

Activision Blizzard, Inc.
Form 10-Q
November 08, 2018
[Table of Contents](#)

UNITED STATES
SECURITIES AND EXCHANGE COMMISSION

Washington, D.C. 20549

FORM 10-Q

(Mark one)

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

For the Quarterly Period Ended September 30, 2018

OR

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

For the transition period from _____ to _____

Commission File Number 1-15839

ACTIVISION BLIZZARD, INC.

(Exact name of registrant as specified in its charter)

Delaware

(State or other jurisdiction of
incorporation or organization)

95-4803544

(I.R.S. Employer Identification No.)

3100 Ocean Park Boulevard, Santa Monica, CA
(Address of principal executive offices)

90405
(Zip Code)

(310) 255-2000

(Registrant's telephone number, including area code)

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 has submitted electronically every Interactive Data File required to be submitted pursuant to Rule 405 of Regulation S-T (§232.405 of this chapter) during the preceding 12 months (or for such shorter period that the registrant was required to submit such files). Yes No

Indicate by check mark whether the registrant is a large accelerated filer, an accelerated filer, a non-accelerated filer, smaller reporting company, or an emerging growth company. See the definitions of large accelerated filer, accelerated filer, smaller reporting company, and emerging growth company in Rule 12b-2 of the Exchange Act.

Large Accelerated Filer

Accelerated Filer

Non-accelerated filer

Smaller reporting company

Emerging growth company

If an emerging growth company, indicate by check mark if the registrant has elected not to use the extended transition period for complying with any new or revised financial accounting standards provided pursuant to Section 13(a) of the Exchange Act.

Edgar Filing: Activision Blizzard, Inc. - Form 10-Q

Indicate by check mark whether the registrant is a shell company (as defined in Rule 12b-2 of the Exchange Act). Yes No

The number of shares of the registrant's Common Stock outstanding at November 1, 2018 was 763,050,718.

--

Table of Contents

ACTIVISION BLIZZARD, INC. AND SUBSIDIARIES

Table of Contents

	<u>Cautionary Statement</u>	3
<u>PART I.</u>	<u>FINANCIAL INFORMATION</u>	
<u>Item 1.</u>	<u>Financial Statements (Unaudited)</u>	
	<u>Condensed Consolidated Balance Sheets at September 30, 2018 and December 31, 2017</u>	4
	<u>Condensed Consolidated Statements of Operations for the three and nine months ended September 30, 2018 and September 30, 2017</u>	5
	<u>Condensed Consolidated Statements of Comprehensive Income for the three and nine months ended September 30, 2018 and September 30, 2017</u>	6
	<u>Condensed Consolidated Statements of Cash Flows for the nine months ended September 30, 2018 and September 30, 2017</u>	7
	<u>Condensed Consolidated Statement of Changes in Shareholders' Equity for the nine months ended September 30, 2018</u>	8
	<u>Notes to Condensed Consolidated Financial Statements</u>	9
<u>Item 2.</u>	<u>Management's Discussion and Analysis of Financial Condition and Results of Operations</u>	41
<u>Item 3.</u>	<u>Quantitative and Qualitative Disclosures About Market Risk</u>	71
<u>Item 4.</u>	<u>Controls and Procedures</u>	73
<u>PART II.</u>	<u>OTHER INFORMATION</u>	73
<u>Item 1.</u>	<u>Legal Proceedings</u>	73
<u>Item 1A.</u>	<u>Risk Factors</u>	74
<u>Item 6.</u>	<u>Exhibits</u>	74
<u>EXHIBIT INDEX</u>		75
<u>SIGNATURE</u>		76
<u>CERTIFICATIONS</u>		

Table of Contents

CAUTIONARY STATEMENT

This Quarterly Report on Form 10-Q contains, or incorporates by reference, certain forward-looking statements within the meaning of the Private Securities Litigation Reform Act of 1995. Such statements consist of any statement other than a recitation of historical facts and include, but are not limited to: (1) projections of revenues, expenses, income or loss, earnings or loss per share, cash flow, or other financial items; (2) statements of our plans and objectives, including those related to releases of products or services; (3) statements of future financial or operating performance, including the impact of tax items thereon; and (4) statements of assumptions underlying such statements. Activision Blizzard, Inc. generally uses words such as outlook, forecast, will, could, should, would, to be, plan, plans, believes, may, might, expects, intends, intends as, anticipates, estimate, future, positioned, potential, project, remain, scheduled, set to, subject to, upcoming and other similar expressions to help identify forward-looking statements. Forward-looking statements are subject to business and economic risks, reflect management's current expectations, estimates and projections about our business, and are inherently uncertain and difficult to predict.

The company cautions that a number of important factors could cause Activision Blizzard, Inc.'s actual future results and other future circumstances to differ materially from those expressed in any forward-looking statements. Such factors include, but are not limited to: sales levels of Activision Blizzard, Inc.'s titles, products, and services; concentration of revenue among a small number of titles; Activision Blizzard, Inc.'s ability to predict consumer preferences, including interest in specific genres and modes and preferences among platforms; the continued growth in the scope and complexity of our business, including the diversion of management time and attention to issues relating to the operations of our newly acquired or started businesses and the potential impact of our expansion into new businesses on our existing businesses; the amount of our debt and the limitations imposed by the covenants in the agreements governing our debt; counterparty risks relating to customers, licensees, licensors, and manufacturers; maintenance of relationships with key personnel, customers, financing providers, licensees, licensors, manufacturers, vendors, and third-party developers, including the ability to attract, retain, and motivate key personnel and developers that can create high-quality titles, products, and services; changing business models within the video game industry, including digital delivery of content and the increased prevalence of free-to-play games; product delays or defects; competition, including from other forms of entertainment; rapid changes in technology and industry standards; possible declines in software pricing; product returns and price protection; the identification of suitable future acquisition opportunities and potential challenges associated with geographic expansion; the seasonal and cyclical nature of the interactive entertainment market; the outcome of current or future tax disputes; litigation risks and associated costs; protection of proprietary rights; potential data breaches and other cybersecurity risks; shifts in consumer spending trends; capital market risks; the impact of applicable laws, rules, and regulations, including changes in those laws, rules, and regulations; domestic and international economic, financial, and political conditions and policies; tax rates and foreign exchange rates; the impact of the current macroeconomic environment; and the other factors identified in Risk Factors included in Part I, Item 1A of our Annual Report on Form 10-K for the year ended December 31, 2017.

The forward-looking statements contained herein are based on information available to Activision Blizzard, Inc. as of the date of this filing and we assume no obligation to update any such forward-looking statements. Although these forward-looking statements are believed to be true when made, they may ultimately prove to be incorrect. These statements are not guarantees of our future performance and are subject to risks, uncertainties and other factors, some of which are beyond our control and may cause actual results to differ materially from current expectations.

Activision Blizzard, Inc.'s names, abbreviations thereof, logos, and product and service designators are all either the registered or unregistered trademarks or trade names of Activision Blizzard, Inc. All other product or service names are the property of their respective owners. All dollar amounts referred to in, or contemplated by, this Quarterly Report on Form 10-Q refer to United States (U.S.) dollars, unless otherwise explicitly stated to the contrary.

Table of Contents**PART I. FINANCIAL INFORMATION****Item 1. Financial Statements****ACTIVISION BLIZZARD, INC. AND SUBSIDIARIES****CONDENSED CONSOLIDATED BALANCE SHEETS**

(Unaudited)

(Amounts in millions, except share data)

	At September 30, 2018	At December 31, 2017
Assets		
Current assets:		
Cash and cash equivalents	\$ 3,308	\$ 4,713
Accounts receivable, net of allowances of \$119 and \$279, at September 30, 2018 and December 31, 2017, respectively	641	918
Inventories, net	174	46
Software development	348	367
Other current assets	501	476
Total current assets	4,972	6,520
Software development	174	86
Property and equipment, net	281	294
Deferred income taxes, net	243	459
Other assets	454	440
Intangible assets, net	826	1,106
Goodwill	9,763	9,763
Total assets	\$ 16,713	\$ 18,668
Liabilities and Shareholders' Equity		
Current liabilities:		
Accounts payable	\$ 312	\$ 323
Deferred revenues	1,017	1,929
Accrued expenses and other liabilities	1,053	1,411
Total current liabilities	2,382	3,663
Long-term debt, net	2,670	4,390
Deferred income taxes, net	11	21
Other liabilities	991	1,132
Total liabilities	6,054	9,206
Commitments and contingencies (Note 16)		
Shareholders' equity:		
Common stock, \$0.000001 par value, 2,400,000,000 shares authorized, 1,191,665,508 and 1,186,181,666 shares issued at September 30, 2018 and December 31, 2017, respectively		
Additional paid-in capital	10,928	10,747
Less: Treasury stock, at cost, 428,676,471 shares at September 30, 2018 and December 31, 2017	(5,563)	(5,563)

Edgar Filing: Activision Blizzard, Inc. - Form 10-Q

Retained earnings	5,907	4,916
Accumulated other comprehensive loss	(613)	(638)
Total shareholders' equity	10,659	9,462
Total liabilities and shareholders' equity	\$ 16,713	\$ 18,668

The accompanying notes are an integral part of these Condensed Consolidated Financial Statements.

