MAJESCO ENTERTAINMENT CO
Form 10-Q
March 13, 2006

UNITED STATES
SECURITIES AND EXCHANGE COMMISSION

WASHINGTON, D.C. 20549

FORM 10-Q

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

For the quarterly period ended January 31, 2006 Commission File No. 000-51128

Majesco Entertainment Company
(Exact name of registrant as specified in its charter)

DELAWARE	606-1529524
(State or Other Jurisdiction of Incorporation or Organization)	(I.R.S. Employer Identification No.)

160 Raritan Center Parkway, Edison, NJ 08837
(Address of principal executive offices)

REGISTRANT'S TELEPHONE NUMBER, INCLUDING AREA CODE: (732) 225-8910

(Former Name, Former Address and Former Fiscal Year, if Changed Since Last Report)

Indicate by check mark whether the registrant (1) has filed all reports required to be filed by Section 13 or 15(d) of the Securities Exchange Act of 1934 during the preceding 12 months (or for such shorter period that the registrant was required to file such reports), and (2) has been subject to such filing requirements for the past 90 days.

Yes No

Indicate by check mark whether the registrant is a large accelerated filer, an accelerated filer, or a non-accelerated filer. See definition of "accelerated filer and large accelerated filer" in Rule 12b-2 of the Exchange Act. (Check one):

Large accelerated filer Accelerated filer Non-accelerated filer

Indicate by check mark whether the registrant is a shell company (as defined in Rule 12b-2 of the Exchange Act).

Yes No

As of March 10, 2006, there were 22,257,631 shares of the Registrant's common stock outstanding.

MAJESCO ENTERTAINMENT COMPANY AND SUBSIDIARY
JANUARY 31, 2006 QUARTERLY REPORT ON FORM 10-Q
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MAJESCO ENTERTAINMENT COMPANY AND SUBSIDIARY
CONDENSED CONSOLIDATED BALANCE SHEET
(in thousands, except share amounts)

	January 31, 2006 (unaudited)	October 31, 2005
ASSETS		
Current assets		
Cash and cash equivalents	$ 2,940	$ 2,407
Due from factor	5,209	—
Income taxes receivable	551	826
Inventory — principally finished goods	7,332	8,058
Capitalized software development costs and prepaid license fees	5,588	17,278
Prepaid expenses	835	508
Total current assets	22,455	29,077
Property and equipment — net	900	862
Other assets	110	142
Total assets	$ 23,465	$ 30,081
LIABILITIES AND STOCKHOLDERS' EQUITY		
Current liabilities		
Accounts payable and accrued expenses	$ 18,898	$ 18,493
Inventory financing payable	1,953	
Due to factor	—	6,343
Advances from customers	271	484
Total current liabilities	21,122	25,320
Stockholders' equity:		
Common stock — $.001 par value; 250,000,000 shares authorized; 22,257,631 and 22,242,476 issued and outstanding at January 31, 2006 and October 31, 2005, respectively	22	22
Additional paid in capital	92,293	92,158
Accumulated deficit	(89,975)	(87,388)
Accumulated other comprehensive income (loss)	3	(31)
Total stockholders' equity	2,343	4,761
Total liabilities and stockholders' equity	$ 23,465	$ 30,081

See accompanying notes

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

	Three Months Ended January 31	
	2006	2005
Net revenues	$ 24,089	$ 30,719

Cost of sales				
Product costs		9,553		16,724
Software development costs and license fees		4,119		3,030
		13,672		19,754
Gross profit		10,417		10,965
Operating expenses				
Research and development		768		814
Selling and marketing		6,907		5,276
General and administrative		2,374		2,618
Depreciation and amortization		135		287
Loss on impairment of software development cost		2,375		
		12,559		8,995
Operating income (loss)		(2,142)		1,970
Other costs and expenses				
Interest expense and financing costs, net		445		734
Unrealized loss on foreign exchange contract		—		69
Income (loss) before income taxes		(2,587)		1,167
Provision for income taxes		—		467
Net income (loss)		(2,587)		700
Fair value charge for warrants exercised at a discount		—		1,100
Net (loss) attributable to common stockholders	$	(2,587)	$	(400)
Net (loss) attributable to common stockholders per share:				
Basic and Diluted	$	(0.12)	$	(0.02)
Weighted average shares outstanding				
Basic and Diluted		22,257,631		16,175,243

See accompanying notes

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

	Three Months Ended January 31			
CASH FLOWS FROM OPERATING ACTIVITIES		2006		2005
	(unaudited)			
Net (loss) income	$	(2,587)	$	700
Adjustments to reconcile net (loss) income to net cash provided by (used in) operating activities				
Depreciation and amortization		135		287
Loss on impairment of software development costs		2,375		
Non-cash compensation expense		135		465
Changes in operating assets and liabilities				
(Increase) decrease in due from factor — net		(11,552)		430

Decrease in inventory	726	4,300
Decrease (increase) in capitalized software development costs and prepaid license fees	9,315	(9,049)
Decrease (increase) in income tax receivable	275	(1,313)
Increase in prepaid expenses	(327)	(186)
Increase in accounts payable and accrued expenses	405	1,447
Decrease in advances from customers	(213)	(128)
Net cash used in operating activities	(1,313)	(3,047)
CASH FLOWS FROM INVESTING ACTIVITIES		
Purchases of property and equipment	(141)	(97)
Net cash used in investing activities	(141)	(97)
CASH FLOWS FROM FINANCING ACTIVITIES		
Net proceeds from secondary offering		41,925
Net proceeds from exercise of warrants at discount		6,482
Net proceeds from exercise of warrants		11,318
Inventory financing	1,953	(6,210)
Net cash provided by investing activities	1,953	53,515
Effect of exchange rates on cash and cash equivalents	34	7
Net increase in cash	533	50,378
Cash and cash equivalents — beginning of period	2,407	4,170
Cash and cash equivalents — end of period	$ 2,940	$ 54,548
SUPPLEMENTAL SCHEDULE OF NON CASH INVESTING AND FINANCING ACTIVITIES		
Fair value charge for warrants exercised at discount	$ —	$ 1,100
Issuance of common stock as a dividend on the preferred stock	$ —	$ 1,261

See accompanying notes

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MAJESCO ENTERTAINMENT COMPANY AND SUBSIDIARY
NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS
(unaudited)

1. PRINCIPAL BUSINESS ACTIVITY AND BASIS OF PRESENTATION

Majesco Entertainment Company and subsidiary (‘‘Majesco’’ or ‘‘Company’’) is a provider of interactive entertainment products. The Company’s offerings include video game software, and other digital entertainment products.

