poolings of interests under Accounting Principles Board Opinion No. 16. Accordingly, all prior period consolidated financial statements presented have been restated to include the combined results of operations, financial position and cash flows as if PCP&L, GA and Volition had always been part of our company.

Revenue Fluctuations and Seasonality. We have experienced, and may continue to experience, significant quarterly fluctuations in net sales and operating results due to a variety of factors. The software market is highly seasonal with sales typically significantly higher during the fourth quarter (due primarily to the increased demand for interactive games during the year-end holiday buying season). Other factors that cause fluctuations include the timing of our release of new titles, the popularity of both new titles and titles released in prior periods, changes in the mix of titles with varying profit margins, the timing of customer orders, the timing of shipments by the manufacturers, fluctuations in the size and rate of growth of consumer demand for software for various platforms, the timing of the introduction of new platforms and the accuracy of retailers' forecasts of consumer demand. Our expenses are based, in part, on our expectations of future revenues and, as a result, operating results would be disproportionately and adversely affected by a decrease in sales or a failure by us to meet our sales expectations. There can be no assurance that we can maintain consistent profitability on a quarterly or annual basis.

Profit margins may vary over time as a result of a variety of factors. Profit margins for cartridge products can vary based on the cost of the memory chip used for a particular title. As games have become more complex by providing richer playing capabilities, the trend in the interactive entertainment software industry has been to utilize chips with greater capacity and thus greater cost. CD-ROMs and DVD-ROMs have significantly lower per unit manufacturing costs than cartridge-based products, generally resulting in higher royalties for CD-ROM and DVD-ROM based products.

Recovery of Prepaid Royalties, Guarantees and Capitalized Development Costs. We typically enter into agreements with licensors of properties and external developers of titles that require advance payments and/or guaranteed minimum payments. All minimum guaranteed royalty payments are initially recorded as an asset (prepaid and deferred royalties) and as a liability (accrued royalties) at the contractual amount upon execution of the contract.

Software development costs are capitalized and recorded as Software development costs after the establishment of technological feasibility of the title. Prepaid and deferred royalties and Software development costs are expensed to Royalties and project abandonment expense at the higher of the contractual royalty rate based on actual net product sales or on the ratio of current units sold to total projected units sold.

We cannot guarantee that the sales of products for which such royalties are paid will be sufficient to cover the amount of these required royalty payments. We analyze these capitalized costs quarterly and write off associated prepaid and deferred royalties and software development costs when, based on our estimate, future revenues will not be sufficient to recover such amounts. As of December 31, 2000, we had prepaid royalties and capitalized development costs of $23.9 million. If we were required to write off prepaid royalties or capitalized development costs in excess of the amounts reserved, our results of operations could be materially and adversely affected.

Discounts, Allowances and Returns; Inventory Management. In general, except for PC titles, our arrangements with our distributors and retailers do not give them the right to return products to us (other than damaged or defective products) or to cancel firm orders. We sometimes negotiate accommodations to retailers (and, less often, to distributors), however when demand for specific games falls below expectations, in order to maintain our relationships with our customers. These accommodations include our not requiring that all booked orders be filled, negotiated price discounts and credits against future orders. We may also permit the return of products. Arrangements made with distributors and retailers for PC titles do customarily require us to accept product returns.

At the time of product shipment, we establish allowances based on estimates of future returns; customer accommodations and doubtful accounts with respect to such products. We base this amount on our historical experience, retailer inventories, the nature of the titles and other factors. For the years ended December 31, 1998, 1999 and 2000, we took provisions of approximately $20.8 million, $35.0 million and $35.4 million, respectively, against gross sales made during such periods. As of December 31, 2000, our aggregate reserve against accounts receivable for returns, customer accommodations and doubtful accounts was approximately $31.5 million.

The identification by us of slow-moving or obsolete inventory, whether as a result of requests from customers for accommodations or otherwise, would require us to establish reserves against such inventory or to write-down the value of such inventory to its estimated net realizable value.

In June 1998, the FASB issued Statement of Financial Accounting Standards ("SFAS") No. 133, "Accounting for Derivative Instruments and Hedging Activities." SFAS No. 133, as amended, establishes accounting and reporting standards for derivative instruments including certain derivative instruments embedded in other contracts and for hedging activities. Under SFAS No. 133, certain contracts that were not formerly considered derivatives may now meet the definition of a derivative. We will adopt SFAS No. 133 effective January 1, 2001. We have calculated the impact of adopting SFAS No. 133, and we believe that such adoption will not have any impact on our financial position; results of operations or cash flows.

In December 1999, the Securities and Exchange Commission issued Staff Accounting Bulletin No. 101, "Revenue Recognition in Financial Statements" ("SAB 101"), which provides additional guidance in applying generally accepted accounting principles to revenue recognition in the financial statements. We have implemented the provisions of SAB 101 and its impact on our revenue recognition policy is immaterial.

Euro Currency Conversion

On January 1, 1999, eleven of the fifteen member countries of the European Union adopted the Euro as their common legal currency. The Euro trades on currency exchanges and is available for non-cash transactions. From January 1, 1999 through January 1, 2002, participating countries can also maintain their national ("legacy") currencies as legal tender for goods and services. Beginning January 1, 2002, new Euro-denominated bills and coins will be issued, and legacy currencies will be withdrawn from circulation no later than July 1, 2002. Our operating subsidiaries in Germany and France have been affected by the Euro conversion and have established plans to address any business issues raised including the competitive impact of cross-border price transparency. It is not anticipated that there will be any near term business ramifications; however, the long-term implications, including any changes or modifications that will need to be made to business and financial strategies, are still being reviewed. From an accounting; treasury and computer system standpoint, the impact from the Euro currency conversion is not expected to have a material impact on the financial position or results of operations of THQ and our subsidiaries.

Results of Operations

Net income for the year ended December 31, 2000 was $18,189,000 ($0.84 per diluted share), as compared to net income of $31,326,000 ($1.48 per diluted share) for the same period in 1999. The 2000 results were negatively impacted by a non-cash charge, as discussed below, totaling $9.8 million before taxes and $5.9 million after taxes ($0.27 per diluted share).

Non-Cash Charge

In May 2000, as part of our regular impaired asset review and also as a result of changing technology in the video game market, we incurred a write-off of $9.8 million or $5.8 million after tax. The write-off consisted of costs associated with prepaid development and related costs for products that had been discontinued or whose values were deemed unrecoverable through future undiscounted cash flows. The following costs were recorded in the consolidated statement of operations in the second quarter of fiscal year 2000 and classified as follows:

Cost of sales	$ 572,000
Royalties and project abandonment	8,531,000
Product development	102,000
Selling and marketing	56,000
General and administrative	528,000
	$9,789,000

The component amount in Cost of sales is a write down of inventory to the lower of cost or market. The charge in Royalties and project abandonment relates directly to discontinued games or unrecoverable prepaid royalties. The charge in Product development and Selling and marketing consists of ancillary product and advertising costs while General and administrative contains an increase for Provision for doubtful accounts.

Net Sales

The following table sets forth, for the periods indicated, the components of our net sales and our consolidated operating data as a percentage of net sales:

	Years Ended December 31,		
	1998	1999	2000
Domestic sales	86.6%	75.4%	77.8%
Foreign sales	13.4	24.6	22.2
Net sales	100.0%	100.0%	100.0%
Costs and expenses:			
Cost of sales	46.2%	44.4%	40.6%
Royalties and project abandonment	22.2	15.9	22.4
Product development	4.1	5.1	5.5
Selling and marketing	9.4	11.7	12.2
Payment to venture partner	—	2.0	5.1
General and administrative	4.7	4.9	5.6
In-process research and development	3.3	—	—
Total costs and expenses	89.9%	84.0%	91.4%
Income from operations	10.1%	16.0%	8.6%
Interest income — net	0.4	0.4	0.4
Income before income taxes	10.5%	16.4%	9.0%
Net income	6.2%	10.3%	5.2%

Comparison of the Year Ended December 31, 2000 to the Year Ended December 31, 1999

The following table sets forth, for the years ended December 31, 2000 and 1999, the titles released during such periods for the platforms indicated:

	Years Ended December 31,	
	1999	2000
Nintendo 64	10	4
PC CD-ROM	11	6
PlayStation	10	12
PlayStation 2	—	1
Game Boy Color	11	19
Dreamcast	—	4
Total	42	46

Our net sales increased to $347,003,000 in the year ended December 31, 2000, from $303,483,000 in the same period of 1999, as a result of increased domestic sales, a larger number of products shipped, higher unit sales per title shipped and the market success of key titles. For the year ended December 31, 2000, net sales of our *World Wrestling Federation* titles, *Rugrats* titles and *Power Rangers* titles were $183,225,000 (52.8% of net sales), $46,907,000 (13.5% of net sales), and $18,765,000 (5.4% of net sales), respectively.

Our foreign net sales grew to $76,887,000 for the year ended December 31, 2000 from $74,656,000 in the same period of 1999. They decreased however, as a percentage of net sales to 22.2% from 24.6% primarily as a consequence of our increase in domestic sales. The increase in our foreign net sales in 2000 was attributable to the addition of our French and Australian subsidiaries that were partially offset by expected decreases in our German net sales and unit volumes for titles released on the Nintendo 64 and PlayStation platforms. Overall European revenues were negatively impacted by a devaluation of key foreign currencies compared to the same period last year.

