

No dealer, salesman or any other person has been authorized to give any information or to make any representation not contained in this Prospectus and, if given or made, such information or representation must not be relied on as having been authorized by the Company, the Selling Stockholders or the Underwriters. This Prospectus does not constitute an offer or a solicitation of an offer to buy any securities other than the Common Stock to which it relates, or an offer in any jurisdiction to any person to whom it is unlawful to make such an offer in such jurisdiction. Neither the delivery of this Prospectus nor any sale made hereunder shall, under any circumstances, create any implication that the information contained or incorporated by reference herein is correct at any time after the date hereof.

TABLE OF CONTENTS

	<i>Page</i>
<i>Available Information</i>	2
<i>Prospectus Summary</i>	3
<i>The Company</i>	4
<i>Risk Factors</i>	5
<i>Use of Proceeds</i>	7
<i>Price Range of Common Stock</i>	7
<i>Capitalization</i>	8
<i>Dividend Policy</i>	8
<i>Selected Consolidated Financial Data</i>	9
<i>Management's Discussion and Analysis of Financial Condition and Results of Operations</i>	10
<i>Business</i>	14
<i>Management</i>	23
<i>Principal and Selling Stockholders</i>	27
<i>Description of Capital Stock</i>	28
<i>Shares Eligible for Future Sale</i>	29
<i>Underwriting</i>	30
<i>Legal Matters</i>	31
<i>Experts</i>	31
<i>Additional Information</i>	31
<i>Trademark Information</i>	32
<i>Index to Consolidated Financial Statements</i>	F-1

2,730,000 Shares



THE SOFTWARE TOOLWORKS

Common Stock

PROSPECTUS

MONTGOMERY SECURITIES

September 22, 1989

2,730,000 Shares



Common Stock

Of the 2,730,000 shares of Common Stock offered hereby, 1,700,000 shares are being sold by the Company and 1,030,000 shares are being sold by the Selling Stockholders. See "Principal and Selling Stockholders." The Company will not receive any of the proceeds from the sale of shares by the Selling Stockholders. On September 21, 1989, the last reported sale price for the Company's Common Stock on the NASDAQ National Market System was \$10¾.

See "Risk Factors" for certain information which should be carefully considered by prospective purchasers of the Common Stock offered hereby.

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)	Proceeds to Selling Stockholders(2)
Per Share	\$10.50	\$.65	\$9.85	\$9.85
Total(3)	\$28,665,000	\$1,774,500	\$16,745,000	\$10,145,500

- (1) See "Underwriting" for information concerning indemnification of the Underwriters and other matters.
- (2) Before deducting expenses of the offering payable by the Company estimated at \$635,776 and expenses payable by Selling Stockholders estimated at \$14,596.
- (3) The Company and certain of the Selling Stockholders have granted to the Underwriters an option, exercisable within 30 days of the date hereof, to purchase up to an aggregate of 409,500 additional shares at the Price to Public less Underwriting Discount for the purpose of covering over-allotments, if any. The first 170,800 of such shares will be sold by a Selling Stockholder, the next 71,000 shares will be sold by certain other Selling Stockholders and the balance will be sold by the Company. If the Underwriters exercise this option in full, the Price to Public will total \$32,964,750, the Underwriting Discount will total \$2,040,675, the Proceeds to Company will total \$18,396,845 and the Proceeds to Selling Stockholders will total \$12,527,230.

The shares are offered by the Underwriters named herein when, as and if delivered to and accepted by the Underwriters and subject to the right to reject orders in whole or in part. It is expected that delivery of the certificates representing the shares will be made against payment therefor at the office of Montgomery Securities on or about September 29, 1989.

MONTGOMERY SECURITIES

September 22, 1989

ENTERTAINMENT

EDUCATION

PRODUCTIVITY

UTILITIES



The Software Toolworks' products feature high quality, ease of use, sophisticated graphics and creative packaging.

Priority Software Packaging provides diskette duplication, packaging, printing, assembly and order fulfillment services.



AVAILABLE INFORMATION

The Company is subject to the informational reporting requirements of the Securities Exchange Act of 1934 (the "Exchange Act") and, in accordance therewith, files reports, proxy statements and other information with the Securities and Exchange Commission (the "Commission") that can be inspected and copied at the public reference facilities maintained by the Commission at 450 Fifth Street, N.W., Washington, D.C. and at the following regional offices of the Commission: 230 South Dearborn Street, Chicago, Illinois, and 75 Park Place, 14th Floor, New York, New York. Copies of such material can also be obtained at prescribed rates from the Public Reference Section of the Commission at its principal office at 450 Fifth Street, N.W., Washington, D.C. 20549.

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 THE COMPANY AT A LEVEL ABOVE THAT WHICH MIGHT OTHERWISE PREVAIL IN THE OPEN MARKET. SUCH STABILIZING, IF COMMENCED, MAY BE DISCONTINUED AT ANY TIME.

PROSPECTUS SUMMARY

The following summary is qualified in its entirety by the more detailed information and consolidated financial statements and notes thereto appearing elsewhere in this Prospectus.

The Company

The Software Toolworks, Inc. is a vertically-integrated, diversified software company. The Company develops and publishes entertainment, educational, personal productivity and utility software for retail distribution and for license. The Company's software products are available through over 8,000 retail outlets, including Radio Shack Computer Centers, Egghead Discount Software, B. Dalton Software, Etc., Babbage's and Electronics Boutique. The Company provides diskette duplication, packaging, printing, assembly and order fulfillment services for itself and others, including several major software publishers, original equipment manufacturers ("OEMs") and large corporations. Through an OEM agreement with HeadStart Technologies Co. ("HeadStart"), a division of North American Philips Corporation, the Company licenses its software products for bundling with HeadStart computers. The Company has also developed the operating environment for the HeadStart Explorer computer, which is expected to be available in September 1989. The Company's strategy is to maintain a diverse revenue base through the continued introduction of successful software products across its four product categories, the expansion of its OEM and bundling activities, and the expansion of its diskette duplication, printing and packaging business.

The Company's products include such best-selling software as *Chessmaster*, which received the Software Publishers Association award for Best Entertainment Program in 1986, and *Mavis Beacon Teaches Typing*, which received the Software Publishers Association award for Best Home Learning Program in 1987. Together, over 750,000 units of these two products have been sold or licensed by the Company since their introduction in 1986 and 1987. The Company released seven new products in 1988 and 1989: *The Hunt for Red October*, *Life and Death*, *Twist and Shout*, *Backup Pro*, *Office Manager/The Secretary Bird*, *Beyond the Black Hole* and *Cribbage King/Gin King*.

The Offering(1)

Common Stock offered by the Company.....	1,700,000 shares
Common Stock offered by the Selling Stockholders.....	1,030,000 shares
Common Stock to be outstanding after the offering.....	8,043,481 shares (2)
Use of proceeds by the Company	For general corporate purposes, including working capital and product development, potential acquisitions and possible new facilities.
NASDAQ symbol.....	TWRX

Summary Consolidated Financial Data (3)

	Year Ended March 31,					Three Months Ended June 30,	
	1985	1986	1987	1988	1989	1988	1989
	(In thousands, except per share data)						
Income Statement Data:							
Revenues:							
Computer software	\$ 634	\$ 516	\$2,054	\$2,938	\$ 7,579	\$ 939	\$3,421
Duplication, printing and packaging.....	—	—	119	855	4,221	382	746
Total revenues.....	634	516	2,173	3,793	11,800	1,321	4,167
Income from operations.....	6	(1)	226	979	3,422	338	1,443
Net income.....	\$ 5	\$ (1)	\$ 126	\$ 594	\$ 2,109	\$ 231	\$ 849
Earnings per common and common equivalent share.....	\$ 0.00	\$ 0.00	\$ 0.05	\$ 0.12	\$ 0.34	\$ 0.04	\$ 0.13
Weighted average number of common and common equivalent shares outstanding	4,436	4,436	2,793	4,871	6,273	6,053	6,771
						June 30, 1989	
						Actual	As Adjusted (4)
Balance Sheet Data:							
Working capital						\$ 3,372	\$19,691
Total assets.....						\$10,657	\$26,766
Long-term debt.....						\$ —	\$ —
Stockholders' equity.....						\$ 7,874	\$23,983

(1) Assumes the Underwriters' over-allotment option is not exercised. See "Underwriting."

(2) Excludes 410,026 shares and 333,333 shares reserved for issuance upon exercise of outstanding options and warrants, respectively. See "Management—Stock Option Plans and Agreements" and "Description of Capital Stock—Common Stock Warrants."

(3) See footnote (1) to Selected Consolidated Financial Data.

(4) Adjusted to reflect the sale of 1,700,000 shares by the Company and the estimated net proceeds therefrom. See "Use of Proceeds."

THE COMPANY

The Software Toolworks, Inc. is a vertically-integrated, diversified software company. The Company develops and publishes entertainment, educational, personal productivity and utility software for retail distribution and for license. The Company's software products are available through over 8,000 retail outlets, including Radio Shack Computer Centers, Egghead Discount Software, B. Dalton Software, Etc., Babbage's and Electronics Boutique. Priority Software Packaging, Inc. ("Priority"), the Company's wholly-owned subsidiary, provides diskette duplication, packaging, printing, assembly and order fulfillment services for the Company and others, including several major software publishers, original equipment manufacturers ("OEMs") and large corporations. Through an OEM agreement with HeadStart Technologies Co. ("HeadStart"), a division of North American Philips Corporation, the Company licenses its software products for bundling with HeadStart computers. The Company has also developed the operating environment for the HeadStart Explorer computer, which is expected to be available in September 1989. The Company's strategy is to maintain a diverse revenue base through the continued introduction of successful software products across its four product categories, the expansion of its OEM and bundling activities, and the expansion of its diskette duplication, printing and packaging business.

The Company's products include such best-selling software as *Chessmaster*, which received the Software Publishers Association award for Best Entertainment Program in 1986, and *Mavis Beacon Teaches Typing*, which received the Software Publishers Association award for Best Home Learning Program in 1987. Together, over 750,000 units of these two products have been sold or licensed by the Company since their introduction in 1986 and 1987. The Company released seven new products in 1988 and 1989: *The Hunt for Red October*, *Life and Death*, *Twist and Shout*, *Backup Pro*, *Office Manager/The Secretary Bird*, *Beyond the Black Hole* and *Cribbage King/Gin King*.

The Company's product strategy is to selectively develop or acquire products for which broad, long-term markets exist or which contain features or product advances which significantly distinguish the product. The majority of the Company's computer software revenues are derived from sales or licenses of software products for the IBM PC and compatible personal computers. Where appropriate, the Company creates versions of its software products for use on other personal computers, including Apple Macintosh, Apple II and Apple IIGS, Commodore 64/128 and Commodore Amiga, and Atari ST. The Company believes its software products are distinguishable by their high quality, distinctive features, ease of use, sophisticated graphics and creative packaging.

The Company has a 22-person software development staff whose efforts are supplemented by strategic acquisitions of products, both through acquisitions of companies and through licensing and publishing arrangements with other software developers and publishers. In September 1988, the Company acquired the right to publish a number of entertainment products, including *The Hunt for Red October*, through the acquisition of Intellicreations, Inc., the publisher of the Datasoft line of software products ("Intellicreations"). In April 1989, the Company expanded its offering of utility products through the acquisition of DS Technologies, Inc. ("DS").

The Company's software publishing operations are the result of the October 1986 merger of Software Country, a software publisher founded by Leslie Crane in 1984, and the Company's predecessor, The Software Toolworks, Ltd. ("Toolworks"), a software developer founded by Walter Bilofsky in 1980. Toolworks entered into the diskette duplication and software packaging business through its acquisition of Priority in November 1986. The Company's operations became publicly owned in February 1988 through a reorganization in which Deseret-Western Venture Capital, Inc. ("Deseret-Western"), a publicly-held investment vehicle, acquired all of the outstanding capital stock of Toolworks in a stock-for-stock exchange. In connection with that transaction, the resulting holding company changed its name to The Software Toolworks, Inc. and reincorporated in Delaware, and Toolworks was subsequently merged with and into the Company.

The Company's executive offices are located at 19808 Nordhoff Place, Chatsworth, California 91311, and its telephone number is (818) 885-9000. Unless the context indicates otherwise, the term "Company" refers to The Software Toolworks, Inc. and its predecessor and subsidiaries, and "Consolidated Financial Statements" refers to those for the Company.

RISK FACTORS

The following factors, among others, should be carefully considered in evaluating the Company and its business before purchasing the shares offered hereby:

New Products. The Company's growth and future success depend upon its ability to make timely introductions of new products, to adapt existing products to additional personal computer platforms and, in some instances, to upgrade existing products. Any significant delays in product development or introduction could result in a loss of competitiveness and revenues. In addition, there can be no assurance that the Company's recently introduced or planned products will achieve market acceptance.

Retail Distribution. The Company derives a significant portion of its revenues from its retail distribution relationship with Electronic Arts. Sales to Electronic Arts were \$3,872,000, or 33% of the Company's total revenues, for the fiscal year ended March 31, 1989 and were \$1,375,000, or 33% of the Company's total revenues, for the three months ended June 30, 1989. A significant portion of the Company's accounts receivable is from Electronic Arts, and any financial difficulties encountered by Electronic Arts could impair the collection of these receivables and adversely affect the Company. The amount of accounts receivable due from Electronic Arts can fluctuate considerably, depending upon the timing of new product introductions and seasonality in the retail consumer software industry. As of June 30, 1989, this account receivable was approximately \$1,310,000. See "Business—Software Distribution and Licensing." Although the Company believes that its products could be effectively sold through alternative retail distribution channels, any unexpected termination or disruption of its relationship with Electronic Arts could materially adversely affect the Company's operations until such alternative retail distribution channels could be established.

Entertainment Products. Certain software publishers have experienced declining demand and shortened product lifetimes for their floppy disk-based entertainment products as well as shifts in consumer preference for the platforms and formats for such software. In addition, entertainment and other software publishers are exposed to the risk of product returns from distributors and retailers and, as more complex platforms emerge, the possible lengthening of a product's development cycle. To date, the Company has not experienced a material problem with respect to the above in any of its software product categories. No assurances can be given, however, that the Company will not be materially affected by these factors in the future.

Key OEM Customer. The Company derives a significant portion of its revenues from HeadStart through the licensing and sale of its software products and the provision of diskette duplication, packaging and printing services. For the fiscal year ended March 31, 1989 and the three months ended June 30, 1989, aggregate revenues from HeadStart accounted for 35% and 43%, respectively, of the Company's total revenues. In view of the significant portion of the Company's revenues attributable to HeadStart, any unexpected termination or disruption of the Company's relationship with HeadStart could materially adversely affect the Company's operations. See "Business—Software Distribution and Licensing" and "Business—Priority—Diskette Duplication, Printing and Packaging."

Key Personnel. The Company's success depends on its ability to retain the services of its current key management and other personnel and to continue to attract and retain additional key employees. There is a high level of competition for qualified employees.

Fluctuations in Revenues and Earnings. The Company generates revenues and earnings from a number of different sources, including the retail distribution of software products, the licensing of software products to an OEM and the provision of diskette duplication, packaging and printing services by Priority. Since the operating margins earned by the Company from each of these sources vary, fluctuations in the Company's revenue mix may result in fluctuations in the Company's earnings on a quarter-to-quarter basis. Furthermore, the Company's revenues and earnings may fluctuate from quarter-to-quarter due to the timing of new product introductions and licensing arrangements, and the seasonal nature of the retail consumer software industry where a significant portion of revenues and earnings occur in the fourth and first quarters of each calendar year.

Competition. The personal computer and software industries are highly competitive and are characterized by rapidly changing technology and the need for constant introduction of new products. Competitive pressures could result in price reductions or require significant expenditures for product development or marketing that could adversely affect the Company's revenues and earnings. See "Business—Competition."

Possible Volatility of Stock Price. Market prices of securities of computer software companies have from time to time been highly volatile. There may be significant volatility in the market price of the Company's Common Stock due to factors that may or may not relate to the Company's performance. The market price of the Company's Common Stock could be significantly affected by factors such as the announcement of new software products or technological innovations by the Company or its competitors, as well as by quarterly variations in the Company's results of operations and market conditions in the computer software and hardware industries.

Shares Eligible for Future Sale; Concentration of Ownership. Sales of substantial amounts of the Company's Common Stock in the public market after the offering could adversely affect the market price of the Common Stock. At the conclusion of this offering, there will be outstanding approximately 3,830,000 shares of the Company's Common Stock which are not eligible for sale in the public market without restriction (the "Restricted Shares"). Approximately 3,623,000 of the Restricted Shares will become eligible for sale in the public market in February 1990, and approximately 207,000 of the Restricted Shares will become eligible at various times thereafter, all in accordance with Rule 144 under the Securities Act of 1933, as amended (the "Securities Act"). The holders of all but approximately 325,000 of the Restricted Shares have agreed not to offer, sell or otherwise dispose of any Common Stock for 120 days after the date of this Prospectus without the prior written consent of Montgomery Securities (the "Lock-Up"). Concurrently with the registration of the shares offered hereby, the Company is registering an aggregate of 580,859 shares of Common Stock which are outstanding or issuable upon the exercise of outstanding warrants or a stock option, but the holder of 247,526 such shares has agreed to a similar Lock-Up with respect to such shares. See "Description of Capital Stock—Registration Rights." The Company also intends to register within 90 days of the date of this Prospectus an aggregate of 413,333 shares of Common Stock issuable upon exercise of options granted or to be granted under the Company's stock option plans. See "Shares Eligible for Future Sale." Immediately after the offering, the Company's officers and directors will own approximately 45% of the outstanding Common Stock (assuming the Underwriters' over-allotment option is not exercised). Substantially all of such shares have been contributed to a voting trust of which the Company's Chairman of the Board, Leslie Crane, is voting trustee. See "Principal and Selling Stockholders." Accordingly, Mr. Crane may continue to be able to elect a majority of the Board of Directors and to exercise a controlling influence over the business and affairs of the Company after the offering.

USE OF PROCEEDS

The net proceeds to the Company from the sale of Common Stock offered hereby are estimated to be \$16,109,224 (\$17,761,069 if the Underwriters' over-allotment option is exercised in full). The Company presently has no specific plans for use of any material portion of the proceeds. The Company intends to use the net proceeds, as needed, for general corporate purposes, including working capital and product development, and for possible acquisitions of software publishing companies or software product lines that will complement the Company's software operations. The Company may also seek to expand Priority's service territory by opening or acquiring new facilities. Although the Company has previously acquired other companies and has from time to time engaged in discussions with respect to additional acquisitions, the Company is not at this time negotiating the acquisition of any specific company or product line and has no specific plans to open an additional Priority facility. To the extent the Company does not use the proceeds for any one of the foregoing purposes, the Company intends to apply such proceeds to one or more of the other such purposes.

Pending use thereof, the Company intends to invest the net proceeds in short-term, interest-bearing securities. The Company will not receive any proceeds from the sale of shares of Common Stock by the Selling Stockholders.

PRICE RANGE OF COMMON STOCK

The Company's Common Stock is traded on the NASDAQ National Market System under the symbol "TWRX." The following table sets forth (a) the high and low last reported bid prices for the Company's Common Stock in the over-the-counter market through September 12, 1988 and (b) the high and low last reported sale prices as reported on the NASDAQ National Market System thereafter. Prices on and prior to September 12, 1988 represent inter-dealer quotations without adjustment for retail markup, markdown or commissions and may not necessarily represent actual transactions.

