

THE EYESHADE REPORT

July 26, 2002

<u>Company:</u> ACCLAIM ENTERTAINMENT, INC.	<u>Address and Phone:</u> One Acclaim Plaza Glen Cove, NY 11542 516-656-5000
Ticker: AKLM	Shares Out (basic): 92.5 M
Exchange: NMS	Float: 51.7 M
Market Cap: \$ 214 M	Short Interest: 13.2 M
P/S: 0.82	Closing Price: (7/26/02): \$ 2.31
P/E: 6.6	52 Week Range: \$ 2.04 - \$6.25

Description of Business: Acclaim Entertainment, Inc. (the "Company" or "AKLM") develops and markets video and computer games for interactive entertainment consoles.

UPDATE: This is an update to our prior reports on AKLM dated June 8, 2002, April 18, 2002 and March 15, 2002.

Summary

- Continued increase in receivables days' sales outstanding.
- Continued decline in allowance for returns and price concessions.
- Increase in prepaid expenses.
- Continued increase in capitalized software development costs.
- Decline in amortization of capitalized software development costs.
- Decline in "other expenses" on the income statement.
- Cash flow from operations would still be negative without capitalizing software development costs.
- Decline in gross profit margin.

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Recent News

For the quarter ended June 2, 2002 (Q3 02), the Company reported revenue of \$62,863,000, slightly below consensus estimates of \$65 million, and earnings per share (“EPS”) of \$0.03, in line with estimates.

In a press release date June 27, 2002, the Company maintained its guidance for revenue for fiscal year 2002 of \$306.8 million and pre-tax earnings per share, excluding one-time items, of 39 cents. However, it increased its guidance for fourth quarter revenue to \$92.2 million from \$90 million.

For fiscal 2003, the Company maintained guidance for revenue of \$379 million and earnings of \$66 million. The Company also reiterated its forecast for fiscal 2004 of revenue of \$502 million and earnings per share of 87 cents.

For Q3 02, the Company reported pretax income of \$2,560,000. However, capitalized software development costs rose to \$6,818,000 in Q3 02 (almost three times (3x) pretax income and compared to an average of \$4,236,000 in capitalized software costs in the prior two quarters and \$2,019,000 capitalized in the year ago quarter); amortization of capitalized software development cost fell to \$1,405,000 versus an average of \$2,931,500 in the prior two quarters; prepaid expenses on its balance sheet rose \$2,110,000 from the prior quarter and “other expenses” on its income statement, which averaged \$2,639,000 in the prior two quarters, suddenly fell to only \$764,000. If the Company’s Q3 02 capitalized software costs,¹ “other expenses”² and amortized software costs³ were at the average level of the prior two quarters, its **reported pretax income of \$2,560,000** would have been **reduced** to a pretax **loss of \$3,423,500**.

In addition, the Company’s receivables days’ sales outstanding rose both sequentially and year-over-year to 105 days in Q3 02 and its reserves declined again.

The various changes in its expenses, combined with the high level of receivables and decline in reserves, leave us very concerned about the quality of the Company’s earnings. A more detailed review follows.

Financial Statement Review

Continued increase in receivables days’ sales outstanding – For the quarter ended June 2, 2002 (Q3 02), the Company’s accounts receivable (“A/R”)⁴ increased by 251% from the year ago quarter, while revenue increased 63%. Sequentially, A/R

¹ . The hypothetical involves subtracting from the reported pretax income, the differences between the reported items and their averages for the prior two quarters. For example, re: capitalized software development costs: \$6,818,000 - \$4,236,000 = \$2,582,000 is subtracted from reported pretax income.

² . \$2,639,000 - \$764,000 = \$1,875,000 is subtracted from reported pretax income.

³ . \$2,931,500 - \$1,405,000 = \$1,526,500 is subtracted from reported pretax income.

⁴ . Beginning with its balance sheet for the quarter ended June 2, 2002 (Q3 02), the Company began to include a separate account for “other receivables.” The calculation above combined “accounts receivable, net” with “other receivables” to arrive at total accounts receivable.

increased 2% while revenue declined by 11%. (**N.B.** The total receivables reported on its 10-Q for Q3 02 were slightly higher (\$73,832,000) than the level reported in its press release dated June 27, 2002 (\$72,187,000). We did not locate an explanation for the difference).⁵

(\$ - 000's)	Q2 02	Q3 02	% change	Q3 01	Q3 02	% change
A/R	72,425	73,832	2%	21,035	73,832	251%
Revenue	70,746	62,863	(11%)	38,642	62,863	63%

Quarterly days' sales in accounts receivable ("DSO" – defined as accounts receivable, net, divided by quarterly revenue/days in the quarter)⁶ increased to 106 days from 49 days in the year ago quarter, and 92 days in the prior quarter.