Table of Contents**ACTIVISION BLIZZARD, INC. AND SUBSIDIARIES****CONDENSED CONSOLIDATED STATEMENTS OF OPERATIONS**

(Unaudited)

(Amounts in millions, except per share data)

	For the Three Months Ended September 30,		For the Nine Months Ended September 30,	
	2018	2017	2018	2017
Net revenues				
Product sales	\$ 263	\$ 384	\$ 1,447	\$ 1,373
Subscription, licensing, and other revenues	1,249	1,234	3,672	3,601
Total net revenues (Note 2)	1,512	1,618	5,119	4,974
Costs and expenses				
Cost of revenues product sales:				
Product costs	127	149	416	422
Software royalties, amortization, and intellectual property licenses	20	37	214	200
Cost of revenues subscription, licensing, and other revenues:				
Game operations and distribution costs	257	249	777	717
Software royalties, amortization, and intellectual property licenses	109	117	278	359
Product development	263	273	776	750
Sales and marketing	263	345	741	899
General and administrative	208	191	623	539
Total costs and expenses	1,247	1,361	3,825	3,886
Operating income	265	257	1,294	1,088
Interest and other expense (income), net	13	37	67	109
Loss on extinguishment of debt	40		40	12
Income before income tax expense (benefit)	212	220	1,187	967
Income tax expense (benefit)	(48)	32	25	109
Net income	\$ 260	\$ 188	\$ 1,162	\$ 858
Earnings per common share				
Basic	\$ 0.34	\$ 0.25	\$ 1.53	\$ 1.14
Diluted	\$ 0.34	\$ 0.25	\$ 1.51	\$ 1.12
Weighted-average number of shares outstanding				
Basic	763	755	761	753
Diluted	771	766	771	764

The accompanying notes are an integral part of these Condensed Consolidated Financial Statements.

Table of Contents

ACTIVISION BLIZZARD, INC. AND SUBSIDIARIES

CONDENSED CONSOLIDATED STATEMENTS OF COMPREHENSIVE INCOME

(Unaudited)

(Amounts in millions)

	For the Three Months Ended September 30,		For the Nine Months Ended September 30,	
	2018	2017	2018	2017
Net income	\$ 260	\$ 188	\$ 1,162	\$ 858
Other comprehensive income (loss):				
Foreign currency translation adjustment	3	9	(7)	36
Unrealized gains (losses) on forward contracts designated as hedges, net of tax	(11)	(8)	25	(45)
Unrealized gains (losses) on investments, net of tax		(3)	4	(4)
Total other comprehensive income (loss)	\$ (8)	\$ (2)	\$ 22	\$ (13)
Comprehensive income	\$ 252	\$ 186	\$ 1,184	\$ 845

The accompanying notes are an integral part of these Condensed Consolidated Financial Statements.

Table of Contents

ACTIVISION BLIZZARD, INC. AND SUBSIDIARIES

CONDENSED CONSOLIDATED STATEMENTS OF CASH FLOWS

(Unaudited)

(Amounts in millions)

	For the Nine Months Ended September 30,	
	2018	2017
Cash flows from operating activities:		
Net income	\$ 1,162	\$ 858
Adjustments to reconcile net income to net cash provided by operating activities:		
Deferred income taxes	175	(138)
Depreciation and amortization	385	670
Amortization of capitalized software development costs and intellectual property licenses (1)	238	202
Loss on extinguishment of debt (Note 10)	40	12
Amortization of debt discount and financing costs	5	10
Share-based compensation expense (2)	164	118
Other	15	24
Changes in operating assets and liabilities:		
Accounts receivable, net	290	(140)
Inventories	(127)	(50)
Software development and intellectual property licenses	(305)	(227)
Other assets	(15)	(70)
Deferred revenues	(710)	(320)
Accounts payable	(14)	78
Accrued expenses and other liabilities	(512)	28
Net cash provided by operating activities	791	1,055
Cash flows from investing activities:		
Purchases of available-for-sale investments	(59)	(80)
Capital expenditures	(97)	(86)
Other investing activities	(4)	3
Net cash used in investing activities	(160)	(163)
Cash flows from financing activities:		
Proceeds from issuance of common stock to employees	91	150
Tax payment related to net share settlements on restricted stock units	(85)	(44)
Dividends paid	(259)	(226)
Proceeds from debt issuances, net of discounts		3,741
Repayment of long-term debt	(1,740)	(4,251)
Premium payment for early redemption of note (Note 10)	(25)	
Other financing activities	(2)	(10)
Net cash used in financing activities	(2,020)	(640)
Effect of foreign exchange rate changes on cash and cash equivalents	(15)	72
Net increase (decrease) in cash and cash equivalents and restricted cash	(1,404)	324
Cash and cash equivalents and restricted cash at beginning of period	4,720	3,262
Cash and cash equivalents and restricted cash at end of period	\$ 3,316	\$ 3,586

(1) Excludes deferral and amortization of share-based compensation expense.

(2) Includes the net effects of capitalization, deferral, and amortization of share-based compensation expense.

Edgar Filing: Activision Blizzard, Inc. - Form 10-Q

The accompanying notes are an integral part of these Condensed Consolidated Financial Statements.

Table of Contents

ACTIVISION BLIZZARD, INC. AND SUBSIDIARIES

CONDENSED CONSOLIDATED STATEMENTS OF CHANGES IN SHAREHOLDERS' EQUITY

For the Nine Months Ended September 30, 2018

(Unaudited)

(Amounts and shares in millions, except per share data)

	Common Stock		Treasury Stock		Additional	Retained	Accumulated	Total
	Shares	Amount	Shares	Amount	Paid-In	Earnings	Other	Shareholders
					Capital		Comprehensive	Equity
							Income (Loss)	
Balance at								
December 31, 2017	1,186	\$	(429)	\$ (5,563)	\$ 10,747	\$ 4,916	\$ (638)	\$ 9,462
Cumulative impact from adoption of new revenue accounting standard (Note 3)						88	3	91
Components of comprehensive income:								
Net income						1,162		1,162
Other comprehensive income (loss)							22	22
Issuance of common stock pursuant to employee stock options	5				93			93
Issuance of common stock pursuant to restricted stock units	2							
Restricted stock surrendered for employees' tax liability	(1)				(86)			(86)
Share-based compensation expense related to employee stock options and restricted stock units					174			174
Dividends (\$0.34 per common share)						(259)		(259)
Balance at								
September 30, 2018	1,192	\$	(429)	\$ (5,563)	\$ 10,928	\$ 5,907	\$ (613)	\$ 10,659

The accompanying notes are an integral part of these Condensed Consolidated Financial Statements.

Table of Contents

ACTIVISION BLIZZARD, INC. AND SUBSIDIARIES

Notes to Condensed Consolidated Financial Statements

(Unaudited)

1. Description of Business and Basis of Consolidation and Presentation

Activision Blizzard, Inc. is a leading global developer and publisher of interactive entertainment content and services. We develop and distribute content and services on video game consoles, personal computers (PC), and mobile devices. We also operate esports events and leagues and create film and television content based on our intellectual property. The terms Activision Blizzard, the Company, we, us, and our are used to refer collectively to Activision Blizzard, Inc. and its subsidiaries.

The Company was originally incorporated in California in 1979 and was reincorporated in Delaware in December 1992. In connection with the 2008 business combination by and among the Company (then known as Activision, Inc.), Vivendi S.A. (Vivendi), and Vivendi Games, Inc., then an indirect wholly-owned subsidiary of Vivendi, we were renamed Activision Blizzard, Inc.

