

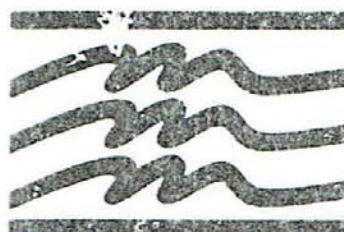
No dealer, sales representative or any other person has been authorized to give any information or to make any representation in connection with this offering other than those contained in this Prospectus, and if given or made, such information or representations must not be relied upon as having been authorized by the Company, the Selling Stockholders or the Underwriters. This Prospectus does not constitute an offer to sell or a solicitation of an offer to buy any of the securities offered hereby by anyone in any jurisdiction in which such offer or solicitation is not authorized or in which the person making such offer or solicitation is not qualified to do so or to any person to whom it is unlawful to make such offer or solicitation. Neither the delivery of this Prospectus nor any sale made hereunder shall under any circumstances create any implication that the information contained herein is correct as of any time subsequent to its date.

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Until July 18, 1988 (25 days after the date of this Prospectus), all dealers effecting transactions in the registered securities, whether or not participating in this distribution, may be required to deliver a Prospectus. This is in addition to the obligation of dealers to deliver a Prospectus when acting as Underwriters and with respect to their unsold allotments or subscriptions.

1,100,000 Shares



MINDSCAPE INC.

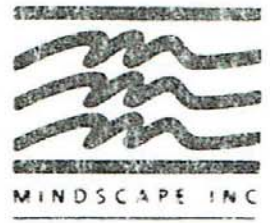
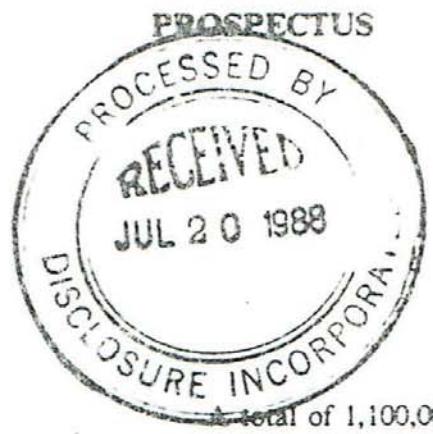
Common Stock

PROSPECTUS

June 23, 1988

William Blair & Company

END



1,100,000 Shares

MINDSCAPE INC.

Common Stock

Total of 1,100,000 shares of Common Stock are being sold by the Company. An additional 110,000 shares of Common Stock may be sold by the Selling Stockholders pursuant to the Underwriters' over-allotment option.

Prior to this offering, there has been no public market for the Common Stock of the Company. See "Underwriting" for information regarding the factors considered in determining the initial public offering price.

This offering involves a high degree of risk. Prospective investors should carefully consider the information set forth under "Investment Considerations."

THESE SECURITIES HAVE NOT BEEN APPROVED OR DISAPPROVED BY THE SECURITIES AND EXCHANGE COMMISSION NOR HAS THE COMMISSION PASSED UPON THE ACCURACY OR ADEQUACY OF THIS PROSPECTUS. ANY REPRESENTATION TO THE CONTRARY IS A CRIMINAL OFFENSE.

	Price to Public	Underwriting Discount (1)	Proceeds to Company (2)
Per Share	\$9.00	\$.65	\$8.35
Total(3).....	\$9,900,000	\$715,000	\$9,185,000

- (1) The Company and the Selling Stockholders have agreed to indemnify the Underwriters against certain liabilities, including liabilities under the Securities Act of 1933. See "Underwriting."
- (2) Before deducting expenses of the offering, estimated at \$850,000, payable by the Company.
- (3) The Selling Stockholders have granted to the Underwriters a 30-day option to purchase up to 110,000 additional shares to cover over-allotments, if any. The Company will not receive any proceeds from the sale of shares by the Selling Stockholders. If all such shares are purchased, the Total Price to Public and Underwriting Discount will be \$10,890,000 and \$786,500, respectively, and the proceeds to the Selling Stockholders will be \$918,500. See "Principal and Selling Stockholders" and "Underwriting."

The Common Stock is offered by the several Underwriters subject to prior sale when, as and if delivered to and accepted by them, subject to the right to reject orders in whole or in part. It is expected that delivery of the certificates for Common Stock will be made on or about June 30, 1988.

William Blair & Company

IN CONNECTION WITH THIS OFFERING, THE UNDERWRITERS MAY OVER-ALLOT OR EFFECT TRANSACTIONS WHICH STABILIZE OR MAINTAIN THE MARKET PRICE OF THE COMMON STOCK OF MINDSCAPE AT A LEVEL ABOVE THAT WHICH MIGHT OTHERWISE PREVAIL IN THE OPEN MARKET. SUCH STABILIZING, IF COMMENCED, MAY BE DISCONTINUED AT ANY TIME.

SUMMARY OF PROSPECTUS

The following summary is qualified in its entirety by the more detailed information and financial data appearing elsewhere in this Prospectus. Unless otherwise indicated, all information in this Prospectus assumes that the Underwriters' over-allotment option is not exercised. See "Underwriting."

THE COMPANY

Mindscape publishes a broad line of microcomputer software products for the consumer and education markets. Consumer market software, which accounted for approximately 82% of the Company's 1987 revenues, includes entertainment, home education and productivity titles developed for use on major microcomputer hardware formats. These products are sold under the Mindscape label or under the lower priced Thunder Mountain label. Education market software includes curriculum, productivity and administrative titles for sale primarily to schools, as well as other educational institutions. During 1987, the Company published over 150 consumer market and over 170 education market titles, with no one title representing more than 7% of revenues. The Company believes that its large number of revenue producing titles and the diversity of its product categories, hardware formats and pricing are critical elements to Mindscape's historical and future success in the consumer and education microcomputer software markets.

THE OFFERING

Shares Offered	1,100,000 shares of Common Stock
Shares Outstanding After the Offering	3,457,500 shares of Common Stock
Use of Proceeds	Reduction of outstanding indebtedness
NASDAQ Symbol	MIND

SUMMARY FINANCIAL DATA(1) (in thousands, except per share data)

	For the Five Months from Inception to December 31, 1984	For the Year Ended December 31,			For the Three Months Ended March 31,	
		1985	1986	1987(2)	1987(2)	1988
Income Statement Data:						
Total revenues	\$ 993	\$4,923	\$9,215	\$20,414	\$3,486	\$5,013
Gross profit (loss)	(4,729)	(751)	3,019	10,616	1,683	2,513
Income (loss) from operations	(10,826)	(7,665)	(3,604)	2,403	(5)	(159)
Net income (loss)	(5,414)	(3,877)	(2,301)	1,839	(125)	(396)
Pro forma net income (loss)(3)	—	—	—	1,027	(125)	(254)
Pro forma net income (loss) per share(3)	—	—	—	.42	(.05)	(.10)
At March 31, 1988						
				Actual	As Adjusted(4)	
Balance Sheet Data:						
Working capital (deficiency)				\$ (447)	\$ 7,888	
Total assets				19,235	19,235	
Total debt				13,066	3,675	
Stockholders' equity				1,467	10,858	

- (1) Summary financial data for the five months ended December 31, 1984 and the years ended December 31, 1985 and 1986 are that of a predecessor and are not comparable to that of the Company. See "Background" and "Selected Financial Data." Net income (loss) reflects the election to be taxed as an S corporation on April 30, 1987.
- (2) Reflects the unaudited, pro forma income statement data of the Company as if the predecessor had been acquired by the Company on January 1, 1987. See "Background" and "Selected Financial Data."
- (3) Reflects a provision for income taxes as if the Company had been taxed as a C corporation for the entire period presented. See "S Corporation Dividends" and "Selected Financial Data."
- (4) Reflects the sale of 1,100,000 shares, the reduction of indebtedness and the contribution of \$1,056,594 of stockholder notes to equity.

THE COMPANY

Mindscape publishes a broad line of microcomputer software products for the consumer and education markets. Consumer market software, which accounted for approximately 82% of the Company's 1987 revenues, includes entertainment, home education and productivity titles developed for use on major microcomputer hardware formats. These products are sold under the Mindscape label or under the lower priced Thunder Mountain label. Education market software includes curriculum, productivity and administrative titles for sale primarily to schools, as well as other educational institutions. Mindscape education market software includes products for kindergarten through college, with the majority of sales to the middle grades and junior high schools. During 1987, the Company published over 150 consumer market and over 170 education market titles, with no one title representing more than 7% of revenues. The Company believes that its large number of revenue producing titles and the diversity of its product categories, hardware formats and pricing are critical elements to Mindscape's historical and future success in the consumer and education microcomputer software markets.

Mindscape consumer market software is sold through specialty retail outlets and mass merchandisers principally in the United States and Canada. Retailers purchase the Company's consumer software from Mindscape's twelve-person direct sales force, as well as from distributors and independent sales representatives. Sales to the education market are made directly to educational institutions in the United States and Canada through a four-person direct sales force, as well as through distributors, dealers, direct mail and selected "master teachers."

Mindscape's executive offices are located at 3444 Dundee Road, Northbrook, Illinois 60062, and its telephone number is (312) 480-7667. As used herein, the terms "Company" and "Mindscape" refer to Mindscape Inc., unless the context otherwise indicates. All information in this Prospectus gives effect to a 2.3-for-1 split of shares of Common Stock effected May 18, 1988, unless otherwise indicated.

BACKGROUND

During 1981 and 1982, Scott, Foresman and Company, a subsidiary of SFN Companies, Inc. ("SFN"), established an electronic publishing group which developed non-curriculum specific educational software for sale to educational institutions as complementary products to its textbooks. In 1983, SFN decided to expand its markets by selling educational software to the consumer market. John R. Purcell, SFN's Chairman and Chief Executive Officer, hired Roger M. Buoy as President and Chief Executive Officer of Mindscape, Inc. in October, 1983 to further develop and execute its business plan.

Mindscape, Inc. received significant financial support from SFN from its incorporation on March 17, 1983 through January 16, 1987. The Company's initial strategy of selling only consumer oriented educational software was supplemented shortly after the Company's inception to include the development and sale of consumer entertainment and productivity software, as well as the development and sale of educational software directly to the institutional education market.

As part of the restructuring and sale of SFN during 1986 and 1987, John R. Purcell and Roger M. Buoy acquired Mindscape, Inc. on January 16, 1987 for a total of \$8.6 million, including \$3 million in cash and the assumption of \$5.6 million of Mindscape's liabilities. SFN retained all net operating loss carryforwards generated by Mindscape through December 31, 1986. In addition, SFN's successor purchased 1,000 shares of the Company's Preferred Stock which were redeemed on April 30, 1987.

INVESTMENT CONSIDERATIONS

Potential investors should carefully consider the following information when evaluating the Company and its business.

Limited Operating History

Mindscape's predecessor commenced the sale of product in August, 1984. Although the Company was profitable in 1987, no assurance can be given that the Company will be profitable in the future. The Company was not profitable in the first quarter of 1988 and does not expect to be profitable in the second quarter as a result of slower revenue growth than was experienced in the first quarter of 1988, increased general and administrative expenses attributable to professional services, and management's decision to incur greater near

term expenses, primarily in selling and marketing, to position the Company for future sales growth. See "Management's Discussion and Analysis of Results of Operations and Financial Condition."

Need For Additional Working Capital

The net proceeds realized from the sale of shares offered hereby will be applied to the repayment of indebtedness. See "Use of Proceeds." While the Company anticipates that its working capital requirements for the remainder of 1988 will not generally exceed its cash from operations and its availability under its Bank Loan Agreement, Mr. Purcell has agreed to make available \$2.5 million of working capital financing (the "Purcell Line") until the earlier of (i) a refinancing of the mortgage loan secured by the Company's headquarters facility or its Bank Loan Agreement, producing \$2.5 million of additional cash or borrowing capacity, or (ii) December 31, 1988. At June 16, 1988, the Company had borrowed \$1 million under the Purcell Line and had \$400,000 of unutilized capacity under the Bank Loan Agreement. See "Financing Arrangements" and "Management's Discussion and Analysis of Results of Operations and Financial Condition—Capital Resources and Liquidity."

New Products and Consumer Demand

Consumer software products tend to have relatively short lifecycles, and therefore, the Company depends on the introduction of successful new products to replace the declining revenues of older products. In addition, relatively long lead times for the development of new products make the Company vulnerable to changes in consumer software and hardware preferences. See "Business—Consumer Market."

Competition

The education and consumer software markets are highly competitive. The Company competes both in the acquisition of new products and the marketing of existing products against companies with greater financial resources, including manufacturers of microcomputers. See "Business—Competition."

Nintendo

During 1988 and 1989, the Company intends to publish and distribute software products for the Nintendo Entertainment System. As of March 31, 1988, the Company had capitalized approximately \$700,000 in license fees and conversion costs for Nintendo products and anticipates additional costs of approximately \$210,000 for products under development. Further costs will be incurred as additional titles are developed. Orders with the supplier of Nintendo cartridges must be prepaid and are non-cancellable. A shortage of microchips for the production of Nintendo software cartridges, a significant decline in consumer demand or an oversupply of software cartridges in the market would materially impair the Company's ability to recover license fees, conversion costs and production expenses. See "Business—Nintendo."

Seasonality

Sales of consumer software, which accounted for approximately 82% of the Company's revenue in 1987, are concentrated in the third and fourth quarters of the year. The seasonality of sales may cause operating results and working capital requirements to vary significantly from quarter to quarter. See "Management's Discussion and Analysis of Results of Operations and Financial Condition—Quarterly Data and Seasonality."

Reliance on Key Personnel

The Company's success will depend to a large degree on its ability to retain the services of its key management personnel, including its President and Chief Executive Officer, Roger M. Buoy. The loss of Mr. Buoy's services could have a material adverse effect on the Company's position in the microcomputer software industry and on its new product development efforts. There is no employment agreement between Mr. Buoy and the Company. See "Business—Personnel."

Control by Management

After the offering and assuming the Underwriters' over-allotment option is exercised in full, the present directors and executive officers of Mindscape will beneficially own approximately 60.8% of the outstanding Common Stock of Mindscape and will be able to elect all of the Company's directors and control management policy. The present directors and executive officers may be able to effect certain corporate transactions such as a sale of substantially all of the Company's assets or a merger, including a merger that may be considered a "going private transaction," without the concurrence of minority stockholders. See "Principal and Selling Stockholders."

Pledged Assets, Dividend Restrictions and Financial Covenants

Mindscape has pledged substantially all of its assets as security pursuant to its financing arrangements. It is anticipated that substantially all of the net proceeds of the offering will be used to repay outstanding indebtedness. The Company expects to incur additional indebtedness in 1988 to finance operations. Certain provisions of the Company's financing arrangements prohibit the payment of dividends on Mindscape's Common Stock and subject it to financial performance requirements. See "Financing Arrangements" and "Use of Proceeds."

Industry Information

No definitive source of information exists regarding the microcomputer hardware and software industries. Various independent research companies as well as industry associations collect and publish data which are sometimes inconsistent.

Absence of Public Market

Prior to the offering, there has been no public market for Mindscape's Common Stock and there can be no assurance that an active trading market will develop. The offering price has been determined through negotiations between the Company, the Selling Stockholders and the Underwriters and may not be indicative of the market price for the Common Stock after the offering. See "Underwriting." This offering will subject new investors to substantial and immediate dilution. See "Dilution."

S CORPORATION DIVIDENDS

Since May 1, 1987, the Company has been treated as an S corporation for income tax purposes. As a result, earnings of the Company have been taxed directly to the Company's stockholders rather than to the Company. In February, 1988, the Company paid a dividend of \$1,868,100 to its stockholders. Concurrently, the stockholders loaned funds in the same aggregate amount to the Company in the form of \$719,219 of 8% senior subordinated notes due June 14, 1988 (the "1988 Notes") and \$1,148,881 of 7½% subordinated notes due January 1, 1991 (the "1991 Notes"). See Notes 3 and 4 of Notes to the December 31, 1987 Financial Statements of the Company. After full repayment of the 1988 Notes and partial repayment of the 1991 Notes, the outstanding principal amount of the 1991 Notes on May 15, 1988 was \$1,056,594. Messrs. Purcell and Buoy will contribute the principal amount of the 1991 Notes to the equity of the Company upon the closing of the sale of the shares offered hereby. The Company's S corporation election will be terminated simultaneously with the closing of the sale of shares offered hereby. Pursuant to an agreement by and among the Company and its current S corporation stockholders (the "Tax Agreement"), an allocable portion of the Company's taxable income (or loss) for the full year ending December 31, 1988 will be treated, for income tax purposes, as S corporation income (or loss), which will be taxable to the Company's current S corporation stockholders, and the remainder of such total taxable income (or loss) will be treated as C corporation income (or loss), which will be directly taxable to the Company. Such allocation will be made based upon the number of days during 1988 that the Company qualifies as an S corporation and as a C corporation, respectively. The Tax Agreement also provides, among other things, that (a) the Company will pay, in cash, on or before April 15, 1989, each current S corporation stockholder an amount equal to 32% of such stockholder's respective share of the Company's S corporation income for 1988 and (b) that the Company and the current S corporation stockholders will treat, for all tax purposes, any payments made to the current S corporation stockholders pursuant to the Tax Agreement as distributions of money by Mindscape with respect to their stock. No purchaser of the shares offered hereby will be entitled to any such payments made pursuant to the Tax Agreement. For periods after 1988, the Company will be taxed as a C corporation for income tax purposes. The Company has a tax loss carryforward which expires in the year 2002 of approximately \$286,000 relating to the period from January 1, 1987, to April 30, 1987 which is available to offset its taxable income as a C corporation. See Note 3 to Notes to the December 31, 1987 Financial Statements of the Company.