Our cost of sales for the year ended December 31, 2000 decreased as a percentage of net sales to 40.6% from 44.4% in the same period of 1999. Our cost of sales decreased in 2000, because we sold a higher proportion of PlayStation; PlayStation 2 and Game Boy Color titles, all of which have higher gross margins than Nintendo 64 games.

Our royalty expense for the year ended December 31, 2000 increased as a percentage of net sales to 22.4% from 15.9% in the same period of 1999. The 2000 results reflect the non-cash charge (as discussed above) as well as a change in our product mix away from Nintendo 64 titles to other platforms that generally carry higher royalty rates. There was also a decline in 2000 of *LucasArts* Star Wars Episode One games, which carry no royalties, from 1999 when sales peaked due to the release of the movie by the same name.

Our product development expenses increased from $15,511,000 in 1999 to $19,151,000 in 2000. This increase reflects the increasing number of internally developed titles, the increase in the number of overall titles under development and the additional complexity and development time for “next generation” products.

Our selling and marketing expenses for the year ended December 31, 2000 remained relatively constant as a percentage of net sales at 12.2% compared to 11.7% for the same period in 1999 but increased in dollar terms by $7,006,000 over 1999. This increase is a result of several significant advertising and promotional campaigns to promote our *World Wrestling Federation; Rugrats; Power Rangers; Evil Dead, Summoner* and *MTV Sports* brands, as well as increased warehouse expenses.

We incur an expense for the payment of a preferred return to JAKKS Pacific Inc. on product sales and other income derived from the *World Wrestling Federation* license. For the year ended December 31, 2000, the amount incurred for such preferred return was $17,707,000. Because the license with the *World Wrestling Federation* was not effective until November 1999, there were no *World Wrestling Federation* product sales in the first ten months of 1999. For the year ended December 31, 1999, the amount incurred for such preferred return was $6,119,000.

Our general and administrative expenses for the year ended December 31, 2000 increased as a percentage of net sales to 5.6% compared to 4.9% for the same period of 1999 and increased in dollar terms by $4,560,000 over 1999. This increase is attributed to higher volumes, increased licensing efforts, and additional backoffice activities to support four new platform launches in 2000 and 2001.

For the year ended December 31, 2000, interest income increased by $214,000 compared to 1999 as a result of increased cash flows from operations and higher average investment balances during the period.

During the year ended December 31, 2000, we recorded a tax provision of $13,054,000, a decrease of $5,239,000 over 1999 primarily due to lower pre-tax net income. In addition, the 1999 effective tax rate was positively impacted by the reversal of a $2,461,000 valuation allowance related to prior years net operating losses.

Comparison of the Year Ended December 31, 1999 to the Year Ended December 31, 1998

The following table sets forth, for the years ended December 31, 1999 and 1998, the titles released during such periods for the platforms indicated:

	Years Ended December 31,	
	1998	1999
Nintendo 64	2	10
PC CD-ROM	5	11
PlayStation	8	10
SNES	1	—
Game Boy Color	5	11
Total	21	42

Our net sales increased to $303,483,000 in the year ended December 31, 1999 from $216,716,000 in the same period of 1998 as a result of increased foreign sales, a larger number of products shipped, and the market success of key titles. For the year ended December 31, 1999, net sales of our *Rugrats* titles; *WCW* titles and *World Wrestling Federation* titles were $84,204,000 (27.8% of net sales), $64,615,000 (21.3% of net sales) and $42,011,000 (13.8% of net sales), respectively.

Our foreign net sales grew to $74,656,000 for the year ended December 31, 1999 from $29,132,000 in the same period of 1998 and increased as a percentage of net sales to 24.6% from 13.4%. The increase in our foreign net sales in 1999 was attributable to the addition of our THQ Entertainment GmbH subsidiary formerly known as Rushware Microhandelsgesellschaft mbH (which added the LucasArts brand in Germany as well as European specific product) and the success of key titles such as wrestling and Rugrats in certain foreign markets.

Our cost of sales for the year ended December 31, 1999 decreased slightly as a percentage of net sales to 44.4% from 46.2% in the same period of 1998 primarily as a result of the increase in PlayStation and CD-ROM product sales which generally have more favorable gross margins than cartridge products.

Our royalty expense for the year ended December 31, 1999 decreased as a percentage of net sales to 15.9% from 22.2% in the same period in 1998. Sales in 1999 consisted of some in-house titles carrying minor or no royalties, *LucasArts* games in Europe which carry no royalties, and selected successful titles which had favorable royalty rates.

Our product development expenses increased from $8,925,000 in 1998 to $15,511,000 in 1999. This increase reflects the addition of three internal studios during the year and an increase in our corporate product development group to better manage our increased volume of titles in development.

For the year ended December 31, 1999, our selling and marketing expenses increased by $15,114,000 compared to the year ended December 31, 1998 as a result of several significant advertising and promotional campaigns to promote our *World Wrestling Federation* titles; *Rugrats; Championship Motocross* and *MTV Sports* brands as well as increased warehouse expenses; infrastructure and personnel costs (both domestic and foreign) incurred as a result of our growth in 1999.

For the year ended December 31, 1999, we incurred expenses in the amount of $6,119,000 to our venture partner, JAKKS Pacific Inc. Pursuant to the arrangement regarding the license with the World Wrestling Federation, THQ pays JAKKS Pacific Inc. a preferred return on product sales, and they also share in sublicense income derived from the license.

Our general and administrative expenses for the year ended December 31, 1999 remained relatively constant as a percentage of net sales at 4.9% compared to 4.7% for the same period of 1998 but increased in dollar terms by $4,863,000 over 1998. This increase can be attributed to the expansion of our corporate offices, amortization of a new sales and financial accounting software package and a full year of general and administrative expenses for THQ Entertainment.

The in-process research and development charge of $7,232,000 incurred during 1998 represents purchase costs relating to the acquisition of GameFx, Inc. ("GameFx"). Purchased research and development includes the value of products in the development stage and not considered to have reached technological feasibility. The technology purchased was completed in 1999 and did not result in a commercially successful product.

For the year ended December 31, 1999, interest income increased by $290,000 compared to 1998 as a result of increased cash flows from operations and higher average investment balances during the period.

During the year ended December 31, 1999, we recorded a tax provision of $18,293,000, an increase of $8,950,000 over 1998 primarily as a result of higher net income before taxes. The effective tax rate for 1999 was 36.9% compared to 41.0% in 1998. The 1998 effective tax rate was negatively impacted by the fact that the purchased in-process research and development costs of $7,232,000 were not deductible for tax purposes. The negative impact of the in-process research and development was offset by the partial reversal of the valuation reserve against deferred tax assets. The 1999 effective tax rate was positively impacted by the reversal of the remaining $2,461,000 valuation allowance.

Liquidity and Capital Resources

Our principal uses of cash are product purchases, guaranteed payments to licensors, advance payments to developers and the costs of internal software development. In order to purchase products from the manufacturers, we typically open letters of credit in their favor or obtain a line of credit from the manufacturer.

Our cash and cash equivalents increased to $27,998,000 at December 31, 2000 from $21,454,000 at December 31, 1999. Cash provided by operating activities for 2000 was $16,136,000. As of March 31, 2001, our cash and cash equivalents were $72,128,000.

Accounts receivable at December 31, 2000 increased from December 31, 1999 as a result of increased sales volume compared to the same period of 1999. Prepaid and deferred royalties and software development costs decreased from December 31, 1999 as we earned out royalties on a number of our major license agreements and also as a result of the non-cash charge (as discussed above). Accrued royalties decreased overall by $1,427,000. This is due primarily to payments made toward the minimum guarantee on the World Wrestling Federation license in the amount of $6,548,000 and partially off set by several new licensing contracts entered into in 2000. As of December 31, 2000, we had obligations with respect to future guaranteed minimum royalties of $11,013,000. Inventory increased during 2000 as the balances reflect the advanced purchases of product scheduled for release in January 2001 as well as the restocking of fourth quarter titles which will be shipped in the first quarter of 2001. Accounts payable and accrued expenses increased due to higher sales volumes and increased activity.

The amount of our accounts receivable is subject to significant seasonal variations as a consequence of the seasonality of our sales and is typically highest at the end of the year. As a result, our working capital requirements are greatest during our third and fourth quarters. We believe that our cash on hand, funds provided by operations, and our revolving credit facilities will be adequate to meet our anticipated requirements for operating expenses, product purchases, guaranteed payments to licensors and software development through 2001.

Income taxes payable increased from December 1999 due to timing differences that result between payment of estimated taxes.

The decrease in our lines of credit is attributable to the cash provided by operating activities in 2000.

Net cash used in investing activities was $2,129,000 and $12,947,000 at December 31, 1999 and 2000, respectively. In 1999, net cash used in investing activities consisted primarily of capital expenditures ($4,447,000) offset by a payment received ($2,540,000) from the seller of THQ Entertainment as part of the renegotiated purchase price of THQ Entertainment. Net cash used in investing activities for 2000 included our investment in Yuke's Co. Ltd., a Japanese corporation, ($5,020,000) and additional capital expenditures ($7,877,000), consisting primarily of the implementation of a new operational and financial system and the acquisition of next generation development tools. We expect to make capital expenditures of between $5,500,000 and $6,500,000 in 2001 as we continue to invest in our infrastructure and next generation development tools.