Majesco’s products provide it with opportunities to capitalize on the large and growing installed base of interactive entertainment platforms and an increasing number of interactive entertainment enthusiasts. The Company sells its products directly and through resellers primarily to U.S. retail chains, including Best Buy, GameStop/Electronics Boutique, Kmart, Target, Toys ‘‘R’’ Us and Wal-Mart. Majesco also sells products internationally through partnerships with international publishers. The Company has developed retail and distribution network relationships over its more than 20-year history.

Majesco provides offerings for most major current generation interactive entertainment hardware platforms, including Nintendo's Game Boy Advance, or GBA, DS, Micro and GameCube, Sony's PlayStation 2, or PS2, and PlayStation Portable, or PSP, Microsoft's Xbox and the personal computer, or PC.

The Company’s offerings include video game software, and other digital entertainment products. The Company’s operations involve similar products and customers worldwide. The products are developed and sold domestically and internationally. The Company is centrally managed and the chief operating decision makers, the chief executive and other officers, use consolidated financial information supplemented by sales information by product category, major product title and platform for making operational decisions and assessing financial performance. Accordingly, the Company operates in a single segment. Sales for the Company in the United States represented $18.6 million or 77.4% and in the United Kingdom $5.4 million or 22.6% for the period ending January 31, 2006. During the same period last year, there were no sales in the United Kingdom.

The accompanying financial statements have been prepared assuming that the Company will continue as a going concern. The Company has suffered losses that raise substantial doubt about its ability to continue as a going concern. Management's plan in regard to these matters is also described below. The financial statements do not include any adjustments that might result from the outcome of this uncertainty.

Although, management believes that alternative forms of financing may be available, there can be no assurance that funds will be available on acceptable terms, if at all. While management has already significantly reduced expenditure levels, in the event that we are unable to maintain our current factoring arrangement or negotiate alternative financing, or negotiate terms that are acceptable to us, we may be forced to further materially modify our business plan, including making further reductions in expenditures. Management believes it can make additional cuts if necessary, and that it can operate under the existing level of financing for at least one year. However, if the current level of financing was reduced and the Company was unable to obtain alternative financing, it could create a material effect on future operating prospects.

The accompanying interim consolidated financial statements of the Company are unaudited, but in the opinion of management, reflect all adjustments, consisting of normal recurring accruals, necessary for a fair presentation of the results for the interim period. Accordingly, they do not include all information and notes required by generally accepted accounting principles for complete financial statements. The results of operations for interim periods are not necessarily indicative of results to be expected for the entire fiscal year or any other period. These interim consolidated financial statements should be read in conjunction with the Company's consolidated financial statements and notes for the year ended October 31, 2005 filed on Form 10-K on February 1, 2006.

The statements contained in this Report on Form 10-Q, that are not purely historical, are forward-looking information and statements within the meaning of Section 27A of the Securities Act

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of 1933 and Section 21E of the Securities Exchange Act of 1934. These include statements regarding our expectations, intentions, or strategies regarding future matters. All forward-looking statements included in this document are based on information available to us on the date hereof. It is important to note that our actual result

could differ materially form those projected in such forward-looking statements contained in this Form 10-Q. The forward-looking statements contained herein are based on current expectations that involve numerous risks and uncertainties. Assumptions relating to the foregoing involve judgments regarding among other things, our ability to secure financing or investment for capital expenditures, future economic and competitive market conditions, and future business decisions. All these matters are difficult or impossible to predict accurately, many of which may be beyond our control. Although we believe that the assumptions underlying our forward-looking statements are reasonable, any of the assumptions could be inaccurate and, therefore, there can be no assurance that the forward-looking statements included in this form 10-Q will prove to be accurate.

2. SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES

Stock Based Compensation. In December 2004, the Financial Accounting Standards Board (''FASB'') issued Statement of Financial Accounting Standards No. 123R (revised 2004), ''Share-Based Payment'' which revised Statement of Financial Accounting Standards No. 123, ''Accounting for Stock-Based Compensation''. This statement supersedes Opinion No. 25, ''Accounting for Stock Issued to Employees.'' The revised statement addresses the accounting for share-based payment transactions with employees and other third parties, eliminates the ability to account for share-based compensation transactions using APB 25 and requires that the compensation costs relating to such transactions be recognized in the statement of operations. The revised statement has been implemented by the Company effective November 1, 2005.

The implementation of FAS No. 123R has the following effect on the statement of operations for the three-month period ended January 31, 2006:

(in thousands, except per share amounts)	Three Months Ended January 31, 2006
Net loss before stock option expense	$ (2,477)
Less stock option expense	(110)
Net loss as reported	$ (2,587)

There is no impact on the basic or diluted earning per share reported on the statement of operations. For the 2005 fiscal year the Company accounted for its employee incentive stock option plans using the intrinsic value method in accordance with the recognition and measurement principles of Accounting Principles Board Opinion No. 25, ''Accounting for Stock Issued to Employees.'' Had the Company determined compensation expenses based on the fair value at the grant dates for those awards consistent with the method of SFAS 123, the Company's net (loss) per share would have increased to the following pro forma amounts:

(in thousands, except per share amounts)		Three Months Ended January 31, 2005
Net income (loss) – as reported	$	700
Add: total stock based employee compensation expense determined under fair value based methods for all awards		279
Less: stock based employee compensation determined under fair value based method net of income tax effect		(534)
Net income (loss) – pro forma	$	445
Net income (loss) attributable to common stockholders per share:		
Basic and diluted net loss per share as reported	$	(.02)
Pro forma and diluted basic loss per share	$	(.04)

The fair value of each option grant is estimated on the date of grant using the Black-Scholes option-pricing model with the following assumptions:

	January 31, 2006	January 31, 2005
Risk free annual interest rate	4.30%	3.30% and 3.70%
Expected volatility	90%	50%
Expected life	5 years	5 years
Assumed dividends	None	None

Effective November 1, 2005, the Company adopted FAS No. 123R utilizing the modified prospective method. FAS No. 123R requires the recognition of stock-based compensation expense in the financial statments.