DIVIDEND POLICY

The Company does not intend to pay dividends for the foreseeable future. Earnings, if any, and other cash resources of the Company will be used to further reduce indebtedness and to continue the development

and expansion of the Company's business. Under the terms of its bank loan agreement, the Company is restricted from paying dividends, other than stock dividends. See "Financing Arrangements."

DILUTION

The net tangible book value (tangible assets less liabilities) of Mindscape at March 31, 1988, after giving effect to the exercise of stock options for 17,250 shares exercisable prior to December 31, 1988 at a weighted average exercise price of \$.65, was \$1,390,106 or \$.59 per share. After taking into account the contribution of the 1991 Notes of \$1,056,594 and the completion of the offering, the pro forma net tangible book value of Mindscape would have been \$10,781,700 or \$3.10 per share after deduction of underwriting and estimated offering expenses of \$1,565,000. The following table illustrates as of March 31, 1988 the immediate per share dilution to purchasers of shares in this offering:

Public offering price(1)	\$9.00
Net tangible book value at March 31, 1988	\$.59
Contribution of the 1991 Notes44
Increase attributable to new investors(2)	2.07
Pro forma net tangible book value after offering	<u>3.10</u>
Dilution to new investors	<u>\$5.90</u>

- (1) Before deduction of the underwriting discount and estimated offering expenses payable by the Company.
 (2) After deduction of the underwriting discount and estimated offering expenses payable by the Company.

The following table summarizes at March 31, 1988 the differences in the average amounts received by the Company for shares of Common Stock owned by existing stockholders and 17,250 of the 69,000 shares subject to options and those purchased by new investors in this offering:

	Shares Purchased from the Company		Total Consideration		Average Price Per Share
	Number	Percentage	Amount	Percentage	
Existing Stockholders	2,374,750	68.3%	\$ 2,605,344	20.8%	\$1.10
New Investors (1)	1,100,000	31.7	9,900,000	79.2	9.00
Total	<u>3,474,750</u>	<u>100%</u>	<u>\$12,505,344</u>	<u>100%</u>	

- (1) Before deduction of the estimated offering expenses and underwriting discount payable by the Company. Assumes no exercise of the Underwriters' over-allotment option.

FINANCING ARRANGEMENTS

Pursuant to the terms of a loan agreement (the "Bank Loan Agreement"), dated as of May 12, 1988, Mindscape may borrow up to \$13,000,000. The outstanding principal amount of loans under this agreement may not exceed the sum of (i) 65% of eligible receivables and the lesser of 25% of eligible inventory or \$1,000,000, plus (ii) prior to August 15, 1988, \$1,500,000, plus (iii) \$7,000,000 pursuant to guaranties from each of Messrs. Purcell and Buoy (the "Guaranties"). The Guaranties will terminate upon receipt by Mindscape of net proceeds of at least \$7,000,000 of equity or subordinated debt financing. The Company expects that the Bank Loan Agreement will permit maximum borrowings of approximately \$6,000,000 after the closing of the offering made hereby based on present and anticipated levels of inventory and receivables. Loans bear interest at the rate of 1½% over the prime rate. The aggregate outstanding amount of such loans was \$11,880,000 at June 16, 1988, secured by substantially all of Mindscape's assets other than its headquarters building, which was pledged to secure a mortgage loan. Mindscape intends to borrow additional amounts from time to time under the Bank Loan Agreement. See "Management's Discussion and Analysis of Results of Operations and Financial Condition—Capital Resources and Liquidity."

The Bank Loan Agreement restricts Mindscape's ability to incur or guaranty indebtedness, incur liens, pay dividends, lease property or purchase stock or substantially all of the assets of another entity. In addition, the Bank Loan Agreement requires Mindscape to maintain tangible net worth, as defined therein, of \$1,900,000 until September 30, 1988, of \$3,900,000 from October 1, 1988 until December 30, 1988, of \$6,000,000 as of December 31, 1988, and of \$5,000,000 after December 31, 1988. The Bank Loan Agreement terminates on April 30, 1990. See Note 6 of Notes to the March 31, 1988 Condensed Financial Statements of the Company.

In January, 1987, Messrs. Purcell and Buoy loaned \$1,000,000 to Mindscape to finance operations, evidenced by promissory notes that bear interest of 7½% per annum and mature on January 1, 1991. In February, 1988, Messrs. Purcell and Buoy loaned to Mindscape an additional amount, evidenced by the 1991 Notes. Messrs. Purcell and Buoy will contribute the outstanding \$1,056,594 principal amount of the 1991 Notes to the equity of the Company upon the closing of the sale of the shares offered hereby. See "S Corporation Dividends."

Mindscape acquired its Northbrook headquarters facility subject to the obligations under an existing mortgage loan and assignment of rents to Connecticut Mutual Life Insurance Company. The mortgage and assignment of rents secure indebtedness which bears interest at the rate of 10.75% per annum and at March 31, 1988 had an outstanding principal balance of \$1,494,671. The final principal payment of such loan, in the amount of \$1,226,971, is due on April 1, 1996. The Company is currently reviewing proposals to refinance the mortgage loan and in connection with such refinancing expects to incur additional indebtedness of up to \$4,000,000. The Company presently expects to use any such proceeds to repay indebtedness on its bank loan.

Mr. Purcell has agreed to make available to the Company \$2,500,000 of working capital financing pursuant to a 9½% demand note subordinated under the Bank Loan Agreement. Mr. Purcell has agreed not to demand payment of the note until the earlier of (i) a refinancing of the mortgage loan on the Company's headquarters building which produces at least \$2,500,000 of additional cash, (ii) a refinancing of the Bank Loan Agreement which produces at least \$2,500,000 of additional borrowing capacity or (iii) December 31, 1988. At June 16, 1988, the Company had borrowed \$1,000,000 under the Purcell Line.

USE OF PROCEEDS

Based on a public offering price of \$9.00 per share, Mindscape will receive net proceeds of approximately \$8,335,000 from the sale of 1,100,000 shares of Common Stock offered hereby, after deduction of the underwriting discount and estimated expenses. Such proceeds will be used to repay a portion of Mindscape's bank indebtedness, due April 30, 1990. The indebtedness to be repaid had an effective rate of interest at June 16, 1988 of 10½% and was incurred on May 12, 1988 for the purpose, in part, of repaying \$3,018,018 of indebtedness to Mr. Purcell and \$6,714,000 of indebtedness under a previous bank loan agreement, all of which had been incurred to fund working capital requirements. Upon receipt of the proceeds from the sale of the shares of Common Stock offered hereby, the Guaranties provided by Messrs. Purcell and Buoy under the Bank Loan Agreement will terminate. The Company expects that none of the proceeds from the offering will be available for working capital purposes. As of June 16, 1988, \$11,880,000 was outstanding under the Bank Loan Agreement. See "Financing Arrangements," "Capitalization" and "Certain Transactions."

CAPITALIZATION

The following table sets forth the short-term debt and capitalization of the Company at May 15, 1988 and as adjusted to give effect to the sale of the shares of Common Stock offered hereby resulting in estimated net proceeds of approximately \$8,335,000, the application of such net proceeds to repay bank indebtedness as described under "Use of Proceeds" and the contribution of the 1991 Notes to equity as described under "S Corporation Dividends."

	May 15, 1988	
	Actual	As Adjusted
	(in thousands)	
Short-term debt:(1)		
Current portion of mortgage note payable	\$ 20	\$ 20
Total short-term debt	<u>\$ 20</u>	<u>\$ 20</u>
Long-term debt:(1)		
Notes payable to bank	\$ 9,790	\$ 1,455
1991 notes(2)	1,056	—
Stockholder notes payable	1,000	1,000
Mortgage note payable	<u>1,474</u>	<u>1,474</u>
Total long-term debt	13,320	3,929
Stockholders' equity:		
Common stock, \$.00001 par value; 4,600,000 shares authorized, 2,357,500 shares outstanding, 3,457,500 shares as adjusted(3)	—	—
Capital in excess of par value(2)(4)	1,537	10,661
Retained earnings (deficit) at March 31, 1988(4)	<u>(70)</u>	<u>197</u>
Total stockholders' equity	<u>1,467</u>	<u>10,858</u>
Total capitalization	<u>\$14,787</u>	<u>\$14,787</u>

- (1) See "Financing Arrangements" and Notes 2 and 6 of Notes to the March 31, 1988 Condensed Financial Statements of the Company for additional information concerning indebtedness.
- (2) See "S Corporation Dividends" for information regarding the contribution of the 1991 Notes to equity.
- (3) Does not include 115,000 shares of Common Stock reserved for issuance pursuant to the Company's Stock Option Plan for Key Employees.
- (4) The excess of distributions to stockholders over the cumulative S corporation income of \$267,005 has been reclassified from deficit to capital in excess of par value in the "As Adjusted" column.

SELECTED FINANCIAL DATA

The selected financial data for the years ended December 31, 1986 and 1985 have been derived from the audited financial statements of a predecessor and are not comparable to the information of the Company because such data are presented on such predecessor's historical cost basis. Such selected financial data should be read in conjunction with the financial statements of the predecessor and the report of Arthur Andersen & Co., independent public accountants, thereon included elsewhere herein. The selected financial data for such predecessor for the five months ended December 31, 1984 are unaudited; however, in the opinion of management, such unaudited data include all adjustments (consisting only of normal recurring accruals) that it considered necessary for a fair presentation. The selected financial data for the year ended December 31, 1987 and the three months ended March 31, 1987 are shown on an unaudited, pro forma combined basis. The selected financial data for the year ended December 31, 1987 should be read in conjunction with the financial statements of the Company and the report of Arthur Young & Company, certified public accountants, thereon included elsewhere herein. The selected financial data for the three months ended March 31, 1988 and 1987 are unaudited; however in the opinion of management, such unaudited data include all adjustments (consisting only of normal recurring accruals) that the Company considers necessary for a fair presentation. The results for the three months ended March 31, 1988 are not indicative of the results which may be expected for the full year. See "Management's Discussion and Analysis of Results of Operations and Financial Condition—Quarterly Data and Seasonality."

	For the Five Months from Inception to December 31, 1984	For the Year Ended December 31,			For the Three Months Ended March 31,	
		1985	1986	1987(1)	1987(1)	1988
				(pro forma)	(pro forma)	
		(in thousands, except share and per share data)				
Income Statement Data:						
Revenues:						
Net sales	\$ 797	\$ 4,741	\$ 8,705	\$19,194	\$3,336	\$4,830
Distribution income	—	—	133	744	48	105
Other income	196	182	377	476	102	78
Total revenues	993	4,923	9,215	20,414	3,486	5,013
Cost of goods sold	5,722	5,674	6,196	9,798	1,803	2,500
Gross profit (loss)	(4,729)	(751)	3,019	10,616	1,683	2,513
Selling and marketing expenses ..	4,834	4,718	4,325	6,017	1,256	2,114
General and administrative ex- penses	1,263	2,196	2,298	2,196	436	558
Income (loss) from opera- tions	(10,826)	(7,665)	(3,604)	2,403	(9)	(159)
Interest expense	112	166	1,045	536	116	243
Income (loss) before income taxes	(10,938)	(7,831)	(4,649)	1,867	(125)	(402)
Provision (benefit) for income taxes(2)	(5,524)	(3,954)	(2,348)	28	—	(6)
Net income (loss)	<u>\$ (5,414)</u>	<u>\$ (3,877)</u>	<u>\$ (2,301)</u>	<u>\$ 1,839</u>	<u>\$ (125)</u>	<u>\$ (396)</u>
Pro Forma data(2):						
Net income (loss)	—	—	—	\$ 1,027	\$ (125)	\$ (254)
Net income (loss) per share(4)	—	—	—	.42(3)	(.05)	(.10)
Weighted average shares(4)	—	—	—	2,426,500	2,426,500	2,426,500

	At December 31,				At
	1984	1985	1986	1987	March 31, 1988
	(in thousands)				
Balance Sheet Data:					
Working capital (deficiency)	\$ (155)	\$ 632	\$ 584	\$ 442	\$ (447)
Total assets	6,220	6,148	8,954	19,709	19,235
Short-term borrowings	9	17	579	6,029	9,442
Long-term debt	1,531	1,521	1,500	3,481	3,624
Stockholders' equity	1,557	2,746	3,570	1,863	1,467

- (1) In January 1987, Mindscape Holdings Corporation ("Holdings") was incorporated and on January 16, 1987, Mindscape, Inc. (predecessor) was acquired by Holdings through the merger of its wholly owned subsidiary, Mindscape Acquisition Corporation, with and into Mindscape, Inc. with Mindscape, Inc. being the surviving corporation. The selected financial data for the year ended December 31, 1987 and the three months ended March 31, 1987 are shown on an unaudited, pro forma combined basis reflecting the allocation of the purchase price to the fair value of assets and liabilities acquired as if the acquisition had taken place as of January 1, 1987 and reflecting the appropriate pro forma adjustments to the predecessor's results of operations for the period January 1, 1987 to January 16, 1987. Such pro forma adjustments consist of a decrease in general and administrative expenses of \$934 to reflect a reduction in depreciation expense as a result of the purchase price allocation, an increase in interest expense of \$8,750 assuming that the debt incurred in the acquisition was outstanding as of January 1, 1987 and an elimination of the provision for income taxes.
- (2) The Company was taxed as a C corporation for income tax purposes through April 30, 1987. Effective May 1, 1987, the Company elected to be taxed as an S corporation, and therefore, generally federal and certain state income taxes imposed on the Company's income for the period subsequent to April 30, 1987 have been the obligations of the individual stockholders. Pro forma data assumes that the Company was taxed as a C corporation and reflects additional income taxes of \$812,000 for the year ended December 31, 1987 and an additional benefit for income taxes of \$142,000 for the three months ended March 31, 1988. No income tax benefit was recorded for the three months ended March 31, 1987 as the Company could not carry back the net operating loss to prior periods. The Company has a tax loss carryforward which expires in the year 2002 of approximately \$286,000 relating to the period from January 1, 1987 to April 30, 1987 which is available to offset future taxable income from a C corporation. See Note 3 to Notes to the December 31, 1987 Financial Statements of the Company. For income tax provision (benefit) data for the predecessor to the Company, see Note 6 to the Notes to Financial Statements for the years ended December 31, 1986 and 1985.
- (3) Assuming the contribution of the 1991 Notes to equity at the beginning of the period and that the offering had occurred from time-to-time during 1987 to the extent that net proceeds would have been necessary to reduce outstanding indebtedness, pro forma net income per share for the year ended December 31, 1987 would have been \$.39 based on a weighted average number of shares outstanding of 3,045,839.
- (4) Adjusted for the 1000 for-1 stock split effected on April 30, 1987 and the 2.3-for-1 split effected on May 18, 1988. Calculated as if the 69,000 shares issuable upon future exercise of employee stock options had been exercised at the beginning of the period and as if the 1,100,000 shares of Common Stock offered hereby were not outstanding.

**MANAGEMENT'S DISCUSSION AND ANALYSIS OF
RESULTS OF OPERATIONS AND FINANCIAL CONDITION**

Results of Operations

The following table shows, for the periods indicated, items included in Selected Financial Data as a percentage of total revenues and the percentage changes in the dollar amounts of such items compared to the prior period.

	Percentage of Total Revenues					Period-to-Period Percentage Increase (Decrease)		
	Year Ended December 31,			Three Months Ended March 31,		1986 over 1985	1987 over 1986	Three Months 1988 over Three Months 1987
	1985	1986	1987	1987	1988			
Total revenues	100.0%	100.0%	100.0%	100.0%	100.0%	87.2%	121.5%	43.8%
Cost of goods sold	115.3	67.2	48.0	51.7	49.9	9.2	58.1	38.7
Gross profit (loss)	(15.3)	32.8	52.0	48.3	50.1	*	251.7	49.3
Selling and marketing expenses	95.8	46.9	29.5	36.0	42.2	(8.3)	39.1	68.3
General and administrative expenses	44.6	24.9	10.8	12.5	11.1	4.6	(4.4)	28.0
Income (loss) from operations	(155.7)	(39.0)	11.7	(.2)	(3.2)	(53.0)	*	*
Interest expense	3.4	11.4	2.6	3.4	4.8	529.5	(49.6)	109.5
Income (loss) before income taxes	(159.1)	(50.4)	9.1	(3.6)	(8.0)	(60.6)	*	(221.6)
Pro forma provision (benefit) for income taxes			4.1	—	(3.0)			*
Pro forma net income (loss)			5.0	(3.6)	(5.0)			(103.2)

*Calculation not meaningful.

First Quarter 1988 Compared to First Quarter 1987

Total revenues increased \$1,527,000, or 43.8%, to \$5,013,000 in the first quarter of 1988 compared to \$3,486,000 in 1987. Consumer software sales contributed the majority of this increase. Educational software sales grew \$278,000 over the first quarter of 1987. This increase is primarily the result of sales of product titles acquired from other publishers.

Cost of goods sold declined to 49.9% of total revenues in 1988 from 51.7% in 1987. The resulting improvement in gross margin is due primarily to cost savings in product packaging and labor, but is offset to some extent by higher royalty rates. Royalty expense which is included in cost of goods sold totalled \$847,116 and \$511,665, or 16.9% and 14.7% of total revenues for 1988 and 1987, respectively. The increase in royalty expenses as a percentage of total revenues is primarily attributable to a greater concentration of sales of products licensed under a license agreement with a higher than average royalty rate. The Company does not expect future royalty expenses to vary significantly, based upon known license arrangements and trends.