	Q4 00	Q1 01	Q2 01	Q3 01	Q4 01	Q1 02	Q2 02	Q3 02
Qtr. DSO	21.4	37.1	34.3	49	94.9	88	92.1	105.7

The Company's press release dated June 27, 2002 stated that its accounts receivables days' sales outstanding stood at 59 days at June 2, 2002. However, we do not know how AKLM calculated that number.

When questioned about its high level of DSO's during the Q3 02 conference call, Company officials refused to answer the question and hung up on the caller. When that same caller attempted to call back again, after the moderator announced the caller's name⁷ his telephone call was "disconnected" before he could ask a question.

Continued decline in allowance for returns and price concessions – For the quarter ended June 2, 2002 (Q3 02), the Company's allowance for returns and price concessions ("Allowance" or "All.") declined by double-digit amounts sequentially and year-over-year, while its accounts receivable increased by 251% on a year-over-year basis and by 2% sequentially.

(\$ - 000's)	Q2 02	Q3 02	% change	Q3 01	Q3 02	% change
A/R	72,425	73,832	2%	21,035	73,832 ⁸	251%
Allowance	7,870	5,851	(26%)	24,796	5,851	(76%)

⁵ . The valuation of its long-term assets also changed – declining to \$45,360,000 on its 10-Q from \$47,005,000 on its press release. We did not locate an explanation for the decline, though we note it offsets the increase in accounts receivable.

⁶ . All calculations in the table assume 90 days in each quarter.

⁷ . The caller was Marc Cohodes of Rocker Partners.

⁸ . This figure combines the "accounts receivable, net" and "other receivables" accounts from the Company's balance sheet.

In addition, the allowance level at June 2, 2002 represented the lowest dollar amount and the lowest percentage (at 8%) of allowances to accounts receivable (“All./A/R”) at any time in the periods examined in the following table.

(\$ - 000's)	Q2 02	Q3 01	Q4 01	Q1 02	Q2 02	Q3 02
A/R, net	15,344	21,035	49,074	79,188	72,425	73,832
All.	34,791	24,796	16,847	13,808	7,870	5,851
All./A/R	227%	118%	34%	17%	11%	7.9%

This level of allowances to accounts receivable is the lowest level of any period we examined back as far as Q2 97.⁹ **N.B.** – The “Allowance” amount included in the above table¹⁰ is only the Company’s allowance for returns and price concession, which is a contra-asset account. The Company apparently also has what it calls a “channel reserve” account, which is a liability account that the Company discloses in its allowance for returns and discounts in its 10-K’s,¹¹ but we did not locate in its 10-Q presentations.¹²

While we did not locate the amount of the Company’s “channel reserves” for this quarter or the year ago quarter, the combined reserves (i.e., the allowance for returns and price concessions plus channel reserves) appear to have declined sequentially on a percentage basis as a Company official stated during the Q3 02 conference call that reserves were 14% versus 17.2% at the end of the second quarter of fiscal 2002.¹³

	Q2 02	Q3 02
Combined Reserves	17.2%	14%

Increase in prepaid expenses - For the quarter ended June 2, 2002 (Q3 02), the Company’s asset account on its balance sheet entitled “prepaid expenses” (“Pre. Ex.”) increased by 415% from the year ago quarter, while revenue increased 63%. Sequentially, prepaid expenses increased 36% while revenue declined by 11%.

(\$ - 000's)	Q2 02	Q3 02	% change	Q3 01	Q3 02	% change
Pre. Ex.	5,849	7,959	36%	1,545	7,959	415%
Revenue	70,746	62,863	(11%)	38,642	62,863	63%

We have insufficient information to determine whether the increase in prepaid expenses in Q3 02 was a result of the Company capitalizing as an asset on its balance

⁹ . For a table of the Company’s allowances to accounts receivable ratio back to Q2 97, please see our prior report on the Company dated March 15, 2002, pp. 7-8.

¹⁰ . And in the tables on pp. 7-8 in our previous report dated March 15, 2002

¹¹ . AKLM, 10-K (8/31/01 filed 11/29/01), p. 78.