The common stock of Activision Blizzard is traded on The Nasdaq Stock Market under the ticker symbol ATVI.

Our Segments

Based upon our organizational structure, we conduct our business through three reportable segments, as follows:

(i) Activision Publishing, Inc.

Activision Publishing, Inc. (Activision) is a leading global developer and publisher of interactive software products and entertainment content, particularly for the console platforms. Activision primarily delivers content through retail and digital channels, including full-game and in-game sales, as well as by licensing software to third-party or related-party companies that distribute Activision products. Activision develops, markets, and sells products based on our internally developed intellectual properties, as well as some licensed properties. We have also established a long-term alliance with Bungie to publish its game universe, Destiny.

Activision's key product franchises include: Call of Duty®, a first-person shooter for the console and PC platforms; and Destiny, an online universe of first-person action gameplay (which we call a shared-world shooter) for the console and PC platforms.

(ii) *Blizzard Entertainment, Inc.*

Blizzard Entertainment, Inc. (*Blizzard*) is a leading global developer and publisher of interactive software products and entertainment content, particularly for the PC platform. *Blizzard* primarily delivers content through retail and digital channels, including subscriptions, full-game, and in-game sales, as well as by licensing software to third-party or related-party companies that distribute *Blizzard* products. *Blizzard* also maintains a proprietary online gaming service, *Blizzard Battle.net®*, which facilitates digital distribution of *Blizzard* content and selected Activision content, online social connectivity, and the creation of user-generated content. *Blizzard* also includes the activities of the *Overwatch League™*, the first major global professional esports league with city-based teams, and our Major League Gaming (*MLG*) business, which is responsible for various esports events and serves as a multi-platform network for Activision *Blizzard* esports content.

Blizzard's key product franchises include: *World of Warcraft®*, a subscription-based massive multi-player online role-playing game for the PC platform; *StarCraft®*, a real-time strategy franchise for the PC platform; *Diablo®*, an action role-playing franchise for the PC and console platforms; *Hearthstone®*, an online collectible card franchise for the PC and mobile platforms; *Heroes of the Storm®*, a free-to-play team brawler for the PC platform; and *Overwatch®*, a team-based first-person shooter for the PC and console platforms.

Table of Contents

(iii) King Digital Entertainment

King Digital Entertainment (King) is a leading global developer and publisher of interactive entertainment content and services, particularly on mobile platforms, such as Google Inc. s (Google) Android and Apple Inc. s (Apple) iOS. King also distributes its content and services on the PC platform, primarily via Facebook. King s games are free to play, however, players can acquire in-game items, either with virtual currency or directly using real currency.

King s key product franchises, all of which are for the mobile and PC platforms, include: Candy Crush , which features match three games; Farm Heroes , which also features match three games; and Bubble Witch , which features bubble shooter games.

Other

We also engage in other businesses that do not represent reportable segments, including:

- the Activision Blizzard Studios (Studios) business, which is devoted to creating original film and television content based on our library of globally recognized intellectual properties, and which, in September 2018, released the third season of the animated TV series *Skylanders Academy* on Netflix; and
- the Activision Blizzard Distribution (Distribution) business, which consists of operations in Europe that provide warehousing, logistics, and sales distribution services to third-party publishers of interactive entertainment software, our own publishing operations, and manufacturers of interactive entertainment hardware.

Basis of Consolidation and Presentation

The accompanying unaudited condensed consolidated financial statements have been prepared in accordance with the rules and regulations of the Securities and Exchange Commission (the SEC) and accounting principles generally accepted in the United States of America (U.S. GAAP) for interim reporting. Accordingly, certain notes or other information that are normally required by U.S. GAAP have been condensed or omitted if they substantially duplicate the disclosures contained in our annual audited consolidated financial statements. The year-end condensed consolidated balance sheet data was derived from audited financial statements but does not include all disclosures required by U.S. GAAP. Accordingly, the unaudited condensed consolidated financial statements should be read in conjunction with the audited consolidated financial statements and notes thereto included in our Annual Report on Form 10-K for the year ended December 31, 2017.

The preparation of the condensed consolidated financial statements in conformity with U.S. GAAP requires management to make estimates and assumptions that affect the amounts reported in the condensed consolidated financial statements and accompanying notes. In the opinion of

Edgar Filing: Activision Blizzard, Inc. - Form 10-Q

management, all adjustments (consisting of normal recurring accruals) considered necessary for the fair statement of our financial position and results of operations in accordance with U.S. GAAP have been included in the accompanying unaudited condensed consolidated financial statements. Actual results could differ from these estimates and assumptions.

The accompanying condensed consolidated financial statements include the accounts and operations of the Company. All intercompany accounts and transactions have been eliminated. Certain reclassifications have been made to prior year amounts to conform to the current period presentation.

The Company considers events or transactions that occur after the balance sheet date, but before the financial statements are issued, to provide additional evidence relative to certain estimates or to identify matters that require additional disclosures.

Table of Contents

Supplemental Cash Flow Information

For the nine months ended September 30, 2018, the beginning and ending cash and cash equivalents and restricted cash reported within our condensed consolidated statement of cash flows include restricted cash of \$7 million and \$8 million, respectively. For the nine months ended September 30, 2017, the beginning and ending cash and cash equivalents and restricted cash reported within our condensed consolidated statement of cash flows included restricted cash of \$17 million and \$10 million, respectively.

2. Summary of Significant Accounting Policies

During the nine months ended September 30, 2018, there were no significant changes to our accounting policies, except for our adoption of a new revenue accounting standard as discussed below. Refer to Note 2 contained in our Annual Report on Form 10-K for the year ended December 31, 2017 for a summary of our other significant accounting policies.

Adoption of Accounting Standards Codification 606: Revenue from Contracts with Customers

In May 2014, the Financial Accounting Standards Board (FASB) issued new accounting guidance related to revenue recognition. The new standard replaces all current U.S. GAAP guidance on this topic, eliminating all industry-specific guidance and providing a unified model to determine when and how revenue is recognized. The core principle is that a company should recognize revenue upon the transfer of promised goods or services to customers in an amount that reflects the consideration to which the company expects to be entitled in exchange for those goods or services. On January 1, 2018, we adopted the new accounting standard and related amendments (collectively, the new revenue accounting standard). As a result, we have updated our significant accounting policy disclosure for revenue recognition herein. Refer to Note 3 for the impact of adoption on our condensed consolidated financial statements.

Revenue Recognition

We generate revenue primarily through the sale of our interactive entertainment content and services, principally for console, PC, and mobile devices, as well as through the licensing of our intellectual property. Our products span various genres, including first-person shooter, action/adventure, role-playing, strategy, and match three, among others. We primarily offer the following products and services:

- full games, which typically provide access to main game content, primarily for console or PC;
- downloadable content, which provides players with additional in-game content to purchase following the purchase of a full game;

Edgar Filing: Activision Blizzard, Inc. - Form 10-Q

- microtransactions, which typically provide relatively small pieces of additional in-game content or enhancements to gameplay; and
- subscriptions to players in our World of Warcraft franchise, which provide continual access to the game content.

When control of the promised products and services is transferred to our customers, we recognize revenue in the amount that reflects the consideration we expect to receive in exchange for these products and services.

We determine revenue recognition by:

- identifying the contract, or contracts, with a customer;
- identifying the performance obligations in the contract;

Table of Contents

- determining the transaction price;
- allocating the transaction price to performance obligations in the contract; and
- recognizing revenue when, or as, we satisfy performance obligations by transferring the promised goods or services.

Certain products are sold to customers with a *street date* (which is the earliest date these products may be sold by retailers). For these products, we recognize revenues on the later of the street date and the date the product is sold to our customer. For digital full-game downloads sold to customers, we recognize revenue when it is available for download or is activated for gameplay. Revenues are recorded net of taxes assessed by governmental authorities that are imposed at the time of the specific revenue-producing transaction between us and our customer, such as sales and value-added taxes.

Payment terms and conditions vary by contract type, although terms generally include a requirement of payment immediately upon purchase or within 30 to 90 days. In instances where the timing of revenue recognition differs from the timing of invoicing, we do not adjust the promised amount of consideration for the effects of a significant financing component when we expect, at contract inception, that the period between our transfer of a promised product or service to our customer and payment for that product or service will be one year or less.