Selling and marketing expenses increased from 36.0% of total revenues in 1987 to 42.2% in 1988. This resulted primarily from higher advertising and promotion expense, as well as increased personnel and related travel costs, incurred with a view to revenue generation in future quarters.

General and administrative expenses declined to 11.1% of total revenues in 1988 from 12.5% in 1987. In total dollars, such expenses increased by \$122,000 from the first quarter of 1987 due primarily to increased staffing levels.

The Company's loss from operations increased from \$9,000 in 1987 to \$159,000 in 1988. This increase in 1988 is attributable to management's decision to incur greater near term expenses, primarily in selling and marketing, to position the Company for future sales growth. As a result of this decision, as well as slower revenue growth than was experienced in the first quarter of 1988, and higher general and administrative

expenses attributable primarily to professional services, management expects to incur operating and net losses during the second quarter of 1988 as well.

Interest expense increased from 3.4% of total revenues in 1987 to 4.8% in 1988. The increase is attributable to higher working capital borrowings to fund the Company's current and anticipated levels of business.

Year Ended December 31, 1987 Compared to Year Ended December 31, 1986

Total revenues increased \$11,199,000 in 1987 to \$20,414,000, a 121.5% increase over 1986. This increase is primarily a result of the successful introductions of new Mindscape label products, growth in the new, lower priced Thunder Mountain label products and sales of education market products.

Cost of goods sold declined from 67.2% of total revenues in 1986 to 48.0% in 1987. This decrease resulted from bringing product assembly in-house in mid-1987 and obtaining more favorable quantity pricing on raw material purchases. Royalty expense which is included in cost of goods sold was \$3,055,773 and \$1,665,613, or 15.0% and 18.1% of total revenues, for 1987 and 1986, respectively.

Selling and marketing expenses declined from 46.9% of total revenues in 1986 to 29.5% in 1987. The dollar amount of selling and marketing expenses increased in 1987 by \$1,692,000 to \$6,017,000, as a result of additional staffing and additional marketing expenses.

General and administrative expenses declined from 24.9% of total revenues in 1986 to 10.8% in 1987. The decrease resulted from significantly higher sales and slightly lower general and administrative expenses.

The Company recorded operating income of 11.7% of total revenues in 1987 compared with an operating loss in 1986 and prior periods. The increase in net sales volume, without a comparable increase in operating costs, accounted for this operating profit.

Interest and income tax expenses are not comparable due to the acquisition of the predecessor by the Company.

Year Ended December 31, 1986 Compared to Year Ended December 31, 1985

Total revenues increased \$4,292,000 in 1986 to \$9,215,000, an 87.2% increase over 1985. This increase is primarily a result of an expanded product line.

Cost of goods sold declined from 115.3% of total revenues in 1985 to 67.2% of total revenues in 1986. This decrease is primarily the result of the standardization of packaging between products and the reduction of printing costs as well as a reduction of write-offs of royalty advances. Royalty expense which is included in cost of goods sold was \$1,665,613 and \$2,046,059, or 18.1% and 41.6% of total revenues, for 1986 and 1985, respectively.

Selling and marketing expenses declined from 95.8% of total revenues in 1985 to 46.9% in 1986. This decrease is primarily attributable to a change in marketing direction and a concentration on media and point-of-sale advertising.

General and administrative expenses declined from 44.6% of total revenues in 1985 to 24.9% in 1986. This decrease is a result of significant net sales growth while general and administrative expenses remained relatively constant.

The Company recorded an operating loss of \$7,665,000 in 1985 compared to an operating loss of \$3,604,000 in 1986. The decrease in the operating loss results from the growth in net sales volume without a comparable increase in operating costs.

Quarterly Data and Seasonality

The following table presents the unaudited quarterly results for 1986 and 1987 and for the three months ended March 31, 1988. The quarterly results for the three months ended March 31, 1987 are prepared on a pro forma combined basis reflecting the allocation of the purchase price to the fair value of assets and liabilities acquired as if the acquisition had taken place as of January 1, 1987 and reflect the appropriate pro forma adjustments to the results of operations of the predecessor for the period January 1, 1987 to January 16, 1987:

	For the Three Months Ended								
	March 31, 1986	June 30, 1986	Septem- ber 30, 1986	Decem- ber 31, 1986	March 31, 1987	June 30, 1987	Septem- ber 30, 1987	Decem- ber 31, 1987	March 31, 1988
Total revenues	\$1,244	\$1,746	\$2,608	\$3,617	\$3,486	\$4,234	\$5,183	\$7,511	\$5,013
Cost of goods sold	860	1,220	1,671	2,445	1,803	1,992	2,549	3,454	2,500
Gross profit	384	526	937	1,172	1,683	2,242	2,634	4,057	2,513
Selling and marketing expenses ..	803	666	1,064	1,792	1,256	1,287	1,378	2,096	2,114
General and administrative ex- penses	424	567	504	803	436	533	461	766	558
Income (loss) from operations ..	(843)	(707)	(631)	(1,423)	(9)	422	795	1,195	(159)
Interest expense	230	265	267	283	116	109	131	180	243
Income (loss) before income taxes	<u>\$ (1,073)</u>	<u>\$ (972)</u>	<u>\$ (898)</u>	<u>\$ (1,706)</u>	(125)	313	664	1,015	(402)
Pro forma provision (benefit) for income taxes					—	95	295	450	(148)
Pro forma net income (loss) ...					<u>\$ (125)</u>	<u>\$ 218</u>	<u>\$ 369</u>	<u>\$ 565</u>	<u>\$ (254)</u>

Mindscape's sales are highly seasonal, with consumer sales concentrated in the third and fourth quarters and education market sales concentrated in the second and third quarters. In 1986 and 1987, respectively, fourth quarter total revenues accounted for 39.3% and 36.8% of Mindscape's annual revenues.

Capital Resources and Liquidity

The Company's Bank Loan Agreement permits up to \$13,000,000 in borrowings based on (i) the levels of inventory and receivables, plus (ii) prior to August 15, 1988, \$1,500,000, plus (iii) \$7,000,000 pursuant to Guaranties from each of Messrs. Purcell and Buoy. Upon the closing of the offering made hereby, the Guaranties by Messrs. Purcell and Buoy will terminate. The Company expects that the Bank Loan Agreement will permit maximum borrowings of approximately \$6,000,000 after the closing of the offering made hereby based on present and anticipated levels of inventory and receivables. See "Financing Arrangements."

The Company's working capital borrowings are highest in the third and fourth quarters, as the level of inventory and accounts receivable increase for the holiday selling season. Due to the seasonal nature of the Company's business, the cash flow from revenues recorded in the fourth quarter is generally realized in the first quarter.

In January 1988, the Company reorganized its accounts receivable department to enhance collection efforts. For the twelve months ended May 31, 1988, the average age of receivables was 78 days as compared to 84 days for the twelve months ended at December 31, 1987. Accounts receivable written off for 1987 aggregated approximately \$95,000, and for the three months ended March 31, 1988 aggregated approximately \$128,000.

From time to time the Company pays third parties advance license fees and amounts for future inventory purchases to assure availability of product. Such payments aggregated approximately \$300,000 in 1987 and

\$1,800,000 during the period January 1, 1988 through June 20, 1988. In addition, the Company has long-term purchase commitments for approximately \$3,300,000 of inventory over the next two and one-half years.

The Company is licensed to publish product titles for the Nintendo Entertainment System. Under the agreement with Nintendo, raw materials are ordered from overseas suppliers through the use of bank letters of credit. Because the time from placing an order to receiving the materials and shipping the finished product is significantly longer than with other Mindscape products, working capital financing needs will increase once the Company begins placing orders for Nintendo products. See "Business—Nintendo."

While the Company anticipates that its working capital requirements for the remainder of 1988 will not generally exceed its cash from operations and its availability under its Bank Loan Agreement, Mr. Purcell has agreed to make available additional working capital financing until December 31, 1988 at the latest under the Purcell Line. At June 16, 1988, the Company had borrowed \$1,000,000 under the Purcell Line. See "Financing Arrangements." The Company believes that after termination of the Purcell Line, the anticipated refinancing of its headquarters facility mortgage loan, or a refinancing of the Bank Loan Agreement, will provide adequate working capital financing. No assurance can be given, however, that either of these will be consummated.

BUSINESS

Mindscape publishes a broad line of microcomputer software products for the consumer and education markets. Consumer market software, which accounted for approximately 82% of the Company's 1987 revenues, includes entertainment, home education and productivity titles developed for use on major microcomputer hardware formats. These products are sold under the Mindscape label or under the lower priced Thunder Mountain label. Education market software includes curriculum, productivity and administrative titles for sale primarily to schools, as well as other educational institutions. During 1987, the Company published over 150 consumer market and over 170 education market titles, with no one title representing more than 7% of revenues. The Company believes that its large number of revenue producing titles and the diversity of its product categories, hardware formats and pricing are critical elements to Mindscape's historical and future success in the consumer and education microcomputer software markets.

Industry

The market for consumer and education microcomputer software has experienced substantial growth in recent years. The consumer market includes home and other non-business markets, while the education market includes elementary schools, secondary schools and, to a lesser degree, colleges and other educational institutions. The following table details estimates of the industry-wide growth of software sales in these markets from 1985 through 1987:

	Industry Retail Sales For the Year Ended December 31,		
	1985	1986	1987
Consumer Market(1)	\$285,000,000	\$350,000,000	\$505,000,000
	Industry Retail Sales For the 12 Months Ended June 30,		
	1985	1986	1987
Education Market(2)	\$135,000,000	\$150,000,000	\$170,000,000

Source: (1) Software Publishers Association

(2) Talmis, Inc., for grades kindergarten through 12

Mindscape believes that growth of microcomputer software sales is the result of increased microcomputer ownership, the development of increasingly sophisticated, user-friendly software, and the

emergence of various retail distribution channels. The following table details the industry-wide growth in installed units and the penetration of microcomputers in the consumer and education markets between 1985 and 1987:

	Industry Data For the Year Ended December 31,		
	1985	1986	1987
Consumer Market(1)			
Installed Units	13,120,000	16,735,000	20,563,000
Household Penetration	14%	17%	20%
Education Market(2)			
Installed Units	792,000	1,050,000	1,253,000
School Penetration	91%	94%	95%

Source: (1) Link Resources Corp.

(2) Quality Education Data, Inc. for grades kindergarten through 12

As microcomputer penetration in the consumer market has increased, publishers of software products have developed a large number of programs with greater capabilities, more sophisticated applications and more creative graphics. The Company believes that entertainment products represent the largest segment of consumer market sales, with home education and productivity products representing important, but smaller segments.

Increasing consumer demand and the expanded offering of microcomputer software products have stimulated the development of a variety of retail distribution channels. Initially sold through computer hardware outlets, microcomputer software is now also sold by mass merchandisers (often in specialized software departments), book store chains, toy store chains, software specialty stores and various independent retail stores. Software specialty store chains have experienced significant growth over the last few years, which Mindscape believes has increased the availability and consumer awareness of microcomputer software products.

Consumer Market

Mindscape's strategy for the consumer market is to offer a broad product line covering multiple product categories, microcomputer hardware formats and price points.

The Company's consumer software products are concentrated primarily in the entertainment category, but also include titles in the home education and productivity categories. Entertainment software is itself a broad category encompassing adventure/fantasy, action/arcade, sports and simulations/strategy titles. Home education/productivity titles include products to prepare students for standardized scholastic achievement tests and graphic design products, among others. The following table details the Company's revenues in the various consumer product categories:

	For the Year Ended December 31,		
	1985	1986	1987
Adventure/Fantasy	\$1,398,000	\$2,852,000	\$ 3,662,000
Action/Arcade	258,000	1,230,000	6,088,000
Sports	—	296,000	2,174,000
Simulations/Strategy	208,000	1,555,000	2,090,000
Home Education/Productivity	2,292,000	2,364,000	2,819,000
Total	<u>\$4,156,000</u>	<u>\$8,297,000</u>	<u>\$16,833,000</u>

Mindscape's recent emphasis on action/arcade products results in part from its relationship with one licensor, from which the Company licensed seven products in 1987 for two- and three-year terms. The Company expects to continue to offer a large selection of action/arcade titles in 1988 and beyond but is also developing and acquiring products to expand its offerings in other categories.

Because software written for one hardware format cannot run on microcomputers with alternate formats and because several different hardware formats have significant ownership bases, the Company develops its consumer software for most major microcomputer systems. Conversion of an existing title from one format (e.g., IBM) to another (e.g., Macintosh) normally takes from four to nine months and generally costs from \$15,000 to \$40,000, depending on the complexity of the program. The Company often introduces a title in one format and then follows with other formats over periods of up to two years.

A product's initial success is often closely related to its initial hardware format. Because of the lead time necessary to convert software from one hardware format to another, a significant change in consumer hardware preference could have material adverse consequences on sales of the Company's products.

In 1987, sales of the Company's consumer products were spread over the following hardware formats: 34% for Commodore 64/128; 22% for IBM and IBM compatibles; 12% for Apple IIe/c/GS; 12% for Macintosh; 9% for Amiga; 9% for Atari ST/XE/XL; and 2% for other formats. The large percentage of sales to Commodore 64/128 users reflects the Company's strength in the action/arcade product segment, which historically have been targeted to Commodore-owners. Although Mindscape showed strong sales to IBM users in 1987, the percentage of IBM software sold was not commensurate with IBM's current household penetration. Consequently, the Company's current product development efforts place greater emphasis on the IBM format.

Products

The Company markets its consumer products under two labels: Mindscape and Thunder Mountain. Retail prices of Mindscape label products generally range from \$29 to \$50, while retail prices of Thunder Mountain label products typically are less than \$15. At March 31, 1988, the Company offered 65 Mindscape label titles and 75 Thunder Mountain label titles, most of which were offered for use on multiple hardware formats. While many Mindscape titles have enjoyed considerable recognition and sales volume success, the Company is not dependent on one or a few "hit" titles. During 1987, no single Mindscape title represented more than 7% of total Company revenues.

Mindscape Label. Mindscape label products are first-run titles developed for use on a broad range of microcomputer hardware formats. The Company publishes Mindscape label titles in all the principal entertainment and home education/productivity product categories. The following table details the breadth of Mindscape label titles:

	Number of Titles Published During 1987	Number of Titles Introduced During 1987
Adventure/Fantasy	14	3
Action/Arcade	16	12
Sports	4	3
Simulations/Strategy	9	2
Home Education/Productivity	50	9
Total	<u>93</u>	<u>29</u>

In 1988, the Company plans to introduce 27 new Mindscape label titles, which will be released on an average of two hardware formats each. In addition, the Company will convert approximately 26 titles introduced in previous years to new hardware formats. This results in an anticipated Mindscape label product development effort of approximately 75 individual software products in 1988. The Company may introduce more Mindscape label products than anticipated or may, for a variety of reasons, not actually proceed with all the products and/or conversions currently planned.

The following describes Mindscape label product categories and representative titles:

- * **Adventure/Fantasy:** Adventures, through graphics and narrative, recount the quests of fictional characters. Fantasy products go one step further by permitting players to manipulate variables to create a character in the adventure. Products in this category include *Shadowgate*, *Infiltrator* and *Deja Vu*.
- * **Action/Arcade:** Action titles are fast moving games which typically require hand/eye coordination. Arcade games are computer versions of games popularized in coin-operated arcades. Action and arcade products include *Gauntlet*, *Paperboy*, *Bop'n Wrestle* and *Xevious*.
- * **Sports:** Titles include *Superstar Ice Hockey* and *Superstar Soccer*. These two products allow a player to choose a role as a team member playing the game, as a coach developing game tactics and strategies, or as a general manager drafting and trading players to build a franchise.
- * **Simulations/Strategy:** Products in this category provide intellectual and graphic entertainment. These products include *Balance of Power* and *Harrier Combat Simulator*.
- * **Home Education/Productivity:** Home education products include scholastic test preparation titles, such as *The Perfect Score*, which helps prepare students for the SAT. Productivity titles include *Graphic Works 1.1*, a desktop publishing program, which allows users to edit and produce graphics from scanned high-resolution images.

Thunder Mountain Label. The Company offers re-released titles from the Mindscape label and other publishers, classic arcade titles and lower priced first-run titles under its Thunder Mountain label. Mindscape believes that segmenting its products by price and brand name allows it to achieve greater retail store penetration and presence.

Thunder Mountain entertainment titles include popular first-run action/arcade products such as *Top Gun* and *Rambo*, strategy products such as *Cyrus Chess*, and re-released arcade classics such as *Pole Position*. Thunder Mountain home education/productivity titles include *A Mission in Our Solar System* and the *Tink Tonk* series, which were former Mindscape label products, as well as *Songwriter*.

The following table details the breadth of Thunder Mountain label offerings, including re-released Mindscape label products:

	Number of Titles Published During 1987	Number of Titles Introduced During 1987
Adventure/Fantasy	6	—
Action/Arcade	18	15
Sports	2	1
Simulations/Strategy	12	7
Home Education/Productivity	20	2
Total	<u>58</u>	<u>25</u>

The Company currently plans to release 25 Thunder Mountain label titles in 1988 on an average of two hardware formats each, for a total of approximately 50 individual software products. The Company may introduce more Thunder Mountain label products than anticipated or may, for a variety of reasons, not actually proceed with all the products and/or conversions currently planned.