Under the modified prospective method, the provisions of FAS No. 123R apply to all awards granted or modified after the date of adoption. In addition, the unrecognized expense of awards not yet vested at the date of adoption, determined under the original provisions of FAS 123, ‘‘Accounting for Stock Based Compensation’’, shall be recognized in net earnings in the periods after the date of adoption. Stock based compensation consists primarily of stock options. Stock options are granted to employees at exercise prices equal to the fair market value of the Company’s stock at the dates of grant. Stock options generally vest over three years and have a term of seven years. Compensation expense for stock options is recognized over the period for each separately vesting portion of the stock option award.

The fair value for options issued prior to November 1, 2005 was estimated at the date of grant using a Black-Scholes option-pricing model. The risk free rate was derived from the U.S. Treasury yield curve in effect at the time of the grant. The volatility factor was determined based on a study done by an independent securities valuation firm. The Black-Scholes option-pricing model was developed for use in estimating the fair value of traded options that have no vesting restrictions and are fully transferable. In addition, option-pricing models require the input of highly subjective assumptions including the expected stock price volatility. Because the Company's employee stock options have characteristics significantly different from those of traded options and because changes in the subjective input assumptions can materially affect the fair value estimate, in management's opinion the existing models do not necessarily provide a reliable single measure of the fair value of its employee stock options.

MAJESCO ENTERTAINMENT COMPANY AND SUBSIDIARY
NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (continued)
(unaudited)

A summary of the status of the Company's options for the three months ended January 31, 2006 is as follows:

	Shares	Weighted Average Exercise Price	Remaining Life	Aggregate Intrinsic Value
Balance at beginning of period	1,820,550	$ 8.45		
Granted	200,000	$ 1.46		
Cancelled or Expired	(41,527)	$ 7.72		
Exercised	—	—		
Outstanding at end of period	1,979,023	$ 6.61	5	$ 0

A summary of the status of the Company's nonvested shares as of January 31, 2006, and changes during the three months ended January 31, 2006 is presented below:

	Number of Shares	Weighted-Average Fair Value at Grant Date	Weighted-Average Remaining Contractual Term (in years)
Non-vested shares at October 31, 2005	1,581,260	$ 4.51	9.5
Options granted	200,000	$ 1.02	9.75
Options vested	(10,833)	$ 4.52	9.25
Options forfeited or expired	(390,656)	$ 1.86	9.7
Non-vested shares at January 31, 2006	1,379,771	$ 4.34	8.5

As of January 31, 2006, there was approximately $900,000 of unrecognized compensation cost related to non-vested stock option awards, which is expected to be recognized over a remaining weighted-average vesting period of 2.95 years.

Estimates. The preparation of financial statements in conformity with accounting principles generally accepted in the United States of America requires management to make estimates and assumptions that affect the reported amounts of assets and liabilities or the disclosure of gain or loss contingencies at the date of the financial statements and the reported amounts of revenues and expenses during the reporting period. Among the more significant estimates included in these financial statements are the estimated customer allowances, the valuation of inventory and the recoverability of advance payments for software development costs and intellectual property licenses. Actual results could differ from those estimates.

Loss per share. Basic loss per common share is computed by dividing the net loss applicable to common stockholders by the weighted-average number of shares of common stock outstanding for the period. Diluted loss per common share for the period ended January 31, 2006 and 2005 has not been presented because the impact of the conversion or exercise, as applicable, of the warrants (2,070,687 and 2,184,971 at January 31, 2006 and 2005, respectively) and stock options (1,979,023 and 1,689,748 at January 31, 2006 and 2005, respectively) would be antidilutive.

Recent accounting pronouncements. The Company does not believe that any other recently issued, but not yet effective accounting standards will have a material effect on the Company's consolidated financial position, results of operations or cash flows.

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MAJESCO ENTERTAINMENT COMPANY AND SUBSIDIARY
NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (continued)
(unaudited)

3. DUE FROM FACTOR

Due from (to) factor consists of the following:

	January 31, 2006 (inthousands)		October 31, 2005 (in thousands)	
Outstanding accounts receivable sold to factor	$	11,387	$	4,842
Less: allowance		(6,022)		(9,551)
Advances from factor		(156)		(1,634)
		5,209	$	(6,343)

The following table sets forth the adjustments to the price protection and other customer sales incentive allowances included as a reduction of the amounts due from factor:

	Three Months Ended January 31, (inthousands)			
	2006		2005	
Balance — beginning of period	$	(9,551)	$	(4,860)
Add: provision		(1,279)		(1,364)
Less: amounts charged against allowance		4,808		2,901
Balance — end of period	$	(6,022)	$	(3,323)

4. ACCOUNTS PAYABLE AND ACCRUED EXPENSES

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

	January 31, 2006	October 31, 2005

Accounts payable-trade	$	10,106	$	9,563
Royalties — including accrued minimum guarantees		4,648		5,634
Sales commissions		486		467
Professional fees		590		—
Salaries and other compensation		1,473		1,481
Other accruals		1,595		1,348
	$	18,898	$	18,493

5. CONTINGENCIES AND COMMITMENTS

Commitments

At January 31, 2006 the Company was committed under agreements with certain developers for future milestone and license fee payments aggregating $5.2 million which are payable through October 31, 2006. Milestone payments represent scheduled installments due to the Company's developers based upon the developers providing the Company certain deliverables, as predetermined in the Company's contracts. The milestone payments also represent advances against royalties to the developers. These payments will be used to reduce future royalties due to the developers from sales of the Company's videogames.

At January 31, 2006, the Company had open letters of credit aggregating $700,000 under the Company's purchase order assignment arrangements for inventory to be delivered during the subsequent quarter.

The Company has entered into ‘‘at will’’ employment agreements with several key executives. These employment agreements include provisions for, among other things, annual compensation, bonus arrangements and stock option grants. These agreements also contain provisions related to severance terms and change of control provisions.