	<u>High</u>	<u>Low</u>
Fiscal 1988		
Fourth quarter (from February 2, 1988)	\$3.38	\$2.10
Fiscal 1989		
First quarter	4.28	1.50
Second quarter	5.75	4.28
Third quarter	7.00	4.25
Fourth quarter	7.38	4.50
Fiscal 1990		
First quarter	10.25	6.75
Second quarter (through September 21, 1989).....	11.00	7.63

On September 21, 1989, the last reported sale price of the Company's Common Stock, as reported on the NASDAQ National Market System, was \$10¾ per share. As of August 3, 1989, the Company had approximately 260 stockholders of record, excluding those shares held by depository companies for certain beneficial owners.

CAPITALIZATION

The following table sets forth the Company's capitalization as of June 30, 1989, and as adjusted to reflect the estimated net proceeds from the sale of 1,700,000 shares of Common Stock offered by the Company hereby.

	June 30, 1989	
	<u>Actual</u>	<u>As Adjusted</u>
	(In thousands)	
Long-term debt.....	\$ —	\$ —
Stockholders' equity:		
Common stock, \$.01 par value, 50,000,000 shares authorized; 6,343,481 shares issued and outstanding; 8,043,481 shares issued and outstanding, as adjusted(1)	63	80
Additional paid-in capital	4,353	20,445
Retained earnings	3,458	3,458
Total stockholders' equity	<u>7,874</u>	<u>23,983</u>
Total capitalization	<u>\$7,874</u>	<u>\$23,983</u>

- (1) Does not include (i) 410,026 shares of Common Stock reserved at the date of this Prospectus for issuance upon exercise of outstanding options under the Company's stock option plans and outstanding options granted to two individuals outside the Company's stock option plans, and (ii) 230,833 shares of Common Stock available at the date of this Prospectus for future grant under such plans. See "Management—Stock Option Plans and Agreements." Also does not include 333,333 shares reserved at the date of this Prospectus for issuance upon exercise of outstanding warrants to purchase Common Stock. See "Description of Capital Stock—Common Stock Warrants."

DIVIDEND POLICY

The Company has never declared or paid cash dividends on its Common Stock. The Company presently intends to retain future earnings to finance the operation and expansion of its business and does not anticipate declaring cash dividends in the foreseeable future. The Company has recently negotiated a secured lending arrangement that contains restrictions on payments of dividends. See "Management's Discussion and Analysis of Financial Condition and Results of Operations—Liquidity and Capital Resources."

SELECTED CONSOLIDATED FINANCIAL DATA

The selected consolidated financial data in the following table is qualified in its entirety by, and should be read in conjunction with, the consolidated financial statements and notes thereto and other financial and statistical information included elsewhere in this Prospectus. The following table sets forth selected consolidated financial data for each of the five years in the period ended March 31, 1989 and the three months ended June 30, 1988 and 1989. The income statement data for each of the three years in the period ended March 31, 1989 and the balance sheet data as of March 31, 1988 and 1989 have been derived from the consolidated financial statements of the Company included herein which have been examined by Deloitte Haskins & Sells, independent public accountants, whose report appears elsewhere in this Prospectus. The income statement data for each of the two years in the period ended March 31, 1986 and the three months ended June 30, 1988 and 1989, and the balance sheet data as of March 31, 1985, 1986 and 1987, and June 30, 1988 and 1989 are unaudited. In the opinion of management, such data include all adjustments, consisting only of normal recurring adjustments, necessary for a fair statement of the financial position and the results of operations for such periods. The results of operations for the three months ended June 30, 1989 are not necessarily indicative of results to be expected for the year ending March 31, 1990.

	Year Ended March 31,					Three Months Ended June 30,	
	1985	1986	1987	1988	1989	1988	1989
Income Statement Data:(1)							
(In thousands, except per share amounts)							
Revenues:							
Computer software.....	\$ 634	\$ 516	\$2,054	\$2,938	\$7,579	\$ 939	\$ 3,421
Duplication, printing and packaging.....	—	—	119	855	4,221	382	746
Total revenues.....	<u>634</u>	<u>516</u>	<u>2,173</u>	<u>3,793</u>	<u>11,800</u>	<u>1,321</u>	<u>4,167</u>
Cost of revenues:							
Computer software.....	289	208	618	775	2,854	311	1,264
Duplication, printing and packaging.....	—	—	68	662	2,796	265	566
Total cost of revenues.....	<u>289</u>	<u>208</u>	<u>686</u>	<u>1,437</u>	<u>5,650</u>	<u>576</u>	<u>1,830</u>
Gross profit.....	345	308	1,487	2,356	6,150	745	2,337
Selling, general and administrative expenses.....	339	309	1,261	1,377	2,728	407	894
Income from operations.....	6	(1)	226	979	3,422	338	1,443
Other income (expense).....	(1)	—	(7)	(19)	133	27	19
Income before income taxes.....	5	(1)	219	960	3,555	365	1,462
Provision for income taxes.....	—	—	93	366	1,446	134	613
Net income.....	<u>\$ 5</u>	<u>\$ (1)</u>	<u>\$ 126</u>	<u>\$ 594</u>	<u>\$2,109</u>	<u>\$ 231</u>	<u>\$ 849</u>
Earnings per share data:							
Earnings per common and common equivalent share.....	<u>\$0.00</u>	<u>\$0.00</u>	<u>\$ 0.05</u>	<u>\$ 0.12</u>	<u>\$ 0.34</u>	<u>\$ 0.04</u>	<u>\$ 0.13</u>
Weighted average number of common and common equivalent shares outstanding.....	<u>4,436</u>	<u>4,436</u>	<u>2,793</u>	<u>4,871</u>	<u>6,273</u>	<u>6,053</u>	<u>6,771</u>
Balance Sheet Data:(1)							
Working capital.....	\$ 54	\$ 63	\$ 58	\$3,470	\$3,863	\$3,500	\$ 3,372
Total assets.....	\$ 98	\$ 90	\$ 686	\$4,981	\$9,329	\$4,741	\$10,657
Long-term debt.....	—	—	—	—	—	—	—
Stockholders' equity.....	\$ 79	\$ 78	\$ 161	\$4,092	\$6,476	\$4,323	\$ 7,874

(1) Results prior to October 1986 represent the operations of The Software Toolworks, Ltd., the predecessor of the Company. Results from October 1986 through February 1988 represent the operations of The Software Toolworks, Ltd. and Software Country, which merged in October 1986. In February 1988, the Company was reorganized through a stock-for-stock exchange with a publicly-held investment vehicle. The Company acquired Priority Software Packaging, Inc., Intellicreations, Inc. and DS Technologies, Inc. in November 1986, September 1988 and April 1989, respectively. See "The Company" and Notes 1 and 2 of Notes to Consolidated Financial Statements.

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

Results of Operations

The following table sets forth, for the periods indicated, the percentage of net revenues represented by certain items in the Company's consolidated statements of income.

	Percentage of Net Revenues				
	Year Ended March 31,			Three Months Ended June 30,	
	1987	1988	1989	1988	1989
Revenues:					
Computer software.....	94.5%	77.5%	64.2%	71.1%	82.1%
Duplication, printing and packaging	5.5	22.5	35.8	28.9	17.9
Total	100.0%	100.0%	100.0%	100.0%	100.0%
Gross profit	68.4	62.1	52.1	56.4	56.1
Selling, general and administrative expenses	58.0	36.3	23.1	30.8	21.5
Income from operations	10.4	25.8	29.0	25.6	34.6
Net income	5.8%	15.7%	17.9%	17.5%	20.4%

Fiscal Years 1987, 1988 and 1989

The following table sets forth the Company's revenues in each of its business segments and product categories for each of the last three fiscal years:

	Year Ended March 31,		
	1987	1988	1989
	(In thousands)		
Computer software:			
Entertainment	\$2,054	\$1,933	\$ 3,961
Education	—	841	1,581
Productivity and utility.....	—	164	2,037
Total.....	2,054	2,938	7,579
Duplication, printing and packaging.....	119	855	4,221
Total revenues	\$2,173	\$3,793	\$11,800

Consolidated revenues increased \$1,620,000, or 75%, in fiscal 1988 and \$8,007,000, or 211%, in fiscal 1989, reflecting revenue increases in both the computer software and duplication, printing and packaging segments of the Company's business. The increase in consolidated revenues in fiscal 1988 reflected an increase of \$884,000 in computer software revenues, principally due to the introduction of an education product, *Mavis Beacon Teaches Typing*, and an increase of \$736,000 in Priority's third-party duplication, printing and packaging revenues due to an expansion of its business.

In fiscal 1989, revenues from the Company's computer software segment increased by \$4,641,000. Of that increase, approximately \$1,680,000 resulted from the release of *Chessmaster 2100* and the introduction of two new productivity and utility products, *Twist and Shout* and *Office Manager/The Secretary Bird*, and a new entertainment product, *Life and Death*. Sales to HeadStart accounted for \$1,640,000 of the increase in revenues. The acquisition of Intellicreations contributed \$1,321,000 to the increase, primarily as a result of sales of *The Hunt for Red October*, a computer game based on Tom Clancy's best selling novel of the same title. See Note 2 of Notes to Consolidated Financial Statements for a description of the Company's fiscal 1988 and 1989 consolidated pro forma results of operations with respect to the September 1988 acquisition of Intellicreations and the April 1989 acquisition of DS Technologies, Inc. ("DS").

In the duplication, printing and packaging segment, Priority's revenues increased by \$3,366,000 in fiscal 1989. This increase was due to a number of factors, including significantly increased revenues from HeadStart, which accounted for approximately \$2,312,000 of Priority's revenues for fiscal 1989. Other factors contributing to Priority's increased revenues in fiscal 1989 include its expansion into printing services, the addition of a second production facility and an increase in demand for duplication of 3½" floppy diskettes, which are higher-priced than 5¼" floppy diskettes. Although Priority has continued to enjoy a significant increase in revenues for the first three months of fiscal 1990 over the comparable period in fiscal 1989, the Company does not anticipate that the growth in Priority's revenues in fiscal 1990 will continue at the same rate that occurred in fiscal 1989.

Overall cost of revenues increased by \$4,213,000 in fiscal 1989. In the Company's computer software segment, cost of revenues includes materials, labor and overhead, as well as royalties payable to third parties for certain products and amortized software development costs. In the Company's third-party duplication, printing and packaging segment, cost of revenues includes materials, labor and overhead. The increase in overall cost of revenues in fiscal 1989 reflected increased sales levels, as well as higher royalty expense and amortization of software development costs. Royalty expense increased from \$244,000 in fiscal 1988 to \$1,268,000 in fiscal 1989. Amortized software development costs increased from \$43,000 in fiscal 1988 to \$220,000 in fiscal 1989, reflecting increased capitalized software development expenditures in both fiscal 1988 and fiscal 1989. See Note 1 of Notes to Consolidated Financial Statements.

The Company's overall gross profit as a percentage of revenue was 68%, 62% and 52% in fiscal 1987, 1988 and 1989, respectively. The decrease in gross profit margin in fiscal 1989 was primarily due to a change in revenue mix. The Company experienced increased sales of software products for which higher royalty rates were payable, and Priority's revenues increased as a percentage of overall revenues. Priority's duplicating, printing and packaging revenues generally generate lower gross profit margins than those earned from software sales. Increased revenues of Priority as a percentage of total revenues were primarily responsible for the decrease in overall gross margin from fiscal 1987 to fiscal 1988.

The Company's selling, general, and administrative expenses declined as a percentage of revenues from 58% in fiscal 1987 to 36% in fiscal 1988 and 23% in fiscal 1989. The decrease resulted from the realization of economies of scale as the Company's revenue base expanded. The absolute increases each year were due to higher operating costs, principally related to increased personnel, required to support the expanded business. The absolute increase in fiscal 1989 was also due to expenses incurred in connection with the Company's move to new facilities, as well as duplication of certain administrative expenses for a limited period of time while Intellicreations was integrated into the Company's operations.

Other income in fiscal 1989 consisted primarily of interest earned on cash balances invested in highly liquid cash instruments.

During 1988, the Financial Accounting Standards Board released Statement of Financial Accounting Standards No. 96—Accounting for Income Taxes ("SFAS 96"). Among other provisions, SFAS 96 changes current accounting practice for the computation of income tax expenses. SFAS 96 will be adopted by the Company for the fiscal year commencing April 1, 1990. The Company expects that the adjustment required, if any, in the fiscal year SFAS 96 is adopted will not materially affect net income.

Net income increased 371% to \$594,000 in fiscal 1988 and 255% to \$2,109,000 in fiscal 1989. Earnings per share increased by 183% for fiscal 1989 because of the increase in the number of common and common equivalent shares, primarily as a result of the February 1988 reorganization of the Company.

First Three Months of Fiscal 1989 and Fiscal 1990

Revenues increased by 215% to \$4,167,000 for the current quarter ended June 30, 1989 from \$1,321,000 for the quarter ended June 30, 1988. This increase reflected revenue increases in both of

the Company's segments. Computer software revenues increased \$2,482,000 due to a significant increase in revenues from HeadStart, as well as new product introductions and increased sales of certain existing software products for retail distribution, and revenues from Priority also increased by \$364,000 during this period. Software licensing, development and publishing revenue from HeadStart increased by approximately \$1,600,000 from the first quarter of fiscal 1989 to the first quarter of fiscal 1990 primarily as a result of the publication of a second multiple-title package for resale and certain software development and licensing arrangements. In addition, sales of products acquired in connection with the acquisitions of DS and Intellicreations accounted for approximately \$595,000 and \$252,000, respectively, of the Company's first quarter 1990 revenues. The introduction of three new products, *Beyond the Black Hole*, *Cribbage King/Gin King* and *Backup Pro*, also contributed to the net revenue increase.

The Company's overall gross profit margin was approximately 56% for the fiscal quarter of both fiscal 1990 and fiscal 1989. During the first quarter of fiscal 1990, sales of products for which higher royalty rates were payable increased, but the gross margin impact was offset by a decrease in the percentage of total revenues contributed by Priority.

Selling, general and administrative expenses declined as a percentage of revenue to 21% during the quarter ended June 30, 1989 from 31% during the quarter ended June 30, 1988 due to economies of scale realized from the Company's expanding revenue base. The absolute increase of \$487,000 reflected higher operating costs to support the Company's increased revenues, as well as duplication of certain administrative and personnel expenses while DS was being integrated into the Company's operations.

Net income increased by 268% to \$849,000 for the quarter ended June 30, 1989. Earnings per share increased by 225% during this period.

Quarterly Results of Operations

The following table sets forth unaudited condensed results of operations for each quarter during fiscal 1989 and the first three months of fiscal 1990. The Company believes this information has been prepared on the same basis as the audited information and includes all normal recurring adjustments necessary for a fair presentation of the information for the periods presented.

	Quarter Ended				Fiscal 1990 June 30, 1989
	Fiscal 1989				
	June 30, 1988	Sept. 30, 1988	Dec. 31, 1988	Mar. 31, 1989	
	(In thousands, except per share data)				
Revenues:					
Computer software.....	\$ 939	\$1,946	\$2,024	\$2,670	\$3,421
Duplicating, printing and packaging.....	382	503	1,861	1,475	746
Total.....	<u>1,321</u>	<u>2,449</u>	<u>3,885</u>	<u>4,145</u>	<u>4,167</u>
Gross profit.....	745	1,621	1,933	1,851	2,325
Selling, general and administrative expenses.....	<u>407</u>	<u>711</u>	<u>885</u>	<u>725</u>	<u>882</u>
Income from operations.....	338	910	1,048	1,126	1,443
Net income.....	<u>\$ 231</u>	<u>\$ 569</u>	<u>\$ 635</u>	<u>\$ 676</u>	<u>\$ 849</u>
Earnings per common and common equivalent share.....	<u>\$ 0.04</u>	<u>\$ 0.09</u>	<u>\$ 0.10</u>	<u>\$ 0.11</u>	<u>\$ 0.13</u>

The Company's software business may be affected on a quarterly basis by new product releases, the timing of OEM orders and the seasonality of the retail consumer software industry. Priority's revenues may fluctuate due to its customers' hardware and software product introductions and upgrades, the seasonality relating to sales of consumer software, as well as the needs of its corporate customers to update new information from time to time through the dissemination of diskette-based

media. In addition, the Company's operating margins can vary due to changes in the Company's revenue mix from quarter to quarter. Accordingly, quarter to quarter comparisons may not be meaningful and should not be relied upon as indicators of future performance.

Liquidity and Capital Resources

The Company's primary source of liquidity has been cash flow from operations and \$3,500,000 of proceeds provided by the reorganization of the Company in February 1988. See "The Company" and Notes 1 and 3 of Notes to Consolidated Financial Statements.

Increased revenue levels have resulted in increased cash requirements, primarily to finance significantly higher levels of accounts receivable (which increased from \$691,000 to \$3,510,000 in fiscal 1989 and were \$4,016,000 at June 30, 1989) and inventory (which increased from \$193,000 to \$1,268,000 in fiscal 1989 and were \$1,222,000 at June 30, 1989). The increase in accounts receivable was principally the result of significant revenue increases due to new product releases, increased HeadStart revenues and increased sales by Priority. The increase in inventory reflected increased purchases of raw materials to support the Company's higher revenue levels, increased inventory attributable to new products released during the June 30, 1989 quarter, and inventories acquired as a result of the acquisitions of Intellicreations and DS. The Company also incurs significant capital expenditures for software development. Expenditures for capitalized software development costs increased from \$362,000 in fiscal 1988 to \$841,000 in fiscal 1989, and totaled \$341,000 for the three months ended June 30, 1989. See Note 1 of Notes to Consolidated Financial Statements.

The Company acquired Intellicreations and DS in September 1988 and April 1989, respectively. The Company's primary purpose in each acquisition was to obtain additional products to supplement its existing product offerings, and the Company shortly thereafter eliminated each company's separate facilities and integrated their operations into the Company's existing operations. In each case, the Company incurred duplicative administrative and personnel expenses until the integration was completed. The Company also assumed and paid certain accounts payable and other liabilities of each acquired company. As a result, the Company's cash outlays increased following each acquisition. In addition, in the case of DS, a portion of the purchase price was paid in the form of cash and short-term notes payable. See Note 2 of Notes to Consolidated Financial Statements.

As a result of the foregoing expenditures, cash and cash equivalents, together with marketable securities, decreased from \$3,436,000 at March 31, 1988 to \$1,388,000 at March 31, 1989 and to \$227,000 at June 30, 1989. See Consolidated Statements of Cash Flows.

To date, the Company has not used bank debt to finance its operations. The Company has recently put into place a secured lending arrangement providing for a loan facility of \$500,000 for fixed asset purchases and a revolving line of credit of \$2,000,000 for working capital purposes, but the Company has not yet utilized either facility.

The Company anticipates that higher sales volumes will continue to require additional financing of accounts receivable and inventory. In addition, the Company from time to time reviews possible new software development projects and acquisitions of software publishing businesses or software products that will complement the Company's software operations. The Company may also expand Priority's service territory by opening or acquiring new facilities. The Company believes that the net proceeds of this offering and its borrowing capability under its recently established lending arrangement, together with existing cash and cash equivalent balances and cash flow from operations, will be sufficient to fund the Company's anticipated capital needs through the remainder of the current fiscal year. The Company is not at this time negotiating the acquisition of any specific company or product line and has no specific plans to open or acquire an additional Priority facility.

BUSINESS

The Company is a vertically-integrated, diversified software company. The Company develops and publishes entertainment, educational, personal productivity and utility software for retail distribution and for license. The Company's software products are available through over 8,000 retail outlets. The Company provides diskette duplication, packaging, printing, assembly and order fulfillment services for itself and others, including several major software publishers, OEMs and large corporations. Through an OEM agreement with HeadStart Technologies Co., a division of North American Philips Corporation, the Company licenses its software products for bundling with HeadStart computers. The Company has also developed the operating environment for the HeadStart Explorer computer, which is expected to be available in September 1989.