¹² . During the Q2 02 conference call with analysts on April 11, 2002, the Company’s spokesman, Gerard F. Agoglia, CFO, stated: “...reserves for accounts receivable include our allowance for returns and price concessions, which is a contra-asset account, and our channel reserves, a liability account found in accrued sales allowances, amount to 17.2%.”

¹³ . Per the Q2 02 conference call.

sheet items that it previously expensed on its income statement. However, we become concerned when prepaid expenses increase at such a faster rate than revenue.

Continued increase in capitalized software development costs – In the quarter ended June 2, 2002 (Q3 02), AKLM capitalized \$6,818,000 in software development costs.¹⁴ This represented a more than 50% increase in the amount capitalized versus the prior quarter and almost as much as was capitalized in the entire fiscal year ended August 31, 2002 (FY 01).

(\$ - 000's)	FY 00	FY 01	Q1 02	Q2 02	Q3 02
Capitalized Software¹⁵	0	7,404	4,149	4,323	6,818

Capitalizing software development costs is within GAAP.¹⁶ However, companies have flexibility in how much cost is capitalized¹⁷ (and some do not capitalize any costs, including another company in the game software business, Electronic Arts, Inc. (ticker: ERTS)).¹⁸ Each dollar that is capitalized represents one less dollar appearing as an expense on a company's income statement.

Decline in amortization of capitalized software development costs – Despite the increase in capitalized software development costs, in the quarter ended June 2, 2002 (Q3 02), the amount of capitalized software development costs amortized (“Amort. software”) declined to \$1,405,000¹⁹ from \$3,237,000 in the prior quarter.

¹⁴. Calculated by taking the capitalized software development costs at the end of Q3 02 from the statement of cash flows from investing activities (\$15,290,000) and subtracting from that the level at the end of Q2 02 (\$8,472,000).

¹⁵. The figures in this table are taken from the Company's statement of cash flows from investing activities.

¹⁶. SFAS No. 86 provides that costs incurred to create a computer software product or to develop an enhancement to an existing product are expensed until technological feasibility for the product is established. Thereafter, all software development costs are capitalized and reported at the lower of unamortized cost or net realizable value. Capitalization ceases when the product or enhancement is available for general release to customers.

¹⁷. SFAS No. 86 provides that technological feasibility is achieved when all planning, designing, coding and testing activities have been completed to the extent necessary to show that the application can meet its design specifications. Hence, software costs can be capitalized once a detailed design program is complete and any large development issues are overcome. Therefore, the later a company waits in the development process to prepare a detailed program design, the less costs it can capitalize.

¹⁸. Electronic Arts, Inc. (ticker: ERTS) states: “Research and development costs, which consist primarily of software development costs, are expensed as incurred.” ERTS, 10-K (3/31/01), p. 53. Similarly, Microsoft Corp. (ticker: MSFT) does not capitalize any software development costs stating: “Research and development costs are expensed as incurred. Statement of Financial Accounting Standards (SFAS) 86, Accounting for the Costs of Computer Software to Be Sold, Leased, or Otherwise Marketed, does not materially affect the Company.” MSFT, 10-K (6/30/01), p. 31.

¹⁹. Calculated by taking the “amortization of capitalized software development costs” at Q3 02 from the statement of cash flows from operating activities (\$7,268,000) and subtracting the Q2 02 amount of that same account (\$5,863,000).

\$ - in 000's	Q1 02	Q2 02	Q3 02
Amort. Software	2,626	3,237	1,405

Decline in “other expenses” on the income statement – In the quarter ended June 2, 2002 (Q3 02), the Company experienced an unusual decline in the “other expense” account (“Oth. Exp.”) on its income statement.

	Q3 01	Q4 01	Q1 02	Q2 02	Q3 02
Oth. Exp.	2,176	2,667	3,022	2,256	764

We did not find an explanation for the sudden decline in “other expenses.”²⁰

Cash flow from operations would still be negative without capitalizing software development costs – For the nine months ended June 2, 2002, the Company reported positive cash flow from operations (“CFFO”) of \$9,184,000. However, the CFFO was enhanced by the Company’s increased capitalization of software development costs.²¹ Had the Company expensed the software development costs, its cash flows from operations would have been a **negative \$6,106,000**.