Contingencies

On December 2, 2005, a vendor filed a complaint against us in the Supreme Court of the State of New York, County of New York, alleging breach of contract and failure to pay in connection with services rendered. The complaint seeks approximately $2.6 million in damages plus interest and costs, including attorney’s fees. We intend to vigorously defend this action.

In July 2005, four purported class action complaints were filed against the Company and several current and former directors and officers of the Company in the United States District Court for the District of New Jersey. On September 12, 2005, a fifth purported class action complaint was filed in the same court on behalf of a class of individuals who purchased shares of the Company common stock in the Company’s January 26, 2005 offering of six million shares of common stock (the ‘‘Offering’’). The complaint named as defendants the Company, current and former officers of the Company, and certain financial institutions who served as underwriters with respect to the Offering.

On October 11, 2005, the Court consolidated the five cases and appointed a Lead Plaintiff. On December 14, 2005, the Lead Plaintiff filed an Amended Consolidated Complaint, which is now the operative Complaint. The Complaint names the following as defendants: the Company, Carl Yankowski, Jan E. Chason, Jesse Sutton, Joseph Sutton, Morris Sutton, Laurence Aronson, F. Peter Cuneo, James Halpin, Louis Lipschitz, Marc Weisman, RBC Capital Markets Corporation, JMP Securities LLC, Harris Nesbitt & Corp., Wedbush Morgan Securities Inc., and Goldstein Golub Kessler LLP.

The Complaint alleges that the Registration Statement and Prospectus filed with the SEC in connection with the Company’s Offering and certain of the Company’s press releases and other public filings contained material misstatements and omissions about the Company’s financial condition and prospects as well as its products. The lead Plaintiff asserts a claim under Section 11 of the Securities Act against all the defendants on behalf of investors who purchased in the Offering. It asserts a Section 12(a)(2) claim against the Company and the financial institutions who served as underwriters in connection with the Offering, and a Section 15 control person claim against defendants Carl Yankowski, Jan Chason, Jesse Sutton, Joseph Sutton, and Morris Sutton (the ‘‘Defendants’’). Lead Plaintiff also asserts a claim under Section 10(b) of the Exchange Act and Rule 10b-5 promulgated there under against the Company and the Defendants and a claim under Section 20(a) of the Exchange Act against the Defendants. The Complaint seeks damages in an unspecified amount. The proposed class period for the Exchange Act claims is December 8, 2004 through September 12, 2005. We will vigorously contest the action.

The Company is party to other routine claims and suits brought by the Company and against the Company in the ordinary course of business, including disputes arising over contractual claims and collection matters. In the opinion of management, after consultation with legal counsel, the outcome of such routine claims will not have a material adverse effect on the Company's business, financial condition, and results of operations or liquidity. However, the costs and other effects of pending or future litigation, governmental investigations, legal and administrative cases and proceedings (whether civil or criminal), settlements, judgments and investigations, claims and changes in those matters (including the matters described above), and developments or assertions by or against the Company relating to intellectual property rights and intellectual property licenses, could have a material adverse effect on the Company's business, financial condition, and results of operations or liquidity.

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6. RELATED PARTIES

The Company receives printing and packaging services from a business of which the brother of Morris Sutton, the Company's Chairman and Interim CEO, is a principal. During the three months ended January 31, 2006 the Company was charged $447,000 compared to $1.2 million for the three months ended January 31, 2005. These charges are included in product costs in the accompanying consolidated statement of operations. Such charges are, to the Company's knowledge, on terms no less favorable to what the Company could receive from providers of similar services.

7. STOCKHOLDERS EQUITY

During the three months ended January 31, 2006 the Company recorded a non-cash compensation charge of $25,000 for the issuance of 15,155 shares of common issued to its non-employee directors.

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

Overview

We are a provider of interactive entertainment products. Our products allow us to capitalize on the large and growing installed base of interactive entertainment platforms and an increasing number of interactive entertainment enthusiasts. We sell our products primarily to large retail chains, specialty retail stores, video game rental outlets and distributors. We also sell our products internationally through distribution agreements with international publishers. We have developed our retail and distribution network relationships over our 19-year history.

We publish software games for most major current generation interactive entertainment hardware platforms, including Nintendo's Game Boy Advance, or GBA, DS, Micro and GameCube, Sony's PlayStation 2, or PS2, and PlayStation Portable, or PSP™, Microsoft's Xbox and the personal computer, or PC.

Our video game titles are targeted at various demographics at a range of price points, from lower-priced ‘‘value’’ titles to more expensive ‘‘premium’’ titles. In some instances, these titles are based on licenses of well-known properties, and in other cases based on original properties. We collaborate and enter into agreements with content providers and video game development studios for the creation of our video games.

Majesco Sales Inc. was incorporated in 1986 under the laws of the State of New Jersey. On December 5, 2003, Majesco Sales Inc. completed a reverse merger with Majesco Holding Inc (formerly, ConnectivCorp) then a publicly traded company with no active operations. Majesco Holding Inc. was incorporated in 1998 under the laws of the State of Delaware. As a result of the merger, Majesco Sales Inc. became a wholly-owned subsidiary and the sole operating business of the public company. On April 4, 2005, Majesco Sales Inc. was merged into Majesco Holdings Inc., and in connection with the merger Majesco Holdings Inc. changed its name to Majesco Entertainment Company.

During the second half of fiscal 2005, we had several major developments that ultimately led us to revise our business model and shift our product strategy away from capital intensive premium console games to a focus on value products and lower-cost games for handheld systems. We now look to offer a greater number of value titles and try to capitalize on our history and expertise in this market. In addition, we will continue to publish titles for popular handheld systems such as the GBA, DS and PSP, as well as look for opportunistic titles for home consoles and personal computers. We believe that a decreased emphasis on premium titles, along with a renewed focus on value and handheld titles, although there can be no assurance, will allow us to capitalize on our strengths and expertise while reducing some of the cost and risk associated with publishing a large number of premium titles.