Industry Background

The market for personal computer software has grown substantially in recent years. The Company believes that this growth has resulted primarily from increased personal computer ownership, availability of more powerful and less expensive personal computers, development of more sophisticated, user-friendly and graphically-oriented software, and the expansion of various retail distribution channels that offer personal computer hardware and software.

As personal computers have become more powerful and less expensive, their use in both the home and business environments has expanded markedly, creating increased demand for a wide variety of software products. As demand for more diverse categories of software has increased, channels of distribution for consumer software have expanded accordingly. Personal computer software is now sold by software specialty retail chains, bookstore chains, independent retail stores, large mail order outlets and mass merchandisers such as Radio Shack Computer Centers, Babbage's, B. Dalton Software, Etc., Egghead Discount Software, Electronics Boutique, 47th Street Computers, Lechmere and Waldensoftware.

The overall expansion of the personal computer hardware and software industry as well as the substantial growth in the utilization of diskette-based media for the storage and dissemination of information has created increasing demand for diskette duplication services. Demand for the printing of manuals and packaging of software and hardware with documentation has also grown as a result of this expansion.

Business Strategy

The Company's strategy is to maintain a diverse revenue base through the continued introduction of successful software products across its entertainment, educational, personal productivity and utility product categories, the expansion of its OEM and bundling activities, and the expansion of its diskette duplication, printing and packaging business. The Company believes it has successfully implemented this strategy to date by (i) selectively developing and acquiring premium quality software products, (ii) diversifying its software product line, (iii) vertically integrating its operations, and (iv) developing a significant OEM licensing relationship.

Product Selection and Quality. The Company's product strategy has been to selectively develop or acquire products for which broad, long-term markets exist, such as *Chessmaster*, its chess-playing program, and *Mavis Beacon Teaches Typing*, its typing tutorial program, or which contain features or product advances which significantly distinguish the product, such as *Beyond the Black Hole*, its stereoscopic 3-D computer game, and *Life and Death*, its interactive hospital simulation program. The Company believes its products are distinguishable by their high quality, distinctive features, ease of use, sophisticated graphics and creative packaging.

Product Diversification. The Company develops and publishes software in four distinct product categories: entertainment, educational, personal productivity and utility. In addition, the Company is awaiting approval from Nintendo of America, Inc. for use of *Chessmaster* on the Nintendo Entertainment System. See "Software Distribution and Licensing." The Company believes that its

diversified product line reduces dependence on any single product or product category and expands the potential markets for the Company's products to include the consumer, business, government and education markets.

Vertical Integration. The services of Priority provide the Company with cost and production advantages not shared by publishers who must contract with outside vendors for diskette duplication, packaging and printing. Priority also provides the Company with an additional source of revenues and earnings apart from sales of its software products.

OEM Relationship. The Company has derived significant revenues and earnings through the development of an OEM relationship with HeadStart. The Company licenses certain of its software products to HeadStart for bundling with HeadStart computers and has developed the operating environment for the HeadStart Explorer computer. The Company is also seeking to develop licensing arrangements with other OEMs. See "Software Distribution and Licensing."

Software Products

The Company develops and publishes entertainment, educational, personal productivity and utility software. The majority of the Company's computer software revenues are derived from sales or licenses of software products for the IBM PC and compatible personal computers. Where appropriate, the Company creates versions of its software products for use on other personal computers, including Apple Macintosh, Apple II and Apple IIGS, Commodore 64/128 and Commodore Amiga, and Atari ST. The Company's products are competitively priced, generally ranging in suggested retail price from \$39.95 to \$99.95.

The principal products offered by the Company are set forth below. All of these products are sold through retail distribution channels and, where indicated, are also bundled or sold directly to customers.

Chessmaster, a chess program which enables the user to play chess with the computer. *Chessmaster* offers 12 levels of playing expertise and a library of 110 "Classic Games." *Chessmaster 2000*, the initial version of the product, was released in 1986 and received the Software Publishers Association award for Best Entertainment Program in that year. *Chessmaster 2100*, an enhanced version of *Chessmaster 2000*, was released by the Company in September 1988. Sales of *Chessmaster* accounted for 60%, 47% and 15% of the Company's total revenues for the fiscal years ended March 31, 1987, 1988 and 1989, respectively. *Chessmaster* is also bundled with HeadStart personal computers.

Mavis Beacon Teaches Typing, a typing tutorial program which offers customized lessons for individual user needs through the utilization of artificial intelligence techniques. *Mavis Beacon Teaches Typing* was released in 1987 and received the Software Publishers Association award for Best Home Learning Program in that year. The product accounted for 14% of the Company's total revenues for the fiscal year ended March 31, 1989. *Mavis Beacon Teaches Typing* is also bundled with HeadStart personal computers and is sold directly to school districts, other education customers and corporate customers.

The Hunt for Red October, a submarine simulation game based on Tom Clancy's best-selling novel of the same title. The novel is also the basis for an upcoming motion picture. Originally released by Intellicreations in March 1988, *The Hunt for Red October* was repackaged by the Company and released in October 1988.

Life and Death, an interactive hospital simulation game which utilizes sophisticated graphics technology to allow the user to perform a variety of surgical operations on electronic patients. The fate of the patient depends on the surgical technique chosen by the player. *Life and Death* was released in October 1988 and was a 1989 Software Publishers Association nominee for Best Entertainment Product, Best Simulation Program and Best Original Game Achievement awards.

Twist & Shout, a printing utility program which allows users to turn files “on their side” and print them sideways in a continuous stream. This eliminates the need to paste or tape together several sheets for spreadsheets and other files which are too wide to be printed on a single sheet. *Twist & Shout* also prints graphics, banners and signs in various type fonts and sizes. This product was released in June 1988 and is also bundled with HeadStart personal computers.

Office Manager/The Secretary Bird, a comprehensive multi-purpose product incorporating word processing, spreadsheet and database programs designed for small business and personal use. The product is licensed to HeadStart for bundling with its personal computers under the name *Office Manager*. The retail version of this product is sold under the name *The Secretary Bird*. *Office Manager/The Secretary Bird* was released in July 1988.

Backup Pro, a network-compatible, hard disk back-up program which combines advanced data compression technology and four levels of data security with an easy-to-use, menu-driven user interface. *Backup Pro* was released by the Company in June 1989. This product is also bundled with HeadStart personal computers and is sold directly to government and corporate customers.

Beyond the Black Hole, a multi-level game which employs techniques that produce true stereoscopic, three-dimensional game graphics. Each of the game’s 35 levels is a puzzle with its own logic which must be solved before the player can advance to the next level. This product was released by the Company in June 1989.

Cribbage King/Gin King, computer versions of the classic card games which combine high resolution graphics with strong game play. *Cribbage King* offers the user the choice of playing two-handed, four-handed or five-card cribbage, and *Gin King* offers the user the choice of playing either standard or Oklahoma-style gin. Each game allows the user to play against seven different computer-generated playing personalities. This product was released by the Company in June 1989.

Family Pac, a compilation of the programs *Quicken*, *PrintMaster Plus*, *PrintMaster Art Gallery I*, *MathTalk* and *MathTalk Fractions*. These programs are licensed by the Company from other software publishers and sold exclusively to HeadStart for resale under a private label. This product was released in March 1989.

Fun Pac, a compilation of the programs *Chuck Yeager’s Advanced Flight Trainer*, *Test Drive*, *Paperboy*, *Superstar Indoor Sports* and *Airplane Factory*. These programs are licensed by the Company from other software publishers and sold exclusively to HeadStart for resale under the HeadStart label. This product was released in June 1989.

The following table sets forth the formats for which the Company's principal products are currently available or under development for future introduction, and also sets forth the channels of distribution for these products:

Product	Format								Distribution Channel		
	IBM PC and IBM PC Compatibles	Apple Macintosh	Apple II	Apple IIGS	Commodore 64/128	Commodore Amiga	Atari 8-bit	Atari ST	Retail	OEM	Direct
Chessmaster(*).....	•	•	•	•	•	•	•	•	•	•	
Mavis Beacon Teaches Typing.....	•	•	•	•	•	•		•	•	•	•
The Hunt for Red October.....	•	•	•	•	•	•		•	•		
Life and Death.....	•	•		○		○			•		
Twist and Shout.....	•								•	•	•
Office Manager/The Secretary Bird.....	•								•	•	•
Backup Pro.....	•								•	•	•
Beyond the Black Hole.....	•				○				•		
Cribbage King/Gin King.....	•	○		○		○			•		
Family Pac.....	•								•		
Fun Pac.....	•								•		

- Currently available format.
- The Company intends to introduce a version of the product for this format in late 1989.

* *Chessmaster 2100* is available for the IBM PC and compatible, Apple II, Apple IIGS and Commodore 64/128 formats and the Company intends to introduce *Chessmaster 2100* for the Apple Macintosh in late 1989. The Company continues to publish *Chessmaster 2000* for all of the formats listed above.

In connection with the Company's acquisition of DS Technologies, Inc., the Company acquired the right to publish a number of products, including *DS Backup*, the predecessor to *Backup Pro*, *DS Tutor*, a personal computer training program, *DS Optimize*, a program which reorganizes hard disk information to improve memory efficiency, and *DS Help*, a program which provides personal computer users with an instantly accessible on-line reference to DOS commands. The Company continues to publish these products under the DS label. In connection with the acquisition of Intellicreations, the Company acquired the right to publish a number of arcade-type entertainment programs. The Company continues to publish these products under the Datasoft label.

The Company is also developing a martial arts computer game, *Bruce Lee Lives*, which will incorporate artificial intelligence techniques. The Company intends to release this product in late 1989.

The Company has entered into an agreement with a licensed independent publisher of game cartridges for the Nintendo Entertainment System to develop a modified version of *Chessmaster* for use on Nintendo. This publisher has received preliminary, and is awaiting formal, approval from Nintendo of America, Inc. for publication of this product. The Company is also modifying *Beyond the Black Hole* and *The Hunt for Red October* for possible use on Nintendo and is negotiating similar licensing agreements for such products. No assurances can be given as to whether *Chessmaster* or any of the other products will receive the necessary Nintendo approvals or when production of *Chessmaster* will commence. See "Software Distribution and Licensing."

Software Development and Acquisition

The Company's 22-person software development staff develops new products, adapts existing products for additional personal computer formats, modifies licensed or acquired products and reviews new product submissions by independent authors. The Company has obtained products through internal product development, licensing from independent authors and strategic acquisitions of other software publishers. When the Company licenses or acquires a software product, the Company's development staff typically rewrites the program to add features, enhance graphics and improve the user interface. The Company also upgrades the packaging and documentation for the product to ensure that it meets the Company's product quality standards.

The Company believes its development staff has built significant expertise in incorporating artificial intelligence techniques, advanced data compression algorithms and sophisticated graphics technology into its consumer software products. The Company believes this expertise allows it to more effectively develop and enhance future products. In addition, the Company has developed a proprietary windowing and menuing implementation technology which allows its programmers to more efficiently create uniform user interfaces and to port the Company's software products to a variety of computer platforms.

A number of the Company's principal products have been developed from programs or algorithms licensed from others, including *Chessmaster*, *Office Manager/The Secretary Bird*, *Twist and Shout*, *The Hunt for Red October*, *Life and Death* and *Cribbage King/Gin King*. Products obtained from independent authors are licensed pursuant to agreements which provide the Company with an exclusive right to market the product. In return, the author receives a royalty based on revenues received by the Company on sales of the licensed product. The majority of these royalty rates range from 5% to 15% of net revenues. In certain circumstances, royalty rates may exceed this range due to the nature and anticipated life of the product, the skill and experience of the author and the type and extent of development services the author provides. Special royalty arrangements apply with respect to the programs included in *Family Pac* and *Fun Pac*. The Company's license agreements have generally not provided for advance payments or royalty guarantees, thereby reducing the risk to the Company in the event a product is unsuccessful in the marketplace. License terms range generally from two to ten years. The license term for *Chessmaster* is subject to renewal in 1999. The license term of *The Hunt for Red October* is subject to renewal in December 1989. Programs included in *Family Pac* and *Fun Pac* are licensed for one-year terms, subject to renewal.

The Company's software development staff developed the operating environment for the new HeadStart Explorer computer and is modifying several of the Company's products for use on the Nintendo Entertainment System. See "Software Distribution and Licensing."

The Company's development strategy is to incorporate proven technology into its products. Typically, the Company obtains minimum order levels for a proposed product prior to incurring any material development expense. This practice significantly increases the probability that such proposed product will be commercially viable.

Capitalized software development costs, as determined in accordance with generally accepted accounting principles, amounted to \$841,000 for the fiscal year ended March 31, 1989 and \$341,000 for the three months ended June 30, 1989. See Note 1 of the Notes to Consolidated Financial Statements.

Software Distribution and Licensing

Retail Distribution and Direct Sales. Since August 1985, the Company's products have been primarily distributed to retail customers through Electronic Arts Distribution, a distributor of consumer market computer software. Through Electronic Arts' distribution network, the Company's software products are available through over 8,000 retail outlets, including Radio Shack Computer Centers, Egghead Discount Software, B. Dalton Software, Etc., Babbage's and Electronics Boutique. Sales to Electronic Arts for the fiscal years ended March 31, 1987, 1988 and 1989 and for the three months ended June 30, 1989 were \$1,649,000, \$2,530,000, \$3,872,000 and \$1,375,000, respectively, which amounts represent 76%, 67%, 33% and 33% of the Company's consolidated revenues for such periods.

The Company also sells its software products directly to education, government and corporate customers through its four-person direct sales staff. The Company intends to expand the size of its direct sales staff in order to increase the Company's presence in these markets. The Company's direct sales force is also pursuing licensing arrangements for the Company's products with OEMs.

The Company is distributing its products in Europe exclusively through Mindscape International Limited, a London-based distributor. The Company has also granted exclusive distribution rights for *Mavis Beacon Teaches Typing* in Japan to a locally-based distributor.

The Company's distribution agreement with Electronic Arts was renewed for an additional three-year term commencing July 1988, and generally provides Electronic Arts with exclusive distribution rights to major software retailers in the United States and Canada for all of the Company's principal software products. In addition, Electronic Arts has the right to distribute any new disk-based software program developed or acquired by the Company during the term of the agreement. The Company provides Electronic Arts with "stock balancing" and "price protection" rights. These rights permit Electronic Arts to return slow-moving products to the Company for credit and to receive a retroactive price adjustment for any Company product in the inventories of Electronic Arts or its customers if the Company lowers the price of such product. To date, stock balancing returns and price protection credits have been insignificant.

The Company's practice is to fulfill all products through Priority promptly after receipt of customer orders. Consequently, the Company does not maintain a material backlog of orders. The Company's products may be returned if found to be defective in materials or packaging. To date, returns of defective products have been insignificant.

Software Licensing. The Company derives a significant portion of its revenues through licensing its software to HeadStart for bundling with HeadStart's computer products. These bundling arrangements permit HeadStart, in exchange for license fees to the Company, to include the Company's software with its computers. The Company is also seeking to develop licensing relationships with other OEMs.

The Company publishes two multiple-product packages, *Fun Pac* and *Family Pac*, which are sold directly by HeadStart through mass merchandisers. These packages consist of a number of different software products selected by the Company and licensed from other publishers. The products are duplicated and assembled in a single package by Priority, and are then sold exclusively to HeadStart for resale under the HeadStart label and another private label.

The Company has developed the operating environment, including the graphical user interface and a number of applications programs, for HeadStart's Explorer computer. The Explorer is an IBM PC compatible personal computer designed by HeadStart and the Company for the consumer market. The Explorer will be sold through mass merchandisers such as Montgomery Ward, Best Products and Circuit City. The Company will receive a license fee for each Explorer computer sold by HeadStart. HeadStart has licensed a number of the Company's software products for bundling on a hard disk drive to be sold for Explorer computers. HeadStart announced the Explorer computer in April 1989 and expects to commence shipments in September 1989.

Aggregate revenues from HeadStart, including revenues to Priority, were \$4,073,000, or 35% of the Company's total revenues, for the fiscal year ended March 31, 1989, and were \$1,798,000, or 43%, of the Company's total revenues for the three months ended June 30, 1989. Of the total revenues from HeadStart during the fiscal year ended March 31, 1989, \$1,761,000 were earned from software sales and licenses and \$2,312,000 were earned by Priority for diskette duplication, printing and packaging services. At June 30, 1989, the Company's account receivable due from HeadStart was \$1,731,000.

The Company has entered into an agreement with Hi Tech Expressions, Inc. ("Hi Tech"), a licensed independent publisher of game cartridges for the Nintendo Entertainment System, to develop a version of *Chessmaster* for use on Nintendo. The Company has completed the necessary development, and Hi Tech has received preliminary, and is awaiting formal, approval from Nintendo of America, Inc. for publication of the product. Hi Tech will pay the Company a royalty based on Hi Tech's revenues, net of returns, from sales of the product. The Company is also modifying other products for possible use on Nintendo and is negotiating similar licensing agreements for such products. No assurance can be given as to whether *Chessmaster* or such other products will receive the necessary Nintendo approvals or when production of *Chessmaster* will commence.

Software Marketing

The Company believes that its reputation for high quality and innovative products has been a significant factor in the success of the Company's software products. To that end, the Company designs products for targeted market segments, and develops products that it believes incorporate significant technological advances over competing products.

The reputation of the Company's products is the result of both favorable press reviews and consumer word of mouth. The Company's four-person corporate communications department submits all of the Company's products for editorial review to software and computer publications and national consumer media. A number of the Company's principal products have received favorable reviews in such publications as *A+*, *The Boston Herald*, *Classroom Computer Learning*, *The Chicago Tribune*, *Infoworld*, *Mac World*, *The New York Times*, *PC Magazine*, *PC Week* and *Personal Computing*, and on *The ABC Television Network*.

In order to capitalize on consumer traffic in the major software chains, the Company designs what it believes to be unique, eye-catching packaging. The Company also prepares in-store display materials, such as product brochures, posters and counter cards, which it supplies to retail outlets that market its products. Additionally, the Company participates in a cooperative advertising program for retailers of its products. Under this program, retailers are reimbursed for the cost of newspaper, magazine, and catalogue advertising.

The Company participates in over a dozen industry and end-user trade shows each year, including the Consumer Electronics Show, COMDEX and PCW (in London). In addition, the Company sends its programmers to consumer user group meetings where, on a regular basis, the Company's products are demonstrated and promoted. The Company also electronically distributes demonstration disks of its products to computer information services.

The Company maintains a mailing list of over 500,000 customers. New products and upgrades are marketed directly to the Company's customers through direct mail campaigns. The Company also maintains a toll-free telephone "hotline" staffed by customer support personnel to answer product questions from customers.

Priority—Diskette Duplication, Printing and Packaging

Priority provides diskette duplication, documentation printing, packaging, assembly and order fulfillment services for the Company and others, including several major software publishers, OEMs and large corporations.

The Company benefits in several respects from the vertical integration provided by Priority. The Company obtains a cost advantage over those software publishers who must contract with outside vendors for these services. In addition, the Company enjoys improved turnaround time and increased flexibility and control in the manufacturing of its products. These advantages enable the Company to reduce the cost of production for products obtained through the acquisition of other software publishers, making such acquisitions more attractive.