(\$ - in thousands)	9 months to 6/2/01 ²²	9 months to 6/2/02
Reported net income	18,715	23,697
Reported CFFO	(5,775)	9,184
Capitalized software development costs	(3,543)	(15,290)
CFFO minus capitalized software costs	(9,318)	(6,106)

²⁰ . The only reference to “other expenses” we found in the Company’s most recently filed 10-Q was the Company’s following statement: “Commencing in September 2001, the Company was required to make a \$336 monthly payment to certain investors in connection with the July 2001 private placement of common stock, until the resale of the shares of common stock issued in connection with the private placement were registered with the SEC. During the nine months ended June 2, 2002, the Company paid an aggregate of \$1,008 to the investors, which is included in the Company’s other expenses.” AKLM, 10-Q (6/2/02), p. 15.

²¹ . We believe it is useful to subtract capitalized software development costs in calculating CFFO because when a company capitalizes software development costs instead of expensing them, it is reported on the statement of cash flows as an investing activity, **not** an operating activity. Additionally, the cost does not lower net income on the income statement because it is capitalized. Hence, it does not lower the top line (the net income line) of the statement of cash flows from operations. The company does incur an expense on its income statement for the amortization of the software development costs, but that amortization is added back to net income when determining the cash flows from operating activities. Thus, the amortization is a “wash” from the perspective of the statement of cash flows from operating activities. Nonetheless, the development costs are a true “cash” expense for the company and, in our opinion, represent a use of cash for operating activities.

²² . The CFFO number for the nine months ended 6/2/01 was “reclassified” with the 10-Q filed for the quarter ended 6/2/02 from the original financial statements. The figures in the table above for the nine months ended 6/2/01 were taken from the Company’s most recently filed 10-Q.

Decline in gross profit margin – For the quarter ended June 2, 2002 (Q3 02), the Company’s gross profit margin (“GPM” - calculated as gross profit divided by revenue), declined to 57.5% from 71% in the year ago quarter and 58.6% in the previous quarter.

	Q1 01	Q2 01	Q3 01	Q4 01	Q1 02	Q2 02	Q3 02
GPM	66.6%	66.3%	70.8%	71.8%	63.9%	58.6%	57.5%

The Company attributed the decline in gross profit to “...primarily a result of the amortization of capitalized software development costs, included in cost of revenues, off-price sales of catalog software at lower margins to certain customers in a relatively new distribution channel and sales of software in the rental market.”²³

However, if the amortization of capitalized software development costs were added back to gross profit for Q3 02²⁴ and Q3 01,²⁵ the gross profit margins would have been as follows.

GPM Adjusted to Excluded Amortization of Capitalized Software

	Q3 01	Q3 02
Adjusted GPM	72.5%	59.8%

The previous table indicates that the amount of the decline attributable to the amortized software development cost is relatively small. Thus, it appears that most of the year-over-year decline in gross profit margin is due to “...off-price sales of catalog software at lower margins to certain customers in a relatively new distribution channel and sales of software in the rental market.”

With the large increase in days’ sales in receivables and the decline in gross profit margin due to “off-price sales” in “a relatively new distribution channel,” we wonder if the Company is extending generous payment terms to this lower margin “relatively new distribution channel” in order to increase revenue, while utilizing the various accounting adjustments described in this report in order to meet EPS guidance.

²³ . AKLM, 10-Q (6/2/02), p. 27.

²⁴ . Assuming Q3 02 amortization of \$1,405,000.

²⁵ . Assuming Q3 01 amortization of \$626,000.

1-Year Stock Chart



Chart courtesy of StockCharts.com (<http://stockcharts.com>).

12 Month Short Interest Data

Settlement Date	Short Interest	Ave. Dly. Vol.	Days to Cover
Jul. 15, 2002	13,192,420	1,690,505	7.80
Jun. 14, 2002	11,856,151	1,488,119	7.97
May 15, 2002	11,009,448	1,515,062	7.27
Apr. 15, 2002	9,427,876	1,357,492	6.95
Mar. 15, 2002	8,965,420	1,046,603	8.57
Feb. 15, 2002	9,429,169	1,725,981	5.46
Jan. 15, 2002	7,216,370	1,314,888	5.49
Dec. 14, 2001	7,311,744	2,062,804	3.54
Nov. 15, 2001	5,998,486	1,305,833	4.59
Oct. 15, 2001	4,737,376	771,562	6.14
Sep. 14, 2001	3,718,779	802,822	4.63
Aug. 15, 2001	2,969,453	970,582	3.06

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