Acquisition and Development

Mindscape continually seeks new products and product sources. Products are generally acquired in one of four ways:

- * acquiring products under development from independent authors;
- * licensing rights to names or characters popularized in other media and creating appropriate software;
- * distributing products from other publishers; and
- * developing original products in-house.

Negotiating agreements with authors. The majority of Mindscape's products are licensed from individual authors (e.g., *Balance of Power* from Chris Crawford), from small development companies (e.g., *Deju Vu* from Icom Simulations), or from other publishing companies (e.g., *Harrier Combat Simulator* from Mirrorsoft Ltd.).

These arrangements generally provide for a non-refundable cash advance to the author to be offset against future royalty payments based on a percentage of net revenues. License terms range generally from two years to the life of the copyright. Licenses are generally terminable by either party upon a material breach remaining uncured for more than 60 days. In a marketplace where the predominant product lifecycle is 18-24 months, Mindscape feels that the duration of its agreements is more than adequate. Although some products are contracted for a single machine format, in most cases Mindscape has the exclusive right to develop and/or market additional machine formats.

Mindscape's ten-person Product Development group works closely with product sources and monitors the development of each product, which includes documentation and packaging, as well as the software itself. Assisting throughout the development process is Mindscape's seven-person, Technical/Programming staff, which helps resolve technical problems as they occur and which is responsible for internally developing or contracting outside vendors to develop conversions of selected titles to alternate hardware formats. Mindscape also maintains a seven-person Quality Assurance staff.

Licensing known properties. Mindscape believes that software utilizing well-known names or titles from other entertainment media has a competitive edge since name recognition, at both the distribution and consumer levels, is immediate and therefore encourages sales. Accordingly, Mindscape has acquired home computer rights to books (Stephen King's *The Mist*, Dick Francis' *High Stakes*), to movies (*Indiana Jones and the Temple of Doom*, *Top Gun*) and to arcade games (*Paperboy*, *Pac Man*).

The licensor typically receives a non-refundable cash advance to be offset against future royalty payments based on a percentage of net revenues. These royalties are often in addition to royalties paid to the independent author or developer. License terms for licenses of known properties generally range from two to five years. Licenses of known properties are generally terminable by either party upon a material breach remaining uncured for more than 30 days.

Distribution relationships. Through distribution relationships, Mindscape seeks products which complement its own product line and which further the Company's position as a broad-based consumer software publisher. In 1987, distribution of software published by third parties accounted for 3.6% of total revenues. The two year term of one distribution agreement with Cinemaware Corporation ("Cinemaware"), which accounted for all 1987 distribution income, expired in April, 1988 and was not renewed when Cinemaware began a direct sale program. Mindscape has entered into several new distribution agreements, but nevertheless anticipates lower distribution income in 1988. Pursuant to one such agreement with Sega of America, Inc., the Company is the exclusive distributor of microcomputer formats of Sega software in the United States and Canada. Sega products primarily include arcade titles and will be sold as part of the Mindscape-label product line. Revenues from the Sega distribution arrangement will be recorded as net sales,

not distribution income, since the product will be placed in the Company's inventory. The Company and Sega have also agreed to use their best efforts to conclude a similar agreement for titles to be sold under the Thunder Mountain label, although no assurance can be given that such an agreement will be consummated.

Internal development. In 1988, Mindscape intends to publish its first internally-designed entertainment product. Although the Company plans to enhance its internal development capability in 1988, it also plans to intensify its search for third-party software sources. Mindscape recognizes the value of working with authors, development groups and other publishing houses since such outside sources serve both to balance the product line and to spur creative growth and innovation.

Marketing and Distribution

The Company's consumer market software is sold through specialty retail outlets and mass merchandisers principally in the United States and Canada. Software specialty stores selling the Company's software include Babbage's, Egghead Software, Electronics Boutique and the software specialty divisions of B. Dalton and Waldenbooks. Mass merchandisers selling the Company's software include Toys "R" Us, Warehouse Entertainment, Sears and Lechmere.

Retailers purchase the Company's consumer software from independent distributors and the Company's direct sales force. Sales to independent distributors accounted for 56% of the Company's 1987 consumer market revenues.

The Company's direct sales force employs eight salespersons with responsibility for Mindscape label products and four salespersons with responsibility for Thunder Mountain label products. The Company's direct sales force sells to more than 29 distributors and 87 retail accounts. The sales force is also responsible for servicing major retail specialty outlets which purchase from distributors. In addition, the sales force supervises two independent Mindscape label sales representatives and nine independent Thunder Mountain label sales representatives. The Company believes that sales to software specialty stores by the Company's sales force will increase as a percent of total Company revenue as software specialty stores increase their market penetration.

The Company uses a variety of tactics to promote retailer participation and consumer sales. In 1988, promotion events will include three nationally advertised sweepstakes, point-of-sale floor displays, counter cards, on-pack offers and posters. In 1988, the Company introduced the "Powerplayers Club" to build consumer loyalty among the action/arcade game enthusiasts. To supplement its own advertising and promotion activities, the Company offers cooperative advertising and special promotion allowances at the retail level.

The Company's returned goods policy requires that retailers and distributors returning Mindscape label products offset the return with a 2-for-1 order (\$2.00 of purchased product for every \$1.00 of returned product). On Thunder Mountain label products the order requirement is 3-for-1.

The Company participates in over a dozen industry and end-user trade shows each year, including the Consumer Electronics Show at which the Company promotes its full line of consumer software to retail merchants and sponsors a major industry media event. In addition, Mindscape aggressively promotes editorial reviews of products in national computer hardware and software publications.

Education Market

Mindscape publishes over 170 titles for the education market. Product offerings include curriculum related programs and software productivity tools intended for student use, as well as administrative programs intended for teacher use. Products are available for kindergarten through college but are targeted primarily to grades three through nine.

The Apple II family of computers has historically dominated the education market. As a result, most of Mindscape's education titles are designed for Apple II systems. To respond to a growing demand for IBM and IBM-compatible products, Mindscape is converting its top revenue-producing titles which are not already available for IBM microcomputers to the MS-DOS hardware format.

Products

Mindscape's education products fall into three broad categories: curriculum, productivity and administrative programs. Curriculum related programs, such as *Success with Math*, *Success with Algebra* and *Reading Workshop*, supplement instruction in the basic disciplines: mathematics, reading, language arts, social studies, physical and biological sciences, and foreign languages. Productivity tools are designed for student use, but do not correlate to specific curricular areas, and include word processing and database software. Administrative programs, designed to help teachers manage their classrooms, include: *Crossword Magic*, which allows teachers to create crossword puzzles for worksheets, quizzes and tests for a variety of subjects; *Gradebook Plus*, which helps teachers computerize their gradebook functions; and *Principal's Assistant*, which provides an easy mechanism for developing award and other recognition certificates.

In addition to products developed specifically for educational use, Mindscape sells special packages of some of its consumer titles to schools. These crossover consumer titles, like Mindscape's other education products, are typically packaged with a teacher's guide and back-up disk.

Acquisition and Development

The Company's broad product line and the relatively long lifecycle of education products have reduced Mindscape's need to continually acquire new programs for the education market. Consequently, in 1988, Mindscape is focusing on completing and introducing previously-unreleased titles which were acquired in 1986 and 1987 from Educational Patterns, Inc. and Holt, Rinehart and Winston, Inc.

In 1987, Mindscape was one of four publishers chosen by the State of California from a field of seventy-five to develop curriculum programs for school use. Under this project, California will advance one-half of Mindscape's proposed costs to develop a mathematics problem-solving series for grades kindergarten through six. California's advances are recoverable out of proceeds, if any, from Mindscape's sales in other states. In addition to software, the project encompasses print materials, manipulatives and an optional videodisk. If successfully completed, management believes that Mindscape will be one of the first companies to offer interactive videodisk products in the education market.

Marketing and Distribution

Mindscape markets its education products through a staff of four salespersons, all of whom have advanced degrees in education. In addition to this staff, Mindscape relies on direct mail, distributors, dealers, and "master teachers" to sell its education products. Master teachers distribute product information in less populous market areas in exchange for complimentary products. In 1987, one independent distributor, Softkat, Inc. accounted for approximately 35% of the Company's educational revenues. Loss of this customer would result in significantly reduced sales in the education market in the near term.

In addition to standard education product packages which include a teacher's guide and back-up disk, Mindscape offers site licensing and networking versions of selected products. Site licenses, which tend to be limited to products that are past the peak of their sales, allow schools to obtain a master disk and the right to make copies for use at individual computer stations. Networked versions of curriculum programs allow the use of one specially-designed, copy protected master disk on a networked system of computer terminals.

Mindscape regularly participates in major national and state educational conferences, as well as in educational workshops sponsored by the major hardware companies. Mindscape works closely with Apple Computer, Tandy and IBM, to coordinate its product development and marketing with new hardware introductions. In addition, Mindscape enhances its relationship with its customer base by offering value added special services such as user-guides, a toll-free hotline to answer teachers' questions about Mindscape programs and teacher training seminars.

Nintendo

Mindscape is licensed to produce and distribute up to ten new titles for the Nintendo Entertainment System. The Nintendo Entertainment System connects to most television sets and plays video game cartridges. The Nintendo product is well established in Japan, and was more recently introduced in the United States. The Company believes that in 1987 approximately 3,000,000 hardware units and approximately 15,000,000 software units were sold in the United States.

Mindscape has developed two new Nintendo titles, *Indiana Jones and the Temple of Doom* and *Paperboy*, and is currently developing four additional titles for introduction in late 1988 or early 1989. Introduction of any of these titles will depend on an adequate supply of microcomputer chips used in the manufacture of Nintendo software cartridges.

As of March 31, 1988, the Company had capitalized approximately \$700,000 in license fees and conversion costs for Nintendo products and anticipates additional conversion costs of approximately \$210,000 for products under development. Further costs will be incurred as additional titles are developed. Orders with the supplier of Nintendo cartridges must be prepaid and are non-cancellable.

Mindscape regards this license arrangement as an attractive opportunity to exploit the current popularity of the Nintendo Entertainment System. Three factors, however, make this a speculative venture. A shortage of microchips used in the manufacture of Nintendo software cartridges could substantially impair the Company's ability to procure an adequate supply of Nintendo cartridges from its supplier before year-end. In addition, the market for Nintendo cartridges may become saturated if Nintendo licenses too many publishers or manufactures too many cartridges. Mindscape believes that as of March 31, 1988, Nintendo had licensed more than 30 publishers in the United States. Finally, the short life span of similar products marketed in the past raises the possibility of a quick and substantial decline in demand for Nintendo cartridges. No Nintendo products have been ordered or sold by Mindscape and no assurance can be given that Mindscape will receive any Nintendo cartridges prior to 1989. The Company is not hiring additional personnel or planning to dedicate capital resources to Nintendo after 1989 unless the then-prevailing market conditions warrant.

Manufacturing

All of the diskettes sold by the Company are produced by independent companies, from master programs supplied by the Company. Packaging is designed by the Company. Printing of the user manual and packaging and the related materials are produced to the Company's specifications by outside sources. Components consisting of diskettes, instruction manuals, labels and packaging are assembled by Mindscape employees at its Wheeling warehouse, and finished goods are stored at and distributed through its Northbrook facility.

To date the Company has not experienced any material difficulties or delays in manufacturing of components from its outside vendors. The Company has numerous sources for product components, and has no reason to believe it will experience any material problems with availability from vendors.

Nintendo products are developed by the Company and a master program is shipped to Japan for manufacture on software cartridges compatible with the Nintendo Entertainment System hardware unit. Due to a shortage in the availability of memory related microchips, the Company has been informed by Nintendo that receipt of initial orders of software cartridges will be delayed and that the number of software cartridges shipped to the Company will be reduced from early 1988 indications. The Company believes it will receive shipment of its *Indiana Jones and the Temple of Doom* and *Paperboy* products in the fourth quarter of 1988.

Competition

The consumer and education microcomputer software markets are highly competitive. In the consumer market, the Company competes both in the acquisition of new products from authors and in the marketing and sale of its existing products. Competition in the acquisition of products is based principally upon royalty terms to authors, marketing capability and the relationships between the authors and the Company. Competition in the sale of products is based principally upon product quality, hardware compatibility and software pricing.

Competition in the sale of education market products is based primarily on the breadth of product, product quality, purchase options, preview policies (which allow teachers to review software prior to actual purchase) and return policies.

The consumer and education software markets attract hundreds of authors and publishers, many of which produce only a limited number of products in small niche markets. The Company's competitors vary in size from small companies with limited resources to large corporations, including manufacturers of microcomputers, with substantially greater financial and management resources than the Company and with the technical ability to develop and financial ability to acquire products similar to those offered by the Company.

Copy Protection

Most of Mindscape's products are protected against unauthorized reproduction with software copy protection. No assurance can be given, however, that copy protection will prevent unauthorized copying and/or distribution of Mindscape's software products.

Trademarks

The names "Mindscape" and "Thunder Mountain" are used extensively in the Company's business and its right to them continues so long as it uses them. Nintendo® and Nintendo Entertainment System® are trademarks of Nintendo of America Inc.

Personnel

As of March 31, 1988, the Company had 130 employees. Mindscape's success is largely dependent on its ability to attract and retain qualified employees. Competition for employees is intense in the software industry. To date, the Company believes it has been successful in its efforts to recruit qualified employees, but there is no assurance that it will continue to be successful in the future. None of the Company's employees are subject to collective bargaining or employment agreements. The Company believes its relations with its employees are good.

Property

Mindscape owns a 41,400 square foot facility in Northbrook, Illinois, which includes the Company's corporate headquarters, a warehouse of 10,500 square feet for storage and distribution of finished product and 2,269 square feet of space leased to a third party tenant. In addition, the Company leases a 27,028 square foot warehouse in Wheeling, Illinois for a remaining term of two years. Mindscape also leases 972 square feet of office space in Minneapolis, Minnesota. The Company owns a condominium in Northbrook, Illinois, which is used by Mr. Buoy.

MANAGEMENT

Directors and Officers

The directors, officers and other key personnel of the Company are as follows:

<u>Name</u>	<u>Age</u>	<u>Position</u>
John R. Purcell	56	Chairman* and Director
Roger M. Buoy	42	President and Chief Executive Officer* and Director
Peter G. Diamandis	56	Nominee for Director
Richard T. Morgan	51	Nominee for Director
Roger T. Young	41	Executive Vice President and Treasurer*
Linda J. Gosser-Meurer	39	Vice President—Finance and Secretary*
Kathleen M. Harley	42	Vice President, Educational Products†
Robert C. Ingersoll	45	Vice President of Marketing, Consumer Products†
Dennis A. O'Malley	40	Vice President of Sales, Consumer Products†
John S. Nichols	48	Vice President, Art and Innovation, Consumer Products†
Sandra M. Schneider	32	Vice President and Creative Director, Consumer Products†
Robert P. Pasquale	42	Director of Associated Companies†
Robert J. Dahm	49	Director of Personnel†

* Executive officers.

† Divisional, not corporate, officers.

JOHN R. PURCELL. Mr. Purcell has been Chairman and a director of Mindscape since January, 1987. From November, 1982 to December, 1986, Mr. Purcell was Chairman, President and Chief Executive Officer of SFN Companies Inc. Mr. Purcell is also a director of Omnicom Group, Inc. and Bausch & Lomb, Inc. Mr. Purcell served as Executive Vice President of CBS, Inc., responsible for publishing and toy operations, from March, 1977 to July, 1981 and as Senior Vice President of Gannett Co., Inc., responsible for financial and business operations, from September, 1968 to February, 1977.

ROGER M. BUOY. Mr. Buoy has been a director and President and Chief Executive Officer of Mindscape since October, 1983. From December, 1981 to September, 1983 Mr. Buoy was an Executive Vice President of Scholastic, Inc., an educational publishing company, with responsibility for the software publishing group. From February, 1971 to December, 1981, Mr. Buoy worked at Arthur Young & Company in both New York and Sydney, Australia and became a partner in 1977.

PETER G. DIAMANDIS. Mr. Diamandis has been nominated to become a director of Mindscape. Since October, 1987, Mr. Diamandis has served as President and Chief Executive Officer of Diamandis Communications, Inc. From September, 1983 to October, 1987, he was President of CBS Magazines, a division of CBS Inc. From February, 1982 to September, 1983, Mr. Diamandis served as Vice President, Group Publisher, Women's Magazine Group, CBS Magazines, and Publisher, *Woman's Day*. Mr. Diamandis is also Vice Chair of the Magazine Publishers Association and a director of The Publishers Information Bureau.

RICHARD T. MORGAN. Mr. Morgan has been nominated to become a director of Mindscape. Since January, 1987, Mr. Morgan has been President and Chief Executive Officer of Scott, Foresman and Company, a wholly owned subsidiary of Time Inc. From January, 1984 to January, 1987, Mr. Morgan served in various capacities at SFN, including President of Scott, Foresman and Company, Senior Vice President of SFN and Vice President of SFN. Since April, 1987, Mr. Morgan has also been Vice President of Time Inc. From February, 1979 until he joined SFN, Mr. Morgan was Executive Vice President and President of the School Division of Macmillan Publishing Company. Mr. Morgan is also a director of Scott, Foresman and Company, Canada Publishing Company, Book Industry Study Group, Evanston Hospital and Book-of-the-Month Club, and Chairman of the Association of American Publishers.

ROGER T. YOUNG. Mr. Young joined Mindscape on April 4, 1988 as Executive Vice President and was elected Treasurer in May, 1988. From August, 1983 until he joined Mindscape, Mr. Young served as Vice President and General Manager of CSS, the software distribution division of Chas. Levy Companies. From January, 1977 to August, 1983, he was a financial manager for Chas. Levy Companies.