Net cash provided by financing activities was $12,081,000 and $3,076,000 at December 31, 1999 and 2000, respectively. In 1999, net cash provided by financing activities was primarily provided from the short-term borrowings and the exercise of options and warrants to purchase our common stock. In 2000, net cash provided by financing activities was provided from the exercise of options and warrants to purchase our common stock offset by a reduction in our short-term borrowings.

Credit Facilities. On August 31, 2000 we entered into a Revolving Credit with Union Bank of California and a syndicate of other financial institutions. This agreement expires on July 1, 2001 and permits us to borrow (and maintain obligations under outstanding letters of credit) up to an aggregate of $50,000,000 subject to the following:

We may maintain outstanding letters of credit for product purchases and outstanding borrowings in the aggregate for up to $40,000,000 for September 2000; $50,000,000 between October 1, 2000 and December 31, 2000; $40,000,000 in January 2001 and $25,000,000 between February 1, 2001 and June 30, 2001.

In addition, outstanding borrowings cannot exceed $15,000,000 in September 2000; $30,000,000 from October 1 through October 31, 2000; $50,000,000 from November 1, 2000 through December 31, 2000; $35,000,000 from January 1, 2001 through January 31, 2001 and $15,000,000 from February 1, 2001 to June 30, 2001.

We are also required to not have any outstanding borrowings for a period of at least 60 days during the term of the agreement.

This credit facility is secured by a lien on substantially all of our assets and contains customary financial and non-financial covenants which limit the ability for us to incur additional indebtedness, pay dividends or make distributions, sell assets and enter into certain mergers or acquisitions. Amounts outstanding under these credit facilities bear interest, at our choice, at either a) the bank's prime rate (9.5% at December 31, 2000) or b) the London Interbank Offered Rate (6.56% at December 31, 2000) plus 1.85%. As of December 31, 2000, we had approximately $5,341,000 in obligations with respect to outstanding letters of credit and $15,473,000 in outstanding borrowings.

Quantitative and Qualitative Disclosures About Market Risk

We are exposed to certain market risks arising from transactions in the normal course of business, principally risk associated with interest rate and foreign currency fluctuations.

Interest Rate Risk
Our interest rate risk is immaterial due to the short maturity of the debt. We have no fixed rate debt.

Foreign Currency Risk
We have not hedged our foreign currency exposure in the past. It is possible that in the future we will enter into foreign currency contracts in order to manage or reduce foreign currency market risk.

Our earnings are affected by fluctuations in the value of our subsidiaries' functional currency, as compared to the currencies of our foreign denominated sales and purchases, leaving us susceptible to changes in the dollar/Euro; dollar/British pound and dollar/German mark exchange rates. Therefore, the results of operations of our subsidiaries, as reported in U.S. dollars, may be significantly affected by fluctuations in the value of the local currencies in which we transact business. Such amount is recorded upon the translation of the foreign subsidiaries' financial statements into U.S. dollars and is dependent upon the various foreign exchange rates and the magnitude of the foreign subsidiaries' financial statements. As of December 31, 2000, our foreign currency translation loss adjustment was $1,715,000. Currency transaction gains and losses for the years ended December 31, 1998, 1999 and 2000 were not significant. A hypothetical 10% change in the relevant currency rates at December 31, 2000 would not have a material impact on our financial statements. In addition to the direct effects of changes in exchange rates, which are a changed dollar value of the resulting sales and related expenses, changes in exchange rates also may affect the volume of sales or the foreign currency sales price as competitors' products become more or less attractive.

MARKET FOR THE REGISTRANT'S COMMON EQUITY AND RELATED SHAREHOLDER MATTERS

The common stock is quoted on the NASDAQ National Market under the symbol "THQI." The following table sets forth, for the periods indicated, the high and low closing sales prices of our common stock as reported by the NASDAQ National Market:

	Closing Sales Prices	
	High	Low
2000		
First Quarter	29 8/16	17
Second Quarter	20	8 14/16
Third Quarter	26 12/16	12 1/16
Fourth Quarter	24 8/16	17 8/16
1999		
First Quarter	20 9/16	11 11/16
Second Quarter	19 3/16	13 7/16
Third Quarter	28 13/16	17 15/16
Fourth Quarter	38 4/16	22 7/16

The last reported price of the common stock on March 26, 2001, as reported by NASDAQ National Market, was $36.875 per share.

Holders

As of March 26, 2001, there were approximately 320 holders of record of the common stock.

Dividend Policy

We have never paid cash dividends on our capital stock. We currently intend to retain future earnings, if any, to finance the growth and development of our business and, therefore, we do not anticipate paying any cash dividends in the future. Our principal banking agreements provide that at such times as we have any outstanding borrowings or letters of credit under that facility, we will not pay any cash dividends.

INDEPENDENT AUDITORS' REPORT

To the Shareholders of THQ Inc.,
Calabasas, California

We have audited the accompanying consolidated balance sheets of THQ Inc. and subsidiaries (the "Company") as of December 31, 1999 and 2000, and the related consolidated statements of operations, shareholders' equity, and cash flows for each of the three years in the period ended December 31, 2000. These financial statements are the responsibility of the Company's management. Our responsibility is to express an opinion on these financial statements based on our audits.

We conducted our audits in accordance with auditing standards generally accepted in the United States of America. Those standards require that we plan and perform the audit to obtain reasonable assurance about whether the financial statements are free of material misstatement. An audit includes examining, on a test basis, evidence supporting the amounts and disclosures in the financial statements. An audit also includes assessing the accounting principles used and significant estimates made by management, as well as evaluating the overall financial statement presentation. We believe that our audits provide a reasonable basis for our opinion.

In our opinion, such consolidated financial statements present fairly, in all material respects, the financial position of the Company as of December 31, 1999 and 2000, and the results of its operations and its cash flows for each of the three years in the period ended December 31, 2000 in conformity with accounting principles generally accepted in the United States of America.

Deloitte & Touche LLP

DELOITTE & TOUCHE LLP

Los Angeles, California
February 16, 2001

CONSOLIDATED BALANCE SHEETS

	December 31, 1999	December 31, 2000
ASSETS		
Current assets:		
Cash and cash equivalents	$ 21,454,000	$ 27,998,000
Accounts receivable — net	97,014,000	135,048,000
Inventory	5,455,000	10,707,000
Prepaid and deferred royalties	21,891,000	8,756,000
Software development costs	11,640,000	11,818,000
Deferred income taxes	6,817,000	9,202,000
Income taxes receivable	965,000	—
Prepaid expenses and other current assets	2,225,000	4,557,000
Total current assets	167,461,000	208,086,000
Property and equipment — net	5,746,000	10,607,000
Deferred royalties — net of current portion	3,371,000	2,382,000
Software development costs — net of current portion	1,824,000	949,000
Deferred income taxes — net of current portion	2,865,000	581,000
Other long-term assets	2,790,000	7,337,000
Total assets	$184,057,000	$229,942,000
LIABILITIES AND SHAREHOLDERS' EQUITY		
Current liabilities:		
Lines of credit	$ 16,702,000	$ 15,473,000
Accounts payable	14,540,000	22,956,000
Accrued expenses	13,105,000	23,448,000
Accrued royalties	31,254,000	29,869,000
Income taxes payable	—	6,071,000
Total current liabilities	75,601,000	97,817,000
Accrued royalties — net of current portion	150,000	—
Commitments and contingencies	—	—
Shareholders' equity:		
Common Stock, par value $.01, 35,000,000 shares authorized; 19,897,234 and 20,460,538 shares issued and outstanding as of December 31, 1999 and 2000, respectively	199,000	205,000
Additional paid-in capital	79,250,000	85,747,000
Accumulated other comprehensive loss	(842,000)	(1,715,000)
Retained earnings	29,699,000	47,888,000
Total shareholders' equity	108,306,000	132,125,000
Total liabilities and shareholders' equity	$184,057,000	$229,942,000

See notes to consolidated financial statements.

CONSOLIDATED STATEMENTS OF OPERATIONS

	Years Ended December 31,		
	1998	1999	2000
Net sales	$216,716,000	$303,483,000	$347,003,000
Costs and expenses:			
Cost of sales	100,019,000	134,563,000	140,699,000
Royalties and project abandonment	48,130,000	48,370,000	77,550,000
Product development	8,925,000	15,511,000	19,151,000
Selling and marketing	20,326,000	35,440,000	42,446,000
Payment to venture partner	—	6,119,000	17,707,000
General and administrative	10,107,000	14,970,000	19,530,000
In-process research and development	7,232,000	—	—
Total costs and expenses	194,739,000	254,973,000	317,083,000
Income from operations	21,977,000	48,510,000	29,920,000
Interest income, net	819,000	1,109,000	1,323,000
Income before income taxes	22,796,000	49,619,000	31,243,000
Income taxes	9,343,000	18,293,000	13,054,000
Net income	$ 13,453,000	$ 31,326,000	$ 18,189,000
Net income per share — basic	$ .75	$ 1.65	$ .91
Net income per share — diluted	$ .63	$ 1.48	$ .84
Shares used in per share calculation — basic	17,929,000	19,040,000	20,091,000
Shares used in per share calculation — diluted	21,229,000	21,197,000	21,568,000

See notes to consolidated financial statements.