Net Revenues. Our revenues are derived from the following types of offerings:

- Games. Our video games consisted of ‘‘premium’’ titles and ‘‘value’’ titles for console and handheld video game systems. Premium titles are higher-priced video games that typically involve significant development and marketing costs. We work with third-party development studios to develop our own proprietary titles and we also license rights to well-known properties from third parties. Value titles are typically sold at suggested retail

prices below $20 and typically involve comparatively lower development and marketing costs than our premium titles; and

- Other digital entertainment products. Our GBA Video titles utilize compression technology that enables users to view up to 90 minutes of color video content with stereo audio on their GBA or DS, using a standard GBA cartridge and with no additional hardware required. We enter into licensing agreements with entertainment industry leaders for GBA Video content. In addition, we develop, manufacture and market a variety of digital media peripherals and applications including a stand-alone TV Arcade ‘‘plug-and-play’’ video game system which consists of a firmware-enabled joystick that connects directly to a user's television and plays pre-installed video games without the need for a dedicated console.

Our revenues are recognized net of reserves for price protection and other allowances.

Cost of Sales. Cost of sales consists of product costs and amortization of software development costs and license fees. A significant component of our cost of sales is product costs. These are comprised primarily of manufacturing and packaging costs of the disc or cartridge media, royalties to the platform manufacturer and manufacturing and packaging costs of peripherals. Commencing upon the related product's release, capitalized software development and intellectual property license costs are amortized to cost of sales.

Gross Profit. Our gross profit is directly affected by the mix of revenues from our premium versus value titles. Gross profit margins have the potential to be substantially higher from publishing premium titles given the relatively lower manufacturing costs and higher sales prices. Our value titles are generally characterized as having lower gross profit margin potential than premium titles as a result of their lower sales price.

Product Research and Development Expenses. Product research and development expenses relate principally to our cost of supervision of the third-party developers of our new video games and other products, testing new products and conducting quality evaluations during the development cycle. Costs incurred are employee-related, may include equipment and are not allocated to cost of sales. Although there can be no assurance, we anticipate that, with our focus now on low-cost handheld game and value products, expenditures for product research and development will decrease.

Selling and Marketing Expenses. Selling and marketing expenses consist of marketing and promotion expenses, the cost of shipping products to customers and related employee costs. A large component of this expense relates to marketing and promotion expenses, which includes certain customer marketing allowances. We anticipate, with our focus now on low-cost handheld game and value products, that expenditure for selling and marketing will decrease for the full year.

General and Administrative Expenses. General and administrative expenses primarily represent employee related costs, including corporate executive and support staff, general office expenses, professional fees and various other overhead charges. Professional fees, including legal and accounting expenses, typically represent the second largest component of our general and administrative expenses. These fees are partially attributable to our required activities as a publicly traded company, such as SEC filings. We expect to continue to incur increased costs for litigation related to the class action lawsuit as well as consultants in connection with our required compliance as a public company with new regulations regarding corporate governance and accounting. Under our revised business plan we expect a decrease in certain general and administrative expenses as a result of decreased headcount and related expenses.

Interest and Financing Costs. Interest and financing costs are directly attributable to our factoring and our purchase-order financing arrangements.

(Benefit)Provision for Income Taxes.   For the year ended 2005, we incurred, a loss and recognized the availability for income tax purposes of a carryback of such losses to the prior year. Utilization of our net operating loss carryforwards may be subject to a substantial annual limitation due to the ‘‘change in ownership’’ provisions of the Internal Revenue Code. The annual limitation may result in the expiration of net operating loss carryforwards before utilization. Since the Company has a history of losses, a full valuation allowance has been established under the provisions of SFAS No. 109 and the company intends to maintain a valuation allowance for its net operating loss carryforwards until sufficient positive evidence exists to support its reversal.

Critical Accounting Policies

Our discussion and analysis of the financial condition and results of operations is based upon our consolidated financial statements, which have been prepared in accordance with accounting principles generally accepted in the United States.

The preparation of these consolidated financial statements requires us to make estimates and judgments that affect the reported amounts of assets, liabilities, revenues and expenses, and related

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disclosure of contingent assets and liabilities. We base our estimates on historical experience and on various other assumptions that are believed to be reasonable under the circumstances, the results of which form the basis for making judgments about the carrying values of assets and liabilities that are not readily apparent from other sources. Actual results could differ materially from these estimates under different assumptions or conditions.

We have identified the policies below as critical to our business operations and the understanding of our financial results. The impact and any associated risks related to these policies on our business operations is discussed throughout management's discussion and analysis of financial condition and results of operations where such policies affect our reported and expected financial results.

Revenue Recognition. The Company recognizes revenue upon shipment of its product when title and risk of loss are transferred and persuasive evidence of an arrangement exists. In order to recognize revenue, the Company must not have any continuing obligations and it must also be probable that the Company will collect the accounts receivable. Revenues, including sales to resellers and distributors, are recognized when these conditions are met.

For those agreements, which provide customers with the right to multiple copies in exchange for guaranteed minimum royalty amounts, revenue is recognized at delivery of the product master or the first copy since the Company has no continuing obligations including requirements for duplication. Royalties on sales that exceed the guaranteed minimum are recognized as earned.

The Company generally sells its products on a no-return basis, although in certain instances, the Company may provide price protection or other allowances on certain unsold products. Price protection, when granted and applicable, allows customers a partial credit against amounts they owe the Company with respect to merchandise unsold by them. Revenue is recognized net of estimates of these allowances.

Inventory. Inventory, which consists of finished goods, is stated at the lower of cost as determined by the first-in, first-out method, or market. The Company estimates the net realizable value of slow-moving inventory on a title-by-title basis and charges the excess of cost over net realizable value to cost of sales.

Reserves for Price Protection and Other Allowances. We derive revenue from the sale of packaged video game software designed for play on consoles such as PlayStation 2, Xbox and GameCube, and hand-held game devices, including the GBA, DS and PSP. We generally sell our products on a no-return basis, although in certain instances, we may provide price protection or other allowances on certain unsold products in accordance with industry practices. Price protection, when granted and applicable, allows customers a partial credit with respect to merchandise unsold by them. Revenue is recognized net of estimates of these allowances. Sales incentives and other consideration that represent costs incurred by us for assets or services received, such as the appearance of our products in a customer's national circular advertisement, are reflected as selling and marketing expenses. We estimate potential future product price protection and other discounts related to current period product revenue. Generally our price protection for premium-priced titles is higher than that needed for our value titles.