Priority's services to outside customers provide the Company with a source of revenues and earnings apart from sales of its software products. The Company is able to offer Priority's services when it licenses its software products to OEMs, giving the Company a cost and service advantage over publishers who do not have duplication, printing or packaging capabilities. The Company's software development staff provides technical assistance to Priority in the areas of copy protection, data compression and installation technology for customers' programs. The Company believes that such technical assistance allows Priority to provide a value-added service unavailable from diskette duplicators which do not have access to a software development staff.

Priority has two production facilities and one warehouse occupying a total of approximately 33,000 square feet. In addition to its original production plant in Santa Ana, California, Priority maintains a second plant in Chatsworth, California adjacent to the Company's executive offices. Both

production facilities provide diskette duplication, packaging, assembly and order fulfillment services. The Company's printing operations are located in the Chatsworth facility. The warehouse facility, located in Azusa, California, is used primarily for the storage of diskettes, packaging and other materials and supplies. Several of Priority's employees have full or part-time responsibility for the solicitation of additional customers.

Due to the short turnaround time between order placement and fulfillment, Priority does not maintain a material backlog of orders.

Priority obtains blank diskettes and other necessary supplies from various vendors. The Company believes that multiple sources are currently available for diskettes and other supplies. Although the Company experienced a temporary shortage of diskettes in late 1988, current supplies of diskettes are sufficient for the Company's anticipated needs, and the Company believes that sufficient supplies of diskettes will remain available for the near future.

Priority's revenues from outside customers accounted for 36% and 18% of the Company's consolidated revenues for the fiscal year ended March 31, 1989 and the three months ended June 30, 1989, respectively. Revenues from HeadStart to Priority accounted for 20% and 6% of the Company's total revenues for the fiscal year ended March 31, 1989 and the three months ended June 30, 1989, respectively.

Competition

The consumer market for personal computer software is highly competitive and is based on product development capability, quality, availability, marketing and price. Because of the diverse nature of its products and activities, the Company is not aware of any company which competes directly against it in all of its product categories and business segments. The Company faces competition from larger corporations with considerably greater resources which presently compete in the software market or which could enter the software market in the future. Smaller companies which may develop and introduce new software titles could also become significant competitors. Current competitors of the Company in one or more of its product categories include Spinnaker Software Corporation, Sierra On-Line, Inc., Fifth Generation Systems, Inc., Central Point Software, Inc., Peter Norton Computing, Inc., Funk Software, Inc. and Simon & Schuster, Inc.

There is also a high level of competition in Priority's diskette duplication, packaging, printing and related services business. Generally, such competition is based on order turnaround time, reliability and quality of service, and location and price. To date, the Company believes Priority has competed successfully in these areas. Priority's competitors include larger corporations with considerably greater resources.

Employees

As of June 30, 1989, the Company had a total of 127 employees. The Company employed 46 persons in connection with its software publishing activities, of whom 25 were employed in marketing, administration and customer support capacities, and 21 were engaged in software development capacities. Priority employed 81 persons, of whom 12 were employed in sales, administrative and managerial capacities and 69 were engaged in printing, production and packaging capacities.

None of the Company's employees is subject to a collective bargaining agreement nor has the Company experienced any work stoppages. The Company believes that its employee relations are good.

Trademarks, Copyrights and Product Protection

The Company seeks to protect its trade identity, trademarks, copyrights and other proprietary information. The Company has registered "Software Toolworks" as a trademark. The Company also obtains trademark and copyright protection for its software and trademark and/or copyright protection for promotional materials, software instructions and point of purchase and advertising materials

where such protection is deemed necessary. Substantially all of the Company's product names referred to herein are registered trademarks or are the subject of pending trademark registration applications.

As the number of software products in the industry increases and the functionality of products overlaps, software developers may become increasingly subject to infringement claims. This possibility is potentially greater for vendors that obtain certain of their products through publishing agreements or acquisitions, since they have less direct control over the development of those products. Although such claims may ultimately prove to be without merit, they can be time consuming and expensive to defend.

The Company incorporates software copy protection safeguards in certain of its products. Despite the legal and technical safeguards used by the Company, it may be possible for competitors or users to copy the Company's products or to obtain information which the Company regards as trade secrets. Most computer software cannot be patented, and existing copyright laws and available technology afford only limited practical protection. The Company believes that the rapid pace of technological change in the computer software industry makes copyright protection of less significance than such factors as the knowledge and experience of management and software designers and the Company's ability to develop and market its products.

Properties

The executive offices of the Company are located in leased premises at 19808 Nordhoff Place, Chatsworth, California 91311. The Chatsworth facility contains approximately 11,000 square feet of office space, along with an adjacent 11,000 square foot production facility, which is used by Priority. In addition, Priority leases an 8,020 square foot production facility in Santa Ana, California and a 14,500 square foot warehouse facility in Azusa, California.

The leases for the Chatsworth facility and the Santa Ana facility expire in February 1992 and February 1990, respectively. The lease for the Azusa warehouse facility expires in June 1994. The Company has obtained an option to renew the lease on the Azusa warehouse for an additional five years. Management believes that the leased premises in Chatsworth, Santa Ana and Azusa are well maintained and suitable for all activities currently conducted by the Company. The facilities provide sufficient space for such activities, and management believes that suitable additional space will be available on reasonable terms if needed.

See Note 6 of Notes to Consolidated Financial Statements for further information regarding the Company's lease obligations.

MANAGEMENT

Executive Officers and Directors

The executive officers and directors of the Company are as follows:

<u>Name</u>	<u>Age</u>	<u>Position</u>
Leslie Crane.....	55	Chairman of the Board of Directors, President and Chief Executive Officer
Joseph Abrams	37	Executive Vice President, Chief Financial Officer and Director
Walter Bilofsky.....	43	Senior Vice President, Assistant Secretary and Director
Norman Worthington.....	29	Senior Vice President, Secretary and Director
Michael E. Duffy	34	Vice President
Arthur E. Levine.....	37	Director
Michael L. Noel.....	48	Director

Leslie Crane served as the President, Chief Executive Officer and Chairman of the Board of The Software Toolworks, Ltd. ("Toolworks"), the Company's predecessor, since October 1986 and continued in these positions after the Company's February 1988 reorganization. Software Country, the company he co-founded in 1984 and of which he was President, was merged with Toolworks in October 1986. See "The Company." Prior to founding Software Country, Mr. Crane started Communications Counseling Services, Inc. in the late 1970's, a firm that implemented communications training programs for companies such as American Telephone & Telegraph Company, Xerox Corporation and Southern California Edison Company. Mr. Crane had previously spent over 30 years in the communications industry. In the late 1950's, he created radio's "Top 40" format. During the 1960's, Mr. Crane hosted his own late-night talk show on ABC-TV, "The Les Crane Show." In the early 1970's Mr. Crane formed a music publishing business and won a Grammy for the album "The Desiderata."

Joseph Abrams served as Executive Vice-President, Chief Financial Officer and a director of Toolworks from 1983 to 1988 and continued to serve in those positions after the Company's February 1988 reorganization. Mr. Abrams was Chief Financial Officer for 7-Eleven of Oklahoma City, a chain of convenience stores with annual revenues in excess of \$100 million, prior to joining Toolworks. Mr. Abrams and Walter Bilofsky, both executive officers and directors of the Company, are first cousins.

Walter Bilofsky founded Toolworks in 1980 and became Senior Vice President, Assistant Secretary and a director of the Company in connection with its February 1988 reorganization. Mr. Bilofsky, a Phi Beta Kappa graduate of Cornell University with degrees from Massachusetts Institute of Technology in Mathematics and Computer Science, has been in the computer industry since 1960. He is one of the founders of Interactive Systems, Incorporated, a developer of UNIX-based software for microcomputers and mini-computers. In addition, Mr. Bilofsky was a consultant in the computer industry. Among his clients were Raytheon Company, The Rand Corporation and Yale University.

Norman Worthington joined Toolworks in August 1986 and became Senior Vice President, Secretary and a director of the Company in connection with its February 1988 reorganization. Prior to that he attended Northwestern School of Law, where he received his Juris Doctor in 1986. During 1984, while he was a student at Northwestern Law School, Mr. Worthington co-founded Worthington-Babcock, Inc., a microcomputer software publisher and distribution firm. In addition to developing several microcomputer software products, Mr. Worthington supervised Worthington-Babcock's distribution operations.

Michael E. Duffy joined Toolworks in January 1987 as a software engineer and became Vice President of the Company in connection with its February 1988 reorganization. Prior to joining Toolworks, he served as a part-time consultant to various software companies, including Toolworks (1983 to 1987). Mr. Duffy received his Bachelor of Arts *cum laude* from Harvard University in 1978. Responsible for the first DEC VAX installation at Harvard, Mr. Duffy has over 14 years of software development experience in areas ranging from operating systems to computer phototypesetting.

Arthur E. Levine was elected to the Board of Directors of the Company in September 1988. Since July 1987, Mr. Levine has served as Chairman of the Board of Levine, Tessler, Leichtman & Co., a leveraged buy-out firm. From June 1983 until December 1986, Mr. Levine served as a director of Westwood One, Inc., a publicly-held radio programming company. He also served Westwood One in various employment capacities from January 1978 to January 1987.

Michael L. Noel was elected to the Board of Directors of the Company in July 1989. Mr. Noel has served as Treasurer and Vice President of Southern California Edison Company, a public utility, since 1976 and 1980, respectively. Mr. Noel also serves as a director of Current Income Shares, Inc., a bond mutual fund, and Hancock Savings and Loan Association.

Executive Compensation

The following table sets forth the cash compensation paid to each of the most highly compensated executive officers of the Company whose cash compensation exceeded \$60,000 and all executive officers as a group during the fiscal year ended March 31, 1989:

<u>Name of Individual</u>	<u>Capacities in Which Served</u>	<u>Base Compensation</u>	<u>Incentive Bonus (1)</u>
Leslie Crane	Chairman of the Board of Directors, President and Chief Executive Officer	\$ 159,135	\$ 150,800
Joseph Abrams.....	Executive Vice President and Chief Financial Officer	\$ 99,251	\$ 62,400
Norman Worthington	Senior Vice President and Secretary	\$ 82,423	\$ 31,200
Michael E. Duffy.....	Vice President	\$ 85,158	—
All executive officers as a group (5 persons)		\$475,678	\$244,400

(1) These amounts represent cash bonuses which were paid in April 1989 with respect to services rendered during the fiscal year ended March 31, 1989.

Stock Option Plans and Agreements

The executive officers of the Company listed in the above table are eligible to participate in the Company's 1988 Incentive Stock Option Plan (the "Incentive Plan") and 1988 Non-Qualified Stock Option Plan (the "Non-Qualified Plan"), which provide for the grant of options to purchase up to 300,000 shares and 113,333 shares of Common Stock, respectively (the Incentive Plan and the Non-Qualified Plan are collectively referred to herein as the "Option Plans"). The Option Plans provide for the grant of options on such terms and conditions as a stock option committee composed of two or more directors appointed by the Board to administer the Option Plans may determine, subject to the limitations of the Option Plans and applicable law. Incentive stock options (as defined by the Internal Revenue Code) may be granted under the Incentive Plan to officers and key employees (including directors who are officers or key employees) of the Company or any of its subsidiaries, and non-qualified stock options may be granted pursuant to the Non-Qualified Plan to directors, officers and key employees of the Company or any of its subsidiaries. Under the Option Plans, the option exercise price may be not less than 100% of the fair market value of the Common Stock on the date on which the options are granted (110% of the fair market value under the Incentive Plan if the optionee owns more than 10% of the combined voting power of all classes of stock).

In October 1988, the Company granted options to purchase an aggregate of 158,500 shares of Common Stock under the Incentive Plan at an exercise price of \$4.50 per share, including options granted to Mr. Duffy, a Vice President, to purchase 22,000 shares. In January 1989, the Company granted options to purchase an aggregate of 24,000 shares of Common Stock under the Incentive Plan at an exercise price of \$4.88 per share. All outstanding options vest in equal annual installments over

three years, with the first installment of the options granted in October 1988 vesting in October 1989, and the first installment of the options granted in January 1989 vesting in January 1990. No other options have been granted under the Option Plans.

In May 1988, Mr. Levine was granted an option to purchase up to an aggregate of 197,526 shares of Common Stock for his services as a director of the Company. In his capacity as a director of the Company and as a member of the audit committee of the Board of Directors, Mr. Levine provided a number of services, including review and advice regarding the Company's public disclosure filings, bank loan proposals, the Company's reverse stock split, the listing of the Company's Common Stock on the NASDAQ National Market System, the Company's annual report and general expansion of the Company's business. The option granted to Mr. Levine permits him to purchase 187,216 shares of Common Stock, which number shall be increased to 197,526 shares of Common Stock if and to the extent that certain warrants issued by Deseret-Western in connection with its initial public offering in 1986 (and now exercisable for the purchase of Common Stock of the Company) are exercised. See "Description of Capital Stock—Common Stock Warrants." The option is exercisable at a price of \$2.25 per share, which was the public fair market value of the Common Stock on the May 24, 1988 effective date of the option grant. The option will expire to the extent not exercised on May 24, 1996 (the "Termination Date"). The Company has granted certain registration rights to Mr. Levine with respect to the shares issuable upon exercise of this option. See "Description of Capital Stock—Registration Rights."

Certain Transactions

The Company entered into indemnification agreements with Messrs. Crane, Abrams, Bilofsky, Worthington and Levine in September 1988 and with Mr. Noel in August 1989, pursuant to which it agreed to indemnify and hold harmless such persons, to the full extent authorized or permitted by the Delaware General Corporation Law, from claims against them in their capacity as directors, officers, employees or agents of the Company. The agreements also provide, among other things, for indemnification under certain circumstances of amounts paid in respect of judgments or settlements of actions brought by or on behalf of the Company, and require that the Company advance expenses incurred by directors in the defense of actions brought against them. In addition, the indemnification agreements provide that the Company shall contribute to the amount of expenses, judgments, fines and other amounts paid in settlement by the directors in certain cases where indemnity rights are otherwise unavailable to the directors.

In September 1988 the Company agreed to issue 50,000 shares of Common Stock to Mr. Levine as full consideration for financial advisory services rendered by Mr. Levine to the Company in connection with the Company's acquisition of Intellicreations, including advice regarding the amount of the purchase price to be paid, the form of the consideration and the structure of the transaction. The Board of Directors, without the participation of Mr. Levine, determined the fair market value per share to be \$2.25, which was approximately one-half of the bid price of the Common Stock on the date the Company agreed to issue these shares to Mr. Levine. This determination was based upon an opinion rendered by an investment banker that the fair market value of the shares issued to Mr. Levine should reflect a discount of this amount because of the restrictions on transfer imposed under the Securities Act. The Company has granted certain registration rights to Mr. Levine with respect to these shares. See "Description of Capital Stock—Registration Rights."

During the fiscal year ended March 31, 1988, Toolworks borrowed from Messrs. Crane, Abrams and Bilofsky a total of \$103,000 for working capital purposes, which amount was repaid in its entirety later in the fiscal year, together with interest at the rate of 10% per annum.

In June 1987, Toolworks repurchased and retired all of the shares of capital stock then held by David Badley, one of the founders of Software Country. Mr. Badley's Toolworks shares, which were received pursuant to the merger of Toolworks and Software Country, constituted approximately 19% of the then-outstanding shares of Toolworks capital stock. Mr. Badley's original purchase price for the shares of Software Country was \$300, and Toolworks paid Mr. Badley an aggregate purchase price of \$250,000 for both the shares and an agreement not to compete with Toolworks prior to March 1,

1988. \$100,000 of the purchase price was paid in cash and the balance was paid in the form of a promissory note bearing interest at 10% per annum. The note was paid in its entirety later in the fiscal year.

Deseret-Western

Deseret-Western was organized in April 1986. An aggregate of 5,000,000 shares of Deseret-Western Common Stock was issued to the founders of Deseret-Western in connection with its organization for an aggregate purchase price of \$5,000. In addition, an aggregate of 10,000,000 shares was issued in connection with the initial public offering of Deseret-Western's Common Stock in October 1986 for an aggregate purchase price of \$100,000. An aggregate of 200,000,000 shares was issued at various times from June 1987 to September 1987 upon the exercise of warrants for an aggregate exercise price of \$3,500,000. The warrants were issued in connection with Deseret-Western's initial public offering in October 1986. The Deseret-Western shares were converted into shares of the Company at the ratio of 150:1 as a result of the 1988 reorganization and the subsequent reverse stock split of the Company's shares.

In the February 1988 reorganization of the Company, Toolworks effected a stock-for-stock exchange with Deseret-Western as described under "The Company." In that transaction (and in exchange for Toolworks shares then held by them), Messrs. Crane, Abrams, Bilofsky and Worthington received all of the shares of the Company which they now hold as set forth below under "Principal and Selling Stockholders" and Mr. Duffy received 38,808 shares of the Company, which shares constituted approximately 64% of the Company's outstanding Common Stock immediately following the transaction. The Company issued an aggregate of 739,200 shares of Common Stock to certain persons retained as finders in connection with this transaction, including 492,800 shares to Blinder International Enterprises, Inc., which shares constituted approximately 12% of the Company's outstanding Common Stock immediately following the transaction. In addition, the Company issued an aggregate of 1,433,333 shares of Common Stock to the shareholders of Deseret-Western, which shares constituted the remaining approximately 24% of the Company's Common Stock outstanding immediately following the transaction. In connection with this transaction, the Company also became obligated to issue up to 333,333 shares of Common Stock at a price of \$3.75 upon exercise of certain warrants which were originally issued in connection with Deseret-Western's initial public offering (the "Warrants"). See "Description of Capital Stock—Common Stock Warrants."

In September 1987, Deseret-Western received a subpoena duces tecum from the Securities and Exchange Commission (the "Commission") pursuant to a formal order of private investigation concerning certain issuers, and responded by submitting various documents relating primarily to the organization, financial condition and corporate proceedings and records of Deseret-Western prior to that time. Attorneys for the Company have contacted representatives of the Commission and discussed the investigation. Although the Company cannot determine the full scope and intent of the investigation, the Company believes, based on these discussions and on published accounts of this and other governmental investigations of these matters, that the investigation is primarily directed at various individuals who, prior to September 1987, may have been associated with certain companies (including Deseret-Western) which were originally organized as publicly-owned investment vehicles, or "blind pools." According to these accounts, these individuals may have caused false registration statements to be filed with respect to the initial public offering of these "blind pools" to conceal the fact that the officers, directors and shareholders of these companies were in fact nominees of these individuals. If these published reports are correct, the beneficial owners of the Warrants may in fact be the individuals under investigation by the Commission.

No persons who were officers, directors or employees of Deseret-Western prior to the February 1988 reorganization were retained as officers, directors or employees of the Company after the reorganization, or have otherwise been associated with management of the Company or its operations.

PRINCIPAL AND SELLING STOCKHOLDERS

The following table sets forth certain information regarding the beneficial ownership of the Company's Common Stock as of August 3, 1989, and as adjusted to reflect the sale of the shares offered by this Prospectus, by (i) all those persons known by the Company to be beneficial owners of more than 5% of its voting securities, (ii) all directors, (iii) all officers and directors of the Company as a group and (iv) other Selling Stockholders.