CONSOLIDATED STATEMENTS OF SHAREHOLDERS' EQUITY

	Years Ended December 31, 1998, 1999 and 2000					
	Common Shares	Common Stock	Additional Paid-in Capital	Accumulated Other Comprehensive Income (Loss)	Retained Earnings (Accumulated Deficit)	Total
Balance at January 1, 1998	17,083,366	$ 20,000	$48,821,000	$ 81,000	$(15,080,000)	$ 33,842,000
Exercise of warrants and options	902,519	5,000	2,345,000	—	—	2,350,000
Stock compensation	—	—	187,000	—	—	187,000
Issuance of common stock	782,706	4,000	10,647,000	—	—	10,651,000
Tax benefit related to the exercise of employee stock options	—	—	1,603,000	—	—	1,603,000
Reincorporation	—	100,000	(100,000)	—	—	—
Comprehensive income:						
Net income	—	—	—	—	13,453,000	13,453,000
Other comprehensive income						
Foreign currency translation adjustment	—	—	—	(21,000)	—	(21,000)
Comprehensive income	—	—	—	—	—	13,432,000
Balance at December 31, 1998	18,768,591	129,000	63,503,000	60,000	(1,627,000)	62,065,000
Exercise of warrants and options	1,128,643	8,000	4,955,000	—	—	4,963,000
Issuance of warrants	—	—	3,627,000	—	—	3,627,000
Stock compensation	—	—	464,000	—	—	464,000
Tax benefit related to the exercise of employee stock options	—	—	6,763,000	—	—	6,763,000
Three-for-two stock dividend	—	62,000	(62,000)	—	—	—
Comprehensive income:						
Net income	—	—	—	—	31,326,000	31,326,000
Other comprehensive income						
Foreign currency translation adjustment	—	—	—	(902,000)	—	(902,000)
Comprehensive income	—	—	—	—	—	30,424,000
Balance at December 31, 1999	19,897,234	199,000	79,250,000	(842,000)	29,699,000	108,306,000
Exercise of warrants and options	563,304	6,000	4,299,000	—	—	4,305,000
Stock compensation	—	—	406,000	—	—	406,000
Tax benefit related to the exercise of employee stock options	—	—	1,792,000	—	—	1,792,000
Comprehensive income:						
Net income	—	—	—	—	18,189,000	18,189,000
Other comprehensive income						
Foreign currency translation adjustment	—	—	—	(873,000)	—	(873,000)
Comprehensive income	—	—	—	—	—	17,316,000
Balance at December 31, 2000	20,460,538	$205,000	$85,747,000	$(1,715,000)	$ 47,888,000	$132,125,000

See notes to consolidated financial statements.

CONSOLIDATED STATEMENTS OF CASH FLOWS

	Years Ended December 31,		
	1998	1999	2000
Cash Flows from Operating Activities:			
Net income	$ 13,453,000	$ 31,326,000	$ 18,189,000
Adjustments to reconcile net income to net cash provided by (used in) operating activities:			
Depreciation and amortization	947,000	1,678,000	3,566,000
Provision for doubtful accounts, discounts and returns	20,838,000	35,009,000	35,387,000
Litigation settlement	—	564,000	—
Loss on disposal of property and equipment	40,000	63,000	114,000
Loss on sale of investment securities	218,000	—	—
Stock compensation	187,000	464,000	406,000
Tax benefit from disqualified disposition	1,603,000	6,763,000	1,792,000
In-process research and development	7,232,000	—	—
Deferred income taxes	(8,708,000)	692,000	(112,000)
Changes in operating assets and liabilities:			
Accounts receivable	(43,755,000)	(72,742,000)	(74,770,000)
Inventory	(13,780,000)	11,200,000	(5,442,000)
Prepaid and deferred royalties and software development costs	2,346,000	(24,269,000)	14,409,000
Prepaid expenses and other current assets	(239,000)	(670,000)	(2,374,000)
Accounts payable and accrued expenses	14,047,000	(3,086,000)	19,291,000
Accrued royalties	8,823,000	15,134,000	(1,427,000)
Income taxes payable (receivable)	4,437,000	(9,203,000)	7,107,000
Net cash provided by (used in) operating activities	7,689,000	(7,077,000)	16,136,000
Cash Flows Used in Investing Activities:			
Proceeds from sale of investment securities	863,000	—	—
Purchase of investment securities	(1,081,000)	—	—
Proceeds from sale of property and equipment	—	39,000	64,000
Acquisition adjustment	—	2,540,000	—
Acquisitions, net of cash acquired	(2,369,000)	—	—
Acquisition of property and equipment	(1,465,000)	(4,447,000)	(7,877,000)
Investment in Yuke's Co., Ltd.	—	—	(5,020,000)
Increase in other long-term assets	(2,010,000)	(261,000)	(114,000)
Net cash used in investing activities	(6,062,000)	(2,129,000)	(12,947,000)
Cash Flows Provided by Financing Activities:			
Net increase (decrease) in short-term borrowings	3,265,000	7,118,000	(1,229,000)
Proceeds from exercise of warrants and options	2,350,000	4,963,000	4,305,000
Net cash provided by financing activities	5,615,000	12,081,000	3,076,000
Effect of exchange rate changes on cash	(156,000)	(535,000)	279,000
Net increase in cash and cash equivalents	7,086,000	2,340,000	6,544,000
Cash and cash equivalents — beginning of period	12,028,000	19,114,000	21,454,000
Cash and cash equivalents — end of period	$ 19,114,000	$ 21,454,000	$ 27,998,000
Supplemental Disclosures of Cash Flow Information:			
Cash paid during the year for:			
Income taxes	$ 12,714,000	$ 19,569,000	$ 4,350,000
Interest	$ 196,000	$ 247,000	$ 354,000

Supplemental Schedule of Non-Cash Activities:

In 1999, we consolidated the venture with JAKKS Pacific Inc. resulting in the consolidation of our $2,010,000 investment.

On August 2, 1999, we issued to the World Wrestling Federation Entertainment (the "World Wrestling Federation") and a related party to the World Wrestling Federation, warrants, expiring December 31, 2009, to purchase 281,250 shares of common stock at $10.42 per share which had a fair value at the time of issuance of $3,063,000. (See Note 12).

On May 1, 1998, we issued 523,776 shares of common stock as part of the purchase price for GameFx. We also assumed the stock options issued by GameFx to its employees that, if and when exercised, permit the holders thereof to acquire approximately 22,275 shares of THQ stock. This issuance increased common stock and additional paid-in capital by $2,000 and $6,217,000, respectively, and was allocated among the net assets acquired, (part of which was written off as in-process research and development). (See Note 11).

On December 2, 1998, we issued 249,930 shares of common stock as part of the purchase price for Rushware Microhandelsgesellschaft mbH. The name was subsequently changed to THQ Entertainment Gmbh ("THQ Entertainment"). This issuance increased common stock and additional paid-in capital by $2,000 and $4,430,000, respectively, and was allocated among the net assets acquired. (See Note 11.)

Details of 1998 Acquisitions:

	GameFx, Inc.	THQ Entertainment
Fair value of assets acquired	$ 7,492,000	$ 18,581,000
Liabilities assumed	—	(12,567,000)
Value of common stock and stock options issued	(6,219,000)	(4,432,000)
Cash paid	1,273,000	1,582,000
Less cash acquired	—	(486,000)
Net cash paid for acquisitions	$ 1,273,000	$ 1,096,000

In 1999, we renegotiated the purchase of THQ Entertainment and received a payment of $2,540,000 from the sellers.

See notes to consolidated financial statements.

Note 1. Description of Business

Business. THQ Inc., a Delaware corporation, is a developer, publisher and distributor of interactive entertainment software for the leading hardware platforms in the home video game market. We currently publish titles for Sony's PlayStation and PlayStation 2, Nintendo 64, Nintendo Game Boy Color and personal computers ("PCs") in most interactive software genres including childrens, action, adventure, driving, fighting, puzzle, role playing, simulation, sports and strategy. Our customers include Wal-Mart, Toys "R" Us, Electronics Boutique, Target, Kmart Stores, Babbages Etc., Best Buy, Kay Bee Toys, and other national and regional retailers, discount store chains and specialty retailers.

Unless the context otherwise requires, references in this document to "THQ" or the "Company" include THQ Inc. and all of its wholly owned subsidiaries.

License Agreements. We have two license agreements with Sony pursuant to which we have the non-exclusive right to utilize the Sony name and its proprietary information and technology in order to develop and market software for use with the 32-bit Sony PlayStation in the United States and Canada, and Europe, respectively, which expire in August 2002 and December 2005, respectively. We also have a license agreement with Sony for use with the 128-bit Sony PlayStation 2 in the United States and Canada which expires in March 2003.

We have two license agreements with Nintendo pursuant to which we have the non-exclusive right to utilize the Nintendo name and its proprietary information and technology in order to develop and market software for use with the 64-bit Nintendo 64 in North America and Latin America, and Europe, Australia and New Zealand which expire in May 2003 and January 2004, respectively. We also have a license agreement with Nintendo for use with the Game Boy Color portable game console in North America and Latin America, and Europe, Australia and New Zealand which expire in March 2002 and October 2002, respectively.

Our business is dependent on these license agreements with Sony and Nintendo. Substantially all of our products are manufactured by Sony and Nintendo who charge us a fixed amount for each CD-ROM, DVD-ROM or cartridge manufactured. This charge includes a manufacturing, printing and packaging fee as well as a royalty for the use of their respective names, proprietary information and technology.