Product Sales

Product sales consist of sales of our games, including physical products and digital full-game downloads. We recognize revenues from the sale of our products after both (1) control of the products has been transferred to our customers and (2) underlying performance obligations have been satisfied.

Revenues from product sales are recognized after deducting the estimated allowance for returns and price protection, which are accounted for as variable consideration when estimating the amount of revenue to recognize. Returns and price protection are estimated at contract inception and updated at the end of each reporting period as additional information becomes available.

Sales incentives and other consideration given by us to our customers, such as rebates and product placement fees, are considered adjustments of the transaction price of our products and are reflected as reductions to revenues. Sales incentives and other consideration that represent costs incurred by us for distinct goods or services received, such as the appearance of our products in a customer's national circular ad, are recorded as *Sales and marketing* expense when the benefit from the sales incentive is separable from sales to the same customer and we can reasonably estimate the fair value of the good or service.

Products with Online Functionality

For our software products that include both offline functionality (i.e., do not require an Internet connection to access) and significant online functionality, such as titles for the Call of Duty franchise, we evaluate whether the license of our intellectual property and the online functionality are distinct and separable. This evaluation is performed for each software product or product add-on, including downloadable content. If we determine that our software products contain a license of intellectual property separate from the online functionality, we consider market conditions and other observable inputs to estimate the transaction price for the license, since we do not generally sell the software license on a standalone basis. These products may be sold in a bundle with other products and services, which often results in the recognition of additional performance obligations.

We recognize revenue for arrangements that include both a license of intellectual property and separate online functionality when control of the license transfers to our customers for the portion of the transaction price allocable to the license and ratably over the estimated service period for the portion of the transaction price allocable to the online functionality. Similarly, we defer a portion of the cost of revenues on these arrangements and recognize the costs as the related revenues are recognized. The cost of revenues that are deferred include product costs, distribution costs, and software royalties, amortization, and intellectual property licenses, and excludes intangible asset amortization.

Table of Contents

Online Hosted Software Arrangements

For our online hosted software arrangements, such as titles for the Destiny, Overwatch, World of Warcraft, and Candy Crush franchises, substantially all gameplay and functionality are obtained through our continuous hosting of the game content for the player. Similar to our software products with online functionality, these arrangements may include other products and services, which often results in the recognition of additional performance obligations. Revenues related to online hosted software arrangements are generally recognized ratably over the estimated service period.

Subscription Arrangements

Subscription revenue arrangements are mostly derived from *World of Warcraft*, which is playable through Blizzard's servers and is generally sold on a subscription-only basis. Revenues associated with the sales of subscriptions are deferred until the subscription service is activated by the consumer and are then recognized ratably over the subscription period as the performance obligations are satisfied.

Revenues attributable to the purchase of *World of Warcraft* software by our customers, including expansion packs, are classified as Product sales, whereas revenues attributable to subscriptions and other in-game revenues are classified as Subscription, licensing, and other revenues.

Licensing Revenues

In certain countries, we utilize third-party licensees to distribute and host our games in accordance with license agreements, for which the licensees typically pay us a fixed minimum guarantee and sales-based royalties. These arrangements typically include multiple performance obligations, such as an upfront license of intellectual property and rights to specified or unspecified future updates. Our estimate of the selling price is comprised of several factors including, but not limited to, prior selling prices, prices charged separately by other third-party vendors for similar service offerings, and a cost-plus-margin approach. Based on the allocated transaction price, we recognize revenue associated with the minimum guarantee when we transfer control of the upfront license of intellectual property and/or upon transfer of control of future specified updates and ratably over the contractual term in which we provide the customer with unspecified future updates. Royalty payments in excess of the minimum guarantee are generally recognized when the licensed product is sold by the licensee.

Other Revenues

Other revenues primarily include revenues from downloadable content (e.g., multi-player content packs), microtransactions, and licensing of intellectual property other than software to third-parties.

Microtransaction revenues are derived from the sale of virtual currencies and goods to our players to enhance their gameplay experience. Proceeds from these sales of virtual currencies and goods are initially recorded in deferred revenue. Proceeds from the sales of virtual currencies are recognized as revenues when a player uses the virtual goods purchased with a virtual currency. Proceeds from the sales of virtual goods

Edgar Filing: Activision Blizzard, Inc. - Form 10-Q

directly are similarly recognized as revenues when a player uses the virtual goods. We categorize our virtual goods as either consumable or durable. Consumable virtual goods represent goods that can be consumed by a specific player action; accordingly, we recognize revenues from the sale of consumable virtual goods as the goods are consumed and our performance obligation is satisfied. Durable virtual goods represent goods that are accessible to the player over an extended period of time; accordingly, we recognize revenues from the sale of durable virtual goods ratably over the period of time the goods are available to the player and our performance obligation is satisfied, which is generally the estimated service period.

Revenues from the licensing of intellectual property other than software to third parties primarily include the licensing of our (1) brand, logo, or franchise to customers and (2) media content. Fixed fee payments from customers for the license of our brand or franchise are generally recognized over the license term. Fixed fee payments from customers for the license of our media content are generally recognized when control has transferred to the customer, which may be upfront or over time.

Table of Contents

Significant Judgment around Revenue Arrangements with Multiple Deliverables

Our contracts with customers often include promises to transfer multiple products and services. Determining whether products and services are considered distinct performance obligations that should be accounted for separately versus together may require significant judgment. Certain of our games, such as titles in the Call of Duty franchise, may contain a license of our intellectual property to play the game offline, but also depend on a significant level of integration and interdependency with the online functionality. In these cases, significant judgment is required to determine whether this license of our intellectual property should be considered distinct and accounted for separately, or not distinct and accounted for together with the online functionality provided and recognized over time. Generally, for titles in which the software license is functional without the online functionality and a significant component of gameplay is available offline, we believe we have separate performance obligations for the license of the intellectual property and the online functionality.

Significant judgment is also required to determine the standalone selling price for each distinct performance obligation and to determine whether there is a discount that needs to be allocated based on the relative standalone selling price of the various products and services. To estimate the standalone selling price we consider market data, including our pricing strategies for the product being evaluated and other similar products we may offer, competitor pricing to the extent data is available, and costs to determine whether the estimated selling price yields an appropriate profit margin.

Estimated Service Period

We consider a variety of data points when determining the estimated service period for players of our games, including the weighted average number of days between players' first and last days played online, the average total hours played, the average number of days in which player activity stabilizes, and the weighted-average number of days between players' first purchase date and last date played online. We also consider known online trends, the service periods of our previously released games, and, to the extent publicly available, the service periods of our competitors' games that are similar in nature to ours. We believe this provides a reasonable depiction of the transfer of services to our customers, as it is the best representation of the time period during which our customers play our games. Determining the estimated service period is subjective and requires management's judgment. Future usage patterns may differ from historical usage patterns, and therefore the estimated service period may change in the future. The estimated service periods for players of our current games are generally less than 12 months.

Principal Agent Considerations

We evaluate sales of our products and content via third-party digital storefronts, such as Microsoft Corporation's (Microsoft) Xbox Games Store, Sony Interactive Entertainment Inc.'s (Sony) PSN, the Apple App Store, and the Google Play Store, to determine whether revenues should be reported gross or net of fees retained by the storefront. Key indicators that we evaluate in determining gross versus net treatment include, but are not limited to, the following:

- which party is primarily responsible for fulfilling the promise to provide the specified good or service; and
- which party has discretion in establishing the price for the specified good or service.

Edgar Filing: Activision Blizzard, Inc. - Form 10-Q

Based on our evaluation of the above indicators, we report revenues on a gross basis for sales arrangements via the Apple App Store and the Google Play Store, and we report revenues on a net basis (i.e., net of fees retained by the digital storefront) for sales arrangements via Microsoft's Xbox Games Store and Sony's PSN.

Table of Contents

Contract Balances

We generally record a receivable related to revenue when we have an unconditional right to invoice and receive payment, and record deferred revenue when cash payments are received or due in advance of our performance, even if amounts are refundable.

The allowance for doubtful accounts reflects our best estimate of probable losses inherent in our accounts receivable balance. In estimating the allowance for doubtful accounts, we analyze the age of current outstanding account balances, historical bad debts, customer concentrations, customer creditworthiness, current economic trends, and changes in our customers' payment terms and their economic condition, as well as whether we can obtain sufficient credit insurance. Any significant changes in any of these criteria would affect management's estimates in establishing our allowance for doubtful accounts.