Name of Beneficial Owner	Shares Beneficially Owned Prior to Offering (1)		Shares to be Sold in Offering(2)	Shares Beneficially Owned After Offering	
	Number	Percent		Number	Percent
Leslie Crane, as Voting Trustee pursuant to Voting Trust Agreement dated February 11, 1988(3)	3,960,221	62.4%	519,200	3,441,021	42.8%
Leslie Crane(3)(4)	2,360,742	37.2%	429,200	1,931,542	24.0%
Joseph Abrams(3)	509,179	8.0%	20,000	489,179	6.1%
Walter Bilofsky(3)	509,179	8.0%	20,000	489,179	6.1%
Norman Worthington(3)	462,890	7.3%	20,000	442,890	5.5%
Arthur E. Levine(5)(6)	237,216	3.6%	—	237,216	2.9%
Michael L. Noel(7)	—	—	—	—	—
All directors and officers as a group (7 persons)(8)	4,204,808	64.3%	519,200	3,685,608	44.7%
Blinder International Enterprises, Inc.(9)	492,800	7.8%	492,800	—	—
Other Selling Stockholders as a group (5 persons)(10)	161,465	2.5%	48,000	113,465	1.4%

- (1) Unless otherwise indicated, the persons named in the table have sole voting and sole investment power with respect to all shares of Common Stock shown as beneficially owned by them, subject to community property laws where applicable.
- (2) Assumes the Underwriters' over-allotment option is not exercised.
- (3) The address of Messrs. Crane, Abrams, Bilofsky and Worthington is the Company's offices at 19808 Nordhoff Place, Chatsworth, California 91311. These individuals, as well as Michael E. Duffy, Theodore J. Hofmann and the Estate of Rollin Perry, have entered into a Voting Trust Agreement whereby Mr. Crane has the right to vote each such person's shares (other than 6 shares per person withheld from the Voting Trust Agreement) in connection with all shareholder actions. Each member of the Voting Trust retains sole dispositive power over his shares. The Voting Trust terminates on February 10, 1998 unless the members of the Voting Trust agree to terminate or extend the Voting Trust. Members of the Voting Trust may also obtain release from the Voting Trust of any shares which they wish to sell pursuant to Rule 144 under the Securities Act.
- (4) These shares are held by Mr. Crane as Trustee of the Leslie Crane Family Trust, dated as of August 30, 1989.
- (5) Concurrently with the registration of the shares offered hereby, the Company is registering an aggregate of 247,526 restricted shares of Common Stock which will be offered by Mr. Levine in one or more transactions in the over-the-counter market or in negotiated transactions. These shares consist of 50,000 shares which were issued to Mr. Levine in September 1988, and an aggregate of 197,246 shares which are issuable to Mr. Levine upon the exercise of an outstanding stock option. See "Management—Certain Transactions" and "Management—Stock Option Plans and Agreements." The percentages set forth in this table under the caption "Shares Beneficially Owned After Offering" do not reflect sales which may be made by Mr. Levine pursuant to such registration.
- (6) Mr. Levine is a director of the Company. The shares beneficially owned by Mr. Levine prior to the offering include 187,216 shares which are currently exercisable pursuant to an option granted to Mr. Levine. See "Management—Stock Option Plans and Agreements."
- (7) Subsequent to August 3, 1989, Mr. Noel and his wife purchased 990 and 2,000 shares of the Company's Common Stock, respectively. Mr. Noel disclaims beneficial ownership as to his wife's shares.
- (8) Includes 7,333 shares which are exercisable within sixty days of the date of this Prospectus pursuant to an option granted to Mr. Duffy, an officer of the Company. See "Management—Stock Option Plans and Agreements."
- (9) The address of Blinder International Enterprises, Inc. is 6455 South Yosemite Street, Englewood, Colorado 80111.
- (10) This group includes the Estate of Rollin Perry, who died on September 10, 1989, and four employees of the Company, Theodore J. Hofmann, Gordon A. Landies, William E. Terrill and Joseph Szczepaniak. Each Selling Stockholder in this group owns beneficially less than one percent of the Company's Common Stock.

DESCRIPTION OF CAPITAL STOCK

Common Stock

The Company is authorized to issue up to 50,000,000 shares of Common Stock, \$.01 par value per share.

The holders of Common Stock are entitled to one vote for each share held of record on each matter submitted to a vote of stockholders and are not entitled to cumulate their votes in the election of directors of the Company. Holders of Common Stock are entitled to receive ratably such dividends, if any, as may be declared by the Board of Directors out of funds legally available for dividend distribution. In the event of the liquidation, dissolution or winding up of the Company, holders of Common Stock are entitled to share equally and ratably in all assets, if any, remaining after payment of all liabilities. The Company has never paid cash dividends on its Common Stock and does not anticipate paying any in the foreseeable future. See "Dividend Policy." Holders of Common Stock have no preemptive rights or rights to subscribe to additional securities of the Company. The outstanding shares of Common Stock are, and the Common Stock to be outstanding upon completion of this offering will be, fully paid and nonassessable.

As of August 3, 1989, there were 6,343,481 shares of Common Stock issued and outstanding.

Common Stock Warrants

In its 1986 initial public offering, Deseret-Western issued warrants to purchase common stock of Deseret-Western which, as a result of the Company's February 1988 reorganization, are now exercisable to purchase Common Stock of the Company. See "The Company" and "Management—Deseret-Western." As of August 3, 1989, there remained outstanding warrants to purchase 333,333 shares of Common Stock of the Company at a price of \$3.75 per share (the "Warrants"). The Warrants are generally exercisable at any time before October 15, 1989.

Preferred Stock

At the Company's next annual meeting of stockholders, tentatively scheduled for November 1989, the Board of Directors intends to submit for stockholder approval an amendment to the Company's Certificate of Incorporation authorizing the Company to issue 2,000,000 shares of Preferred Stock. The proposed amendment would give the Board of Directors the authority to issue the Preferred Stock in one or more series and to fix the rights, preferences, privileges, qualifications, limitations and restrictions thereof, including dividend rights and rates, conversion rights, voting rights, terms of redemption, redemption prices, liquidation preferences and the number of shares constituting any series or the designation of such series, without any vote or action by the stockholders. The issuance of such Preferred Stock could have the effect of delaying or preventing a change in control of the Company without further action by the stockholders. The issuance of such Preferred Stock with voting and conversion rights may adversely affect the voting power of the holders of Common Stock, including the loss of voting control to others. The Company has no present plans to issue any of the proposed Preferred Stock.

Registration Rights

The Company has granted registration rights to Arthur Levine, a director of the Company, pursuant to which the Company at its expense is obligated to use its best efforts to register under the Securities Act an aggregate of up to 247,526 shares of Common Stock owned by Mr. Levine or which he may purchase upon exercise of a stock option. The registration rights require the Company to qualify the shares for sale in such jurisdictions as Mr. Levine requests and to keep such registration and qualification effective until the Termination Date. See "Management—Stock Option Plans and Agreements" and "Management—Certain Transactions." The registration rights also provide

indemnity between the Company and Mr. Levine and his underwriters and affiliates, if any. The Company is registering Mr. Levine's shares pursuant to these registration rights concurrently with the registration of the shares offered by this Prospectus.

The Warrants and the shares issuable upon exercise thereof were registered under the Securities Act by Deseret-Western which undertook in connection therewith to maintain such registration statement in effect. As a result of the February 1988 reorganization of the Company, the Warrants are now exercisable to purchase Common Stock of the Company and the Company is complying with such registration obligation by registering concurrently herewith the Common Stock issuable upon exercise of the Warrants.

Limitation on Directors' Liabilities

The Company's Certificate of Incorporation limits the liability of its directors to the Company or its stockholders to the fullest extent permitted by law. This provision is intended to allow the Company's directors the benefit of the Delaware General Corporation Law, which provides that directors of Delaware corporations may be relieved of monetary liability for breach of their fiduciary duty of care, except under certain circumstances involving the breach of the director's duty of loyalty, acts or omissions not in good faith or involving intentional misconduct or a knowing violation of law or any transaction from which the director derived any improper personal benefit.

Transfer Agent and Warrant Agent

The Transfer Agent for the Company's Common Stock and the Warrant Agent for the Warrants is City National Bank, 120 South Spalding Drive, Suite 408, Beverly Hills, California.

SHARES ELIGIBLE FOR FUTURE SALE

On the date of this Prospectus, in addition to the 2,730,000 shares offered hereby, approximately 1,433,000 shares of Common Stock are freely tradeable in the public market without restriction. At the conclusion of this offering, there will be outstanding approximately 3,830,000 Restricted Shares. See "Risk Factors—Shares Eligible for Future Sale; Concentration of Ownership." Approximately 3,623,000 of the Restricted Shares will become eligible for sale in the public market in February 1990, and approximately 207,000 of the Restricted Shares will become eligible at various times thereafter, all in accordance with Rule 144 under the Securities Act. The holders of all but approximately 325,000 of the Restricted Shares have agreed not to offer, sell or otherwise dispose of any Common Stock for 120 days after the date of this Prospectus without the prior written consent of Montgomery Securities (the "Lock-Up.") Concurrently with the registration of the shares offered hereby, the Company is registering an aggregate of 580,859 shares of Common Stock which are outstanding or issuable upon the exercise of outstanding warrants or a stock option, but the holder of 247,526 such shares has agreed to a Lock-Up with respect to such shares. See "Description of Capital Stock—Registration Rights." The Company also intends to register within 90 days of the date of this Prospectus an aggregate of 413,333 shares of Common Stock issuable upon exercise of options granted or to be granted under the Company's stock option plans. See "Management—Stock Option Plans and Agreements." Sales of substantial amounts of the Company's Common Stock in the public market after the offering could adversely affect the market price of the Common Stock.

UNDERWRITING

The Underwriters named below, represented by Montgomery Securities (the "Representative"), have severally agreed, subject to the terms and conditions contained in the Underwriting Agreement, to purchase from the Company and the Selling Stockholders the number of shares of Common Stock set forth opposite their respective names below. The Underwriters are committed to purchase all of the shares if they purchase any of the shares.

<u>Underwriter</u>	<u>No. of Shares to be Purchased</u>
Montgomery Securities	1,850,000
Hambrecht & Quist Incorporated.....	80,000
Kidder, Peabody & Co. Incorporated.....	80,000
Merrill Lynch Capital Markets	80,000
PaineWebber Incorporated.....	80,000
Prudential-Bache Capital Funding	80,000
Robertson, Stephens & Company.....	80,000
Dean Witter Reynolds Inc.	80,000
Adams, Harkness & Hill, Inc.	40,000
Dain Bosworth Incorporated.....	40,000
Gulfstream Financial Associates, Inc.	40,000
Ladenburg, Thalmann & Co. Inc.	40,000
Piper, Jaffray & Hopwood Incorporated	40,000
Soundview Financial Group.....	40,000
Volpe Covington & Welty.....	40,000
Wessels, Arnold & Henderson	40,000
Total	<u>2,730,000</u>

The Representative has advised the Company and the Selling Stockholders that the Underwriters propose initially to offer the Common Stock to the public at the public offering price set forth on the cover page of this Prospectus. The Underwriters may allow to selected dealers a concession of not more than \$0.375 per share, and the Underwriters may allow, and such dealers may re-allow, a concession of not more than \$0.10 to certain other dealers. After the initial public offering, the price and concessions and reallowances to dealers may be changed by the Representative. The Common Stock is offered subject to receipt and acceptance by the Underwriters, and to certain other conditions.

The Company and certain of the Selling Stockholders have granted an option to the Underwriters, exercisable during the 30-day period after the date of this Prospectus, to purchase up to a maximum of 409,500 additional shares of Common Stock to cover over-allotments, if any, at the same price per share as the initial 2,730,000 shares to be purchased by the Underwriters. The first 170,800 of such shares will be sold by Leslie Crane, a Selling Stockholder, the next 71,000 of such shares will be sold by certain other Selling Stockholders and the balance will be sold by the Company. To the extent that the Underwriters exercise this option, the Underwriters will be committed, subject to certain conditions, to purchase 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 made in connection with this offering.

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

The Company also has agreed that for a period of 120 days after the date of this Prospectus, it will not, without the consent of the Underwriters, issue, sell or dispose of any shares of its Common Stock or any shares convertible or exchangeable into any shares of Common Stock, except pursuant to its existing stock option and employee benefit plans. All of the Selling Stockholders, the officers and directors of the Company and each stockholder beneficially owning in the aggregate five percent or more of the shares of Common Stock of the Company have agreed not to offer, sell or otherwise dispose of any shares of Common Stock for a period of 120 days after the date of this Prospectus, without the consent of the Underwriters.

LEGAL MATTERS

The validity of the shares of Common Stock offered hereby will be passed upon for the Company and the Selling Stockholders by Riordan & McKinzie, a Professional Law Corporation, Los Angeles, California. Pillsbury, Madison & Sutro, San Francisco, California, are acting as counsel for the Underwriters in connection with certain legal matters relating to the Common Stock offered hereby.

EXPERTS

The financial statements of the Company as of March 31, 1988 and 1989 and for each of the three years in the period ended March 31, 1989 included in this Prospectus and the related supplemental schedule included elsewhere in this Registration Statement have been audited by Deloitte Haskins & Sells as stated in their reports appearing herein and elsewhere in the Registration Statement. The financial statements of Intellicreations, Inc. and DS Technologies, Inc. have been audited by Deloitte Haskins & Sells and William J. Vlazny, respectively, as stated in their reports herein. Such financial statements of the Company, Intellicreations, Inc. and DS Technologies, Inc. are included herein in reliance upon such reports given upon the authority of the respective accountant as an expert in auditing and accounting. Each of the foregoing are independent public accountants.

ADDITIONAL INFORMATION

The Company has filed with the Securities and Exchange Commission, Washington, D.C. 20549, a Registration Statement under the Securities Act with respect to the Common Stock offered hereby. This Prospectus does not contain all of the information set forth in the Registration Statement, certain portions of which are omitted as permitted by the rules and regulations of the Commission. For further information regarding the Company and the shares offered hereby, reference is made to the Registration Statement, and the exhibits and schedules thereto. Statements contained in this Prospectus as to the contents of any 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, each such statement being qualified in all respects by such reference. A copy of the Registration Statement may be inspected without charge at the principal office of the Securities and Exchange Commission in Washington, D.C. and copies of all or any part of the Registration Statement may be obtained from the Commission upon the payment of certain fees prescribed by the Commission.

TRADEMARK INFORMATION

The Company believes that the following are registered or unregistered trademarks (including servicemarks and/or trade names) of the companies listed: *Advanced Flight Trainer* is a trademark of Electronics Arts. *Amiga* is a trademark of Commodore-Amiga, Inc. *Apple* and *Apple IIGS* are trademarks of, and *Macintosh* is a trademark licensed to, Apple Computer, Inc. *Atari* is a trademark of Atari Corporation. *Babbage's* is a trademark of Babbage's, Inc. *B. Dalton Software, Etc.* is a trademark of B. Dalton Company. *Best Products* is a trademark of Best Products Co., Inc. *Broderbund* is a trademark of Broderbund Software, Inc. *Central Point Software Incorporated* is a trademark of Central Point Software, Inc. *Circuit City* is a trademark of Circuit City Stores, Inc. *Commodore* is a trademark of Commodore Electronics Ltd. *Egghead Discount Software* is a trademark of DJ&J Software Corporation. *Electronics Boutique* is a trademark of The Electronics Boutique, Inc. *47th Street Computers* is a trademark of 47th Street Photo, Inc. *HeadStart*, *Family Pac*, *Fun Pac* and *Office Manager* are trademarks of North American Philips Corporation. *Hewlett-Packard* is a trademark of Hewlett-Packard Company. *The Hunt for Red October* is a trademark of the United States Naval Institute. *Indoor Sports* is a trademark of DesignStar Consultants, Inc. *Lechmere* is a trademark of Lechmere, Inc. *MathTalk* and *MathTalk Fractions* are trademarks of First Byte, Inc. *MS-DOS* is a trademark of Microsoft Corporation. *Montgomery Ward* is a trademark of Montgomery Ward & Co., Incorporated. *Nintendo Entertainment System* is a trademark of Nintendo of America Inc. *Paperboy* is a trademark of Tengen. *Printmaster Plus* and *Printmaster Art Gallery I* are trademarks of Unison World, Inc. *Quicken* is a trademark of Intuit, Inc. *Radio Shack Computer Center* is a trademark of Tandy Corporation. *Sierra On-Line, Inc.* is a trademark of Sierra On-Line, Inc. *Simon & Schuster* is a trademark of Simon & Schuster, Inc. *Test Drive* is a trademark of Accolade, Inc. *UNIX* is a trademark of American Telephone & Telegraph Company. *Waldensoftware* is a trademark of Walden Book Company, Inc.

THE SOFTWARE TOOLWORKS, INC.

INDEX TO CONSOLIDATED FINANCIAL STATEMENTS

	<u>Page</u>
The Software Toolworks, Inc.:	
Independent auditors' report.....	F-2
Consolidated balance sheets.....	F-3
Consolidated statements of income.....	F-4
Consolidated statements of stockholders' equity.....	F-5
Consolidated statements of cash flows.....	F-6
Notes to consolidated financial statements.....	F-8
Unaudited pro forma condensed consolidated statement of operations.....	F-15
Notes to unaudited pro forma condensed consolidated statement of operations.....	F-17
Intellicreations, Inc.:	
Independent auditors' report.....	F-18
Balance sheet.....	F-19
Statements of operations and accumulated deficit.....	F-20
Statements of cash flows.....	F-21
Notes to financial statements.....	F-22
DS Technologies, Inc.:	
Report of independent accountant.....	F-24
Consolidated balance sheet.....	F-25
Consolidated statement of income and retained earnings.....	F-26
Consolidated statement of cash flows.....	F-27
Notes to consolidated financial statements.....	F-28
Unaudited condensed statements of operations.....	F-31
Unaudited condensed statements of cash flows.....	F-32
Notes to unaudited interim financial statements.....	F-33

INDEPENDENT AUDITORS' REPORT

The Software Toolworks, Inc.:

We have audited the consolidated balance sheets of The Software Toolworks, Inc. and its subsidiaries as of March 31, 1988 and 1989, and the related consolidated statements of income, stockholders' equity, and cash flows for each of the three years in the period ended March 31, 1989. These financial statements are the responsibility of the Company's management. Our responsibility is to express an opinion on the financial statements based on our audits.

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

In our opinion, such consolidated financial statements present fairly, in all material respects, the financial position of The Software Toolworks, Inc. and its subsidiaries at March 31, 1988 and 1989 and the results of their operations and their cash flows for each of the three years in the period ended March 31, 1989 in conformity with generally accepted accounting principles.

DELOITTE HASKINS & SELLS

Los Angeles, California
May 15, 1989

THE SOFTWARE TOOLWORKS, INC.

CONSOLIDATED BALANCE SHEETS

ASSETS

	Notes	March 31,		June 30, 1989
		1988	1989	(Unaudited)
CURRENT ASSETS:				
Cash and cash equivalents.....	1	\$2,486,000	\$1,388,000	\$ 227,000
Marketable securities.....	1	950,000		
Accounts receivable.....		691,000	3,510,000	4,016,000
Inventory.....	1	193,000	1,268,000	1,222,000
Other current assets.....		19,000	207,000	237,000
Total current assets.....		4,339,000	6,373,000	5,702,000
PROPERTY AND EQUIPMENT:				
Machinery and equipment.....	1	221,000	640,000	721,000
Leasehold improvements.....		7,000	278,000	399,000
Furniture and fixtures.....		108,000	275,000	350,000
Automobiles.....		18,000	18,000	18,000
Total property and equipment.....		354,000	1,211,000	1,488,000
Less accumulated depreciation and amortization.....		103,000	223,000	285,000
Property and equipment—net.....		251,000	988,000	1,203,000
SOFTWARE DEVELOPMENT COSTS	1	319,000	940,000	1,217,000
INTANGIBLE ASSETS	1,2,3	59,000	744,000	2,140,000
OTHER ASSETS		13,000	284,000	395,000
TOTAL ASSETS		\$4,981,000	\$9,329,000	\$10,657,000

LIABILITIES AND STOCKHOLDERS' EQUITY

CURRENT LIABILITIES:				
Accounts payable.....		\$ 273,000	\$ 532,000	\$ 487,000
Notes payable—bank.....	2			270,000
Notes payable—other.....	2			590,000
Income taxes payable.....	1,5	299,000	835,000	458,000
Accrued royalties payable.....	6	53,000	761,000	463,000
Accrued salaries and bonuses.....		188,000	318,000	
Other current liabilities.....		56,000	64,000	62,000
Total current liabilities.....		869,000	2,510,000	2,330,000
DEFERRED INCOME TAXES	1,5	20,000	343,000	453,000
COMMITMENTS AND CONTINGENCIES	6			
STOCKHOLDERS' EQUITY:				
Common stock, \$.01 par value, 50,000,000 shares authorized; 6,053,333, 6,163,820 and 6,343,481 shares issued and outstanding as of March 31, 1988, 1989 and June 30, 1989, respectively.....	1,2,3,4	61,000	62,000	63,000
Additional paid-in capital.....		3,531,000	3,805,000	4,353,000
Retained earnings.....		500,000	2,609,000	3,458,000
Total stockholders' equity.....		4,092,000	6,476,000	7,874,000
TOTAL LIABILITIES AND STOCK- HOLDERS' EQUITY		\$4,981,000	\$9,329,000	\$10,657,000

See accompanying notes to consolidated financial statements.