In addition, we must indemnify Sony and Nintendo as appropriate, with respect to all loss, liability and expense resulting from any claim against Sony and Nintendo involving the development, marketing, sale or use of our titles, including any claims for copyright or trademark infringement brought against Sony and Nintendo. As such, we bear the risk that the properties and information and technology licensed from Sony and Nintendo and incorporated in the software may infringe the rights of third parties. Generally, we are entitled to indemnification from our software developers and property licensors to cover our indemnification obligations to Sony and Nintendo but no assurance can be given that, if any claim is brought against us, the developers and/or licensors will have sufficient resources to indemnify us.

Note 2. Summary of Significant Accounting Policies

Principles of Consolidation. The consolidated financial statements include the accounts of THQ Inc. and our wholly owned subsidiaries. All material intercompany balances and transactions have been eliminated in consolidation.

Foreign Currency Translation. Assets and liabilities of foreign operations are translated at current rates of exchange while results of operations are translated at average rates in effect for the period. Translation gains or losses are shown as a separate component of shareholders' equity as Accumulated other comprehensive income (loss). Foreign currency gains and losses result from exchange rate changes for transactions denominated in currencies other than the functional currency. Foreign currency transaction gains and losses are not material.

Cash Equivalents. We consider all highly liquid investments purchased with maturities less than three months to be cash equivalents.

Fair Values of Financial Instruments. The carrying value of our draws on our line of credit from our banks are considered to approximate their fair value because the interest rate of these instruments is based on variable reference rates.

Concentrations of Credit Risk. Financial instruments which potentially subject us to concentration of credit risk consist principally of cash and cash equivalents and accounts receivable. We place cash and cash equivalents with high credit-quality institutions and limit the amount of credit exposure to any one institution. Most of our sales are made directly to mass merchandisers and national retailers. Due to the increased volume of sales to these channels, we have experienced an increased concentration of credit risk, and as a result, may maintain individually significant receivable balances with such mass merchandisers and national retailers. While we frequently monitor and manage this risk, financial difficulties on the part of one or more of our major customers may have a material adverse effect on us.

Sales (before returns and allowances) to a major customer represented 19%, 15% and 17% of gross sales in the years ended December 31, 1998, 1999 and 2000, respectively. This customer accounted for approximately 18% and 24% of accounts receivable at December 31, 1999 and 2000, respectively. Sales (before returns and allowances) to another major customer represented 13%, 11% and 16% of gross sales in the years ended December 31, 1998, 1999 and 2000, respectively. This customer accounted for approximately 15% and 20% of accounts receivable at December 31, 1999 and 2000, respectively. We perform ongoing credit evaluations of our customers and maintain an allowance for potential credit losses.

Inventory. Inventory, which consists principally of finished products, are stated at the lower of cost (moving weighted average) or market. We estimate the net realizable value of slow-moving inventory on a title by title basis, and charge the excess of cost over net realizable value to cost of sales.

Property and Equipment. Property and equipment are stated at cost. Depreciation is computed using the straight-line method over the estimated useful lives of the assets. Leasehold improvements are amortized over the shorter of their useful lives or the remaining lease term. Property and equipment consist of the following at:

		December 31	
	Lives	1999	2000
Computer equipment and software	3–10 yrs	$ 6,584,000	$12,534,000
Furniture, fixtures and equipment	5 yrs	1,739,000	2,293,000
Leasehold improvements	3–6 yrs	1,024,000	914,000
Less accumulated depreciation and amortization		(3,601,000)	(5,134,000)
		$ 5,746,000	$10,607,000

Royalties, Software Development Costs and Project Abandonment Loss. All minimum guaranteed royalty payments for the intellectual property licenses are initially recorded as an asset (prepaid and deferred royalties) and as a liability (accrued royalties) at the contractual amount upon execution of the contract. Royalty payments for intellectual property licenses are classified as current assets and current liabilities to the extent they relate to anticipated sales during the subsequent year and long-term assets and long-term liabilities if the sales are anticipated after one year.

We utilize both independent software developers and internal development teams to develop our software. We account for Software development costs in accordance with Statement of Financial Accounting Standards ("SFAS") No. 86, "Accounting for the Costs of Computer Software to be Sold, Leased, or Otherwise Marketed." Technological feasibility is evaluated on a product by product basis. Technological feasibility for console entertainment software has been established by Sony and Nintendo for use with their respective hardware platforms. We are currently capitalizing the costs of video games under development at our Heavy Iron, PCP&L and Volition studios. At December 31, 1999 and 2000, we had capitalized software development costs of $1,034,000 and $2,560,000, respectively, at our studios. During 1999 and 2000, we amortized to expense $54,000 and $1,674,000, respectively, of internally developed capitalized software development costs.

Prepaid and deferred royalties and Software development costs are expensed to Royalties and Project Abandonment expense at the higher of the contractual royalty rate based on actual net product sales or on the ratio of current units sold to total projected units sold. When, in management's estimate, future revenues will not be sufficient to recover previously capitalized advances or software development costs, we expense these items as project abandonment losses. Such abandonment losses are solely attributable to changes in market conditions or product quality considerations. Research and development costs are expensed to product development expense as incurred.

Impairment of Long-lived Assets. We evaluate long-lived assets for impairment whenever events or changes in circumstances indicate that the carrying value of an asset may not be recoverable. If the estimated future cash flows (undiscounted and without interest charges) from the use of an asset are less than the carrying value, a write-down would be recorded to reduce the related asset to its estimated fair value.

Goodwill. Goodwill represents the excess purchase price over net assets acquired and is being amortized on a straight-line basis over 10 years. We review goodwill for impairment whenever events or changes in circumstances indicate that an asset's carrying value may exceed the undiscounted expected future cash flows to be derived from that asset. Whenever undiscounted expected future cash flows are less than the carrying value, the asset will be reduced to an amount equal to the net present value of the expected future cash flows and an impairment loss will be recognized.

Revenue Recognition. Revenue is recognized when products are shipped provided that no significant vendor support obligations remain outstanding and that collection of the resulting receivable is deemed probable by management. Although we generally sell our products on a no-return basis, in certain circumstances we may allow returns, price concessions, or allowances on a negotiated basis. We estimate such returns and allowances based upon management's evaluation of our historical experience and current industry trends. Such estimates are deducted from gross sales. Software is sold under a limited 90-day warranty against defects in material and workmanship. To date, we have not experienced material warranty claims (See Note 5).

In December 1999, the Securities and Exchange Commission issued Staff Accounting Bulletin No. 101, "Revenue Recognition in Financial Statements" (SAB 101), which provides additional guidance in applying generally accepted accounting principles to revenue recognition in the financial statements. We have implemented the provisions of SAB 101 and its impact on our revenue recognition policy is immaterial.

Advertising. Advertising and sales promotion costs are generally expensed as incurred, except for television airtime and print media costs associated with media campaigns which are deferred and charged to expense as the airtime or advertising space is used. Advertising costs were $5,659,000, $10,108,000 and $27,147,000 in the years ended December 31, 1998, 1999 and 2000, respectively.

Stock-Based Compensation. We account for our employee stock plans under the intrinsic value method prescribed by Accounting Principles Board ("APB") Opinion No. 25, "Accounting for Stock Issued to Employees" and related interpretations.

Income Taxes. Deferred income taxes are provided for temporary differences between the financial statement and income tax bases of our assets and liabilities, based on enacted tax rates. A valuation allowance is provided when it is more likely than not that some portion or all of the deferred income tax assets will not be realized.

Basic and Diluted Earnings Per Share. The following table is a reconciliation of the weighted-average shares used in the computation of basic and diluted EPA for the years presented:

	Years Ended December 31,		
	1998	1999	2000
Net income used to compute basic and diluted earnings per share	$13,453,000	$31,326,000	$18,189,000
Weighted average number of shares outstanding — basic	17,929,000	19,040,000	20,091,000
Dilutive effect of stock options and warrants	3,300,000	2,157,000	1,477,000
Number of shares used to compute earnings per share — diluted	21,229,000	21,197,000	21,568,000

Recently Issued Accounting Pronouncements. In June 1998, the FASB issued Statement of Financial Accounting Standards ("SFAS") No. 133, "Accounting for Derivative Instruments and Hedging Activities." SFAS 133, as amended, establishes accounting and reporting standards for derivative instruments, including certain derivative instruments embedded in other contracts and for hedging activities. Under SFAS 133, certain contracts that were not formerly considered derivatives may now meet the definition of a derivative. We will adopt SFAS 133 effective January 1, 2001. We have evaluated the impact of adopting SFAS No. 133, and we believe that such adoption will not have any impact on our financial position, results of operations, or cash flows.

Pervasiveness of Estimates. The preparation of financial statements in conformity with accounting principles generally accepted in United States of America requires management to make estimates and assumptions that affect the reported amounts of assets and liabilities and disclosure of contingent assets and liabilities at the date of the financial statements and the reported amounts of revenues and expenses during the reporting period. Actual results could differ from those estimates. The most significant estimates relate to prepaid and deferred royalties, software development costs, accrued returns and allowances and the allowance for doubtful accounts.

Note 3. Business Combinations

On August 31, 2000, we completed the acquisition of Volition. In the acquisition, each share of Volition was converted into 0.10989011 share of our common stock, or approximately 890,000 shares. In addition, outstanding Volition employee stock options were assumed by us and converted, at the same conversion rate, into options to purchase approximately 110,000 shares of our common stock.

On December 13, 1999, we completed the acquisition of GA. In the acquisition, each share of GA was converted into 0.0536 share of our common stock, or approximately 220,000 shares. In addition, outstanding GA employee stock options were assumed by us and converted, at the same conversion rate, into options to purchase approximately 45,000 shares of our common stock.