Deferred revenue is comprised primarily of unearned revenue related to the sale of products with online functionality or online hosted arrangements. We typically invoice, and collect payment for, these sales at the beginning of the contract period and recognize revenue ratably over the estimated service period. Deferred revenue also includes payments for: product sales pending delivery or activation; subscription revenues; licensing revenues with fixed minimum guarantees; and other revenues for which we have been paid in advance and earn the revenue when we transfer control of the product or service.

Refer to Note 9 for further information, including changes in deferred revenue during the period.

Assets Recognized from Costs to Obtain a Contract with a Customer

We apply the practical expedient to expense costs, as incurred, to obtain a contract with a customer when the amortization period would have been one year or less for certain similar contracts in which commissions are paid to internal personnel or third parties. We believe application of the practical expedient has a limited effect on the amount and timing of cost recognition. Total capitalized costs to obtain a contract were immaterial as of September 30, 2018.

Allowances for Returns and Price Protection

We closely monitor and analyze the historical performance of our various titles, the performance of products released by other publishers, market conditions, and the anticipated timing of other releases to assess future demand of current and upcoming titles. Initial volumes shipped upon title launch and subsequent reorders are evaluated with the goal of ensuring that quantities are sufficient to meet the demand from the retail markets, but at the same time are controlled to prevent excess inventory in the channel. We benchmark units to be shipped to our customers using historical and industry data.

We may permit product returns from, or grant price protection to, our customers under certain conditions. In general, price protection refers to the circumstances in which we elect to decrease, on a short- or longer-term basis, the wholesale price of a product by a certain amount and, when

Edgar Filing: Activision Blizzard, Inc. - Form 10-Q

granted and applicable, allow customers a credit against amounts owed by such customers to us with respect to open and/or future invoices. The conditions our customers must meet to be granted the right to return products or receive price protection credits include, among other things, compliance with applicable trading and payment terms and consistent return of inventory and delivery of sell-through reports to us. We may also consider other factors, including achievement of sell-through performance targets in certain instances, the facilitation of slow-moving inventory, and other market factors.

Significant management judgments and estimates with respect to potential future product returns and price protection related to current period product revenues must be made and used when establishing the allowance for returns and price protection in any accounting period. We estimate the amount of future returns and price protection for current period product revenues utilizing historical experience and information regarding inventory levels and the demand and acceptance of our products by the end consumer, and record revenue for the transferred products in the amount of consideration to which we expect to be entitled to. The following factors are used to estimate the amount of future returns and price protection for a particular title: historical performance of titles in similar genres; historical performance of the hardware platform; historical performance of the franchise; console hardware life cycle; sales force and retail customer feedback; industry pricing; future pricing assumptions; weeks of on-hand retail channel inventory; absolute quantity of on-hand retail channel inventory; our warehouse on-hand inventory levels; the title's recent sell-through history (if available); marketing trade programs; and the performance of competing titles. The relative importance of these factors varies among titles depending upon, among other things, genre, platform, seasonality, and sales strategy.

Table of Contents

Based upon historical experience, we believe that our estimates are reasonable. However, actual returns and price protection could vary materially from our allowance estimates due to a number of reasons, including, among others: a lack of consumer acceptance of a title, the release in the same period of a similarly themed title by a competitor, or technological obsolescence due to the emergence of new hardware platforms. There may be material differences in the amount and timing of our revenues for any period if factors or market conditions change or if matters resolve in a manner that is inconsistent with management's assumptions utilized in determining the allowances for returns and price protection.

Shipping and Handling

Shipping and handling costs consist primarily of packaging and transportation charges incurred to move finished goods to customers. We recognize all shipping and handling costs as an expense in Cost of revenues-product costs, including those incurred when control of the product has already transferred to the customer.

3. Recently Issued Accounting Pronouncements

Recently Adopted Accounting Pronouncements

Revenue Recognition

As noted in Note 2 above, we adopted the new revenue accounting standard effective January 1, 2018, utilizing the modified retrospective method. Additionally, we elected to apply the new revenue accounting standard only to contracts not completed as of the adoption date. For contracts that were modified before the period of adoption, we elected to reflect the aggregate effect of all modifications when (1) identifying the satisfied and unsatisfied performance obligations, (2) determining the transaction price, and (3) allocating the transaction price to the satisfied and unsatisfied performance obligations. We recognized the cumulative effect of initially applying the new revenue accounting standard as an adjustment to the opening

Table of Contents

balance of retained earnings. The comparative information has not been restated and continues to be reported under the accounting standards in effect for those periods. The cumulative effect adjustment recorded to our retained earnings was \$88 million (see our condensed consolidated statements of changes in shareholders' equity) and included the impact from the following adjustments to our condensed consolidated balance sheet at January 1, 2018 (amounts in millions):

Condensed Consolidated Balance Sheet:	Balance at December 31, 2017	Adjustments due to adoption of new revenue accounting standard	Balance at January 1, 2018
Assets			
Accounts receivable, net	\$ 918	\$ 3	\$ 921
Software development	367	(20)	347
Other current assets	476	(35)	441
Deferred income taxes, net	459	(32)	427
Other assets	440	4	444
Liabilities and Shareholders' Equity			
Deferred revenues	\$ 1,929	\$ (194)	\$ 1,735
Other liabilities	1,132	23	1,155
Shareholders' equity	9,462	91	9,553

The most significant impacts of the new revenue accounting standard for us are:

- The accounting for our sales of our games with significant online functionality for which we do not have vendor-specific objective evidence (VSOE) for unspecified future updates and ongoing online services provided.* Under the prior accounting standards, VSOE for undelivered elements was required. This requirement was eliminated under the new revenue accounting standard. Accordingly, we are required to recognize as revenue a portion of the sales price upon delivery of this software, as compared to recognizing the entire sales price ratably over an estimated service period as previously required. This difference in accounting primarily impacts revenues from our Call of Duty franchise, where approximately 20% of the sales price is now recognized as revenue upon delivery of the games to our customers. The amount of revenue recognized upon delivery of games to our customers is analyzed on a title-by-title basis and may change in the future. For example, we expect the entire sales price from our *Call of Duty: Black Ops 4* release to be recognized ratably over an estimated service period, as the gameplay has an increased focus towards the online competitive and cooperative game modes with no single-player campaign mode. Many of our other franchises, such as Destiny, Overwatch, World of Warcraft, and Candy Crush, are online hosted arrangements, and the accounting for our sales of these games under the new standard is relatively unchanged; and
- The accounting for certain of our software licensing arrangements.* While the impact of the new revenue accounting standard may differ on a contract-by-contract basis (as the actual revenue recognition treatment required under the standard will depend on contract-specific terms), the new revenue accounting standard generally results in earlier revenue recognition for these arrangements.

Edgar Filing: Activision Blizzard, Inc. - Form 10-Q

Table of Contents

Adoption of the new revenue accounting standard impacted our condensed consolidated statement of operations for the three and nine months ended September 30, 2018, and our condensed consolidated balance sheet as of September 30, 2018 as follows (in millions, except per share data):

	For the Three Months Ended September 30, 2018		
	Under new revenue accounting standard	Under old revenue accounting standards	Increase (decrease) due to adoption of new revenue accounting standard
Condensed Consolidated Statement of Operations:			
Net revenues			
Product sales	\$ 263	\$ 269	\$ (6)
Subscription, licensing, and other revenues	1,249	1,226	23
Total net revenues	1,512	1,495	17
Costs and expenses			
Cost of revenues product sales:			
Product costs	127	126	1
Software royalties, amortization, and intellectual property licenses	20	24	(4)
Cost of revenues subscription, licensing, and other revenues:			
Game operations and distribution costs	257	257	
Software royalties, amortization, and intellectual property licenses	109	109	
Product development	263	263	
Sales and marketing	263	263	
General and administrative	208	208	
Total costs and expenses	1,247	1,250	(3)
Operating income	265	245	20
Interest and other expense (income), net	13	13	
Loss on extinguishment of debt	40	40	
Income before income tax expense (benefit)	212	192	20
Income tax expense (benefit)	(48)	(57)	9
Net income	\$ 260	\$ 249	\$ 11
Earnings per common share			
Basic	\$ 0.34	\$ 0.33	\$ 0.01
Diluted	\$ 0.34	\$ 0.32	\$ 0.02