THE SOFTWARE TOOLWORKS, INC.
CONSOLIDATED STATEMENTS OF INCOME

	Notes	Year Ended March 31,			Three Months Ended June 30,	
		1987	1988	1989	1988	1989
					(Unaudited)	(Unaudited)
REVENUES:	1,7					
Computer software.....		\$2,054,000	\$2,938,000	\$ 7,579,000	\$ 939,000	\$3,421,000
Duplication, printing and packaging.....		119,000	855,000	4,221,000	382,000	746,000
Total.....		<u>2,173,000</u>	<u>3,793,000</u>	<u>11,800,000</u>	<u>1,321,000</u>	<u>4,167,000</u>
COST OF REVENUES:	6					
Computer software.....		618,000	775,000	2,854,000	311,000	1,264,000
Duplication, printing and packaging.....		68,000	662,000	2,796,000	265,000	566,000
Total.....		<u>686,000</u>	<u>1,437,000</u>	<u>5,650,000</u>	<u>576,000</u>	<u>1,830,000</u>
GROSS PROFIT		1,487,000	2,356,000	6,150,000	745,000	2,337,000
SELLING, GENERAL AND ADMINISTRATIVE EXPENSES .	6	<u>1,261,000</u>	<u>1,377,000</u>	<u>2,728,000</u>	<u>407,000</u>	<u>894,000</u>
INCOME FROM OPERATIONS.....	7	226,000	979,000	3,422,000	338,000	1,443,000
OTHER INCOME (EXPENSE).....		<u>(7,000)</u>	<u>(19,000)</u>	<u>133,000</u>	<u>27,000</u>	<u>19,000</u>
INCOME BEFORE INCOME TAXES		219,000	960,000	3,555,000	365,000	1,462,000
PROVISION FOR INCOME TAXES	1,5	<u>93,000</u>	<u>366,000</u>	<u>1,446,000</u>	<u>134,000</u>	<u>613,000</u>
NET INCOME.....		<u>\$ 126,000</u>	<u>\$ 594,000</u>	<u>\$ 2,109,000</u>	<u>\$ 231,000</u>	<u>\$ 849,000</u>
EARNINGS PER SHARE DATA:	1					
Earnings per common and common equivalent share.....		<u>\$0.05</u>	<u>\$0.12</u>	<u>\$0.34</u>	<u>\$0.04</u>	<u>\$0.13</u>
Weighted average number of common and common equivalent shares outstanding.....		<u>2,792,654</u>	<u>4,871,207</u>	<u>6,273,075</u>	<u>6,053,333</u>	<u>6,770,870</u>

See accompanying notes to consolidated financial statements.

THE SOFTWARE TOOLWORKS, INC.

CONSOLIDATED STATEMENTS OF STOCKHOLDERS' EQUITY

	Common Stock		Additional Paid-in Capital	Retained Earnings	Total
	Shares	Amount			
BALANCE AT APRIL 1, 1986	4,435,915	\$ 2,000		\$ 76,000	\$ 78,000
Repurchase and cancellation of stock	(2,823,633)	(2,000)		(47,000)	(49,000)
Acquisition of Software Country	2,360,743	6,000			6,000
Net income				126,000	126,000
BALANCE AT MARCH 31, 1987	3,973,025	6,000		155,000	161,000
Repurchase and cancellation of stock	(593,924)	(1,000)		(249,000)	(250,000)
Shares issued for software copyrights.....	501,699	59,000			59,000
Recapitalization of Company and issuance of common stock	2,172,533	(3,000)	\$3,531,000		3,528,000
Net income				594,000	594,000
BALANCE AT MARCH 31, 1988	6,053,333	61,000	3,531,000	500,000	4,092,000
Acquisition of Intellicreations, Inc.	110,534	1,000	274,000		275,000
Repurchase of fractional shares arising from stock split	(47)				
Net income				2,109,000	2,109,000
BALANCE AT MARCH 31, 1989	6,163,820	62,000	3,805,000	2,609,000	6,476,000
Acquisition of DS Technologies, Inc.— Unaudited	179,661	1,000	548,000		549,000
Net income—Unaudited				849,000	849,000
BALANCE AT JUNE 30, 1989—Unaudited	6,343,481	\$63,000	\$4,353,000	\$3,458,000	\$7,874,000

See accompanying notes to consolidated financial statements.

THE SOFTWARE TOOLWORKS, INC.

CONSOLIDATED STATEMENTS OF CASH FLOWS

	Year Ended March 31,			Three Months Ended June 30,	
	1987	1988	1989	1988	1989
				(Unaudited)	(Unaudited)
CASH FLOWS FROM OPERATING ACTIVITIES:					
Net income	\$ 126,000	\$ 594,000	\$ 2,109,000	\$ 231,000	\$ 849,000
Adjustments to reconcile net income to net cash provided by operating activities:					
Depreciation and amortization of property and equipment.....	24,000	42,000	120,000	6,000	62,000
Amortization of software development costs and intangible assets.....		43,000	332,000	12,000	149,000
Loss on marketable securities		50,000	30,000		
Provision for deferred income taxes.....	25,000	15,000	154,000	55,000	110,000
Changes in assets and liabilities, net of effects from the acquisitions of Intelli-creations, Inc. and DS Technologies, Inc.:					
Accounts receivable.....	(466,000)	(188,000)	(2,689,000)	(180,000)	(303,000)
Inventory	(49,000)	(134,000)	(1,003,000)	22,000	136,000
Accounts payable.....	123,000	143,000	1,000	(27,000)	(384,000)
Income taxes payable.....	68,000	231,000	536,000	(299,000)	(377,000)
Accrued royalties payable.....	64,000	(11,000)	621,000	44,000	(375,000)
Accrued salaries and bonuses.....	234,000	(46,000)	130,000	(188,000)	(322,000)
Other.....	(4,000)	6,000	36,000	(80,000)	(8,000)
Total adjustments	19,000	151,000	(1,732,000)	(635,000)	(1,312,000)
Net cash provided by (used for) operating activities.....	145,000	745,000	377,000	(404,000)	(463,000)
CASH FLOWS FROM INVESTING ACTIVITIES:					
Acquisition of property and equipment.....	(104,000)	(191,000)	(814,000)	(101,000)	(201,000)
Sale (purchase) of marketable securities.....		(1,000,000)	920,000		
Cash paid for acquisition of DS Technologies, Inc.....					(45,000)
Increase in software development costs		(362,000)	(841,000)	(161,000)	(341,000)
Increase in other assets	(9,000)	(4,000)	(253,000)	(12,000)	(69,000)
Net cash used for investing activities.....	(113,000)	(1,557,000)	(988,000)	(274,000)	(656,000)
CASH FLOWS FROM FINANCING ACTIVITIES:					
Common stock recapitalization.....		3,528,000			
Repurchase of common stock.....	(49,000)	(250,000)			
Issuance (repayment) of debt.....		9,000	(487,000)		(42,000)
Net cash provided by (used for) financing activities.....	(49,000)	3,287,000	(487,000)		(42,000)
NET INCREASE (DECREASE) IN CASH AND CASH EQUIVALENTS.....	(17,000)	2,475,000	(1,098,000)	(678,000)	(1,161,000)
CASH AND CASH EQUIVALENTS AT BEGINNING OF PERIOD.....	28,000	11,000	2,486,000	2,486,000	1,388,000
CASH AND CASH EQUIVALENTS AT END OF PERIOD.....	\$ 11,000	\$ 2,486,000	\$ 1,388,000	\$ 1,808,000	\$ 227,000
SUPPLEMENTAL DISCLOSURE OF CASH FLOW INFORMATION:					
Cash paid for interest	\$ 5,000	\$ 9,000			
Cash paid for income taxes		\$ 120,000	\$ 756,000	\$ 439,000	\$ 880,000

(Continued on following page)

THE SOFTWARE TOOLWORKS, INC.

CONSOLIDATED STATEMENTS OF CASH FLOWS—(Continued)

SUPPLEMENTAL DISCLOSURE OF NONCASH INVESTING ACTIVITIES:

During the year ended March 31, 1987, the Company purchased all of the common stock of Software Country in a stock-for-stock transaction (See Note 2).

During the year ended March 31, 1988, the Company issued shares of its common stock in exchange for software copyrights valued at \$59,000.

During the year ended March 31, 1989 and the three months ended June 30, 1989, the Company purchased all of the common stock of Intellicreations, Inc. and DS Technologies, Inc., respectively (See Note 2). In conjunction with these acquisitions, liabilities were assumed as follows:

	<u>March 31,</u> <u>1989</u>	<u>June 30,</u> <u>1989</u>
		(Unaudited)
Fair value of assets acquired	\$1,072,000	\$1,923,000
Value ascribed to common stock issued.....	(275,000)	(549,000)
Cash payment on acquisition		(45,000)
Liabilities assumed	<u>\$ 797,000</u>	<u>\$1,329,000</u>

See accompanying notes to consolidated financial statements.

THE SOFTWARE TOOLWORKS, INC.

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

**Information Relating to the Three Months Ended
June 30, 1988 and 1989 is Unaudited**

1. General and Summary of Significant Accounting Policies

The Software Toolworks, Inc. and its subsidiaries (the "Company") are in the business of developing and publishing entertainment, personal productivity, educational and utility software for personal computers. The Company also provides disk duplication, printing, packaging and other services for other software publishers. In addition, the Company licenses the use of its software for "bundling" by computer hardware manufacturers.

The Company's publishing operations are the product of an October 1986 merger of Software Country, a software publisher, and The Software Toolworks, Ltd. ("Toolworks"), a software developer. The Company's operations became publicly owned with the February 1988 reorganization of the Company with Deseret-Western Venture Capital, Inc. ("Deseret-Western"), a publicly-held investment vehicle with no previous operations. Deseret-Western acquired the outstanding stock of Toolworks in a stock-for-stock exchange, reincorporated in the state of Delaware, and changed its name to The Software Toolworks, Inc. Subsequent to the reincorporation, Toolworks was merged into the Company.

Basis of Presentation and Principles of Consolidation—The acquisition of Toolworks by Deseret-Western, whose assets at the date of acquisition consisted principally of cash aggregating approximately \$3,500,000, has been accounted for as though it were a recapitalization of Toolworks with the exchange of its common stock for Deseret-Western common stock and, accordingly, Toolworks was considered the continuing entity and its retained deficit was carried forward; no adjustment of assets of either company to "fair value" was made and no goodwill was recognized as a result of the transaction.

The accompanying financial statements include the accounts of The Software Toolworks, Inc. and its subsidiaries. All significant intercompany balances and transactions have been eliminated in consolidation.

Revenues—Revenue on sales of computer software is recorded when products are shipped. The Company records allowances for sales returns, if necessary, based upon management's assessment of potential returns. Revenue is recognized on licensing arrangements when the Company fulfills all of its obligations pursuant to the related agreements.

Revenue for duplication, printing and packaging services is recorded when products are shipped.

Cash and Cash Equivalents—In compliance with Statement of Financial Accounting Standards No. 95, the Company is presenting statements of cash flows. In prior years, the Company had presented statements of changes in financial position. Prior years' statements have been conformed to the new presentation. Cash and cash equivalents include investments in liquid money-market accounts.

Marketable Securities—Marketable securities at March 31, 1988 consisted of 100,000 units of Dean Witter Government Income Trust securities, and was stated at the lower of original cost or market value.

Inventory—Inventory is stated at the lower of cost or market using the first-in, first-out method of accounting. Inventory consisted of the following:

	March 31,		June 30, 1989
	1988	1989	
Raw materials	\$191,000	\$ 868,000	\$ 842,000
Finished goods	2,000	400,000	380,000
Total	\$193,000	\$1,268,000	\$1,222,000

THE SOFTWARE TOOLWORKS, INC.

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS—(Continued)

Information Relating to the Three Months Ended
June 30, 1988 and 1989 is Unaudited

1. General and Summary of Significant Accounting Policies—(Continued)

Property and Equipment—Property and equipment are recorded at cost. Depreciation and amortization are computed principally using the straight-line method over estimated useful lives ranging from five to seven years.

Software Development Costs—Costs related to establishing the technological feasibility of software are charged to operations as incurred. Software development costs incurred after establishing the technological feasibility are capitalized until the product is available for distribution, and are amortized over the estimated useful lives of the products developed, generally not exceeding three years. Software development costs capitalized and related amortization were as follows:

	Year Ended March 31,		Three Months Ended June 30,	
	1988	1989	1988	1989
Software development costs capitalized	\$362,000	\$841,000	\$161,000	\$341,000
Amortization of capitalized costs	\$ 43,000	\$220,000	\$ 12,000	\$ 64,000

Intangible Assets—Intangible assets consisting principally of goodwill, trademarks, tradenames, patents, copyrights and certain other rights, are amortized over periods ranging from two to eight years. The amortization of intangible assets aggregated \$112,000 during the year ended March 31, 1989 and \$85,000 during the three months ended June 30, 1989.

Income Taxes—The Company provides for income taxes on the basis of items included in the determination of income for financial reporting purposes regardless of the period when such items are reported for tax purposes. Deferred income taxes are provided for timing differences in the recognition of revenue and expense for financial and tax reporting.

During 1988, the Financial Accounting Standards Board released Statement of Financial Accounting Standards No. 96—Accounting for Income Taxes (SFAS 96). The Statement is required to be adopted by the Company no later than 1990. The Company expects that the adjustment required, if any, in the year SFAS 96 is adopted, will not be material to the consolidated financial statements.

Earnings Per Share—Earnings per share are calculated using the weighted average number of shares issued and outstanding during each period presented. In addition, during the year ended March 31, 1989 and the three months ended June 30, 1989, dilutive warrants and options, amounting to approximately 109,200 and 427,300 shares (using the treasury stock method), respectively, are included in the computation of weighted average number of shares outstanding. Fully diluted earnings per share were not significantly different from the amounts presented.

Reclassifications—Certain amounts recorded in the financial statements for the years ended March 31, 1987 and 1988 have been reclassified to conform to the 1989 presentation.

Interim Financial Statements—In the opinion of management, the accompanying unaudited financial statements include all adjustments, consisting of normal recurring adjustments, necessary to present fairly the financial position of the Company at June 30, 1989, and the results of operations and cash flows for the three months ended June 30, 1988 and 1989. The results of operations for the three months ended June 30, 1989 are not necessarily indicative of the results to be expected for the year ending March 31, 1990.

THE SOFTWARE TOOLWORKS, INC.

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS—(Continued)

**Information Relating to the Three Months Ended
June 30, 1988 and 1989 is Unaudited**

2. Business Acquisitions

During the years ended March 31, 1987 and 1989, and the three months ended June 30, 1989, the Company consummated several business acquisitions. All of the acquisitions were accounted for by the purchase method and, accordingly, the net assets and results of operations of the acquired entities are included in the consolidated financial statements from the dates of acquisition.

Software Country ("Country")—In October 1986, the Company issued 2,360,743 shares of common stock in exchange for all the issued capital stock of Software Country, a software publisher. The shares were valued at \$6,000, the fair market value of the assets acquired. If Country had been acquired at April 1, 1986, there would not have been a material effect on the Company's revenues, net income or earnings per share for the year ended March 31, 1987.

Priority Software Packaging, Inc. ("Priority")—In November 1986, the Company paid \$8,000 and acquired all the issued capital stock of Priority Software Packaging, Inc., which was engaged in the business of disk duplication and packaging for the computer industry. If Priority had been acquired at April 1, 1986, there would not have been a material effect on the Company's revenues, net income or earnings per share for the year ended March 31, 1987.

Intellicreations Inc. ("Intellicreations")—In September 1988, the Company acquired all the issued common stock of Intellicreations, Inc., a publisher of entertainment software, in exchange for 110,534 restricted shares (including 50,000 shares to a director who assisted in negotiating and structuring the transaction) of the Company's common stock valued at \$275,000. In connection with this acquisition the Company recorded intangible assets, in the amount of \$797,000, including goodwill, trademarks, tradenames and certain other rights.

DS Technologies, Inc. ("DS")—In April 1989, the Company acquired all the issued and outstanding common stock of DS Technologies, Inc., a publisher of business productivity software, in exchange for \$45,000 in cash, \$350,000 in a note payable and 179,661 restricted shares of the Company's common stock valued at approximately \$549,000. The \$350,000 acquisition note is non-interest bearing and repayable as follows: \$60,000 in April 1989, \$131,000 in July 1989, \$100,500 in October 1989 and \$58,500 in January 1990. In connection with the acquisition, the Company also assumed pre-existing debt to former stockholders of DS in the amount of approximately \$300,000, which is payable in full in March 1990, with quarterly interest payments at 12% per annum. In addition, the Company assumed pre-existing notes payable to a bank. The balance of the notes payable to bank at June 30, 1989, \$270,000, is repayable, together with interest at 12% per annum, in monthly installments through August 1990. In connection with this acquisition, the Company recorded intangible assets, in the amount of \$1,481,000, including goodwill, trademarks, tradenames and certain other rights.

Had the acquisition of Intellicreations been consummated as of April 1, 1987 and the acquisition of DS as of April 1, 1988, the Company's consolidated proforma results of operations for the years ended March 31, 1988 and 1989 would have been as follows:

	<u>1988</u>	<u>1989</u>
Revenues	<u>\$6,287,000</u>	<u>\$14,177,000</u>
Net Income.....	<u>\$ 293,000</u>	<u>\$ 1,567,000</u>
Earnings per common and common equivalent share	<u>\$ 0.06</u>	<u>\$ 0.24</u>

THE SOFTWARE TOOLWORKS, INC.

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS—(Continued)

**Information Relating to the Three Months Ended
June 30, 1988 and 1989 is Unaudited**

3. Common Stock

During April 1986, the Company repurchased and retired 2,823,633 shares of common stock, previously held by a founder, for \$49,000 in the form of a promissory note bearing interest at 10% per annum, payable on or before March 31, 1987.

During October 1986, the Company issued 2,360,743 shares of common stock to the shareholders of Software Country in exchange for all the issued capital stock of that company. (See Note 2).

During February 1988, in connection with the recapitalization of the Company, as described in Note 1, 2,172,533 shares of common stock were issued for net proceeds of \$3,528,000. Of the total shares issued, 739,200 shares were issued to individuals instrumental in effecting the transaction.