Our reserves for price protection and other allowances fluctuate over periods as a result of a number of factors including analysis of historical experience, current sell-through of retailer inventory of our products, current trends in the interactive entertainment market, the overall economy, changes in customer demand and acceptance of our products and other related factors. However, actual allowances granted could materially exceed our estimates as unsold products in the distribution channels are exposed to rapid changes in consumer preferences, market conditions or technological obsolescence due to new platforms, product updates or competing products. For example, the risk of requests for allowances may increase as consoles pass the midpoint of their lifecycle and an increasing number of competitive products heighten pricing and competitive pressures. While management believes it can make reliable estimates regarding these matters, these estimates are inherently subjective. Accordingly, if our estimates change, this will result in a change in our reserves, which would impact the net revenues and/or selling and marketing expenses we report. For the three months

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ended January 31, 2006 and 2005 we provided allowances for future price protection and other allowances of $1.3 million and $1.4 million, respectively. The fluctuations in the provisions reflected our estimates of future price protection based on the factors discussed above. We do not have significant exposure to credit risk as the factor generally buys our receivables without recourse.

Software development costs and prepaid license fees. Software development costs include development fees, most often in the form of milestone payments made to independent software developers for development services. Software development costs are capitalized once technological feasibility of a product is established and it is determined that such costs should be recoverable against future revenues. For products where proven game engine technology exists, this may occur early in the development cycle. Technological feasibility is evaluated on a product-by-product basis. Amounts related to software development that are not capitalized are charged immediately to product research and development costs. Prepaid license fees represent license fees to holders for the use of their intellectual property rights in the development of our products. Minimum guaranteed royalty payments for intellectual property licenses are initially recorded as an asset (prepaid license fees) and a current liability (accrued royalties payable) at the contractual amount upon execution of the contract when no significant performance remains with the licensor. Capitalized software development costs classified as non-current relate to titles for which we estimate the release date to be more than one year from the balance sheet date.

Commencing upon a related product's release, capitalized software development costs and prepaid license fees are amortized to cost of sales based upon the higher of (i) the ratio of current revenue to total projected revenue or (ii) the straight-line method. The amortization period is usually no longer than one year from the initial release of the product. The recoverability of capitalized software development costs and prepaid license fees is evaluated based on the expected performance of the specific products to which the costs relate. The following criteria are used to evaluate expected product performance: historical performance of comparable products using comparable technology; orders for the product prior to its release; and estimated performance of a sequel product based on the performance of the product on which the sequel is based. As of January 31, 2006 we charged operations $2.4 million for development costs related to projects which were either canceled, or for which full recoverability was not expected. There were no similar charges in the period ended January 31, 2005. In the three month period ended January 31, 2006 and 2005, we charged $4.1 million and $3.0 million, respectively, to cost of sales for amortization of software development costs, prepaid license fees and royalties on products which were sold in the period.

Accounting for Stock-Based Compensation. In December 2004, the FASB issued SFAS No. 123 (revised 2004), ‘‘Share Based Payment’’ (‘‘SFAS 123(R)’’). SFAS 123(R) requires all share-based payments to employees, including grants of employee stock options, to be recognized in the financial statements based on their fair values. We adopted SFAS 123(R) on November 1, 2005. SFAS 123(R) permits public companies to adopt its requirements using either the modified prospective or modified retrospective transition method. We have decided to use the modified prospective transition method, which require that compensation cost is recognized for all awards granted, modified or settled after the effective date as well as for all awards granted to employees prior to the effective date that remain unvested as of the effective date. We expect that our adoption of SFAS 123(R) will have a material impact on our consolidated financial statements.

Results of operations

Three months ended January 31, 2006 versus three months ended January 31, 2005

Net revenues. Net revenues for the three months ended January 31, 2006 decreased to $24.1 million from $30.7 million in the comparable quarter last year. The decrease is reflective of the Company’s change in strategy of selling fewer premium games, a general industry weakness as a result of the hardware transition, as well as lower sales of our GBA Video and TV Arcade products. In the first quarter of 2006, the decrease was partially offset by International revenues which we did not have in the comparable quarter last year.

Gross profit. Gross profit for the three months ended January 31, 2006 was $10.4 million compared to a gross profit of $11.0 million in the first quarter last year, while the profit margin was 43.2% compared to 35.7% in the prior year. The nominal decrease in gross profit is primarily attributable to a shift in product mix, specifically higher sales of our GBA Video product line in the prior year quarter. The increase in gross margin percentage in the current period is reflective of the lower sales volume of GBA Video products in the first quarter of 2006, which generally contribute a lower margin.

Product Research and Development Expenses. For the three months ended January 31, 2006 product research and development costs decreased to $768,000 from $814,000 in the comparable 2005 period. The decrease is principally attributable to lower quality assurance employee costs as a result of the fewer number of premium game projects currently in the development cycle.

Selling and Marketing Expenses. In the three months ended January 31, 2006 total selling and marketing expenses increased to $6.9 million from $5.3 million in the same three month period in 2005, an increase of $1.6 million. As a percentage of sales, selling and marketing increased to 29% from 17% in the prior year period, principally the result of media campaigns and promotions to support the launch of our premium game and DS products during the quarter. We expect that marketing expenses will decrease as we realize the effects of our transition to a more value-focused model.

General and Administrative Expenses. For the three month period ended January 31, 2006 general and administrative expenses remained the same at $2.2 million as the comparable 2005 period. Included in the expenses are employee related costs, professional fees, insurance and other costs incurred as a result of being a public company, including compliance cost associated with the Sarbanes Oxley Act and costs for litigation and claims including costs related to the class action lawsuit.

Other Operating Expenses. In the three months ended January 31, 2006 and 2005 we recorded non-cash compensation charges of $135,000 and $465,000, respectively, and in the three months ended January 31, 2006 $250,000 of expense related to severance agreements. In addition, during the first quarter 2006, we charged operations $2.4 million to write-off capitalized costs related to games for which development plans were changed such that it is uncertain whether potential value of that development will be realized.