Table of Contents

	For the Nine Months Ended September 30, 2018		
	Under new revenue accounting standard	Under old revenue accounting standards	Increase (decrease) due to adoption of new revenue accounting standard
Condensed Consolidated Statement of Operations:			
Net revenues			
Product sales	\$ 1,447	\$ 1,593	\$ (146)
Subscription, licensing, and other revenues	3,672	3,645	27
Total net revenues	5,119	5,238	(119)
Costs and expenses			
Cost of revenues product sales:			
Product costs	416	438	(22)
Software royalties, amortization, and intellectual property licenses	214	232	(18)
Cost of revenues subscription, licensing, and other revenues:			
Game operations and distribution costs	777	777	
Software royalties, amortization, and intellectual property licenses	278	278	
Product development	776	776	
Sales and marketing	741	740	1
General and administrative	623	623	
Total costs and expenses	3,825	3,864	(39)
Operating income	1,294	1,374	(80)
Interest and other expense (income), net	67	67	
Loss on extinguishment of debt	40	40	
Income before income tax expense	1,187	1,267	(80)
Income tax expense	25	41	(16)
Net income	\$ 1,162	\$ 1,226	\$ (64)
Earnings per common share			
Basic	\$ 1.53	\$ 1.61	\$ (0.08)
Diluted	\$ 1.51	\$ 1.59	\$ (0.08)

Table of Contents

	At September 30, 2018		
	Under new revenue accounting standard	Under old revenue accounting standards	Increase (decrease) due to adoption of new revenue accounting standard
Condensed Consolidated Balance Sheet:			
Assets			
Accounts receivable, net	\$ 641	\$ 637	\$ 4
Software development	348	350	(2)
Other current assets	501	519	(18)
Deferred income taxes, net	243	262	(19)
Other assets	454	469	(15)
Liabilities and Shareholders Equity			
Deferred revenues	\$ 1,017	\$ 1,077	\$ (60)
Accrued expenses and other liabilities	1,053	1,056	(3)
Other liabilities	991	1,005	(14)
Shareholders equity	10,659	10,632	27

Adoption of the new revenue accounting standard had no impact to net cash from or used in operating, investing, or financing activities in our condensed consolidated statement of cash flows.

Financial Instruments

In January 2016, the FASB issued new guidance related to the recognition and measurement of financial assets and financial liabilities. The new standard, among other things, generally requires companies to measure investments in other entities, except those accounted for under the equity method, at fair value and to recognize any changes in fair value in net income. The new standard also simplifies the impairment assessment of equity investments without readily determinable fair values. The new standard is effective for fiscal years beginning after December 15, 2017, and the guidance should be applied by means of a cumulative-effect adjustment to the balance sheet as of the beginning of the fiscal year of adoption. The guidance related to equity investments without readily determinable fair values (including disclosure requirements) is applied prospectively to equity investments that exist as of the date of adoption. We adopted the new standard during the first quarter of 2018 and it did not have a material impact on our condensed consolidated financial statements.

Statement of Cash Flows-Restricted Cash

In November 2016, the FASB issued new guidance related to the classification of restricted cash in the statement of cash flows. The new standard requires that a statement of cash flows explain any change during the period in total cash, cash equivalents, and restricted cash. Therefore, restricted cash will be included with Cash and cash equivalents when reconciling the beginning-of-period and end-of-period total amounts shown on the statement of cash flows. The new standard is effective for fiscal years beginning after December 15, 2017, and should be applied retrospectively.

We adopted the new standard during the first quarter of 2018 and applied the standard retrospectively for all periods presented. The application of this new standard did not have a material impact on our condensed consolidated statements of cash flows for the nine months ended September 30, 2018 and 2017.

In our Annual Report on Form 10-K for the year ending December 31, 2018, there will be a significant impact to the consolidated statements of cash flows for 2016, as this period includes, as an investing activity, the \$3.6 billion movement in restricted cash resulting from the transfer of cash into escrow at December 31, 2015 to facilitate the acquisition of King, and the subsequent release of that cash in 2016 to complete the acquisition. Under this new standard, the restricted cash balance will be included in the beginning and ending total cash, cash equivalents, and restricted cash balances and, hence, will not be included as an investing activity in the statement of cash flows.

Table of Contents

Derivatives and Hedging

In August 2017, the FASB issued new guidance related to the accounting for derivatives and hedging. The new guidance expands and refines hedge accounting for both financial and non-financial risk components, aligns the recognition and presentation of the effects of hedging instruments and hedged items in the financial statements, and includes certain targeted improvements to ease the application of current guidance related to the assessment of a hedge's effectiveness. The new standard is effective for fiscal years beginning after December 15, 2018. Early adoption is permitted. We adopted the standard during the first quarter of 2018. The adoption of the standard did not have a material impact to our condensed consolidated financial statements.

Recent Accounting Pronouncements Not Yet Adopted

Leases

In February 2016, the FASB issued new guidance related to the accounting for leases. The new standard will replace all current U.S. GAAP guidance on this topic. The new standard, among other things, requires a lessee to classify a lease as either an operating or financing lease, and to recognize a lease liability and a right-of-use asset for its leases. Classification will be based on criteria that are largely similar to those applied in current lease accounting. The lease liability will be equal to the present value of lease payments. The asset will be based on the lease liability, subject to adjustment for initial direct costs, lease incentives received, and any prepaid lease payments. Operating leases will result in a straight-line expense pattern, while finance leases will result in a front-loaded expense pattern. The standard is effective for fiscal years, and interim periods within those fiscal years, beginning after December 15, 2018. Early adoption is permitted. When the new standard was initially issued, it was required to be adopted using a modified retrospective transition that required application of the new guidance at the beginning of the earliest comparative period presented, subject to certain transition practical expedients available to provide relief in connection with the adoption. In July 2018, the FASB issued guidance to provide for an optional adoption method that allows companies to use the effective date of the new lease standard as the initial date of application on transition, and therefore does not require prior periods to be restated.

Although we continue to evaluate the impact of this new accounting guidance on our financial statements, we expect it to have a significant impact on our consolidated balance sheet as a result of establishing lease liabilities and right-of-use assets for our operating leases. As part of our evaluation process, we have established a project implementation team that is evaluating our lease portfolio and system solutions, as well as identifying required process and policy changes, which include consideration of internal controls. We have made progress in gathering the necessary data elements for our lease population, have selected a system provider, and system configuration and implementation is underway. We do not plan to early adopt this new standard but do expect to elect and apply the available transition practical expedients, including the optional adoption method discussed above.

Goodwill

In January 2017, the FASB issued new guidance that eliminates Step 2 from the goodwill impairment test. Instead, if an entity forgoes a Step 0 test, an entity will be required to perform its annual or interim goodwill impairment test by comparing the fair value of a reporting unit, as determined in Step 1 from the goodwill impairment test, with its carrying amount and recognize an impairment charge, if any, for the amount by which the carrying amount exceeds the reporting unit's fair value, not to exceed the total amount of goodwill allocated to the reporting unit. The new standard is effective for fiscal years beginning after December 15, 2019, and should be applied prospectively. Early adoption is permitted. The effect of adoption should be reflected as of the beginning of the fiscal year of adoption. We are evaluating the impact, if any, of adopting

this new accounting guidance on our consolidated financial statements.

Table of Contents*Cloud Computing Arrangements*

In August 2018, the FASB issued new guidance related to a customer's accounting for implementation costs incurred in a cloud computing arrangement (i.e. hosting arrangement) that is a service contract. The new guidance requires customers to capitalize implementation costs for these arrangements by applying the same criteria that is utilized for existing internal-use software guidance. The capitalized costs are required to be amortized over the associated term of the arrangement, generally on a straight-line basis, with amortization of these costs presented in the same financial statement line item as other costs associated with the arrangement. The new standard is effective for fiscal years beginning after December 15, 2019, and can be applied retrospectively or prospectively. Early adoption is permitted. We are evaluating the impact, if any, of adopting this new accounting guidance on our financial statements.

4. Inventories, Net

Inventories, net, consist of the following (amounts in millions):

	At September 30, 2018	At December 31, 2017
Finished goods	\$ 161	\$ 45
Purchased parts and components	13	1
Inventories, net	\$ 174	\$ 46

At September 30, 2018 and December 31, 2017, inventory reserves were \$23 million and \$36 million, respectively.