During the year ended March 31, 1988, the Company repurchased 593,924 shares of its common stock for \$250,000; and issued 501,699 shares of its common stock in exchange for software copyrights valued at \$59,000.

During September 1988, the Company issued 110,534 restricted shares of common stock in connection with the acquisition of Intellicreations, Inc. (See Note 2).

In September 1988, the Company effected a 150 for 1 reverse stock split and increased the par value of the common stock from \$.001 to \$.01. All share amounts and earnings per share calculations for all periods presented in the accompanying financial statements have been retroactively restated to give effect to this reverse stock split.

During April 1989, the Company issued 179,661 shares of its common stock in connection with the acquisition of DS Technologies, Inc. (See Note 2).

4. Warrants and Stock Options

At March 31, 1988 and 1989, and June 30, 1989, warrants to purchase up to 333,333 shares of common stock, at \$3.75 per share, were outstanding. The warrants, issued at the time of Deseret-Western's initial public offering, may be exercised through October 15, 1989.

The Company's 1988 Incentive Stock Option Plan (the "Incentive Plan") and 1988 Non-Qualified Stock Option Plan (the "Non-Qualified Plan") provide for the grant of options to purchase up to 300,000 and 113,333 shares, respectively, of common stock. During the year ended March 31, 1989, the Company granted options to certain employees to purchase an aggregate of 182,500 shares of common stock under the Incentive Plan at exercise prices ranging from \$4.50 to \$4.88 per share. All such outstanding options were granted at fair market value on the date of grant and vest in equal annual installments over three years, with the first such installment vesting in October 1989. No other options have been granted under the Option Plans.

During the year ended March 31, 1989, the Company granted options to purchase up to 197,526 shares of common stock at a price of \$2.25 per share, the fair market value on the date of grant, to one of the Company's directors. Of the options issued, one-half were immediately exercisable, and the balance became exercisable on May 24, 1989. In addition, options were granted to a consultant to purchase 30,000 shares of common stock at \$4.75 per share, the fair market value on the date of grant.

THE SOFTWARE TOOLWORKS, INC.

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS—(Continued)

**Information Relating to the Three Months Ended
June 30, 1988 and 1989 is Unaudited**

5. Income Taxes

The components of the provision for income taxes are as follows:

	Year Ended March 31,			Three Months Ended June 30,	
	<u>1987</u>	<u>1988</u>	<u>1989</u>	<u>1988</u>	<u>1989</u>
Current.....	\$68,000	\$351,000	\$1,292,000	\$ 79,000	\$503,000
Deferred.....	<u>25,000</u>	<u>15,000</u>	<u>154,000</u>	<u>55,000</u>	<u>110,000</u>
	<u>\$93,000</u>	<u>\$366,000</u>	<u>\$1,446,000</u>	<u>\$134,000</u>	<u>\$613,000</u>

There were no significant differences between income taxes provided and income taxes computed at statutory rates except for the provision for State of California income taxes, net of Federal benefit, of \$11,000, \$56,000 and \$222,000 for the years ended March 31, 1987, 1988 and 1989, respectively, and \$22,000 and \$95,000 for the three months ended June 30, 1988 and 1989, respectively.

Deferred income taxes are provided to reflect the differences resulting from different accounting methods used for book and tax purposes. The 1989 provision for deferred income taxes arose principally from the following: \$252,000 provision due to the differences in the timing of deductions for software development costs and \$115,000 benefit due to the deferred deductibility of current year State of California income taxes. The 1987 and 1988 provisions for deferred income taxes arose principally from the use of accelerated methods for depreciating property and equipment for income tax reporting purposes.

As a result of the acquisitions of Intellicreations and DS, the Company is able to apply a portion (approximately \$800,000 through 2003, subject to annual limitations) of the acquired companies' pre-acquisition net operating losses against future taxable income. Because the utilization of the net operating losses is not certain, the Company has not recorded the potential benefit of future utilization in the accompanying financial statements.

6. Commitments and Contingencies

Leases—The Company occupies its office and manufacturing facilities under operating leases expiring at various dates through February 1992. Approximate minimum rentals provided for by these leases are as follows:

	<u>Amount</u>
July 1, 1989 to March 31, 1990.....	\$195,000
Year Ending March 31, 1991	199,000
Year Ending March 31, 1992	199,000

Rent expense for the years ended March 31, 1987, 1988 and 1989 was \$41,000, \$71,000 and \$167,000, respectively and \$25,000 and \$57,000 for the three months ended June 30, 1988 and 1989, respectively.

Royalties—Royalty expense, related principally to the licensing of computer software to be marketed, amounted to \$132,000, \$244,000 and \$1,268,000 for the years ended March 31, 1987, 1988 and 1989, respectively, and \$143,000 and \$380,000 for the three months ended June 30, 1988 and 1989, respectively. Royalties are generally payable as a percentage (primarily ranging from 5%

THE SOFTWARE TOOLWORKS, INC.

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS—(Continued)

Information Relating to the Three Months Ended
June 30, 1988 and 1989 is Unaudited

6. Commitments and Contingencies—(Continued)

to 15%) of sales. As of March 31, 1989, the Company was committed to pay minimum guaranteed royalty payments amounting to approximately \$125,000 on certain future sales through December 31, 1989.

7. Business Segments and Major Customers

Business Segments—The Company's operations are grouped into two segments: the design and sale of computer software; and duplication, printing and packaging services. Summary data for the years ended March 31, 1987, 1988 and 1989 is shown below. The revenues for sales by the duplication, printing and packaging segment to the computer software segment are consistent with amounts charged to third parties and are eliminated in consolidation.

	<u>1987</u>	<u>1988</u>	<u>1989</u>
REVENUES:			
Computer software	\$2,054,000	\$2,938,000	\$ 7,579,000
Duplication, printing and packaging.....	296,000	1,241,000	5,816,000
Total	2,350,000	4,179,000	13,395,000
Less: Duplication, printing and packaging sales to computer software segment	(177,000)	(386,000)	(1,595,000)
Total revenues	<u>\$2,173,000</u>	<u>\$3,793,000</u>	<u>\$11,800,000</u>
INCOME FROM OPERATIONS:			
Computer software	\$ 370,000	\$1,274,000	\$ 2,241,000
Duplication, printing and packaging.....	63,000	(37,000)	1,669,000
Corporate.....	(207,000)	(258,000)	(488,000)
Total income from operations	<u>\$ 226,000</u>	<u>\$ 979,000</u>	<u>\$ 3,422,000</u>
IDENTIFIABLE ASSETS:			
Computer software	\$ 474,000	\$1,095,000	\$ 6,226,000
Duplication, printing and packaging.....	150,000	381,000	1,086,000
Corporate.....	62,000	3,505,000	2,017,000
Total identifiable assets.....	<u>\$ 686,000</u>	<u>\$4,981,000</u>	<u>\$ 9,329,000</u>
CAPITAL EXPENDITURES:			
Computer software	\$ 30,000	\$ 51,000	\$ 291,000
Duplication, printing and packaging.....	74,000	140,000	373,000
Corporate.....	—	—	150,000
Total capital expenditures.....	<u>\$ 104,000</u>	<u>\$ 191,000</u>	<u>\$ 814,000</u>
DEPRECIATION AND AMORTIZATION OF PROPERTY AND EQUIPMENT:			
Computer software	\$ 8,000	\$ 13,000	\$ 26,000
Duplication, printing and packaging.....	11,000	22,000	79,000
Corporate.....	5,000	7,000	15,000
Total depreciation and amortization of property and equipment	<u>\$ 24,000</u>	<u>\$ 42,000</u>	<u>\$ 120,000</u>

THE SOFTWARE TOOLWORKS, INC.

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS—(Continued)

**Information Relating to the Three Months Ended
June 30, 1988 and 1989 is Unaudited**

7. Business Segments and Major Customers—(Continued)

Major Customers—The Company's computer software products are distributed principally by one software distributor, pursuant to an exclusive distribution agreement entered into in 1988. The agreement expires in July 1991 and is renewable for three years unless terminated by either of the parties. Revenues recorded by the computer software segment during the years ended March 31, 1987, 1988 and 1989 from this distributor amounted to \$1,649,000, \$2,530,000 and \$3,872,000, respectively.

During the year ended March 31, 1989, the Company licensed the use of certain computer software for "bundling" to several customers. The Company also performs duplication, printing and packaging services for one such licensee. Revenues recorded by the computer software segment and by the duplication, printing and packaging segment during the year ended March 31, 1989 from this customer amounted to \$1,761,000 and \$2,312,000, respectively.

THE SOFTWARE TOOLWORKS, INC.

UNAUDITED PRO FORMA CONDENSED CONSOLIDATED STATEMENT OF OPERATIONS

Introductory Comments

Intellicreations Inc. ("Intellicreations"). In September 1988, the Company acquired all the issued common stock of Intellicreations, Inc., a publisher of entertainment software, in exchange for 110,534 restricted shares (including 50,000 shares to a director who assisted in negotiating and structuring the transaction) of the Company's common stock valued at \$275,000. In connection with this acquisition, the Company recorded intangible assets, in the amount of \$797,000, including goodwill, trademarks, tradenames and certain other rights.

DS Technologies, Inc. ("DS"). In April 1989, the Company acquired all the issued and outstanding common stock of DS Technologies, Inc., a publisher of business productivity software, in exchange for \$45,000 in cash, \$350,000 in a note payable and 179,661 restricted shares of the Company's common stock valued at approximately \$549,000. The \$350,000 acquisition note is non-interest bearing and repayable as follows: \$60,000 in April 1989, \$131,000 in July 1989, \$100,500 in October 1989 and \$58,500 in January 1990. In connection with the acquisition, the Company also assumed pre-existing debt to former stockholders of DS in the amount of approximately \$300,000, which is payable in full in March 1990, with quarterly interest payments at 12% per annum. In addition, the Company assumed pre-existing notes payable to a bank. The balance of the bank notes payable at June 30, 1989, \$270,000, is repayable, together with interest at 12% per annum, in monthly installments through August 1990. In connection with this acquisition, the Company recorded intangible assets, in the amount of \$1,481,000, including goodwill, trademarks, tradenames and certain other rights.

Basis of Presentation

The following unaudited pro forma condensed consolidated statement of operations has been prepared to reflect the results of operations of the Registrant assuming that the aforementioned acquisitions had been consummated on April 1, 1988, and should be read in conjunction with the accompanying notes, and the audited financial statements of Intellicreations and DS included elsewhere in this Prospectus.

The following pro forma results of operations are not necessarily indicative of the results which would have been reported had the acquisitions actually been effected on April 1, 1988, or which may be reported in the future.

THE SOFTWARE TOOLWORKS, INC.

**UNAUDITED PRO FORMA CONDENSED CONSOLIDATED
STATEMENT OF OPERATIONS**

For the Year Ended March 31, 1989

	<u>Registrant (Audited) (Historical)</u>	<u>Intelli- creations (Historical) (Note A)</u>	<u>DS Technologies (Historical)</u>	<u>Pro Forma Adjustments (Note B)</u>	<u>Pro Forma Consolidated Operations</u>
	(Dollars in thousands)				
Net Revenues.....	\$ 11,800	\$914	\$1,463		\$ 14,177
Cost of Revenues.....	<u>5,650</u>	<u>633</u>	<u>598</u>		<u>6,881</u>
Gross Profit.....	6,150	281	865		7,296
Selling, General and Administrative Expenses	<u>2,728</u>	<u>399</u>	<u>1,143</u>	\$ 243	<u>4,513</u>
Income (Loss) From Operations ...	3,422	(118)	(278)	(243)	2,783
Other Income (Expense).....	<u>133</u>	<u>—</u>	<u>(110)</u>	<u>—</u>	<u>23</u>
Income (Loss) Before Income Taxes	3,555	(118)	(388)	(243)	2,806
Income Tax (Provision) Benefit	<u>(1,446)</u>	<u>—</u>	<u>—</u>	<u>207</u>	<u>(1,239)</u>
Net Income (Loss)	<u>\$ 2,109</u>	<u>\$(118)</u>	<u>\$ (388)</u>	<u>\$ (36)</u>	<u>\$ 1,567</u>
Net Income (Loss) Per Share.....	<u>\$ 0.34</u>				<u>\$ 0.24</u>
Weighted Average Number of Shares Outstanding.....	<u>6,273,075</u>				<u>6,498,661</u>

See Accompanying Notes To Unaudited Pro Forma Condensed Consolidated Statement of Operations.

THE SOFTWARE TOOLWORKS, INC.

**NOTES TO UNAUDITED PRO FORMA CONDENSED CONSOLIDATED
STATEMENT OF OPERATIONS**

For the Year Ended March 31, 1989

(A) Intellicreations

The historical amounts for Intellicreations, Inc. are for the period from April 1, 1988 to the date of acquisition. The results for the period subsequent to that date are included in the Registrant's audited historical results.

(B) Proforma Adjustments

Intangible assets as of the acquisition date are being amortized on a straight-line basis over periods ranging from two to eight years. Accordingly, the accompanying pro forma condensed consolidated statement of operations includes a charge for \$243,000 reflecting the approximate amortization for the year ended March 31, 1989.

The provision for income taxes has been adjusted to reflect the pro forma utilization of the acquired companies' loss for the year in a consolidated tax filing.

INDEPENDENT AUDITORS' REPORT

Intellicreations, Inc.:

We have audited the accompanying balance sheet of Intellicreations, Inc. as of October 31, 1987 and the related statements of operations and accumulated deficit and of cash flows for the year ended October 31, 1987 and the eleven-month period ended September 30, 1988. These financial statements are the responsibility of the Company's management. Our responsibility is to express an opinion on these financial statements based on our audits.

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

In our opinion, such financial statements present fairly, in all material respects, the financial position of Intellicreations, Inc. at October 31, 1987 and the results of its operations and its cash flows for the year ended October 31, 1987 and the eleven-month period ended September 30, 1988 in conformity with generally accepted accounting principles.

DELOITTE HASKINS & SELLS

Los Angeles, California
September 21, 1989

INTELLICREATIONS, INC.

BALANCE SHEET

October 31, 1987

ASSETS

	<u>Notes</u>	
CURRENT ASSETS:		
Cash		\$ 694
Accounts Receivable (Net of allowance for doubtful accounts and returns of \$205,676)		355,719
Inventory.....	1,3	51,243
Prepaid Expenses		21,223
Royalty Advances		<u>114,722</u>
TOTAL CURRENT ASSETS		<u>543,601</u>
PROPERTY AND EQUIPMENT—At Cost:		
Computer Equipment	1	77,458
Office Equipment		11,636
Furniture and Fixtures.....		<u>3,559</u>
		92,653
Less—Accumulated Depreciation		<u>(40,401)</u>
Property and Equipment—Net		<u>52,252</u>
SOFTWARE DEVELOPMENT COSTS—Net	1	<u>82,915</u>
OTHER ASSETS		<u>47,089</u>
TOTAL ASSETS	4	<u><u>\$725,857</u></u>

LIABILITIES AND STOCKHOLDERS' DEFICIENCY

CURRENT LIABILITIES:		
Borrowings Under Bank Line of Credit	3	\$147,522
Accounts Payable.....		157,979
Accrued Expenses		123,079
Due to The Gillette Company	4	<u>365,595</u>
TOTAL CURRENT LIABILITIES		<u>794,175</u>
COMMITMENTS		
	5	
STOCKHOLDERS' DEFICIENCY:		
Common stock, no par value, 100,000 shares authorized, 10,000 shares issued and outstanding.....		4,000
Accumulated Deficit		<u>(72,318)</u>
Total Stockholders' Deficiency		<u>(68,318)</u>
TOTAL LIABILITIES AND STOCKHOLDERS' DEFICIENCY		<u><u>\$725,857</u></u>

See accompanying notes to financial statements.

INTELLICREATIONS, INC.

STATEMENTS OF OPERATIONS AND ACCUMULATED DEFICIT

For the Year Ended October 31, 1987 and the Eleven Months Ended September 30, 1988

	<u>Notes</u>	<u>Year Ended October 31, 1987</u>	<u>Eleven Months Ended September 30, 1988</u>
REVENUE:			
Domestic Sales		\$2,152,343	\$1,855,216
Foreign Sales		<u>297,907</u>	<u>42,797</u>
Total Software Sales.....	6	2,450,250	1,898,013
Less—Returns		<u>(280,087)</u>	<u>(148,801)</u>
Net Sales.....		2,170,163	1,749,212
Other Revenue	4	<u>50,482</u>	<u>400,990</u>
Total Revenue.....		<u>2,220,645</u>	<u>2,150,202</u>
COSTS AND EXPENSES:			
Cost of Sales		591,807	984,723
Royalties and License Fees		338,462	146,269
Product and Software Development.....		557,725	436,825
Selling, General and Administrative.....		<u>1,002,119</u>	<u>849,352</u>
Total Costs and Expenses		<u>2,490,113</u>	<u>2,417,169</u>
OPERATING LOSS		(269,468)	(266,967)
INTEREST EXPENSE		<u>(41,932)</u>	<u>(63,501)</u>
LOSS BEFORE INCOME TAX BENEFIT.....		(311,400)	(330,468)
INCOME TAX BENEFIT	2	<u>122,372</u>	<u></u>
NET LOSS		(189,028)	(330,468)
RETAINED EARNINGS, BEGINNING OF PERIOD.....		<u>116,710</u>	<u>(72,318)</u>
ACCUMULATED DEFICIT, END OF PERIOD.....		<u>\$ (72,318)</u>	<u>\$ (402,786)</u>

See accompanying notes to financial statements.

INTELLICREATIONS, INC.

STATEMENTS OF CASH FLOWS

**For the Year Ended October 31, 1987 and
the Eleven Months Ended September 30, 1988**

	<u>Year Ended October 31, 1987</u>	<u>Eleven Months Ended September 30, 1988</u>
CASH FLOWS FROM OPERATING ACTIVITIES:		
Net Loss.....	\$(189,028)	\$(330,468)
Adjustments to Reconcile Net Loss to Cash Flows from Operating Activities:		
Depreciation.....	23,173	22,496
Amortization of Capitalized Software Development Costs	286,593	154,756
Decrease in Deferred Income Taxes.....	(122,372)	
Decrease (increase) in Accounts Receivable.....	(59,346)	368,739
Increase (decrease) in Allowance for Doubtful Accounts.....	73,885	(190,999)
Increase in Inventory	(13,322)	(17,768)
Decrease (increase) in Prepaid Expenses.....	(17,980)	5,337
Decrease in Royalty Advances.....	44,978	74,872
Decrease in Other Assets	10,160	19,185
Increase in Accounts Payable.....	16,778	33,116
Decrease in Accrued Expenses.....	(13,617)	(59,237)
Increase (decrease) in Amounts Due to The Gillette Company	171,627	(365,595)
Total Adjustments.....	<u>400,557</u>	<u>44,902</u>
Cash Provided by (used for) Operating Activities.....	<u>211,529</u>	<u>(285,566)</u>
CASH FLOWS FROM FINANCING ACTIVITIES:		
Net Repayments Under Bank Line of Credit	(10,266)	(147,520)
Borrowings from The Software Toolworks.....		496,666
Other Borrowings		175,000
Cash Provided by Financing Activities	<u>(10,266)</u>	<u>524,146</u>
CASH FLOWS FROM INVESTING ACTIVITIES:		
Acquisition of Property and Equipment.....	(8,106)	(10,588)
Increase in Capitalized Software Development Costs.....	(210,366)	(192,182)
Cash Used for Investing Activities	<u>(218,472)</u>	<u>(202,770)</u>
INCREASE (DECREASE) IN CASH	<u>\$ (17,209)</u>	<u>\$ 35,810</u>
SUPPLEMENTAL DISCLOSURE OF FINANCIAL STATEMENT INFORMATION—Cash Paid for Interest Expense		
	<u>\$ 41,932</u>	<u>\$ 63,501</u>

See accompanying notes to financial statements.