On May 24, 1999, we completed the acquisition of PCP&L. In the acquisition, each share of PCP&L was converted into 0.09008 shares of our common stock, or approximately 727,000 shares. In addition, outstanding PCP&L employee stock options were assumed by us and converted, at the same conversion rate, into options to purchase approximately 196,000 shares of our common stock.

The acquisitions have been accounted for as poolings of interests under Accounting Principles Board Opinion No. 16. Accordingly, all prior period consolidated financial statements presented have been restated to include the combined results of operations, financial position and cash flows as if PCP&L, GA and Volition had always been part of our company.

All transactions between us, PCP&L, GA and Volition have been eliminated in the consolidated financial statements. The results of operations for the separate companies and the combined amounts presented in the consolidated financial statements are as follows:

	Years Ended December 31,		
	1998	1999	2000
Net Sales			
THQ Inc.	$215,060,000	$301,141,000	$346,951,000
PCP&L	1,379,000	1,676,000	**
GA	222,000	565,000	**
Volition	605,000	2,713,000	1,907,000
Intercompany elimination	(550,000)	(2,612,000)	(1,855,000)
Combined	$216,716,000	$303,483,000	$347,003,000
Net Income (loss)			
THQ Inc.	$ 15,990,000	$ 35,044,000	$ 22,329,000
PCP&L	(348,000)	(667,000)	**
GA	(473,000)	(411,000)	**
Volition	(1,166,000)	(28,000)	(2,285,000)
Intercompany elimination	(550,000)	(2,612,000)	(1,855,000)
Combined	$ 13,453,000	$ 31,326,000	$ 18,189,000

**For fiscal year ended December 31, 2000, the results of operations for PCP&L and GA were included with THQ Inc.

Note 4. Credit Facility

On August 31, 2000, we entered into a Revolving Credit Agreement with Union Bank of California and a syndicate of other financial institutions. This agreement expires on July 1, 2001 and permits us to borrow (and maintain obligations under outstanding letters of credit) up to an aggregate of $50,000,000 subject to the following:

We may maintain outstanding letters of credit for product purchases and outstanding borrowings in the aggregate for up to $40,000,000 for September 2000; $50,000,000 between October 1, 2000 and December 31, 2000; $40,000,000 for January 2001 and $25,000,000 between February 1, 2001 and June 30, 2001.

In addition, outstanding borrowings cannot exceed $15,000,000 for September 2000; $30,000,000 from October 1 through October 31, 2000; $50,000,000 from November 1, 2000 through December 31, 2000; $35,000,000 from January 1, 2001 through January 31, 2001 and $15,000,000 from February 1, 2001 to June 30, 2001.

We are also required to not have any outstanding borrowings for a period of at least 60 days during each year of the agreement.

This credit facility is secured by a lien on substantially all of our assets and contains customary financial and non-financial covenants which limit the ability for us to incur additional indebtedness, pay dividends or make other distributions, sell assets and enter into certain mergers or acquisitions. Amounts outstanding under these credit facilities bear interest, at our choice, at either a) the bank's prime rate (9.5% at December 31, 2000) or b) the London Interbank Offered Rate (6.56% at December 31, 2000) plus 1.85%. As of December 31, 2000 we had approximately $5,341,000 in obligations with respect to outstanding letters of credit and $15,473,000 in outstanding borrowings. Under the previous credit facility at December 31, 1999, we had approximately $8,134,000 in obligations with respect to outstanding letters of credit and $16,702,000 in outstanding borrowings.

Note 5. Accounts Receivable and Accrued Returns and Allowances

Accounts receivable is due primarily from domestic and foreign retailers and distributors, including mass merchants and specialty stores. Accounts receivable at December 31, 1999 and 2000 consists of the following:

	December 31,	
	1999	2000
Accounts receivable — domestic	$ 93,828,000	$137,865,000
Other receivables — domestic	1,469,000	531,000
Allowance for domestic returns and doubtful accounts	(16,845,000)	(21,676,000)
Accounts receivable — foreign	25,888,000	28,186,000
Allowance for foreign returns and doubtful accounts	(7,326,000)	(9,858,000)
Accounts receivable — net	$ 97,014,000	$135,048,000

The allowance for domestic accrued returns and allowances consists of the following:

	Years Ended December 31,		
	1998	1999	2000
Balance at January 1	$ (7,767,000)	$(15,008,000)	$(16,845,000)
Provision for discounts and returns	(18,870,000)	(28,072,000)	(27,390,000)
Actual discounts and returns	11,629,000	26,235,000	22,559,000
Ending balance	$(15,008,000)	$(16,845,000)	$(21,676,000)

The allowance for foreign accrued returns and allowances consists of the following:

	Years Ended December 31,		
	1998	1999	2000
Balance at January 1	$ (372,000)	$(3,890,000)	$(7,326,000)
THQ Entertainment purchase as of December 2, 1998	(3,717,000)	—	—
Provision for discounts and returns	(1,968,000)	(6,937,000)	(7,997,000)
Actual discounts and returns	2,167,000	3,501,000	5,465,000
Ending balance	$(3,890,000)	$(7,326,000)	$(9,858,000)

Note 6. Employee Pension Plan

We sponsor for our U.S. employees, a defined contribution plan under Section 401(k) of the Internal Revenue Code. The plan provides that employees may defer up to 12% of annual compensation, and that we will make a matching contribution equal to each employee's deferral, up to 4% of compensation. We may also contribute funds to the plan in the form of a profit-sharing contribution. Expenses under the plan were $400,000, $477,000, and $1,137,000 in 1998, 1999 and 2000, respectively.

Note 7. Income Taxes

Income before provision for income taxes consisted of:

	For Years Ended		
	1998	1999	2000
United States	$20,762,000	$45,776,000	$29,540,000
Foreign	2,034,000	3,843,000	1,703,000
	$22,796,000	$49,619,000	$31,243,000

The provision for income taxes consists of the following:

	1998	1999	2000
Current			
Federal	$14,655,000	$13,648,000	$ 9,048,000
State	3,275,000	2,897,000	3,395,000
Foreign	121,000	1,056,000	712,000
	18,051,000	17,601,000	13,155,000
Deferred			
Federal	(7,170,000)	121,000	209,000
State	(1,538,000)	755,000	(200,000)
Foreign	—	(184,000)	(110,000)
	(8,708,000)	692,000	(101,000)
Provision for income taxes	$ 9,343,000	$18,293,000	$13,054,000

A reconciliation of the provision for income taxes at the federal statutory rate to the provision recorded in the accompanying financial statements is as follows:

	1998	1999	2000
Federal provision at statutory rate	35.0%	35.0%	35.0%
State taxes (net of Federal benefit)	5.0	5.0	4.1
In-process research and development	10.0	—	—
Change in valuation allowance	(11.8)	(5.2)	—
Preacquisition loss from Volition, Inc.	2.0	1.2	2.5
Foreign taxes and other, net	0.8	0.9	0.2
	41.0%	36.9%	41.8%

	December 31, 1999			December 31, 2000		
	Federal	State	Foreign	Federal	State	Foreign
Current						
Deferred income tax assets:						
Allowance for doubtful accounts, discounts and returns	$ 5,896,000	$ 1,144,000	$184,000	$ 7,855,000	$ 1,347,000	$294,000
License abandonment	5,356,000	1,039,000	—	4,763,000	817,000	—
State income taxes	641,000	—	—	846,000	—	—
Net operating loss	821,000	57,000	—	905,000	—	—
Other — net	476,000	92,000	—	337,000	249,000	—
Total deferred income tax assets	$13,190,000	2,332,000	184,000	$14,706,000	2,413,000	294,000
Deferred income tax liabilities:						
Software development costs	(7,103,000)	$(1,378,000)	—	(6,601,000)	$(1,132,000)	—
State income taxes	(408,000)	—	—	(478,000)	—	—
Net current deferred income tax assets	$ 5,679,000	$ 954,000	$184,000	$ 7,627,000	$ 1,281,000	$294,000
Non-Current						
Deferred income tax assets:						
Deferred compensation	$ 133,000	$ 25,000	$ —	$ 175,000	$ 30,000	$ —
Net operating loss	2,420,000	168,000	—	—	—	—
Other — net	100,000	19,000	—	321,000	55,000	—
Net non-current deferred income tax assets	$ 2,653,000	$ 212,000	$ —	$ 496,000	$ 85,000	$ —

The valuation allowance decreased by $2,992,000 and $2,461,000 during 1998 and 1999, respectively.

As of December 31, 2000 we had federal net operating loss carryforwards of approximately $2,585,000 (expiring from 2009 to 2011).

At December 31, 2000 we had accumulated foreign earnings of $4,327,000. We do not plan to repatriate these earnings, therefore, no U.S. income tax has been provided on the foreign earnings. If such earnings were distributed, U.S. income taxes would be partially reduced for taxes paid to the jurisdictions in which the income was earned. Additionally, we have not tax effected the cumulative translation adjustment as we have no intention of repatriating foreign earnings.

Note 8. Stock Option Plan

We have two stock option plans (the "1990 Plan" and "1997 Plan"), that provide for the issuance of up to 1,462,500 and 4,125,000 shares, respectively, available for employees, consultants and non-employee directors. As of December 31, 2000, no options under the 1990 Plan and 380,542 options under the 1997 Plan were available for grant. Stock options granted under the option plans may be incentive stock options or nonstatutory stock options. Options may be granted under the option plans to, in the case of incentive stock options, all employees (including officers) of THQ; or, in the case of nonstatutory stock options, all employees (including officers), consultants and non-employee directors of THQ.