Depreciation and Amortization Expenses. For the three months ended January 31, 2006 depreciation and amortization expense was $135,000 compared to $287,000 in the comparable 2005 period. Depreciation and amortization expense decreased due to the lower purchasing of office and computer equipment.

Operating (loss) income. For the three month period ended January 31, 2006 we generated an operating loss of $2.1 million, compared to an operating income of $2.0 million in the 2005 period. The decrease in operating income was primarily due to lower sales volumes during the January 31, 2006 period combined with the impact of impairment charges of $2.4 million as a result of our shift in strategy, higher marketing costs, and on-going weak market conditions.

Interest and Financing Costs, net. For the three months ended January 31, 2006 interest and financing costs decreased approximately $289,000 to $445,000 from $734,000 in 2005.

Other Non-Operating Expenses. During the three months ended January 31, 2005 we recorded a charge of $69,000 related to a foreign exchange contract. There were no comparable amounts recorded in the 2006 period.

Income Taxes. As a result of our loss in the current period, we have not recorded any provisions for federal or state income taxes. Federal and state income taxes were provided for at a combined effective rate of 40% in the 2005 periods.

Net (loss) Income. For the three month period ended January 31, 2006, we generated a net loss of $2.6 million compared to a net income of $700,000 in 2005, based upon the information discussed above. In the three month period ended January 31, 2005, a $1.1 million charge related to the fair value of warrants exercised at a discount resulted in a net loss attributable to common stockholders of $400,000.

Liquidity and Capital Resources

Historically, we have met our capital needs through our factoring and purchase order financing arrangements, loans from related persons and advances from customers.

We do not have any bank debt. To satisfy our liquidity needs, we factor our receivables. We also utilize purchase order financing through the factor and through a finance company to provide funding for the manufacture of our products. In connection with these arrangements, the finance company and the factor have a security interest in substantially all of our assets.

Under the terms of our factoring agreement, we assign our accounts receivable to the factor. The factor, in its sole discretion, determines whether or not it will accept a receivable based on its assessment of its credit risk. Once a receivable is accepted by the factor, the factor assumes substantially all of the credit risk associated with the receivable. The factor is required to remit payments to us for the assigned accounts receivable in accordance with the terms of the assigned invoice, regardless of whether the factor receives payment on the receivable, so long as the customer does not have a valid dispute related to the invoice. The amount remitted to us by the factor equals the invoiced amount adjusted for allowances and discounts we have provided to the customer less factor charges of 0.5% of invoiced amounts for these credit and collection services.

We utilize purchase order financing arrangements in order to enable us to provide letters of credit necessary for the manufacture of our products. Manufacturers require us to present a letter of credit in order to manufacture the products required under a purchase order. Currently, we utilize letters of credit from a finance company which charges 3.3% of the purchase order amount for each transaction for 60 days. Our factor also provides purchase order financing at a cost of 0.5% of the purchase order amount for each transaction for 30 days. Additional charges are incurred under both arrangements if letters of credit remain outstanding in excess of the original time period.

In addition, we may request that the factor provide us with cash advances based on our accounts receivable and inventory. The factor may either accept or reject our request for advances at its discretion. Amounts to be paid to us by the factor for any assigned receivable are offset by any amounts previously advanced by the factor. As our needs require, we may request that the factor advance 80% of the eligible receivables and advance 50% of inventory. The interest rate for advances taken is prime plus 1%.

As of January 31, 2006, assuming continued availability of funding at previous levels by the current factor or alternative sources, management believes that there will be sufficient capital resources from operations and financing arrangements in order to meet our requirements for development, production, marketing, purchases of equipment, and the acquisition of intellectual property rights for future products for the next twelve months.

Although, management believes that alternative forms of financing may be available, there can be no assurance that funds will be available on acceptable terms, if at all. While management has already significantly reduced expenditure levels, in the event that we are unable to maintain our current factoring arrangement or negotiate alternative financing, or negotiate terms that are acceptable to us, we may be forced to further materially modify our business plan, including making further reductions in expenditures. Management believes it can make additional cuts if necessary, and that it can operate under the existing level of financing for at least one year. However, if the current level of financing was reduced and the Company was unable to obtain alternative financing, it could create a material effect on future operating prospects.

As a result of recurring losses incurred by us, the report of our independent Registered Public Accounting firm on the financial statements as of October 31, 2005 contained an explanatory paragraph indicating that we may be unable to continue as a going concern.

Advances From Customers. On a case by case basis, distributors and other customers have agreed to provide us with cash advances on their orders. These advances are then applied against future sales to these customers. In exchange for these advances, we offer these customers beneficial pricing or other considerations.

Commitments and Contingencies. We are committed under agreements with certain developers and content providers for milestone and license fee payments aggregating $5.2 million payable through October 31, 2006.

We do not currently have any material commitments with respect to any capital expenditures.

As of January 31, 2006 we had open letters of credit aggregating $700,000 for inventory purchases to be delivered during the quarter ended April 30, 2006.

As of January 31, 2006 we were committed under operating leases for office space and equipment for approximately $1.5 million through July 2009.

In July 2005, four purported class action complaints were filed against the Company and several current and former directors and officers of the Company in the United States District Court for the District of New Jersey. On September 12, 2005, a fifth purported class action complaint was filed in the same court on behalf of a class of individuals who purchased shares of the Company common stock in the Company's January 26, 2005 offering of six million shares of common stock (the "Offering"). The complaint named as defendants the Company, current and former officers of the Company, and certain financial institutions who served as underwriters with respect to the Offering.

On October 11, 2005, the Court consolidated the five cases and appointed a Lead Plaintiff. On December 14, 2005, Lead Plaintiff filed an Amended Consolidated Complaint, which is now the operative Complaint. The Complaint names the following as defendants: the Company, Carl Yankowski, Jan E. Chason, Jesse Sutton, Joseph Sutton, Morris Sutton, Laurence Aronson, F. Peter Cuneo, James Halpin, Louis Lipschitz, Marc Weisman, RBC Capital Markets Corporation, JMP Securities LLC, Harris Nesbitt & Corp., Wedbush Morgan Securities Inc., and Goldstein Golub Kessler LLP.