5. Software Development and Intellectual Property Licenses

The following table summarizes the components of our capitalized software development costs (amounts in millions):

	At September 30, 2018	At December 31, 2017
Internally-developed software costs	\$ 356	\$ 270
Payments made to third-party software developers	166	183
Total software development costs	\$ 522	\$ 453

As of both September 30, 2018 and December 31, 2017, capitalized intellectual property licenses were not material.

Amortization of capitalized software development costs and intellectual property licenses was as follows (amounts in millions):

Edgar Filing: Activision Blizzard, Inc. - Form 10-Q

	For the Three Months Ended		For the Nine Months Ended	
	September 30,		September 30,	
	2018	2017	2018	2017
Amortization of capitalized software development costs and intellectual property licenses	\$ 33	\$ 34	\$ 242	\$ 206

Table of Contents**6. Intangible Assets, Net**

Intangible assets, net, consist of the following (amounts in millions):

	Estimated useful lives	At September 30, 2018		Net carrying amount
		Gross carrying amount	Accumulated amortization	
Acquired definite-lived intangible assets:				
Internally-developed franchises	3 - 11 years	\$ 1,154	\$ (987)	\$ 167
Developed software	2 - 5 years	601	(413)	188
Customer base	2 years	617	(617)	
Trade names	7 - 10 years	54	(21)	33
Other	1 - 15 years	19	(14)	5
Total definite-lived intangible assets		\$ 2,445	\$ (2,052)	\$ 393
Acquired indefinite-lived intangible assets:				
Activision trademark	Indefinite			386
Acquired trade names	Indefinite			47
Total indefinite-lived intangible assets				\$ 433
Total intangible assets, net				\$ 826

	Estimated useful lives	At December 31, 2017		Net carrying amount
		Gross carrying amount	Accumulated amortization	
Acquired definite-lived intangible assets:				
Internally-developed franchises	3 - 11 years	\$ 1,154	\$ (869)	\$ 285
Developed software	2 - 5 years	601	(301)	300
Customer base	2 years	617	(573)	44
Trade names	7 - 10 years	54	(16)	38
Other	1 - 15 years	19	(13)	6
Total definite-lived intangible assets		\$ 2,445	\$ (1,772)	\$ 673
Acquired indefinite-lived intangible assets:				
Activision trademark	Indefinite			386
Acquired trade names	Indefinite			47
Total indefinite-lived intangible assets				\$ 433
Total intangible assets, net				\$ 1,106

Amortization expense of our intangible assets was \$84 million and \$280 million for the three and nine months ended September 30, 2018, respectively. Amortization expense of our intangible assets was \$188 million and \$573 million for the three and nine months ended September 30, 2017, respectively.

At September 30, 2018, future amortization of definite-lived intangible assets is estimated as follows (amounts in millions):

2018 (remaining three months)	\$ 91
2019	210

Edgar Filing: Activision Blizzard, Inc. - Form 10-Q

2020		69
2021		11
2022		7
Thereafter		5
Total	\$	393

Table of Contents**7. Goodwill**

The carrying amount of goodwill by reportable segment at September 30, 2018 and December 31, 2017 was as follows (amounts in millions):

	Activision	Blizzard	King	Total
Goodwill	\$ 6,898	\$ 190	\$ 2,675	\$ 9,763

8. Fair Value Measurements

The FASB literature regarding fair value measurements for certain assets and liabilities establishes a three-level fair value hierarchy that prioritizes the inputs used to measure fair value. This hierarchy requires entities to maximize the use of observable inputs and minimize the use of unobservable inputs. The three levels of inputs used to measure fair value are as follows:

- Level 1 Quoted prices in active markets for identical assets or liabilities;
- Level 2 Observable inputs other than quoted prices included in Level 1, such as quoted prices for similar assets or liabilities in active markets or other inputs that are observable or can be corroborated by observable market data; and
- Level 3 Unobservable inputs that are supported by little or no market activity and that are significant to the fair value of the assets or liabilities, including certain pricing models, discounted cash flow methodologies, and similar techniques that use significant unobservable inputs.

Fair Value Measurements on a Recurring Basis

The table below segregates all of our financial assets and liabilities that are measured at fair value on a recurring basis into the most appropriate level within the fair value hierarchy based on the inputs used to determine the fair value at the measurement date (amounts in millions):

As of September 30, 2018	Fair Value Measurements at September 30, 2018 Using			Balance Sheet Classification
	Quoted Prices in Active Markets for Identical	Significant Other Observable Inputs (Level 2)	Significant Unobservable Inputs (Level 3)	

Edgar Filing: Activision Blizzard, Inc. - Form 10-Q

Assets
(Level 1)

Financial Assets:

Recurring fair value measurements:							
Money market funds	\$	3,087	\$	3,087	\$	\$	Cash and cash equivalents
Foreign government treasury bills		35		35			Cash and cash equivalents
U.S. treasuries and government agency securities		116		116			Other current assets
Foreign currency forward contracts designated as hedges		11				11	Other current assets
Total recurring fair value measurements	\$	3,249	\$	3,238	\$	11	\$

Financial liabilities:

Foreign currency forward contracts not designated as hedges	\$	(5)	\$		\$	(5)	\$	Accrued expenses and other liabilities
Foreign currency forward contracts designated as hedges	\$	(4)	\$		\$	(4)	\$	Accrued expenses and other liabilities

Table of Contents

	Fair Value Measurements at December 31, 2017				Balance Sheet Classification
	As of December 31, 2017	Quoted Prices in Active Markets for Identical Assets (Level 1)	Significant Other Observable Inputs (Level 2)	Significant Unobservable Inputs (Level 3)	
Financial Assets:					
Recurring fair value measurements:					
Money market funds	\$ 4,405	\$ 4,405	\$	\$	Cash and cash equivalents
Foreign government treasury bills	39	39			Cash and cash equivalents
U.S. treasuries and government agency securities	55	55			Other current assets
Total recurring fair value measurements	\$ 4,499	\$ 4,499	\$	\$	
Financial liabilities:					
Foreign currency forward contracts designated as hedges	\$ (5)	\$	\$ (5)	\$	Accrued expenses and other liabilities

Foreign Currency Forward Contracts

Foreign Currency Forward Contracts Designated as Hedges (Cash Flow Hedges)

The total gross notional amounts and fair values of our Cash Flow Hedges are as follows (amounts in millions):

	As of September 30, 2018		As of December 31, 2017	
	Notional amount	Fair value gain (loss)	Notional amount	Fair value gain (loss)
Foreign Currency:				
Buy USD, Sell Euro	\$ 843	\$ 7	\$ 521	\$ (5)

At September 30, 2018, our Cash Flow Hedges have remaining maturities of 15 months or less. Additionally, \$3 million of net realized but unrecognized gains are recorded within Accumulated other comprehensive income (loss) at September 30, 2018 for Cash Flow Hedges that had settled but were deferred and will be amortized into earnings, along with the associated hedged revenues. Such amounts will be reclassified into earnings within the next 12 months.

The amount of pre-tax net realized gains (losses) associated with our Cash Flow Hedges that were reclassified out of Accumulated other comprehensive income (loss) and into earnings was as follows (amounts in millions):

For the Three Months Ended September 30,		For the Nine Months Ended September 30,		Statement of Operations Classification
2018	2017	2018	2017	

Edgar Filing: Activision Blizzard, Inc. - Form 10-Q

Cash Flow Hedges	\$	3	\$	(2)	\$	(11)	\$	7	Net revenues
------------------	----	---	----	-----	----	------	----	---	--------------

Foreign Currency Forward Contracts Not Designated as Hedges

The total gross notional amounts and fair values of our foreign currency forward contracts not designated as hedges are as follows (amounts in millions):

	As of September 30, 2018		As of December 31, 2017	
	Notional amount	Fair value gain (loss)	Notional amount	Fair value gain (loss)
Foreign Currency:				
Buy Euro, Sell USD	\$ 119	\$ (5)	\$	\$

For the three and nine months ended September 30, 2018 and 2017, pre-tax net gains associated with these forward contracts were recorded in General and administrative expenses and were not material.