On June 8, 2000, the Board of Directors approved the THQ Inc. Non-executive Employee Stock Option Plan (the "NEEP Plan"). The NEEP Plan has primarily the same attributes as the 1990 Plan and the 1997 Plan, but participation is reserved for employees who are not executive officers and under the NEEP Plan only nonqualified options will be granted. The NEEP Plan provides for the issuance of up to 550,000 shares, of which no more than 20% is available for awards to our non-executive officers and no more than 15% is available for awards to the non-executive officers or general managers of our subsidiaries or divisions. As of December 31, 2000, 37,850 options were available for grant.

The exercise price per share of all options granted under the plans in 1998, 1999 and 2000 has been the closing market price of the stock on the date of the grant. Stock options issued by PCP&L and GA were issued at below market value. These options were accounted for under APB Opinion No. 25 and we have recognized compensation expense of $187,000, $464,000 and $406,000 for 1998, 1999 and 2000, respectively. Generally, options granted become exercisable over three years and expire within five years from the date of grant.

Stock Options	Weighted Average Exercise Price	Number of Shares
Balance at January 1, 1998	$ 3.46	1,744,087
Granted	$10.93	1,370,525
Exercised	$ 2.11	(553,416)
Canceled	$ 8.79	(78,937)
Balance at December 31, 1998	$ 7.72	2,482,259
Granted	$22.24	1,258,200
Exercised	$ 5.48	(882,119)
Canceled	$11.97	(282,416)
Balance at December 31, 1999	$15.11	2,575,924
Granted	$15.78	1,518,959
Exercised	$ 9.15	(251,665)
Canceled	$14.53	(429,915)
Balance at December 31, 2000	$15.92	3,413,303
Options exercisable at December 31, 2000	$13.47	1,217,779

Options granted and shares exercised relating to options granted outside of our stock option plans during 1998, 1999 and 2000 are listed below. Share exercise prices for these options equal the market price of our common stock at the date of the grant.

Stock Options	Weighted Average Exercise Price	Number of Shares
Balance at January 1, 1998	$ 1.61	848,116
Granted	$ 8.04	508,026
Exercised	$ 1.34	(236,250)
Balance at December 31, 1998	$ 7.72	1,119,892
Granted	$ 2.46	62,204
Exercised	$ 1.80	(199,450)
Canceled	$ 4.81	(26,072)
Balance at December 31, 1999	$15.11	956,574
Exercised	$ 1.95	(211,639)
Canceled	$ 0.69	(30,432)
Balance at December 31, 2000	$ 6.11	714,503
Options exercisable at December 31, 2000	$ 6.72	643,352

The following table summarizes information about stock options outstanding at December 31, 2000:

Range of Exercise Price	Number Outstanding at December 31, 2000	Weighted Average Remaining Contractual Life	Weighted Average Exercise Price
$ 0.23 – $ 9.83	1,251,749	4	$ 5.75
$10.00 – $12.36	825,551	4	$11.10
$12.38 – $18.75	1,078,851	4	$17.00
$19.13 – $26.17	833,955	4	$24.42
$26.17 – $28.54	137,700	4	$26.56
	4,127,806	4	$14.22

Range of Exercise Price	Shares Exercisable at December 31, 2000	Weighted Average Exercise Price
$ 0.23 – $ 9.83	992,728	$ 5.34
$10.00 – $12.36	330,074	$11.08
$12.38 – $18.75	213,804	$16.87
$19.13 – $26.17	263,625	$24.68
$26.17 – $28.54	60,900	$27.05
	1,861,131	$11.13

The estimated fair value of the options granted in 1998, 1999 and 2000 was $13,606,000, $15,443,000 and $12,700,000, respectively. We apply APB Opinion No. 25 and related Interpretations in accounting for stock option plans. Accordingly, no compensation cost for our stock option plans has been recognized in 1998, 1999 or 2000. Had compensation cost for our stock option plans been determined based on the fair value at the grant dates for awards under the plans consistent with SFAS No. 123, Accounting for Stock-Based Compensation, our net income and earnings per share for the years ended December 31, 1998, 1999 and 2000 would have been reduced to the pro forma amounts indicated below:

	For Years Ended December 31,		
	1998	1999	2000
Net income:			
As reported	$13,453,000	$31,326,000	$18,189,000
Pro forma	$ 9,870,000	$24,625,000	$ 8,371,000
Diluted net income per Share:			
As reported	$ .63	$ 1.48	$ .84
Pro forma	$ .47	$ 1.16	$ .39

The fair market value of options granted under the stock option plans during 1998, 1999 and 2000 was determined using the Black-Scholes option pricing model utilizing the following assumptions:

	For Years Ended December 31,		
	1998	1999	2000
Dividend yield	0%	0%	0%
Anticipated volatility	87%	70%	73%
Weighted average risk-free interest rate	5.15%	5.53%	6.12%
Expected lives	4 years	4 years	4 years

Note 9. Related Party Transactions

In 1998 and 1999, we paid Inland Productions, Inc., a software developer in which we acquired a 25% interest on July 1, 1996, $4,891,000 and $4,905,000, respectively. As of December 31, 1998 and 1999, we owed Inland Productions, Inc. $166,000 and $137,000, respectively. In 2000, Inland Productions, Inc., purchased the 25% interest we acquired in 1996 (See Note 11).

Note 10. Capital Stock Transactions

On August 31, 2000, we issued 890,110 shares of common stock as part of the purchase price for Volition. On December 13, 1999, we issued 220,048 shares of common stock in connection with the acquisition of GA. On May 24, 1999, we issued 727,436 shares of common stock as part of the purchase price for PCP&L (See Note 3).

In February 1999, in settlement of litigation, we issued warrants expiring March 19, 2000 to Millennium Partners to purchase 150,000 shares of common stock at $16.08 per share. The fair value of the warrants at issuance was $564,000.

During the years ended December 31, 1998, 1999 and 2000, the number of warrants to purchase our common stock exercised were 113,000, 64,000 and 100,000, respectively. We received proceeds from the exercise of such warrants totaling $827,000, $766,000 and $1,608,000, in the years ended December 31, 1998, 1999 and 2000, respectively. At December 31, 2000, outstanding warrants were 281,000 at an average exercise price of $10.42 with an expiration date of December 31, 2009.

In connection with obtaining the World Wrestling Federation license (See Note 12), in August 1999 we issued to the World Wrestling Federation and a related party to the World Wrestling Federation, warrants expiring December 31, 2009 to purchase 281,250 shares of common stock at $10.42 per share having a fair value of $3,063,000 at the time of issuance.

On July 23, 1998, and October 26, 1999, we announced three-for-two stock splits, effected in the form of 50% stock dividends, which were distributed on August 24, 1998, and December 1, 1999, respectively, to shareholders of record on August 20, 1998 and November 15, 1999, respectively. The accompanying consolidated financial statements have been adjusted to give effect to these stock splits for all periods presented.

On May 1, 1998, we issued 532,776 shares of common stock in connection with the acquisition of GameFx. In December 1998, we issued 249,930 shares of common stock as part of the purchase cost of THQ Entertainment (See Note 11).

Note 11. Other Long-Term Assets

On March 21, 2000, we acquired less than a 20% interest in a privately held Japanese developer Yuke's Co. Ltd. ("Yuke's"). This investment consisted of $5,020,000 in cash and is included in other long-term assets in the accompanying balance sheet. The agreement provides that for a certain time period, under separate development agreements, Yuke's will create exclusively for us wrestling games for the PlayStation and PlayStation 2 in North America and Europe. The value of Yuke's shares is not readily determinable and the investment is carried at cost because we do not exercise significant influence over financial or other operating policies.

In February 2000, Inland Productions, Inc., purchased the 25% interest we acquired on July 1, 1996. No material gain or loss was recognized as a result of this transaction. The equity in the operating results of Inland was not material to the results of operations for any period presented.

In December 1998, we acquired all of the outstanding shares of THQ Entertainment GmbH and its subsidiaries, Softgold Computerspiele GmbH and ABC Spielspass GmbH for consideration consisting of approximately $1,582,000 in cash and 249,930 shares of common stock with a fair value of $4,432,000 which was accounted for as a purchase. In 1999, we renegotiated the purchase of THQ Entertainment and received a payment of $2,540,000 from the sellers. Goodwill, which resulted from the purchase transaction, net of accumulated amortization, was $1,796,000 and $1,517,000 at December 31, 1999 and 2000, respectively. THQ Entertainment now serves as our distributor and publisher in Germany and other German-speaking countries.

On May 1, 1998, we acquired all of the outstanding shares of an applied technology company, GameFx, pursuant to a merger of GameFx with and into our newly formed, wholly owned subsidiary. The consideration paid by us consisted of (i) the issuance of 523,776 shares of common stock, (ii) the assumption of stock options issued by GameFx to its employees that, if and when exercised, permit the holders thereof to acquire approximately 22,275 shares and (iii) approximately $1,273,000 in cash. The total acquisition cost was approximately $7.5 million and was accounted for as a purchase. The purchase price was allocated to certain intangible assets acquired and to purchased in-process research and development ("R&D"). Purchased R&D included the value of products in the development stage and not considered to have reached technological feasibility. In accordance with applicable accounting rules, purchased in-process R&D is expensed. Accordingly, $7,232,000 of the acquisition cost was expensed in the second quarter of 1998.