LINDA J. GOSSER-MAURER. Ms. Gosser-Maurer joined Mindscape in June, 1984 as Controller, became Vice President, Finance and Operations in March, 1986 and became Vice President—Finance and Secretary in January, 1987. From June, 1979 until she joined Mindscape, Ms. Gosser-Maurer served as Controller of the Industrial Chemicals Division of International Minerals and Chemicals Corporation. From April, 1972 to June, 1975, Ms. Gosser-Maurer held a number of positions at American Hospital Supply Corporation, including Director of Accounting and Reporting at the American Critical Care Division.

KATHLEEN M. HURLEY. Ms. Hurley has served as Vice President, Educational Products of Mindscape since May, 1986. From April, 1984 until she joined Mindscape, Ms. Hurley was Vice President, Microcomputer Software for Grolier Electronic Publishing. From February, 1983 to April, 1984, Ms. Hurley was Vice President of Marketing for Intentional Educations, Inc. In addition, Ms. Hurley has four and one-half years experience as a special education teacher.

ROBERT C. INGERSOLL. Mr. Ingersoll has been Vice President of Marketing, Consumer Products since May, 1987. From July, 1986 to May, 1987, Mr. Ingersoll served as a consultant for several microcomputer software firms. From March, 1982 until July, 1986, Mr. Ingersoll was Chairman of Metropolitan Computers d/b/a Computerland of Chicago. From May, 1982 to September, 1984, Mr. Ingersoll was a Senior Vice President and Vice President of Bozell & Jacobs Advertising.

DENNIS A. O'MALLEY. Mr. O'Malley has served as Vice President of Sales, Consumer Products since May, 1987. From July, 1985 to May, 1987, Mr. O'Malley was Vice President of Sales for Softstyles, Inc., a developer of printer utility software. From November, 1984 to June, 1985, Mr. O'Malley was the Midwest Regional Sales Manager for Commodore Business Machines. From January, 1984 to July, 1984, Mr. O'Malley was Director of National Accounts for Atari, Inc. From August, 1983 to December, 1983, Mr. O'Malley was Manager of National Accounts for CBS Electronics.

JOHN S. NICHOLS. Mr. Nichols joined Mindscape in June, 1984 as art director and became Vice President, Art and Innovation in January, 1987. From September, 1981 to January, 1984, Mr. Nichols served as art director for Pizza Time Theatre. In addition, Mr. Nichols has served as an art director at Walt Disney World and Great America.

SANDRA M. SCHNEIDER. Ms. Schneider has served as Vice President and Creative Director, Consumer Products since March, 1986. From December, 1984 to February, 1986, she served as Director of Product Development at Mindscape, and from May, 1984 to December, 1984, Ms. Schneider was Mindscape's Manager of Product Development. From April, 1980 to May, 1984, Ms. Schneider was a Courseware Development Specialist and Courseware Development Supervisor at Scott, Foresman and Company, Electronic Publishing Division.

ROBERT P. PASQUALE. Mr. Pasquale has been Director of the Associated Companies program for Mindscape's Consumer Products since December, 1987. From November, 1983 until he joined Mindscape, Mr. Pasquale was the Midwest Regional Manager for Electronic Arts, Inc., a software publisher.

ROBERT J. DAHM. Mr. Dahm joined Mindscape in May, 1984 as Director of Human Resources. From May, 1980 until he joined Mindscape, Mr. Dahm served as Manager of Employee Relations and Manager of Corporate Recruiting for Universal Oil Products, Inc.

Directors will be elected at the annual stockholders meeting to serve until the election and qualification of successors. Vacancies and newly created directorships may be filled by a majority of directors. The Company intends to establish an Audit Committee of the Board of Directors consisting of non-employee directors to be elected immediately prior to the closing of the shares offered hereby. Mindscape expects to pay directors, other than salaried employees, an annual fee of \$10,000. Corporate officers are chosen by and serve at the discretion of the Board of Directors.

Executive Compensation

The following table sets forth the aggregate cash compensation paid or accrued by Mindscape to each of the executive officers of the Company and to all executive officers as a group for services rendered by such officers in 1987.

<u>Name of Individual or Number of Persons in Group</u>	<u>Capacity</u>	<u>Cash Compensation</u>
John R. Purcell	Chairman	—
Roger M. Buoy	President and Chief Executive Officer	\$165,000
Linda J. Gosser-Maurer	Vice President—Finance and Secretary	80,500
All executive officers as a group (4 persons)*		245,500†

*Includes one person who is no longer an executive officer of Mindscape and received no compensation in 1987.

†Excludes certain personal benefits aggregating less than \$24,550.

Stock Option Plan for Key Employees

Under the Company's Stock Option Plan for Key Employees, an aggregate of 115,000 shares of Common Stock may be issued to selected key employees pursuant to either incentive stock options or nonstatutory stock options granted at the discretion of and on terms specified by the Company's Stock Option Committee. Options granted pursuant to the plan become exercisable in installments of 25%, 35% and 40%, upon the first, second and third anniversaries of the grant date, respectively. Incentive stock options may not be exercisable by any employee in an amount exceeding \$100,000 in any year. The exercise price of options pursuant to the plan may not be less than fair market value on the grant date. Incentive stock options granted under the plan cease to be exercisable within ten years after the grant date. Nonstatutory stock options granted under the plan cease to be exercisable within ten years and one day after the grant date. Options may not be granted under the plan to any employee owning more than 10% of the combined voting power of all classes of Mindscape stock. Options for 69,000 shares were awarded under the plan at an average exercise price of \$.65 per share, including options on 17,250 shares to Ms. Gosser-Maurer. No options became exercisable or were exercised by any of the Company's employees in 1987.

Profit Sharing Plan

Under Mindscape's profit sharing plan, employees of Mindscape over the age of 19, with one year of full-time service may defer from 1% to 10% of their annual compensation as Salary Deferral Contributions and 10% of their annual compensation as Retirement Savings Contributions pursuant to Section 401(k) of the Internal Revenue Code, subject to certain limitations. Employee contributions are matched by Mindscape in an amount equal to 10% of Salary Deferral Contributions to a maximum of 6% of compensation. The plan permits Mindscape to make additional discretionary profit sharing contributions which are allocated among all eligible employees who have completed 1,000 hours of service during the plan year. Allocations of profit sharing contributions are made pro rata in proportion to eligible employees' annual compensation. Employees are 100% vested at all times in their Salary Deferral Contributions and Retirement Savings Contributions. Matching contributions and profit sharing contributions made by Mindscape vest 20% per year beginning with date of hire. The table under Executive Compensation includes all amounts contributed by executive officers under the plan in 1987, but excludes the portion of the Company's contributions which vested during 1987, in the amounts of \$528 and \$313 for Mr. Buoy and Ms. Gosser-Maurer, respectively.

CERTAIN TRANSACTIONS

Since January 16, 1987, Mindscape has borrowed from Messrs. Purcell and Buoy to meet operating expenses and working capital requirements, which borrowings are evidenced by promissory notes (the "Notes"). The largest aggregate principal amount outstanding under the Notes at any time was \$6,053,118.

As of May 12, 1988, Notes in an aggregate principal amount of \$5,371,524 had been repaid. The outstanding Notes at May 15, 1988, in an aggregate principal amount of \$2,056,594, bear interest at 7½% and mature on January 1, 1991. Messrs. Purcell and Buoy will contribute an outstanding principal amount of \$1,056,594 of these Notes to the equity of Mindscape immediately prior to the completion of the offering made hereby. On June 16, 1988, the Company borrowed an additional \$1,000,000 and may borrow up to \$2,500,000 from Mr. Purcell pursuant to the Purcell Line. The Purcell Line bears interest at 9½%. See "S Corporation Dividends" and "Financing Arrangements."

Messrs. Purcell and Buoy provided joint and several guaranties for the full amount of Mindscape's \$7,000,000 line of credit under Mindscape's bank loan arrangement that expired May 12, 1988. Messrs. Purcell and Buoy provide joint and several guaranties of up to \$7,000,000 of Mindscape's indebtedness under Mindscape's Bank Loan Agreement. It is expected that the guaranties will be released immediately following the closing of the sale of the shares offered hereby. See "Financing Arrangements."

Messrs. Purcell and Buoy own approximately 70% of YPA Holdings Pty. Ltd., an Australian corporation ("YPA"), which is engaged in the distribution of microcomputer software in Australia. In 1988, Mindscape began selling products to YPA for distribution in Australia on terms comparable to those offered to its former Australian distributor. For the period from January 1, 1988 through April 30, 1988, Mindscape sales to YPA were approximately \$118,800. In addition, through April 30, 1988, Mindscape loaned an aggregate of \$85,000 to YPA on a demand basis bearing interest at 8.0% per annum to fund YPA's working capital needs. The Company has been advised that YPA has agreed to promptly repay this loan. All future transactions, including loan transactions, with officers, directors and affiliates of the Company will be on terms no less favorable to the Company than are otherwise available from unaffiliated third parties and will be approved by a majority of disinterested, independent, outside directors.

The Company and its S corporation stockholders have entered into the Tax Agreement allocating the Company's total taxable income (or loss) for 1988. See "S Corporation Dividends."

PRINCIPAL AND SELLING STOCKHOLDERS

The following table sets forth as of May 15, 1988 and as adjusted to reflect the sale of shares assuming the over-allotment option is exercised in full and the issuance of 17,250 of the 69,000 shares subject to options, the amount and percentage of outstanding shares of Common Stock beneficially owned by each director, all directors and officers of the Company as a group, each beneficial owner of five percent or more of the Company's Common Stock and each stockholder offering shares as part of the over-allotment option pursuant to this Prospectus.

Name	Shares Beneficially Owned Prior to Offering		Shares to be Sold Pursuant to the Over-Allotment Option	Shares Beneficially Owned After Offering Assuming Full Exercise of the Over-Allotment Option	
	Number	Percent		Number	Percent
John R. Purcell (1)(2)(3)	1,421,400	59.9%	55,000	1,366,400	39.3%
Roger Buoy (1)(4)(5)	798,100	33.6%	55,000	743,100	21.4%
All Officers and Directors as a Group (4 persons)(1)	2,223,812	93.6%	110,000	2,113,812	60.8%

- (1) The address of each of the directors and officers of Mindscape is 3444 Dundee Road, Northbrook, Illinois 60062.
- (2) Director and Chairman. See "Management—Directors and Officers."
- (3) Excludes an aggregate of 92,000 shares owned by Mr. Purcell's four children, as to which Mr. Purcell disclaims beneficial ownership.
- (4) Director, President and Chief Executive Officer. See "Management—Directors and Officers."
- (5) Excludes 46,000 shares held by Mr. Buoy's wife in trust for their two children, as to which Mr. Buoy disclaims beneficial ownership.

Stockholders' Agreement

Pursuant to the Mindscape Inc. Amended and Restated Stockholders' Agreement (the "Stockholders' Agreement") dated as of January 1, 1988, among Mindscape and the existing stockholders (the "Stockholders"), each Stockholder has granted to the others a right of first refusal with respect to the transfer of any or all of his or her shares of Common Stock and the right to sell a pro rata portion of any shares of Common Stock for which an offer to purchase has been received. The Stockholders' Agreement further provides that, subject to certain exceptions, upon the death of a Stockholder, Mindscape will repurchase such Stockholder's Common Stock, and that no Stockholder shall participate in the formation, control, management or operation of a competing software publisher for a two-year period ending after the date on which he or she ceases to be a Stockholder of Mindscape. The Stockholders' Agreement will terminate upon the earlier of the death of either Mr. Purcell or Mr. Buoy or two years after the effectiveness of a registration statement regarding Common Stock of Mindscape. Mindscape and the existing Stockholders will, immediately prior to the closing of the offering, amend the Stockholders' Agreement to delete Mindscape's obligation to repurchase Common Stock upon the death of a Stockholder.

DESCRIPTION OF CAPITAL STOCK

Mindscape's authorized capital stock consists of 4,600,000 shares of Common Stock, par value \$.00001 per share, of which 2,357,500 shares were issued and outstanding on May 15, 1988. All outstanding Common Stock is fully paid and non-assessable. Each holder of shares of Common Stock is entitled to one vote for each share owned on all matters to be voted on by stockholders, including election of directors. The Common Stock is not subject to any preemption or registration rights. The Common Stock is neither redeemable nor convertible. Subject to the restrictions of the Bank Loan Agreement, holders of Common Stock are entitled to such dividends as may be declared from time-to-time by the Board of Directors of Mindscape. See "Dividend Policy" and "Financing Arrangements." In the event of a liquidation, dissolution or winding-up of Mindscape, the holders of Common Stock are entitled to share equally and ratably in the assets of Mindscape, if any, remaining after the payment of all debts and liabilities of Mindscape. The transfer agent and registrar for the Common Stock is Continental Illinois National Bank and Trust Company of Chicago. Mindscape has elected not to be governed by the anti-takeover provisions of Section 203 of the Delaware General Corporation Law. The Company has no authorized preferred stock. Shares of preferred stock redeemed in 1987 were subsequently cancelled.

SHARES ELIGIBLE FOR FUTURE SALE

No shares of Mindscape will be eligible for sale pursuant to Rule 144 prior to January 16, 1989. Mindscape is unable to predict the effect of future sales of Common Stock on the public market. Sales of substantial amounts of such shares on the public market could adversely affect prevailing market prices.

Pursuant to Rule 144 under the Securities Act of 1933, as amended (the "Act"), a person who has beneficially owned "restricted" securities for at least two years, including a person who may be deemed an "affiliate" of Mindscape as the term "affiliate" is defined under the Act, is entitled to sell in "brokers" transactions or to market makers, within any three-month period, a number of shares that does not exceed the greater of 1% of the outstanding shares of Mindscape's Common Stock (34,575 shares, after the sale of the shares offered hereby) or the average weekly trading volume of Mindscape's Common Stock during the four calendar weeks preceding the filing of the notice required by Rule 144. A person who is not deemed an "affiliate" of Mindscape and who has beneficially owned his shares for at least three years would be entitled to sell such shares under Rule 144 without regard to the volume limitations described above. Sales under Rule 144 are also subject to other requirements. The foregoing summary of Rule 144 is not intended to be a complete description thereof.

The Selling Stockholders have agreed that they will not, without the consent of the Representative, publicly sell shares of Common Stock, except pursuant to the Underwriters' over-allotment option, for a period of 180 days from the date of this Prospectus.

UNDERWRITING

The Underwriters named below, for whom William Blair & Company is acting as Representative, have severally agreed, subject to the terms and conditions of the Underwriting Agreement, to purchase from the Company the aggregate number of shares of Common Stock (excluding the over-allotment shares) set forth opposite their names below:

Underwriter	Number of Shares
William Blair & Company	710,000
Alex. Brown & Sons Incorporated	18,000
Dillon, Read & Co. Inc.	18,000
Donaldson, Lufkin & Jenrette Securities Corporation	18,000
Hambrecht & Quist Incorporated	18,000
Montgomery Securities	18,000
Prudential-Bache Capital Funding	18,000
Robertson, Colman & Stephens	18,000
Advest, Inc.	12,000
J. C. Bradford & Co., Incorporated	12,000
Dain Bosworth Incorporated	12,000
Ladenburg, Thalmann & Co. Inc.	12,000
Oppenheimer & Co., Inc.	12,000
Piper, Jaffray & Hopwood Incorporated	12,000
The Robinson-Humphrey Company, Inc.	12,000
Tucker, Anthony & R.L. Day, Inc.	12,000
Robert W. Baird & Co. Incorporated	8,000
Sanford C. Bernstein & Co., Inc.	8,000
Blunt Ellis & Loewi, Inc.	8,000
Cable, Howse & Ragen Incorporated	8,000
The Chicago Corporation	8,000
First Albany Corporation	8,000
First of Michigan Corporation	8,000
Furman Selz Mager Dietz & Birney Incorporated	8,000
Howard, Weil, Labouisse, Friedrichs, Incorporated	8,000
Janney Montgomery Scott Inc.	8,000
Johnson, Lane, Space, Smith & Co.	8,000
The Milwaukee Co.	8,000
Needham & Company, Inc.	8,000
Neuberger & Berman	8,000
Stifel, Nicolaus & Company, Incorporated	8,000
Sutro & Co. Incorporated	8,000
Clary Gull Reiland McDevitt & Collopy Inc.	4,000
First Analysis Securities Corp.	4,000
Gabelli & Company, Inc.	4,000
Hayes & Griffith, Inc.	4,000
McClees Investments, Inc.	4,000
Oberweis Securities, Inc.	4,000
Parker/Hunter Incorporated	4,000
Rodman & Renshaw, Inc.	4,000
Steiner Diamond & Co., Inc.	4,000
Herbert B. White & Co.	4,000
Total	1,100,000

The nature of the Underwriters' obligations under the Underwriting Agreement is such that all shares of Common Stock being offered, excluding shares covered by the over-allotment option granted to the Underwriters, must be purchased if any are purchased.

The Company and the Selling Stockholders have been advised by the Representative that the several Underwriters propose to offer the shares to the public initially at the public offering price set forth on the cover page of this Prospectus, and to certain dealers at such price less a concession not in excess of \$.35 per share. The Underwriters may allow, and such dealers may reallow, a concession not in excess of \$.25 per share on sales to other dealers. The initial public offering price and concessions and reallowances to dealers may be changed by the Representative.