The Complaint alleges that the Registration Statement and Prospectus filed with the SEC in connection with the Company's Offering and certain of the Company's press releases and other public filings contained material misstatements and omissions about the Company's financial condition and prospects as well as its products. Lead Plaintiff asserts a claim under Section 11 of the Securities Act against all the defendants on behalf of investors who purchased in the Offering. It asserts a Section 12(a)(2) claim against the Company and the financial institutions who served as underwriters in connection with the Offering, and a Section 15 control person claim against defendants Carl Yankowski, Jan Chason, Jesse Sutton, Joseph Sutton, and Morris Sutton (the "Defendants"). Lead Plaintiff also asserts a claim under Section 10(b) of the Exchange Act and Rule 10b-5 promulgated thereunder against the Company and the Defendants and a claim under Section 20(a) of the Exchange Act against the Defendants. The Complaint seeks damages in an unspecified amount. The proposed class period for the Exchange Act claims is December 8, 2004 through September 12, 2005. We will vigorously contest the action.

We are party to other routine claims and suits brought by us and against us in the ordinary course of business, including disputes arising over contractual claims and collection matters. In the opinion of management, after consultation with legal counsel, the outcome of such routine claims will not have a material adverse effect on our business, financial condition, and results of operations or liquidity. In addition, the costs and other effects of pending or future litigation, governmental investigations, legal and administrative cases and proceedings (whether civil or criminal), settlements, judgments and investigations, claims and changes in those matters (including those matters described above), and developments or assertions by or against the Company relating to intellectual property rights and intellectual property licenses, could have a material adverse effect on the Company's business, financial condition,

and results of operations or liquidity.

Cash Flows

Cash and cash equivalents were $2.9 million at January 31, 2006 compared to $2.4 million at October 31, 2005.

Operating Cash Flows. Cash used in operating activities during the three months ended January 31, 2006 was $1.3 million compared to cash usage of $3.0 million during the same period in

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the prior year. The $1.7 million decrease in the use of cash in operations in 2006 was due primarily to a decrease in expenditures for capitalized software development costs and prepaid license fees. This was partially offset by an increase in the amount due from factor and our loss from operations. We expect continued volatility in the use and availability of cash due to the seasonality of our business, timing of receivables collections and working capital needs necessary to finance our business and growth objectives.

Investing Cash Flows. Cash used in investing activities for the three months ended January 31, 2006 consists primarily of purchases of computer equipment and leasehold improvements necessary to accommodate our infrastructure growth of $141,000.

Financing Cash Flows. Cash provided by financing activities in the three months ended January 31, 2006 was $2.0 million relating to inventory financing. During the three month period ended January 31, 2005 we generated $53.5 million in cash as a result of our secondary offering and from proceeds from the exercise of warrants.

Item 3. Quantitative and Qualitative Disclosures about Market Risk

We are exposed to various market risks, including the changes in foreign currency exchange rates and interest rates. Market risk is the potential loss arising from changes in market rates and prices. Foreign exchange contracts used to hedge foreign currency exposure are subject to market risk. We do not enter into derivatives or other financial instruments for trading or speculative purposes. At January 31, 2006 we did not have any foreign exchange contracts.

Item 4. Controls and Procedures

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

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

While we believe our disclosure controls and procedures and our internal control over financial reporting have improved, no system of controls can prevent errors and fraud. A control system, no matter how well designed and operated, can provide only reasonable, not absolute, assurance that the control system's objectives will be met. Further, the design of a control system must reflect the fact that there are resource constraints, and the benefits of controls must be considered relative to their costs. Because of the inherent limitations in all control systems, no

evaluation of controls can provide absolute assurance that all control issues and instances of fraud, if any, within our company have been detected. These inherent limitations include the realities that judgments in decision-making can be faulty, and that breakdowns can occur. Controls can also be circumvented by individual acts of some people, by collusion of two or more people, or by management override of the controls. The design of any system of controls is based in part upon certain assumptions about the likelihood of future events, and there can be no assurance that any design will succeed in achieving its stated goals under all potential future conditions. Over time, controls may become inadequate because of changes in conditions or deterioration in the degree of compliance with its policies or procedures. Because of the inherent limitations in a cost-effective control system, misstatements due to error or fraud may occur and not be detected.

During the quarter ended January 31, 2006 we recognized that improvements are necessary in the following areas:

- As a result of recent staff changes, maintaining sufficient personnel with an appropriate level of accounting knowledge and experience and training in the application of generally accepted accounting principles (GAAP) commensurate with our financial reporting requirements is needed.

- Improved documentation of procedures and controls for our European operations which had their first significant revenues during this quarter.

We are actively taking steps to address these situations. We also performed additional post-closing procedures to ensure our consolidated financial statements were prepared in accordance with U.S. GAAP. Subject to the limitations above, management believes that the consolidated financial statements and other financial information contained in this report, fairly present in all material respects our financial condition, results of operations, and cash flows for the periods presented.

Based on the evaluation of the effectiveness of our disclosure controls and procedures, our President and Chief Financial Officer concluded that our disclosure controls and procedures were effective for timely gathering, analyzing and disclosing the information required by this report. There were no changes in our internal control over financial reporting that occurred during our most recent fiscal quarter that materially affected, or that are reasonably likely to materially affect, our internal control over financial reporting.

PART II. OTHER INFORMATION

Item 1. Legal Proceedings

None

Item 1A. Risk Factors

No material changes

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

None

Item 3. Defaults Upon Senior Securities

None

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

None

Item 5. Other Information

None

Item 6. Exhibits

31.1	Certification of Morris Sutton pursuant to Section 302 of the Sarbanes-Oxley Act of 2002.
31.2	Certification of John Gross pursuant to Section 302 of the Sarbanes-Oxley Act of 2002.
32.1	Certification of Morris Sutton pursuant to Section 906 of the Sarbanes-Oxley Act of 2002.
32.2	Certification of John Gross pursuant to Section 906 of the Sarbanes-Oxley Act of 2002.

SIGNATURE

Pursuant to the requirements of the Securities Exchange Act of 1934, the registrant has duly caused this report to be signed on its behalf by the undersigned thereunto duly authorized.

MAJESCO ENTERTAINMENT COMPANY
/s/ Morris Sutton
Morris Sutton
Interim Chief Executive Officer

Date: March 13, 2006