Note 12. Agreement with JAKKS Pacific, Inc. and Titan Sports Inc.

We entered into an agreement with JAKKS Pacific, Inc. ("JAKKS"), to govern our relationship with respect to the World Wrestling Federation license we jointly obtained from Titan Sports, Inc. (now known as World Wrestling Federation Entertainment, Inc.) in June 1999. Our relationship with JAKKS was established to develop, manufacture, distribute, market and sell video games, as well as sublicense product pursuant to the license from the World Wrestling Federation. We control the venture, therefore, all transactions and balances are consolidated with the Company. The principal terms of this operating agreement are as follows:

1. We will be responsible for funding all operations of the venture, including all payments owing to the World Wrestling Federation.
2. For the period commencing November 16, 1999 and ending December 31, 2003, JAKKS will be entitled to receive a preferred payment equal to the greater of a fixed guaranty, payable quarterly, or specified percentages of the "net sales" from World Wrestling Federation licensed games (as defined) in amounts that vary based on the platform. The payment of these amounts is guaranteed by us. We are entitled to the profits and cash distributions remaining after the payment of these amounts. At December 31, 2000, we have exceeded the minimum guarantee for preferred payments.
3. For periods after December 31, 2003, the amount of the preferred payment will be subject to renegotiation between the parties. An arbitration procedure is specified in the event the parties do not reach agreement.
4. We will be responsible for the day-to-day operations of the venture. We will continue to be responsible for development, sales and distribution of the World Wrestling Federation licensed games, while JAKKS will continue to be responsible for the approval process and other relationship matters with the World Wrestling Federation. We will both continue to co-market the games.

The license agreement with the World Wrestling Federation extends through December 31, 2009, with an option for a five-year automatic extension if we pay them a specified minimum amount during the initial ten-year period of the agreement. As of December 31, 2000, we have essentially earned out the entire minimum guarantee specified in the license agreement.

Note 13. Stockholders Rights Plan

On June 20, 2000 the Board of Directors (the "Board") approved a Stockholders Rights Plan (the "Plan"). Pursuant to the Plan, on June 21, 2000 we made a dividend distribution of one preferred stock purchase right ("Right") for each outstanding share of Common Stock as of the close of business on July 3, 2000. Each Right entitles the holder to buy one one-hundredth (1/100) of a share of a new series of preferred stock at an exercise price of $100, subject to adjustment.

The Rights become exercisable 10 days after any person or group acquires, or 10 business days after any person or group has announced its intention to commence a tender offer for, 15% or more of the outstanding Common Stock.

In the event that any person or group acquires 15% or more of our outstanding Common Stock, each holder of a Right (other than such person or group) will be entitled to purchase, at the exercise price, the number of shares of Common Stock having a current market value equal to two times the exercise price of the Right.

If we are acquired in a merger or other business combination, each holder of a Right will be entitled to purchase, at the exercise price, a number of shares of common stock of the acquirer having a current market value equal to two times the exercise price of the Right.

We may redeem the rights for $.01 at any time until 10 days after the acquisition of 15% of our Common Stock. At any time after a person or group has acquired 15% or more but less than 50% of our Common Stock, we may exchange all or part of the Rights for shares of Common Stock at an exchange ratio of one share of Common Stock for each Right or 1/100 of such new series of preferred stock per Right, subject to adjustment. The rights expire on June 21, 2010.

Note 14. Commitments and Contingencies

Royalties. At December 31, 1999 and 2000, accrued royalties were $31,404,000 and $29,869,000, respectively. Royalties are classified as current liabilities if initial sales are to commence within one year.

Leases. We are committed under operating leases with lease termination dates to 2009. Minimum future rentals pursuant to these leases as of December 31, 2000 are as follows:

	Facilities	Equipment
2001	$2,476,000	$166,000
2002	1,780,000	114,000
2003	1,412,000	95,000
2004	959,000	48,000
2005	754,000	23,000
Thereafter	147,000	—
	$7,528,000	$446,000

Rent expense was $616,000, $1,834,000, and $2,220,000 in 1998, 1999 and 2000, respectively.

Legal Proceedings. There have been developments in the legal proceedings previously disclosed in Part I, Item 3 of the 10-K for fiscal year ended December 31, 2000, filed on March 29, 2001. On April 23, 2001, the United States District Court for the Central District of California modified its December 20, 2000 order that dismissed with prejudice two essentially identical class action law suits filed against us on February 18, 2000 and on March 2, 2000, respectively. In its April 23, 2001 order, the court granted plaintiffs leave to file a third amended complaint and the plaintiffs have so filed. The law suits allege that we, and certain of our directors and senior officers, violated Section 10(b) of the Securities and

Exchange Act of 1934 and SEC Rule 10b-5. We believe the claims are without merit, and intend to vigorously defend against them.

On February 13, 2001, the World Championship Wrestling, Inc. filed a civil action against us in the Superior Court in the state of Georgia. The law suit alleges a breach of contract relating to the Interactive License Agreement, dated as of December 29, 1995, between the WCW and us. The Plaintiffs in the law suit allege that we have not paid sufficient royalties due under the agreement for the Nintendo 64 game "Revenge." We intend to vigorously defend against this law suit. We do not believe this law suit will have a material impact on our financial statement.

We are involved in routine litigation arising in the ordinary course of our business. In the opinion of our management, none of the pending litigation will have a material adverse effect on our consolidated financial condition or results of operations.

Note 15. Segment and Geographic Information

We operate in one reportable segment in which we are a developer, publisher and distributor of interactive entertainment software for the leading hardware platforms in the home video game market. The following information sets forth geographic information on our sales and long-lived assets for the years ended December 31, 1998, 1999 and 2000:

(in thousands of dollars)	United States	United Kingdom	Germany	France	Australia	Consolidated
Year ended December 31, 1998:						
Sales to unaffiliated Customers	$187,583	$23,881	$ 5,252	$ —	$ —	$216,716
Long-lived assets at December 31, 1998	$ 6,218	$ 4,763	$ 1,063	$ —	$ —	$ 12,094
Year ended December 31, 1999:						
Sales to unaffiliated Customers	$228,827	$41,404	$33,252	$ —	$ —	$303,483
Long-lived assets at December 31, 1999	$ 10,780	$ 1,962	$ 988	$ 1	$ —	$ 13,731
Year ended December 31, 2000:						
Sales to unaffiliated Customers	$270,116	$44,638	$20,442	$7,979	$3,828	$347,003
Long-lived assets at December 31, 2000	$ 16,792	$ 1,957	$ 1,971	$ 320	$ 235	$ 21,275

Note 16. Quarterly Financial Data (Unaudited)

Our summarized quarterly financial data is as follows:

(Amounts in thousands, except per share data)	March 31	June 30	September 30	December 31
Year ended December 31, 1999:				
Revenues	$79,226	$51,912	$44,610	$127,735
Expenses	63,569	45,050	38,243	107,002
Income before income taxes	15,657	6,862	6,367	20,733
Income taxes	6,300	3,294	2,124	6,575
Net income	$ 9,357	$ 3,568	$ 4,243	$ 14,158
Net income per share:				
Basic	$ .50	$ .19	$ .22	$.73
Diluted	$ .45	$ .17	$ .20	$.65
Year ended December 31, 2000:				
Revenues	$70,390	$32,407	$53,293	$190,913
Expenses	63,315	46,236	50,468	155,741
Income (loss) before income taxes	7,075	(13,829)	2,825	35,172
Income taxes	3,130	(5,226)	1,510	13,640
Net income (loss)	$ 3,945	$ (8,603)	$ 1,315	$ 21,532
Net income (loss) per share:				
Basic	$ .20	$ (0.43)	$ .07	$ 1.06
Diluted	$ .18	$ (0.43)	$ .06	$ .99

CAUTIONARY STATEMENT REGARDING FORWARD-LOOKING STATEMENTS

This Annual Report contains, or incorporates by reference, certain statements that may be deemed "forward-looking statements" within the meaning of the Private Securities Litigation Reform Act of 1995. Such statements appear in a number of places in this Report, including, without limitation, "Business" and "Management's Discussion and Analysis of Financial Condition and Results of Operations". These statements are based on current expectations, estimates and projections about our business based, in part, on assumptions made by management. These statements are not guarantees of future performance and involve risks, uncertainties and assumptions that are difficult to predict. Therefore, actual outcomes and results may differ materially from what is expressed or forecasted in such forward-looking statements due to numerous factors, including those described above and the following: changes in demand for our products, product mix, the timing of customer orders and deliveries, the impact of competitive products and pricing and difficulties encountered in the integration of acquired businesses. In addition, such statements could be affected by growth rates and market conditions relating to the interactive software industry and general domestic and international economic conditions. Specific information concerning these and other such factors is contained in our most recent report on Form 8-K, filed with the Securities Exchange Commission on November 13, 2000 and incorporated herein by reference. A copy of this filing may be obtained by contacting the SEC or us (see below). The forward-looking statements contained herein speak only as of the date on which they are made, and we do not undertake any obligation to update any forward-looking statement to reflect events or circumstances after the date of this release.

For more complete financial information, please refer to our Annual Report on Form 10-K as filed with the Securities and Exchange Commission.

You may request a copy of this report, including the financial statements, at no cost to you, by writing or telephoning us at the following address:
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