The Selling Stockholders have granted to the Underwriters an option, exercisable within 30 days after the date of this Prospectus, to purchase up to an additional 110,000 shares of Common Stock to cover over-allotments at the same price per share to be paid by the Underwriters for the other shares offered hereby. If the Underwriters purchase any such additional shares pursuant to this option, each of the Underwriters will be committed to purchase any such additional shares in approximately the same proportion as set forth in the above table. The Underwriters may purchase such shares only to cover over-allotments, if any, in connection with the offering being made hereby. If the option is exercised, shares will be purchased from the Selling Stockholders in equal amounts.

Prior to this offering there has not been an established market for the Common Stock of the Company. The initial public offering price has been determined by negotiations among the Company, the Selling Stockholders and the Representative. The major factors considered in determining the public offering price of the Common Stock were prevailing market conditions, the market prices relative to earnings, cash flow and assets for publicly traded common stocks of comparable companies, the sales and earnings of the Company and comparable companies in recent periods, the Company's earnings potential, the Company's position in the industry, and the Company's business prospects.

The Representative has informed the Company and the Selling Stockholders that it does not expect the Underwriters to make sales to discretionary accounts.

The Company and the persons named under "Principal and Selling Stockholders" have agreed that, for a period of 180 days after the date of this Prospectus, they will not offer, sell or otherwise dispose of any shares of the Company's Common Stock, except with respect to private sales, existing stock options or bona fide gifts subject to the same limitation on resale, without the prior written consent of the Representative.

The Underwriting Agreement provides that the Company and the Selling Stockholders will indemnify the several Underwriters against certain liabilities, including liabilities under the Act, or will contribute to payments which may be made in respect thereof.

LEGAL OPINIONS

The validity of the Common Stock offered hereby will be passed upon for the Company and the Selling Stockholders by Latham & Watkins and for the Underwriters by McDermott, Will & Emery.

EXPERTS

The financial statements and schedules of the Company at December 31, 1987 and for the period January 13, 1987 to December 31, 1987, and the statement of operations of the predecessor for the period January 1, 1987 to January 16, 1987, appearing in this Prospectus and Registration Statement have been examined by Arthur Young & Company, certified public accountants, as set forth in their reports appearing elsewhere herein and in the Registration Statement, and are included herein in reliance upon such reports and upon the authority of said firm as experts in auditing and accounting.

The balance sheets of Mindscape, Inc. (a predecessor to the Company) as of December 31, 1986 and 1985, and the related statements of operations, shareholder's equity and cash flows for the years then ended, included in this Prospectus and Registration Statement have been examined by Arthur Andersen & Co., independent public accountants, as indicated in their report with respect thereto, and are included herein in reliance upon such report and upon the authority of said firm as experts in giving said report.

ADDITIONAL INFORMATION

A Registration Statement on Form S-1 relating to the Common Stock offered hereby has been filed by Mindscape with the Securities and Exchange Commission, Washington, D.C. This Prospectus does not contain all of the information set forth in the Registration Statement and the exhibits and schedules thereto. For further information with respect to Mindscape and the Common Stock offered hereby, reference is made to such Registration Statement, exhibits and schedules. Statements contained in this Prospectus as to the contents of a contract or other document referred to are not necessarily complete, and in each instance reference is made to the copy of such contract or other document filed as an exhibit to the Registration Statement. The Registration Statement may be inspected without charge at the Commission's principal offices at 450 Fifth Street, Washington, D.C. 20549, and copies of all or any part thereof may be obtained from the Commission upon the payment of certain fees prescribed by the Commission.

Mindscape intends to furnish to its stockholders annual reports containing audited financial statements certified by an independent accounting firm, and quarterly reports containing unaudited financial information for the first three quarters of each fiscal year.

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The Board of Directors and Stockholders
Mindscape Inc.

We have examined the accompanying balance sheet of Mindscape Inc. at December 31, 1987 and the related statements of operations (before pro forma adjustments), stockholders' equity and cash flows for the period from January 13, 1987 (inception) to December 31, 1987. We have also examined the statement of operations (before pro forma adjustments) of the predecessor of Mindscape Inc. for the period January 1, 1987 to January 16, 1987. Our examinations were made in accordance with generally accepted auditing standards and, accordingly, included such tests of the accounting records and such other auditing procedures as we considered necessary in the circumstances.

In our opinion, the statements mentioned above present fairly (1) the financial position of Mindscape Inc. at December 31, 1987, and the results of operations (before pro forma adjustments) and cash flows for the period from January 13, 1987 to December 31, 1987, in conformity with generally accepted accounting principles and (2) the results of operations (before pro forma adjustments) of the predecessor to Mindscape Inc. for the period January 1, 1987 to January 16, 1987, in conformity with generally accepted accounting principles applied on a basis consistent with that of the year ended December 31, 1986.

Arthur Young & Company
Chicago, Illinois
March 25, 1988, except as to the
subsequent events note as to which the
date is May 18, 1988

MINDSCAPE INC.

BALANCE SHEET

December 31, 1987

ASSETS

Current assets:	
Cash	\$ 109,072
Accounts receivable, net	8,907,815
Inventories	3,855,635
Royalty advances	1,243,669
Other current assets	<u>591,253</u>
Total current assets	14,707,446
Property, plant and equipment, at cost:	
Land	340,900
Building and improvements	2,284,748
Equipment	954,901
Furniture and fixtures	<u>267,105</u>
	3,847,654
Less accumulated depreciation and amortization	<u>196,062</u>
	3,651,592
Royalty advances	998,698
Other assets	<u>351,692</u>
	<u>\$19,709,428</u>

LIABILITIES AND STOCKHOLDERS' EQUITY

Current liabilities:	
Notes payable to bank	\$ 6,010,000
Bank overdraft	865,165
Accounts payable	3,406,374
Accrued liabilities	1,074,090
Dividend payable	1,868,100
Royalty obligations	1,022,602
Current portion of long-term debt	<u>19,439</u>
Total current liabilities	14,255,770
Long-term debt, less current maturities (including \$2,000,000 payable to stockholders)	3,480,745
Other long-term liabilities	100,000
Stockholders' equity:	
Common stock, \$0.00001 par value, 4,600,000 shares authorized, 2,357,500 shares issued and outstanding	24
Capital in excess of par value	1,537,476
Retained earnings	<u>325,413</u>
Total stockholders' equity	<u>1,862,913</u>
	<u>\$19,709,428</u>

See accompanying notes.

MINDSCAPE INC.

STATEMENT OF OPERATIONS

	January 1, 1987 to January 16, 1987 (Predecessor)	January 13, 1987 to December 31, 1987 (Company)
Revenues:		
Net sales	\$ 264,582	18,929,464
Distribution income	9,475	734,437
Other income	3,808	471,836
Total revenues	<u>277,865</u>	<u>20,135,737</u>
Costs and expenses:		
Cost of goods sold	176,075	9,622,388
Selling and marketing expenses	337,893	5,679,557
General and administrative expenses	104,321	2,092,048
Total costs and expenses	<u>618,289</u>	<u>17,393,993</u>
Income (loss) from operations	(340,424)	2,741,744
Interest expense	6,939	520,035
Income (loss) before income taxes	(347,363)	2,221,709
Provision for income taxes	—	27,736
Net income (loss)	<u>\$(347,363)</u>	<u>2,193,973</u>
Pro forma data (unaudited) (Note 10)		
Net income (loss) as reported	\$(347,363)	2,193,973
Pro forma adjustments		
Interest charges	8,750	
General and administrative expenses	(934)	
Provision (benefit) for income taxes	<u>(156,928)</u>	968,990
	<u>(149,112)</u>	968,990
Pro forma net income (loss)	<u>\$(198,251)</u>	<u>1,224,983</u>
Pro forma net income (loss) per share		
Based on 2,426,500 shares outstanding giving effect to the 69,000 shares issuable upon future exercise of employee stock options ..	<u>\$ (.08)</u>	<u>.50</u>

See accompanying notes.

MINDSCAPE INC.

STATEMENT OF STOCKHOLDERS' EQUITY

Period from January 13, 1987 to December 31, 1987

	Preferred stock		Common stock		Capital in excess of par value	Retained earnings	Total
	Shares	Par value	Shares	Par value			
Capitalization	1,000	\$ 10	2,300,000	\$23	\$1,519,967		\$1,520,000
Preferred stock dividend ..						(460)	(460)
Redemption of preferred stock	(1,000)	(10)			(19,990)		(20,000)
Issuance of common stock			57,500	1	37,499		37,500
Net income						2,193,973	2,193,973
Common stock dividend ..						(1,868,100)	(1,868,100)
	<u>—</u>	<u>—</u>	<u>2,357,500</u>	<u>\$24</u>	<u>\$1,537,476</u>	<u>\$ 325,413</u>	<u>\$1,862,913</u>

See accompanying notes.

MINDSCAPE INC.

STATEMENT OF CASH FLOWS

Period from January 13, 1987 to December 31, 1987

Increase (decrease) in cash

Cash flows from operating activities:

Net income		\$ 2,193,973
Adjustments to reconcile net income to net cash used in operating activities:		
Depreciation and amortization	\$ 257,479	
Provision for losses on accounts receivable and sales returns and allowances	233,916	
Change in assets and liabilities net of effects of acquisition:		
Increase in accounts receivable	(6,373,397)	
Increase in inventories	(2,358,675)	
Increase in royalty advances	(645,007)	
Increase in other current assets	(553,886)	
Increase in other assets	(280,672)	
Increase in accounts payable and bank overdraft	3,239,467	
Decrease in accrued liabilities and royalty obligations	(533,040)	
Increase in other liabilities	89,339	
Total adjustments		<u>(6,924,476)</u>
Net cash used in operating activities		<u>(4,730,503)</u>

Cash flows from investing activities:

Property, plant and equipment additions	(1,121,594)	
Payment for purchase of Mindscape, Inc.	<u>(3,006,904)</u>	
Net cash used in investing activities		<u>(4,128,498)</u>

Cash flows from financing activities:

Net borrowings under line-of-credit	6,010,000	
Proceeds from issuance of stockholder notes payable	3,375,000	
Payments under mortgage payable	(18,576)	
Payments of stockholder notes payable	(1,375,000)	
Payments of other notes payable	(560,391)	
Proceeds from issuance of preferred stock	20,000	
Redemption of preferred stock	(20,000)	
Payment of preferred stock dividends	(460)	
Proceeds from issuance of common stock	<u>1,537,500</u>	
Net cash provided by financing activities		<u>8,968,073</u>

Net increase in cash and balance at end of period

		<u>\$ 109,072</u>
--	--	-------------------

Cash paid for interest during the period was \$422,366.

The Company purchased all of the capital stock of Mindscape, Inc. for \$3,006,904. In connection with the acquisition, liabilities were assumed as follows:

Purchase price allocated to the fair value of assets acquired	\$8,558,520
Cash paid for the capital stock	<u>3,006,904</u>
Liabilities assumed	<u>\$5,551,616</u>

See accompanying notes.

MINDSCAPE INC.

NOTES TO FINANCIAL STATEMENTS

1. Summary of significant accounting policies

Basis of presentation—

On January 13, 1987, Mindscape Holdings Corporation ("Holdings") was incorporated and had no significant operations until January 16, 1987. On January 16, 1987, Mindscape, Inc. (predecessor) was acquired by Holdings through the merger of its wholly owned subsidiary, Mindscape Acquisition Corporation ("MAC"), with and into Mindscape, Inc. with Mindscape, Inc. being the surviving corporation. All of the outstanding common stock of Mindscape, Inc. which was owned by SFN Partners, L.P., was converted into the right to receive \$3,006,904 in cash. On April 30, 1987, Holdings and Mindscape, Inc. were merged and Holdings, the surviving corporation, changed its name to Mindscape Inc. ("Mindscape" or the "Company"). The acquisition has been accounted for as a purchase and, accordingly, the Company allocated the purchase cost to the assets acquired and liabilities assumed based on their estimated fair value in accordance with Accounting Principles Board Opinion No. 16 as follows:

Current assets	\$5,082,996
Property, plant and equipment	2,730,164
Other assets	745,360
Current liabilities	(3,839,830)
Long term liabilities	(1,711,786)

The statement of operations for the predecessor for the period January 1, 1987 to January 16, 1987 included in the accompanying financial statements has been prepared in conformity with the accounting principles applied by the predecessor for the year ended December 31, 1986.

Unaudited pro forma revenues, operating income and net income for the year ended December 31, 1987 are \$20,413,602, \$2,402,254 and \$1,838,794, respectively, assuming the acquisition had taken place on January 1, 1987 and reflecting the allocation of the purchase price to the fair value of assets and liabilities acquired and appropriate pro forma adjustments to the historical results of the predecessor to Mindscape. The pro forma adjustments to the historical results were not significant.

Acquisition—

In March and May 1987, the Company purchased certain assets (primarily inventory and product rights) and assumed certain liabilities related to a line of software from Helt, Rinehart and Winston, Inc. for \$300,000 in cash. The liabilities assumed consisted primarily of contractual obligations based on the amount of future net sales related to the product rights acquired.

Revenue recognition—

The Company records revenue, net of allowances for estimated sales returns and allowances, at the time its products are shipped. Under a distribution agreement, the Company distributes a line of software products. The Company receives a distribution fee which it records at the time these products are shipped.

Accounts receivable—

Allowances netted against accounts receivable at December 31, 1987 consist of \$1,244,838 of estimated sales returns and allowances and \$140,675 of estimated uncollectible accounts. The Company's policy is generally to allow its customers to exchange undamaged product currently sold by the Company only if a new order is placed for at least twice the value of returned product and generally to allow returns for defective goods.

MINDSCAPE INC.

NOTES TO FINANCIAL STATEMENTS—Continued

Inventories—

Inventories, consisting of \$1,899,768 of raw materials and \$1,955,867 of finished goods, are stated at the lower of cost or net realizable value, with cost determined on the first-in, first-out method.

Royalties—

Royalty advances are paid by the Company at the time a licensing agreement is entered into with the independent software developer and, accordingly, represent prepayments prior to the actual sale of the product. Royalty advances are expensed based on actual net product sales. Royalty advances are classified as current assets based upon estimated net product sales within the next year.

Other royalty payments are accrued based on net product sales. Royalty expense, including amounts earned on royalty advances, totalled \$3,010,125 for the period January 13, 1987 to December 31, 1987 and \$45,648 for the period January 1, 1987 to January 16, 1987 (predecessor).

Property, plant and equipment—

Property, plant and equipment are depreciated on the straight line basis over the estimated useful lives of the assets which generally are 5 years for equipment, 10 years for furniture and fixtures and 40 years for the building. Improvements to leased facilities are capitalized and amortized over the shorter of the life of the asset or the remaining term of the lease. Property, plant and equipment of the predecessor to Mindscape was depreciated on the straight line basis over the estimated useful lives of the assets which generally were five years for equipment, furniture and fixtures and 15 years for building and improvements.

Other assets—

The Company has capitalized \$173,677 of software development costs in accordance with Financial Accounting Standards Board Statement No. 86 which are being amortized over the two year estimated life of the related products.

Line of business—

The Company is in one line of business: publishing a broad line of microcomputer software products for the consumer and education markets. Foreign sales are not significant and all identifiable assets are located in the United States. No single customer accounted for more than 10% of total revenues.

2. Notes payable to bank and long-term debt

The Company has an unsecured revolving credit agreement with a bank which provides for borrowings of up to \$7,000,000 with interest at either the bank's prime rate (8.75% at December 31, 1987) or at a LIBOR rate. The Company pays a commitment fee based on ½ % of the unused borrowings. The credit agreement is supported by the personal guaranties of certain stockholders and expires on April 30, 1988.

Long-term debt consists of the following:

Senior subordinated note payable to a stockholder, due January 1, 1989, 9.5% interest	\$1,000,000
Subordinated notes payable to stockholders, due January 1, 1991, 7.5% interest.....	1,000,000
Mortgage, 10.75% interest, with monthly principal and interest payments of \$15,187 and a balloon payment of \$1,226,971 due April 1, 1996, secured by land and a building with a net book value of \$2,333,454 at December 31, 1987	1,500,184
	<u>3,500,184</u>
Less current maturities	19,439
	<u>\$3,480,745</u>

MINDSCAPE INC.

NOTES TO FINANCIAL STATEMENTS—Continued

The Company expensed \$131,854 of interest related to stockholders' notes during the period ended December 31, 1987.

During the first quarter of 1988, the Company borrowed an aggregate of \$1,167,000 from two stockholders in the form of demand notes at a 9.5% rate of interest.

The following is a summary of long-term debt as of December 31, 1987, which becomes due within each of the next five years:

1988	\$ 19,439
1989	1,024,346
1990	27,096
1991	1,030,156
1992	33,546

3. Income taxes

As provided in the acquisition agreement, the Company included in its income tax returns the tax loss of the predecessor to Mindscape for the period January 1, 1987 to January 16, 1987. The Company was taxed as a C corporation for income tax purposes for the period January 1, 1987 to April 30, 1987. The Company has a tax loss carryforward which expires in 2002 of approximately \$286,000 relating to this period which is available to offset future taxable income from a C corporation. Effective May 1, 1987, the Company elected to be taxed as an S corporation and, therefore, generally federal and certain state income taxes imposed on the Company's income for the period subsequent to April 30, 1987 are the obligations of the individual stockholders. The provision for income taxes in the statement of operations consists of Illinois replacement taxes which are taxed at the corporate level. At December 31, 1987 approximately \$128,636 exists of undistributed income earned since the S corporation election.