INTELLICREATIONS, INC.

NOTES TO FINANCIAL STATEMENTS

1. SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES

Organization. Intellicreations, Inc. (the "Company") is in the business of designing, developing, and manufacturing home computer software. In September 1988, all the outstanding common stock of the Company was acquired by The Software Toolworks, Inc.

Inventory. Inventory is valued at the lower of cost or market on a last-in, first-out (LIFO) basis, and consists principally of packaging and instructional materials.

Property and Equipment. Property and equipment are recorded at cost. Depreciation and amortization are computed using the straight-line method over the estimated useful lives of four years.

Software Development Costs. All costs related to the establishment of technological feasibility of software, including purchased software, are charged to operations as product and software development costs are incurred. Costs incurred after the establishment of technological feasibility are capitalized until the product is available for distribution.

The cost of software to be sold or marketed is amortized generally based on the ratio of current revenues to the total of current and anticipated future revenues over the estimated useful life of the product.

2. INCOME TAXES

At September 30, 1988, the Company had net operating losses for income tax purposes of approximately \$470,000 expiring through 2003, which may be used to reduce future income for Federal income tax purposes. The income tax benefit in 1987 relates to the elimination of deferred taxes provided in 1986 which arose primarily from capitalized software costs. Software costs are expensed as incurred for income tax purposes.

3. BANK LINE OF CREDIT

The Company has a \$200,000 line of credit, limited to 65% of eligible accounts receivable, which bears interest at the prime rate (10% at October 31, 1987) plus 10%. At October 31, 1987, approximately \$50,000 was available under the line of credit.

4. DUE TO THE GILLETTE COMPANY

Amounts due to The Gillette Company ("Gillette") arise from royalty payments related to the sale of software products subsequent to the Company's acquisition of certain assets from Gillette in 1985. At October 31, 1987, the Company had not paid amounts due to Gillette. Gillette holds a secured interest in all assets of the Company. During the eleven-month period ended September 30, 1988 the Company negotiated a settlement with Gillette whereby all obligations to Gillette were settled for less than \$40,000, contingent upon sale of the Company (see Note 1).

5. LEASE COMMITMENTS

The Company leases its principal facilities under an operating lease with a three-year term and one three-year renewal option. Rental payments are adjusted annually based on changes in the Consumer Price Index. Future minimum rentals under operating leases with terms in excess of one year at October 31, 1987 are as follows:

<u>Year Ending</u> <u>October 31</u>	
1988	\$118,807
1989	41,343
1990	958
	<u>\$161,108</u>

INTELLICREATIONS, INC.

NOTES TO FINANCIAL STATEMENTS—(Continued)

5. LEASE COMMITMENTS—(Continued)

Total rental expense for the year ended October 31, 1987 and the eleven-month period ended September 30, 1988 was \$108,000 and \$107,000, respectively.

6. DISTRIBUTION AGREEMENT

The Company has entered into a two-year agreement with Electronic Arts, Inc. ("EA") whereby EA has exclusive rights to distribute the Company's products, except in Europe. Under the agreement terms, EA is able to return merchandise for full credit for up to 180 days after delivery. Sales to EA during the year ended October 31, 1987 and the eleven-month period ended September 30, 1988 totalled approximately \$853,000 and \$1,668,000, respectively.

REPORT OF INDEPENDENT ACCOUNTANT

Board of Directors
DS Technologies, Inc.:

I have audited the accompanying consolidated balance sheet of DS Technologies, Inc. as of December 31, 1988 and the related statements of income and retained earnings and of cash flows for the year then ended. These financial statements are the responsibility of the Company's management. My responsibility is to express an opinion on these financial statements based on my audit.

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

In my opinion, such financial statements present fairly, in all material respects, the financial position of DS Technologies, Inc. at December 31, 1988 and the results of its operations and its cash flows for the year then ended in conformity with generally accepted accounting principles.

William J. Vlazny
Chicago, Illinois
March 20, 1989

DS TECHNOLOGIES, INC.

CONSOLIDATED BALANCE SHEET

December 31, 1988

A S S E T S

CURRENT ASSETS:		
Cash.....		\$ 54,101
Accounts Receivable—Net		415,873
Notes Receivable—Stockholders		38,265
Inventory		109,178
Prepaid Items		<u>14,397</u>
TOTAL CURRENT ASSETS		631,814
PROPERTY & EQUIPMENT:		
Cost	\$148,295	
Less: Accumulated Depreciation	<u>69,166</u>	79,129
OTHER ASSETS:		
Software Development Costs	228,334	
Purchased Software Licenses	63,337	
Software Marketing Agreement	15,000	
Organization Expenses	22,191	
Other Assets	<u>7,395</u>	<u>336,257</u>
TOTAL ASSETS		<u>\$1,047,200</u>

LIABILITIES AND STOCKHOLDERS' EQUITY

CURRENT LIABILITIES:		
Notes Payable—Banks		\$ 251,364
Notes Payable—Stockholders		36,000
Accounts Payable		287,288
Accrued Payroll Taxes.....		5,060
Accrued Expenses.....		<u>133,843</u>
TOTAL CURRENT LIABILITIES		713,555
LONG TERM DEBT:		
Notes Payable—Stockholders	\$ 205,000	
Notes Payable—Other	<u>80,000</u>	<u>285,000</u>
TOTAL LIABILITIES		998,555
STOCKHOLDERS' EQUITY:		
COMMON STOCK: no par value; 1,000,000 shares authorized, and 479,000 shares issued	191,000	
PREFERRED STOCK, SERIES A: no par value, convertible, \$0.40 cumulative, 100,000 shares authorized, and 15,000 shares issued ...	75,000	
RETAINED EARNINGS	<u>(207,115)</u>	
Subtotal	58,885	
TREASURY STOCK—12,000 shares of common stock	<u>(10,240)</u>	<u>48,645</u>
TOTAL LIABILITIES & STOCKHOLDERS' EQUITY		<u>\$1,047,200</u>

See accompanying notes and accountant's report

DS TECHNOLOGIES, INC.

CONSOLIDATED STATEMENT OF INCOME AND RETAINED EARNINGS

For the Year Ended December 31, 1988

NET SALES		\$1,605,728
COST OF SALES		<u>525,013</u>
GROSS PROFIT		1,080,715
OPERATING EXPENSES:		
Advertising	\$452,743	
Selling	332,366	
General & Administrative	482,008	
Research & Development	<u>16,003</u>	<u>1,283,120</u>
Loss From Operations		(202,405)
OTHER EXPENSES—NET		<u>57,102</u>
Loss Before Income Taxes		(259,507)
PROVISION FOR INCOME TAXES		<u>0</u>
NET LOSS		(259,507)
RETAINED EARNINGS—Beginning	\$ 58,392	
Less Dividends	<u>(6,000)</u>	<u>52,392</u>
RETAINED EARNINGS—Ending		<u>\$ (207,115)</u>

See accompanying notes and accountant's report

DS TECHNOLOGIES, INC.

CONSOLIDATED STATEMENT OF CASH FLOWS

For the Year Ended December 31, 1988

CASH FLOWS FROM OPERATING ACTIVITIES:		
Net Loss for the Year		\$(259,507)
Adjustments to Reconcile Net Loss to Net Cash Used in Operating Activities:		
Depreciation & Amortization	\$ 51,034	
Changes in Assets and Liabilities:		
Decrease in Accounts Receivable	192,710	
Increase in Notes Receivable	(17,865)	
Increase in Inventory	(43,954)	
Decrease in Prepaid Items	264	
Increase in Software Development Costs	(153,186)	
Increase in Software Licenses	(20,221)	
Decrease in Other Assets.....	11,157	
Increase in Accounts Payable.....	54,916	
Decrease in Taxes.....	(33,803)	
Increase in Accrued Expenses	<u>86,514</u>	
Total Adjustments.....		<u>127,566</u>
Net Cash Used in Operating Activities.....		(131,941)
CASH FLOWS FROM INVESTING ACTIVITIES:		
Property, Plant & Equipment Purchases		(33,194)
CASH FLOWS FROM FINANCING ACTIVITIES:		
Increase in Bank Loans	126,364	
Increase in Current Notes Payable.....	36,000	
Increase in Long Term Liabilities.....	50,000	
Payment for Purchase of Treasury Stock.....	(240)	
Dividend Payments.....	<u>(6,000)</u>	
Net Cash Provided by Financing Activities		<u>206,124</u>
Net Increase in Cash for the Year.....		<u>\$ 40,989</u>

See accompanying notes and accountant's report

DS TECHNOLOGIES, INC.
NOTES TO CONSOLIDATED FINANCIAL STATEMENTS
DECEMBER 31, 1988

NOTE 1—STATEMENT OF SIGNIFICANT ACCOUNTING POLICIES

The Company

The Company was originally incorporated as Design Systems, Inc. on March 15, 1985. The Company changed its name to DS Technologies, Inc. in 1986. Since its inception, the Company has taken an active role in increasing its position in the microcomputer software industry. On December 31, 1988, the Company merged its subsidiary, Design Software, Inc., with DS Technologies, Inc. in order to reduce operating costs and simplify operations.

Accounting Policies

Principles of Consolidation. The accompanying financial statements include the accounts of the Company and Design Software, Inc., its wholly owned subsidiary. All significant intercompany accounts and transactions have been eliminated in consolidation.

Revenue Recognition. Revenue from sales of equipment, software and services are recognized when the product is shipped or installed.

Accounts Receivable. Accounts receivable are recorded at book value, less an allowance for bad debts of \$14,662.

Inventories. Inventories are valued at the lower of cost or market. Cost is determined on a first-in, first-out, (FIFO) basis. See Note 2—Inventories.

Property and Equipment. Property and equipment are stated at cost. Depreciation expense was computed using accelerated methods over lives ranging from five to seven years.

Software Development Costs. Software development costs relate to internal charges that are capitalized for specific software projects that are being undertaken by the Company. These costs are being amortized over a four year period starting with the first shipment of the product. All other development costs are expensed as incurred.

Software Licenses. Beginning in 1987, the Company began purchasing the rights to publish software products from other authors. These costs are being amortized over a 48 month period. The license agreements are perpetual in nature, but economically benefit the Company during the marketable life of the product.

Royalties. The Company has entered into various royalty contracts with software developers for specific products being sold. In the event the software developers comply with the terms of these contracts, the Company will be obliged to make royalty payments based on the dollar amount of cash receipts from net sales.

Product royalty payments are accrued based on the sale of each software product in conjunction with the related software license and other royalty agreements.

Income Taxes. Research tax credits are being recognized under the flow-through method. The Company was not liable for federal income taxes in 1988 due to its operating loss for the period.

DS TECHNOLOGIES, INC.

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS—(Continued)

DECEMBER 31, 1988

NOTE 2—INVENTORIES

Inventories at December 31, 1988 consisted of computer products and materials that are used to produce retail computer software:

	<u>Total</u>
RAW MATERIAL.....	\$ 61,718
WORK IN PROCESS	2,911
FINISHED GOODS.....	44,549
TOTAL INVENTORY.....	<u>\$109,178</u>

NOTE 3—PROPERTY AND EQUIPMENT

Major categories of property and equipment as of December 31, 1988 are listed below:

	<u>Total</u>
FURNITURE & FIXTURES	\$ 38,929
MACHINERY & EQUIPMENT	3,413
COMPUTER EQUIPMENT	105,953
TOTAL COST.....	148,295
ACCUMULATED DEPRECIATION.....	<u>(69,166)</u>
NET FIXED ASSETS	<u>\$ 79,129</u>

NOTE 4—NOTES PAYABLE—BANK

On March 31, 1988, the Company entered into a revolving credit agreement with a bank which expires on May 1, 1989, interest is computed at one and one-half percent over the bank's prime rate. Substantially all of the Company's assets are pledged as collateral under the revolving credit agreement. The borrowings are guaranteed by certain stockholders.

During 1988, the Company began participating in an export loan program offered by the State of Illinois that guarantees payment on specific export shipments made by the Company.

NOTE 5—NOTES PAYABLE—LONG TERM

DS Technologies' long term obligations total \$285,000. This balance consists of loans from stockholders of \$205,000 and \$80,000 from other sources. The entire balance is due on March 17, 1989 and bears an interest rate of twelve percent.

NOTE 6—PREFERRED STOCK—SERIES A

The Company exchanged preferred stock series A for the acquisition of the common stock of Tech Partners, Inc. in June 1986. The Series A—Preferred stock has a conversion factor that will be adjusted for the dilution of common stock through the issuance of new stock below a set price per share. The stock carries a cumulative dividend requirement.

NOTE 7—TREASURY STOCK

In 1987, the Company repurchased 10,000 shares of common stock from an employee. During the course of 1988, the Company repurchased an additional 2,000 shares from its employees.

DS TECHNOLOGIES, INC.

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS—(Continued)

DECEMBER 31, 1988

NOTE 8—COMMITMENTS AND CONTINGENCIES

The Company has entered into various leases for office space and office equipment. Computer equipment is leased over a three year period. The Company entered into a four year lease for the rental of its office space which expires May 31, 1991. 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:

1989	\$ 59,080
1990	69,032
1991	<u>33,335</u>
Total.....	<u>\$161,447</u>

NOTE 9—SUBSEQUENT EVENTS

In the first quarter of 1989, the Company was engaged in serious negotiations to acquire additional capital. These negotiations may result in the Company acquiring additional capital or recapitalization. At the date of these financial statements, no commitments have been finalized.

DS TECHNOLOGIES, INC.

STATEMENTS OF OPERATIONS

For the Three Months Ended March 31, 1988 and 1989

	<u>1988</u>	<u>1989</u>
	(Unaudited)	
Net Revenues	\$ 376,593	\$ 233,499
Cost of Revenues.....	<u>88,907</u>	<u>161,228</u>
Gross Profit	287,686	72,271
Selling, General and Administrative Expenses.....	<u>391,702</u>	<u>238,833</u>
Loss From Operations.....	(104,016)	(166,562)
Other Expense	<u>(1,902)</u>	<u>(54,566)</u>
Net Loss	<u><u>\$(105,918)</u></u>	<u><u>\$(221,128)</u></u>

See accompanying notes to unaudited interim financial statements.

DS TECHNOLOGIES, INC.

STATEMENTS OF CASH FLOWS

For the Three Months Ended September 31, 1988 and 1989

	<u>1988</u>	<u>1989</u>
	(Unaudited)	
CASH FLOWS FROM OPERATING ACTIVITIES:		
Net loss	\$(105,918)	\$(221,128)
Adjustments to reconcile net loss to cash flows from operating activities:		
Depreciation.....	5,500	5,870
Amortization of capitalized software development costs.	7,500	8,329
Decrease (increase) in accounts receivable	155,056	218,275
Decrease (increase) in notes receivable.....	(15,000)	38,265
Decrease (increase) in inventory	(39,886)	19,404
Decrease (increase) in prepaid expenses.....	(7,300)	12,250
Decrease (increase) in other assets.....		(1,981)
Increase (decrease) in accounts payable.....	(10,049)	(72,125)
Increase (decrease) in accrued expenses.....	(21,726)	83,601
Total adjustments	74,095	311,888
Cash provided by (used for) operating activities	<u>(31,823)</u>	<u>90,760</u>
CASH FLOWS FROM FINANCING ACTIVITIES:		
Net borrowings (repayments) under bank line of credit	7,000	(56,364)
Net borrowing (repayment) from stockholders.....		(16,000)
Cash dividends		(6,000)
Cash provided by financing activities	<u>7,000</u>	<u>(78,364)</u>
CASH FLOWS FROM INVESTING ACTIVITIES:		
Acquisition of property and equipment.....	(2,922)	(3,141)
Increase in capitalized software development costs.....		(57,080)
Cash used for investing activities.....	<u>(2,922)</u>	<u>(60,221)</u>
INCREASE (DECREASE) IN CASH	<u>\$ (27,745)</u>	<u>\$ 47,825</u>
SUPPLEMENTAL DISCLOSURE OF FINANCIAL STATEMENT INFORMATION—Cash paid for interest expense.		
	<u>\$ 2,713</u>	<u>\$ 20,971</u>

See accompanying notes to unaudited interim financial statements.

DS TECHNOLOGIES, INC.

NOTES TO UNAUDITED INTERIM FINANCIAL STATEMENTS

1. BASIS OF PRESENTATION

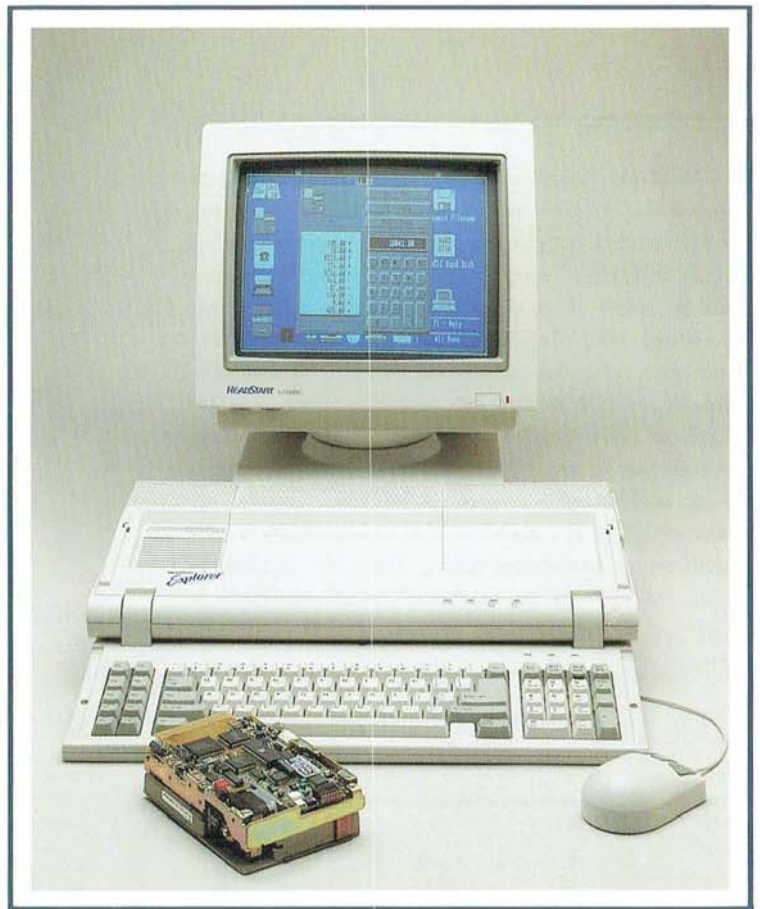
The accompanying unaudited statements of operations and cash flows for the three months ended March 31, 1988 and 1989 have been prepared in conformity with Article 10 of Regulation S-X.

Such unaudited interim financial statements should be read in conjunction with the financial statements, and footnotes thereto, of DS Technologies, Inc. for the year ended December 31, 1988 and Report of Independent Accountant included elsewhere in this Prospectus.

In the opinion of management, the accompanying unaudited statements of operations and cash flows for the three months ended March 31, 1988 and 1989 contain all adjustments (consisting of only normal recurring adjustments) necessary for a fair presentation.

The Software Toolworks licenses its software products to HeadStart Technologies Co., a division of North American Philips, and has developed the operating environment for the Headstart *Explorer* computer, announced in April 1989.

The hard disk for the HeadStart *Explorer* includes a number of the Company's software products.



The Software Toolworks has a 22 person development staff whose efforts are supplemented through strategic acquisitions of products and companies.