4. Capital transactions

The Company was initially capitalized by the issuance, for cash, of 2,300,000 shares of common stock at \$.65 per share, 1,000 shares of preferred stock at \$20.00 per share and issuance of subordinated notes totalling \$2,375,000. On April 30, 1987, the Company redeemed, at \$20.00 per share, all of the preferred stock that had been issued when the Company was initially capitalized. On July 6, 1987, the Company issued an additional 57,500 shares of common stock for cash at \$.65 per share.

The Company declared a cash dividend to stockholders of record as of December 30, 1987. In February 1988, the Company paid the dividend of \$1,868,100 to its stockholders. Concurrently, the stockholders loaned the money to the Company in the form of \$719,219 of 8% senior subordinated notes due June 14, 1988 and \$1,148,881 of 7.5% senior subordinated notes due January 1, 1991.

5. Stock option plan

The Company has a stock option plan which provides for non-qualified and incentive stock options. The Company has reserved 115,000 shares of common stock under the plan. On July 20, 1987, the Company granted options to certain employees to purchase an aggregate of 69,000 shares of common stock at an option price of \$.65 per share (estimated fair market value at date of grant) which are exercisable in three installments beginning one year after date of grant.

MINDSCAPE INC.

NOTES TO FINANCIAL STATEMENTS—Concluded

6. Rental commitments

The Company leases, under operating leases, warehouse facilities, certain computer equipment and other equipment. The following is the future minimum rental payments required under operating leases which are noncancellable and have a remaining lease term of over one year:

Year ending December 31,	
1988	\$130,620
1989	130,620
1990	<u>65,310</u>
Total minimum lease payments.....	<u>\$326,550</u>

Total rental expense for the Company for the period from January 13, 1987 to December 31, 1987 was \$82,303 and \$3,184 for the predecessor for the period January 1, 1987 to January 16, 1987.

7. Commitments

The Company has entered into various royalty contracts with software developers for substantially all products sold. In the event the software developers comply with various conditions of these contracts, the Company will be obligated to make royalty payments based on the dollar amount of net sales.

8. Retirement plan

The Company sponsors a defined contribution retirement plan. Eligible employees can participate after one year of service, including service prior to the merger. The plan provides that participants can contribute specified percentages of their pre-tax earnings to the plan and the Company matches participants' contributions up to certain specified limits. During the period January 16, 1987 to December 31, 1987, the Company expensed \$71,526 for matching contributions to the plan.

9. Subsequent events

The stockholders passed a resolution on May 16, 1988 to effect a 2.3 to 1 common stock split as of May 18, 1988. Accordingly all share amounts in the financial statements have been restated to reflect this common stock split, in addition to the 1000 to 1 common stock split effective as of April 30, 1987.

On May 12, 1988, the Company entered into a new revolving credit agreement with its bank which expires on April 30, 1990 and provides for borrowings of up to \$13,000,000 with interest at the bank's prime rate plus 1½%. The borrowings under this agreement may not exceed the sum of 1) certain qualifying amounts of receivables and inventories, plus 2) prior to August 15, 1988, \$1,500,000, plus 3) \$7,000,000 which is guaranteed by certain stockholders. Substantially all of the Company's assets are pledged as collateral under the new revolving credit agreement, other than its Northbrook facility which is pledged to secure the mortgage loan. Concurrent with entering into this new agreement the Company repaid the \$1,000,000 senior subordinated note payable to a stockholder due January 1, 1989 along with certain other stockholder notes payable issued subsequent to December 31, 1987, using borrowings under the new revolving credit agreement.

10. Pro Forma Data (Unaudited)

Pro forma data is presented assuming the acquisition (see Note 1) had been completed on January 1, 1987 and includes an increase in interest expense assuming the debt incurred in the acquisition was outstanding for the entire year and a decrease in general and administrative expenses to reflect a reduction in depreciation expense as a result of the purchase price allocation. In addition, a provision (benefit) for income taxes has been provided at the effective combined federal and state income tax rate to reflect income taxes as if the Company was taxed as a C corporation.

MINDSCAPE INC.

CONDENSED BALANCE SHEET

March 31, 1988
(Unaudited)

ASSETS

Current assets:	
Cash	\$ 321,630
Accounts receivable, net	6,595,111
Inventories	4,205,055
Royalty advances	1,901,289
Other current assets	573,956
Total current assets	13,597,042
Property, plant and equipment, at cost	4,035,801
Less accumulated depreciation and amortization	272,895
	3,762,906
Royalty advances	1,434,306
Other assets	441,239
	<u>\$19,235,493</u>

LIABILITIES AND STOCKHOLDERS' EQUITY

Current liabilities:	
Notes payable (including \$1,167,000 payable to stockholders)	\$7,703,434
Bank overdraft	657,630
Accounts payable	2,635,261
Accrued liabilities	357,689
Royalty obligations	951,437
Current portion of long-term debt (including \$1,719,219 payable to stockholders)	1,738,608
Total current liabilities	14,044,059
Long-term debt, less current maturities (including \$2,148,881 payable to stockholders)	3,624,163
Other long-term liabilities	100,000
Stockholders' equity:	
Common stock, \$0.00001 par value, 4,600,000 shares authorized, 2,357,500 shares issued and outstanding	24
Capital in excess of par value	1,537,476
Accumulated deficit	(70,229)
Total stockholders' equity	1,467,271
	<u>\$19,235,493</u>

See accompanying notes.

MINDSCAPE INC.

CONDENSED STATEMENT OF OPERATIONS

(Unaudited)

	Period from January 1, 1987 to January 16, 1987 (Predecessor)	Period from January 13, 1987 to March 31, 1987 (Company)	Pro Forma Adjustments	Pro Forma Three Months Ended March 31, 1987	Three Months Ended March 31, 1988
Revenues:					
Net sales	\$ 264,582	3,071,495		3,336,077	4,830,531
Distribution income	9,475	38,798		48,273	104,913
Other income	3,808	97,793		101,601	77,719
Total revenues	<u>277,865</u>	<u>3,208,086</u>		<u>3,485,951</u>	<u>5,013,163</u>
Costs and expenses:					
Cost of goods sold	176,075	1,626,901		1,802,976	2,499,610
Selling and marketing expenses	337,893	918,316		1,256,209	2,113,796
General and administrative expenses	104,321	332,509	(934)	435,896	558,322
Total costs and expenses	<u>618,289</u>	<u>2,877,726</u>	(934)	<u>3,495,081</u>	<u>5,171,728</u>
Income (loss) from operations	(340,424)	330,360	934	(9,130)	(158,565)
Interest expense	6,939	100,245	8,750	115,934	243,077
Income (loss) before income taxes	(347,363)	230,115	(7,816)	(125,064)	(401,642)
Provision (benefit) for income taxes		101,020	(101,020)		(6,000)
Net income (loss)	<u>\$(347,363)</u>	<u>129,095</u>	<u>93,204</u>	<u>(125,064)</u>	<u>(395,642)</u>
Pro forma data (Note 7)					
Net income (loss) as reported				\$(125,064)	(395,642)
Provision (benefit) for income taxes					(141,937)
Pro forma net income (loss) ..				<u>\$(125,064)</u>	<u>(253,705)</u>
Pro forma net income (loss) per share					
Based on 2,426,500 shares outstanding giving effect to the 69,000 shares issuable upon future exercise of employee stock options ..				<u>\$ (.05)</u>	<u>(.10)</u>

See accompanying notes.

MINDSCAPE INC.
CONDENSED STATEMENT OF STOCKHOLDERS' EQUITY

Three Months Ended March 31, 1988

(Unaudited)

	Common Stock		Capital in excess of par value	Retained earnings (accumulated deficit)	Total
	Shares	Par Value			
Balance at December 31, 1987	2,357,500	\$24	1,537,476	325,413	1,862,913
Net loss				(395,642)	(395,642)
Balance at March 31, 1988	<u>2,357,500</u>	<u>\$24</u>	<u>1,537,476</u>	<u>(70,229)</u>	<u>1,467,271</u>

See accompanying notes.

MINDSCAPE INC.

CONDENSED STATEMENT OF CASH FLOWS

(Unaudited)

	Period January 13, 1987 to March 31, 1987	Three Months Ended March 31, 1988
Increase (decrease) in cash		
Cash flows from operating activities:		
Net income (loss)	\$ 129,095	(395,642)
Adjustments to reconcile net income (loss) to net cash provided (used) in operating activities:		
Depreciation and amortization	45,451	115,045
Provision for losses on accounts receivable and sales returns and allowances	15,561	85,128
Change in assets and liabilities net of effects of acquisition:		
(Increase) decrease in accounts receivable	(79,767)	2,227,576
Increase in inventories	(406,553)	(349,421)
Increase in royalty advances	(248,090)	(1,093,228)
Increase in other current assets	(66,739)	(7,701)
Increase in other assets	(2,776)	(102,759)
Increase (decrease) in accounts payable and bank overdraft	1,181,960	(978,648)
Increase (decrease) in accrued liabilities and royalty obligations	254,969	(787,566)
Total adjustments	<u>694,016</u>	<u>(891,574)</u>
Net cash provided (used) in operating activities	823,111	(1,287,216)
Cash flows from investing activities:		
Property, plant and equipment additions	(339,679)	(188,147)
Payment for purchase of Mindscape, Inc.	<u>(3,006,904)</u>	<u> </u>
Net cash used in investing activities	(3,346,583)	(188,147)
Cash flows from financing activities:		
Net borrowings under line-of-credit		526,434
Proceeds from issuance of shareholder notes payable	2,375,000	3,035,100
Payments under mortgage payable	(5,316)	(5,513)
Payments of other notes payable	(416,271)	
Proceeds from issuance of preferred stock	20,000	
Payment of dividends		(1,868,100)
Proceeds from issuance of common stock	<u>1,500,000</u>	<u> </u>
Net cash provided by financing activities	3,473,413	1,687,921
Net increase in cash	949,941	212,558
Cash balance at beginning of period	<u> </u>	<u>109,072</u>
Cash balance at end of period	<u>\$ 949,941</u>	<u>321,630</u>

Cash paid for interest during the period January 13, 1987 to March 31, 1987 was \$40,293 and \$198,312 for the three months ended March 31, 1988.

The Company purchased all of the capital stock of Mindscape, Inc. for \$3,006,904. In connection with the acquisition, liabilities were assumed as follows:

Purchase price allocated to the fair value of assets acquired	\$8,558,520
Cash paid for the capital stock	<u>3,006,904</u>
Liabilities assumed	<u>\$5,551,616</u>

See accompanying notes.

MINDSCAPE INC.

NOTES TO CONDENSED FINANCIAL STATEMENTS

(Unaudited)

1. Basis of presentation

The accompanying condensed financial statements should be read in conjunction with the financial statements of the Company for the period January 13, 1987 to December 31, 1987. In the opinion of the management, all adjustments (consisting of only normal recurring accruals) necessary for a fair presentation have been included.

The statement of operations for the three months ended March 31, 1987 is presented on a pro forma combined basis reflecting the allocation of the purchase price to the fair value of assets and liabilities acquired as if the acquisition had taken place on January 1, 1987 and reflecting the appropriate pro forma adjustments to the predecessor's results of operations for the period January 1, 1987 to January 16, 1987. Such pro forma adjustments consist of a decrease in general and administrative expenses of \$934 to reflect a reduction in depreciation expense as a result of the purchase price allocation, an increase in interest expense of \$8,750 assuming that the debt incurred in the acquisition was outstanding as of January 1, 1987, and an elimination of the provision for income taxes.

2. Notes payable and long-term debt

At March 31, 1988, the Company had borrowed \$6,536,434 under its unsecured revolving credit agreement with a bank with interest at either the bank's prime rate (8.5% at March 31, 1988) or at a LIBOR rate.

During the first quarter of 1988, the Company borrowed an aggregate of \$1,167,000 from two stockholders in the form of demand notes at a 9.5% rate of interest which remain outstanding at March 31, 1988. In April 1988, \$167,000 of these notes was paid. In April 1988, the Company borrowed an aggregate of \$1,018,018 from a stockholder in the form of a demand note at a 9.5% interest rate.

Long term debt consists of the following:

	March 31, 1988
Senior subordinated notes payable to stockholders, due June 14, 1988, 8% interest ..	\$ 719,219
Senior subordinated note payable to a stockholder, due January 1, 1989, 9.5% interest	1,000,000
Senior subordinated notes payable to stockholders, due January 1, 1991, 7.5% interest	1,148,881
Subordinated notes payable to stockholders, due January 1, 1991, 7.5% interest.....	1,000,000
Mortgage, 10.75% interest, with monthly principal and interest payments of \$15,187 and a balloon payment of \$1,226,971 due April 1, 1996, secured by land and a building with a net book value of \$2,189,683 at March 31, 1988	1,494,671
	<u>5,362,771</u>
Less current maturities	<u>1,738,608</u>
	<u>\$3,624,163</u>

The Company expensed \$67,772 of interest related to stockholders' notes during the three months ended March 31, 1988 and \$44,375 for the period January 13, 1987 to March 31, 1987.

3. Capital transactions

The Company declared a cash dividend to stockholders of record as of December 30, 1987. In February 1988, the Company paid the dividend of \$1,868,100 to its stockholders. Concurrently, the stockholders loaned the money to the Company in the form of \$719,219 of 8% senior subordinated notes due June 14, 1988 and \$1,148,881 of 7½% senior subordinated notes due January 1, 1991.

On January 27, 1988, the Company issued an additional 115,000 shares of common stock for cash at \$.65 per share. On May 17, 1988, this issuance was rescinded and, accordingly, the \$75,000 of cash originally received has been classified as accounts payable in the accompanying balance sheet.

MINDSCAPE INC.

NOTES TO CONDENSED FINANCIAL STATEMENTS—Concluded

(Unaudited)

4. Related Party Transaction

The Company has loaned \$75,000 to YPA Holdings PTY. Ltd. (YPA), an Australian corporation, which is owned 70% by the two majority stockholders of the Company. The loan is payable on demand and bears interest at an 8% rate. The Company recorded net sales to YPA of approximately \$116,800 during the three months ended March 31, 1988 on terms comparable to those offered to one other independent distributor.

5. Income Taxes

As provided in the original acquisition agreement, the Company included in its income tax returns the tax loss of the predecessor to the Company for the period January 1, 1987 to January 16, 1987. The Company was taxed as a C corporation for income tax purposes for the period January 1, 1987 to April 30, 1987. Effective May 1, 1987, the Company elected to be taxed as an S corporation.

For income tax purposes, the Company did not have any taxable income for the three months ended March 31, 1987 (nor for the four months ended April 30, 1987) and has a net operating loss carryforward which expires in 2002 relating to this period which is available to offset future taxable income from a C corporation. No benefit for income taxes was recorded in the pro forma results for the three months ended March 31, 1987 as the Company could not carryback the net operating loss to prior periods. The benefit for income taxes for the three months ended March 31, 1988 consists of Illinois replacement taxes which are taxed at the corporate level and can be carried back to 1987. At March 31, 1988, \$267,005 of distributions have been made in excess of income earned since the S corporation election.

6. Subsequent Events

The stockholders passed a resolution on May 16, 1988 to effect a 2 3 to 1 common stock split as of May 18, 1988. Accordingly, all share amounts in the financial statements have been restated to reflect this common stock split, in addition to the 1000 to 1 common stock split effective as of April 30, 1987.

In April 1988, the Company prepaid the \$719,219 of 8% senior subordinated notes due June 14, 1988 and \$92,287 of 7.5% senior subordinated notes due January 1, 1991 which had been issued in February 1988. On May 12, 1988, the Company entered into a new revolving credit agreement (credit agreement) with its bank which expires on April 30, 1990 and provides for borrowings of up to \$13,000,000 with interest at the bank's prime rate plus 1½%. The borrowings under this agreement may not exceed the sum of 1) certain qualifying amounts of receivables and inventories, plus 2) prior to August 15, 1988, \$1,500,000, plus 3) \$7,000,000 which is guaranteed by certain stockholders. Substantially all of the Company's assets are pledged as collateral under the credit agreement, other than its Northbrook facility which is pledged to secure the mortgage loan. Concurrent with entering into this new agreement the Company repaid the \$2,018,018 outstanding demand notes payable to a stockholder and the \$1,000,000 senior subordinated note payable to a stockholder due January 1, 1989, using borrowings under the new revolving credit agreement.

The credit agreement restricts the Company's ability to incur or guaranty indebtedness, incur liens, pay dividends, lease property or purchase stock or substantially all of the assets of another entity. In addition, the agreement requires the Company to maintain tangible net worth, as defined therein, of \$1,900,000 until September 30, 1988, of \$3,900,000 from October 1, 1988 until December 30, 1988, of \$6,000,000 on December 31, 1988, and of \$5,000,000 after December 31, 1988.

7. Pro Forma Data

No income tax benefit was recorded for the pro forma three months ended March 31, 1987 as the Company could not carry back the net operating loss to prior periods. A benefit for income taxes for the three months ended March 31, 1988 was recorded to reflect the carryback of the loss to 1987 as if the Company was taxed as a C corporation.

REPORT OF INDEPENDENT PUBLIC ACCOUNTANTS

To the Shareholder of
Mindscape, Inc.:

We have examined the balance sheets of MINDSCAPE, INC. (a Delaware corporation and a wholly owned subsidiary of SFN Partners, L.P. (formerly SFN Companies, Inc.)) as of December 31, 1986 and 1985, and the related statements of operations, shareholder's equity and cash flows for the years then ended. Our examinations were made in accordance with generally accepted auditing standards and, accordingly, included such tests of the accounting records and such other auditing procedures as we considered necessary in the circumstances.

In our opinion, the financial statements referred to above present fairly the financial position of Mindscape, Inc. as of December 31, 1986 and 1985, and the results of its operations (before the pro forma tax adjustment) and its cash flows for the years then ended, in conformity with generally accepted accounting principles applied on a consistent basis.

ARTHUR ANDERSEN & CO.

Chicago, Illinois,
May 4, 1988.

MINDSCAPE, INC.
(PREDECESSOR COMPANY)
BALANCE SHEETS
December 31, 1986 and 1985

	<u>ASSETS</u>	<u>1986</u>	<u>1985</u>
Current assets:			
Cash		\$ —	\$ 55,236
Accounts receivable, net (Note 2)		2,348,042	1,640,788
Inventories (Note 1)		1,196,960	810,713
Royalty advances (Note 1)		676,805	—
Other current assets		44,994	5,672
Total current assets		<u>4,266,801</u>	<u>2,512,409</u>
Property, plant and equipment, at cost (Note 3):			
Land		400,950	400,950
Building and improvements		2,605,110	2,605,110
Furniture and fixtures		464,350	464,350
Equipment		618,580	579,179
		4,088,990	4,049,589
Less—Accumulated depreciation		877,921	414,298
		<u>3,211,069</u>	<u>3,635,291</u>
Royalty advances (Note 1)		720,555	—
Other noncurrent assets (Note 1)		755,742	—
		<u>\$8,954,167</u>	<u>\$6,147,700</u>
<u>LIABILITIES AND SHAREHOLDER'S EQUITY</u>			
Current liabilities:			
Bank overdraft		\$1,191,413	\$ 623,220
Notes payable (Note 4)		560,391	—
Accounts payable		355,801	412,218
Accrued liabilities (Note 1)		835,516	306,384
Royalty obligations (Note 7)		721,877	521,803
Current maturities of long-term debt (Note 4)		18,360	16,677
Total current liabilities		<u>3,683,358</u>	<u>1,880,302</u>
Long-term debt, less current maturities (Note 4)		<u>1,500,400</u>	<u>1,521,201</u>
Royalty obligations (Note 7)		200,000	—
Shareholder's equity:			
Capital stock, \$1 par value, 1,000,000 and 1,000 shares authorized at December 31, 1986 and 1985, respectively; 1,000 shares issued and outstanding ..		1,000	1,000
Additional paid-in capital		(5,896,995)	(5,896,995)
Retained deficit		(7,617,419)	(3,393,589)
Intercompany payable to SFN (Note 8)		17,083,823	12,035,781
Total shareholder's equity		<u>3,570,409</u>	<u>2,746,197</u>
		<u>\$8,954,167</u>	<u>\$6,147,700</u>

See accompanying notes to financial statements.

MINDSCAPE, INC.
(PREDECESSOR COMPANY)
STATEMENTS OF OPERATIONS
FOR THE YEARS ENDED DECEMBER 31, 1986 AND 1985

	<u>1986</u>	<u>1985</u>
Revenues:		
Net sales	\$ 8,704,881	\$ 4,741,018
Distribution income (Note 1)	133,090	—
Other income	376,711	181,713
Total revenues	<u>9,214,682</u>	<u>4,922,731</u>
Costs and expenses:		
Cost of goods sold	6,196,278	5,674,036
Selling and marketing expenses	4,325,302	4,718,164
General and administrative expenses	2,296,714	2,195,660
Total costs and expenses	<u>12,818,294</u>	<u>12,587,860</u>
Loss from operations	(3,603,612)	(7,665,129)
Interest expense (Note 8)	1,045,308	166,226
Loss before income taxes	(4,648,920)	(7,831,355)
Income tax benefit (Note 6)	2,347,705	3,954,834
Net loss before pro forma tax adjustment	(2,301,215)	(3,876,521)
Pro forma tax adjustment (unaudited) (Note 6)	(2,347,705)	(3,954,834)
Pro forma net loss (unaudited)	<u>\$ (4,648,920)</u>	<u>\$ (7,831,355)</u>

See accompanying notes to financial statements.

MINDSCAPE, INC.
(PREDECESSOR COMPANY)
STATEMENTS OF SHAREHOLDER'S EQUITY
FOR THE YEARS ENDED DECEMBER 31, 1986 AND 1985

	Capital Stock	Additional Paid-In Capital	Retained Deficit	Intercompany Payable to SFN	Total
Balance, January 1, 1985	\$1,000	\$ —	\$(5,414,063)	\$ 6,970,445	\$1,557,382
Recapitalization for Leveraged Buyout of SFN (Note 1)		(5,896,995)	5,896,995		—
Net Loss (before pro forma tax adjustment) (Note 6)			(3,876,521)		(3,876,521)
Net Intercompany Activity				5,065,336	5,065,336
Balance, December 31, 1985	1,000	(5,896,995)	(3,393,589)	12,035,781	2,746,197
Net Loss (before pro forma tax adjustment) (Note 6)			(2,301,215)		(2,301,215)
Deemed Dividend to SFN (Note 8)			(1,922,615)	1,922,615	—
Net Intercompany Activity				3,125,427	3,125,427
Balance, December 31, 1986	<u>\$1,000</u>	<u>\$(5,896,995)</u>	<u>\$(7,617,419)</u>	<u>\$17,083,823</u>	<u>\$3,570,409</u>

See accompanying notes to financial statements.

MINDSCAPE, INC.

(PREDECESSOR COMPANY)

STATEMENTS OF CASH FLOWS

FOR THE YEARS ENDED DECEMBER 31, 1986 AND 1985

	1986	1985
Increase (decrease) in cash		
Cash flows from operating activities:		
Net loss (before pro forma tax adjustment)	\$(2,301,215)	\$(3,876,521)
Adjustments to reconcile net loss (before pro forma tax adjustment) to net cash used in operating activities:		
Depreciation and amortization	479,283	480,315
Loss on sale of property, plant and equipment	4,461	188,832
Provision for losses on accounts receivable and sales returns and allowances	1,302,616	622,717
Change in assets and liabilities:		
(Increase) in accounts receivable, net	(2,009,870)	(1,495,579)
(Increase) decrease in inventories	(297,375)	20,179
(Increase) decrease in royalty advances	(1,097,360)	290,140
(Increase) decrease in other current assets	(40,162)	158,917
(Increase) in other noncurrent assets	(19,159)	—
Increase in bank overdraft	568,193	127,969
Increase in notes payable	560,391	—
(Decrease) in accounts payable	(56,417)	(796,862)
Increase (decrease) in accrued liabilities	529,132	(235,517)
Increase (decrease) in royalty obligations	400,074	(354,566)
Total adjustments	323,807	(993,455)
Net cash used in operating activities	(1,977,408)	(4,869,976)
Cash flows from investing activities:		
Capital expenditures	(52,233)	(216,010)
Payment for acquisition of product line	(1,131,904)	—
Proceeds from sale of assets	—	40,000
Net cash (used in) provided by investing activities	(1,184,137)	(176,010)
Cash flows from financing activities:		
Payments under mortgage payable	(19,118)	(2,587)
Intercompany payable to SFN	5,048,042	5,065,336
Deemed dividend	(1,922,615)	—
Net cash provided by financing activities	3,106,309	5,062,749
Net increase (decrease) in cash	(55,236)	16,763
Cash at beginning of year	55,236	38,473
Cash at end of year	\$ —	\$ 55,236
Cash paid during the year for interest	\$ 178,208	\$ 166,226

See accompanying notes to financial statements.

MINDSCAPE, INC.
(PREDECESSOR COMPANY)
NOTES TO FINANCIAL STATEMENTS
December 31, 1986 and 1985

(1) Summary of Significant Accounting Policies:

Basis of Presentation—

Mindscape, Inc. (MS) is a wholly owned subsidiary of SFN Partners, L.P. (LP) (formerly SFN Companies, Inc.) (SFN). MS manufactures and distributes consumer and educational software products. Sales to two customers during 1986 accounted for 15.2% and 10.4% of net sales and during 1985 accounted for 10.7% and 10.6% of net sales.

On January 30, 1985, stockholders of SFN approved a leveraged buyout proposal (the "Merger") whereby SFN would be acquired by SFN Holding Company (through New SFN Corp.), a newly formed corporation owned by venture banking affiliates of E.M. Warburg, Pincus & Co., Inc.; Drexel Burnham Lambert Incorporated; Hallmark Cards, Incorporated; and members of SFN's senior management. The acquisition was consummated on February 1, 1985, through the Merger of New SFN Corp. with and into the surviving corporation, SFN.

This transaction was treated as if SFN was a new entity accounted for under the purchase method. Accordingly, the purchase price was allocated to the assets and liabilities of SFN based on their estimated fair values at February 1, 1985.

Because MS commenced operations in August, 1984, the allocation of the purchase price in connection with the above-mentioned merger had no impact on the valuations of the assets and liabilities of MS.

On January 16, 1987, LP sold the stock of MS to Mindscape Holding Co. (MSH) for \$3,006,904 in cash and LP purchased \$20,000 of MSH preferred stock. MSH is 100% owned by the Chief Executive Officer ("CEO") of LP and the President and CEO of MS. As part of the sale agreement, LP funded MS checks presented for payment on or before January 16, 1987, and was entitled to the cash received on or before January 16, 1987.

Acquisition—

On December 31, 1986, MS purchased a line of educational software products for \$1,131,904. The assets acquired included \$743,032 of product rights which are included in other noncurrent assets, to be amortized over the anticipated remaining useful life of two years.

Revenue Recognition—

MS records revenue at the time its products are shipped. MS generally allows its customers to return undamaged products for credit against future purchases. Under a distribution agreement entered into during 1986, MS distributes a line of software products. MS receives a distribution fee which it records at the time these products are shipped. Included in accrued liabilities at December 31, 1986, is \$331,799, representing amounts to be collected by MS and which are due to the software developer under the distribution agreement.

Advertising Expenses—

Advertising expenses are included in selling and marketing expenses and amounted to \$545,180 and \$1,289,931 in 1986 and 1985, respectively.

Inventories—

Inventories, consisting of \$468,407 and \$354,265 of raw materials and \$728,553 and \$456,448 of finished goods at December 31, 1986 and 1985, respectively, are stated at the lower of cost or net realizable value, with cost determined on the first-in, first-out method.

MINDSCAPE, INC.

(PREDECESSOR COMPANY)

NOTES TO FINANCIAL STATEMENTS—Continued

December 31, 1986 and 1985

Royalties—

Royalty advances represent prepayments made to independent software developers prior to the actual sale of the product. Royalty advances are expensed as the actual product is sold or if no product is forthcoming. Royalty expenses, including amounts earned by developers on the royalty advances, totaled \$1,665,613 and \$2,046,059 for the years ended December 31, 1986 and 1985, respectively.

(2) **Accounts Receivable:**

Accounts receivable is shown net of reserves for doubtful accounts and sales returns and allowances. The following is an analysis of the reserves:

	Doubtful Accounts	Sales Returns and Allowances	Total
Reserves at January 1, 1985.....	\$ 10,843	\$ 132,265	\$ 143,108
Provision for doubtful accounts charged to income	374,354		374,354
Accounts written off, net	(16,021)		(16,021)
Additional provision for sales returns and allowances, net ..		248,363	248,363
Reserves at December 31, 1985.....	369,176	380,628	749,804
Provision for doubtful accounts charged to income	493,430		493,430
Accounts written off, net	(362,850)		(362,850)
Additional provision for sales returns and allowances, net ..		809,186	809,186
Reserves at December 31, 1986.....	<u>\$499,756</u>	<u>\$1,189,814</u>	<u>\$1,689,570</u>

(3) **Property, Plant and Equipment:**

Property, plant and equipment are depreciated on the straight-line basis over the estimated useful lives of the assets which generally are five years for equipment, furniture and fixtures and 15 years for building and improvements.

The details of the property, plant and equipment accounts are shown below at cost.

	Balance at Beginning of Year	Additions at Cost	Retirements or Sales at Cost	Other	Balance at End of Year
For the year ended December 31, 1985:					
Land	\$ 400,950	\$ —	\$ —	\$ —	\$ 400,950
Building and improvements	2,754,743	31,911	—	(181,544)	2,605,110
Furniture and fixtures	601,922	5,709	—	(143,281)	464,350
Equipment	824,208	178,390	276,516	(146,903)	579,179
Total	<u>\$4,581,823</u>	<u>\$216,010</u>	<u>\$276,516</u>	<u>\$(471,728)</u>	<u>\$4,049,589</u>
For the year ended December 31, 1986:					
Land	\$ 400,950	\$ —	\$ —	\$ —	\$ 400,950
Building and improvements	2,605,110	—	—	—	2,605,110
Furniture and fixtures	464,350	—	—	—	464,350
Equipment	579,179	52,233	12,832	—	618,580
Total	<u>\$4,049,589</u>	<u>\$ 52,233</u>	<u>\$ 12,832</u>	<u>\$ —</u>	<u>\$4,088,990</u>

MINDSCAPE, INC.
(PREDECESSOR COMPANY)
NOTES TO FINANCIAL STATEMENTS—Continued
December 31, 1986 and 1985

The details of the accumulated depreciation of property, plant and equipment accounts are shown below.

	Balance at Beginning of Year	Charged to Expense	Retirements or Sales at Cost	Other	Balance at End of Year
For the year ended December 31, 1985:					
Building and improvements	\$181,391	\$170,054	\$ —	\$(181,544)	\$169,901
Furniture and fixtures	131,776	129,091	—	(143,281)	117,586
Equipment	140,226	181,170	47,682	(146,905)	126,811
Total	<u>\$453,393</u>	<u>\$480,315</u>	<u>\$47,682</u>	<u>\$(471,728)</u>	<u>\$414,298</u>
For the year ended December 31, 1986:					
Building and improvements	\$169,901	\$201,471	\$ —	\$ —	\$371,372
Furniture and fixtures	117,586	110,400	—	—	227,986
Equipment	126,811	160,123	8,371	—	278,563
Total	<u>\$414,298</u>	<u>\$471,994</u>	<u>\$ 8,371</u>	<u>\$ —</u>	<u>\$877,921</u>

The Other column represents the reclassification of accumulated depreciation balances following the leveraged buyout of SFN in 1985 (see Note 1).

(4) Debt:

MS makes monthly principal and interest payments of \$15,187 on a mortgage with a final balloon payment of \$1,226,971 due on April 1, 1996. MS pays interest of 10.75%. This mortgage is secured by land and buildings with a net book value of \$2,634,688 on December 31, 1986.

The following is a summary of long-term debt as of December 31, 1986, which becomes due within each of the next five years:

1987	\$ 18,360
1988	21,859
1989	24,346
1990	27,050
1991	30,156
1992 and thereafter	1,396,943
Subtotal	1,518,760
Less—current maturities	18,360
Total	<u>\$1,500,400</u>

In addition MS has notes payable relating to the purchase of educational software products. One note for \$325,000, at 10%, is due June 30, 1987, and the other note is for \$235,391, of which \$83,333 is due on April 21, 1987. The remainder is due as additional inventory is ordered. MS's intention is to order additional inventory during 1987.

MINDSCAPE, INC.

(PREDECESSOR COMPANY)

NOTES TO FINANCIAL STATEMENTS—Concluded

December 31, 1986 and 1985

(5) Rental Commitments:

MS leases, under operating leases, a telephone system, certain computer equipment and other equipment. The following is the future minimum rental payments required under operating leases which are noncancellable and have a remaining lease term of over one year:

Year ending December 31,	
1987.....	\$29,220
1988.....	23,737
1989.....	<u>5,010</u>
Total minimum lease payments	<u>\$57,967</u>

Total rental expense for 1986 and 1985 was \$32,636 and \$28,941, respectively.

(6) Income Taxes:

MS was a part of SFN which filed a consolidated income tax return. Losses utilizable by the consolidated SFN Group have been benefited on the statements of operations; however, no formal tax sharing agreement existed between the companies. Income taxes on the balance sheet are included in the intercompany account with SFN. The statements of operations reflect an unaudited pro forma tax adjustment to indicate the effect on income if MS had not been a part of a consolidated group.

(7) Royalty Obligations:

MS has entered into various royalty contracts with software developers for substantially all products sold. MS is contractually obligated to make royalty payments under certain of these contracts which are not dependent on future product sales. These amounts are recorded as royalty obligations in the accompanying balance sheets. In addition, in the event the software developers comply with various conditions of these contracts, MS's future obligation to make certain other royalty payments is contingent on the amount of future net sales.

(8) Related-Party Transactions:

The accompanying statements of operations include certain expenses for services provided by SFN and allocated to MS, such as legal, accounting and tax fees, employee benefits, insurance and other directly allocable costs.

In addition to such expenses noted above, in the year ended December 31, 1986, SFN allocated other nondirect corporate expenses on a discretionary basis to MS. The after-tax amount of these charges was \$1,922,615. Since these expenses are not directly attributable to MS and management believes that such amounts would not have been incurred on a separate entity basis and will not be incurred in the future, such expenses have been excluded from the statement of operations and are reflected in retained deficit as a deemed dividend.

During 1986, SFN charged MS interest at SFN's borrowing rate on MS's equity balance (defined as capital stock, paid in capital, retained deficit and the intercompany account). Intercompany interest expense of \$867,000 is included in the 1986 statement of operations. This interest represented 12.5% of the average equity balance of \$6,874,662 in 1986. No such interest charge was incurred in 1985. The average equity balance in 1985 was \$8,290,162.