Table of Contents

Fair Value Measurements on a Non-Recurring Basis

We measure the fair value of certain assets on a non-recurring basis, generally annually or when events or changes in circumstances indicate that the carrying amount of the assets may not be recoverable.

For the three and nine months ended September 30, 2018 and 2017, there were no impairment charges related to assets that are measured on a non-recurring basis.

9. Deferred revenues

We record deferred revenues when cash payments are received or due in advance of the fulfillment of our associated performance obligations. The opening balance of deferred revenues as of January 1, 2018 and the ending balance as of September 30, 2018 were \$1.8 billion and \$1.0 billion, respectively, including our current and non-current balances. For the nine months ended September 30, 2018, the additions to our deferred revenues balance were primarily due to cash payments received or due in advance of satisfying our performance obligations, while the reductions to our deferred revenues balance were primarily due to the recognition of revenues upon fulfillment of our performance obligations, both of which were in the ordinary course of business. During the nine months ended September 30, 2018, \$1.6 billion of revenues were recognized that were included in the deferred revenues balance at the beginning of the period.

As of September 30, 2018, the aggregate amount of contracted revenues allocated to our unsatisfied performance obligations is \$2.2 billion, which includes our deferred revenues balances and amounts to be invoiced and recognized as revenue in future periods. We expect to recognize a significant majority of this balance as revenue over the next 12 months, and the remainder thereafter. This balance does not include an estimate for variable consideration arising from sales-based royalty license revenue in excess of the contractual minimum guarantee.

10. Debt

Credit Facilities

At December 31, 2017, we had outstanding term loans A of approximately \$990 million (the 2017 TLA) and \$250 million available under a revolving credit facility pursuant to a credit agreement entered into on October 11, 2013 (as amended thereafter and from time to time, the Credit Agreement).

On August 24, 2018, using available cash on hand, we made a voluntary prepayment of \$990 million to fully repay and extinguish the 2017 TLA. As a result, we wrote-off unamortized discount and financing costs of \$7 million, which are included in Loss on extinguishment of debt in the condensed consolidated statement of operations. On August 24, 2018, we also entered into the Seventh Amendment (the Amendment) to the Credit Agreement. The Amendment, among other things: (1) provided for a new tranche of revolving credit commitments in an aggregate

Edgar Filing: Activision Blizzard, Inc. - Form 10-Q

principal amount of \$1.5 billion (the New Revolver), which replaced our prior revolving credit facility; (2) amended the Credit Agreement to remove mechanics related to the 2017 TLA, which, as noted above, was repaid in full prior to the effectiveness of the Amendment; and (3) eliminated or amended certain representations, warranties and covenants to reflect our current credit ratings.

The New Revolver is scheduled to mature on August 24, 2023. Borrowings under the New Revolver will bear interest, at the Company's option, at either (1) a base rate equal to the highest of (i) the federal funds rate, plus 0.5%, (ii) the prime commercial lending rate of Bank of America, N.A. and (iii) the London Interbank Offered Rate (LIBOR) for an interest period of one month beginning on such day plus 1.00%, or (2) LIBOR, in each case, plus an applicable interest margin. LIBOR will be subject to a floor of 0% and base rate will be subject to an effective floor of 1.00%. The applicable interest margin for borrowings under the New Revolver will range from 0.875% to 1.375% for LIBOR borrowings and from 0% to 0.375% for base rate borrowings and will be determined by reference to a pricing grid based on the Company's credit ratings. To date, we have not drawn on the New Revolver.

Table of Contents

Under the Credit Agreement, we are subject to a financial covenant requiring the Company's Consolidated Total Net Debt Ratio (as defined in the Credit Agreement) not to exceed 3.75:1.00 (or, at the Company's option and for a limited period of time upon the consummation of a Qualifying Acquisition (as defined in the Credit Agreement), 4.25:1.00). The Credit Agreement contains covenants customary for transactions of this type for issuers with similar credit ratings, including those restricting liens, debt of non-guarantor subsidiaries and certain fundamental changes, in each case with exceptions, including exceptions for secured debt and debt of non-guarantor subsidiaries of the Company, in each case up to an amount not exceeding 7.5% of Total Assets (as defined in the Credit Agreement). We were in compliance with the terms of the Credit Agreement as of September 30, 2018.

Refer to Note 11 contained in our Annual Report on Form 10-K for the year ended December 31, 2017 for further details regarding the Credit Agreement, its key terms, and previous amendments made to it.

Unsecured Senior Notes

At December 31, 2017, we had the following unsecured senior notes outstanding:

- \$750 million of 6.125% unsecured senior notes due September 2023 that we issued on September 19, 2013 (the 2023 Notes), in a private offering made in accordance with Rule 144A under the Securities Act of 1933, as amended (the Securities Act);
- \$650 million of 2.3% unsecured senior notes due September 2021 (the 2021 Notes) and \$850 million of 3.4% unsecured senior notes due September 2026 (the 2026 Notes) that we initially issued on September 19, 2016, in a private offering made in accordance with Rule 144A and Regulation S under the Securities Act, and subsequently exchanged for publicly registered notes in June 2017; and
- \$400 million of 2.6% unsecured senior notes due June 2022 (the 2022 Notes), \$400 million of 3.4% unsecured senior notes due June 2027 (the 2027 Notes), and \$400 million of 4.5% unsecured senior notes due June 2047 (the 2047 Notes), and together with the 2021 Notes, the 2022 Notes, the 2023 Notes, the 2026 Notes, and the 2027 Notes, the Notes, that we issued on May 26, 2017, in a public underwritten offering.

On July 17, 2018, we issued an irrevocable notice of redemption to the holders of all of our outstanding 2023 Notes. Accordingly, on August 16, 2018, using available cash on hand, we redeemed the 2023 Notes in full at a redemption price equal to 100% of the principal amount of the 2023 Notes plus a make-whole premium calculated as set forth in the indenture governing the 2023 Notes and accrued and unpaid interest to the redemption date. The redemption of the 2023 Notes resulted in a Loss on extinguishment of debt recorded in the condensed consolidated statement of operations of \$33 million, comprised of premium payments of \$25 million and a write-off of unamortized discount and deferred financing costs of \$8 million. All other Notes referred to above remained outstanding as of September 30, 2018.

Edgar Filing: Activision Blizzard, Inc. - Form 10-Q

The Notes are general senior obligations of the Company and rank *pari passu* in right of payment to all of the Company's existing and future senior indebtedness, including the New Revolver described above. The Notes are not secured and are effectively junior to any of the Company's existing and future indebtedness that is secured to the extent of the value of the collateral securing such indebtedness. We were in compliance with the terms of the Notes as of September 30, 2018.

Interest is payable semi-annually in arrears on March 15 and September 15 of each year for the 2021 Notes, the 2023 Notes, and the 2026 Notes, and payable semi-annually in arrears on June 15 and December 15 of each year for the 2022 Notes, the 2027 Notes, and the 2047 Notes. Accrued interest payable is recorded within "Accrued expenses and other liabilities" in our condensed consolidated balance sheets. As of September 30, 2018 and December 31, 2017, we had accrued interest payable of \$14 million and \$28 million, respectively, related to the Notes.

Table of Contents

Refer to Note 11 contained in our Annual Report on Form 10-K for the year ended December 31, 2017 for further details regarding key terms under our indentures that govern the Notes.

Interest Expense and Financing Costs

Fees and discounts associated with the issuance of our debt instruments are recorded as debt discount, which reduces their respective carrying values, and are amortized over their respective terms. Amortization expense is recorded within Interest and other expense (income), net in our condensed consolidated statement of operations.

For the three and nine months ended September 30, 2018, interest expense was \$32 million and \$113 million, respectively, and amortization of the debt discount and deferred financing costs were \$1 million and \$5 million, respectively. For the three and nine months ended September 30, 2017, interest expense was \$39 million and \$110 million, respectively, and amortization of the debt discount and deferred financing costs were \$2 million and \$10 million, respectively.

A summary of our outstanding debt is as follows (amounts in millions):

	Gross Carrying Amount		At September 30, 2018 Unamortized Discount and Deferred Financing Costs		Net Carrying Amount	
2021 Notes	\$	650	\$	(4)	\$	646
2022 Notes		400		(3)		397
2026 Notes		850		(8)		842
2027 Notes		400		(5)		395
2047 Notes		400		(10)		390
Total long-term debt	\$	2,700	\$	(30)	\$	2,670

	Gross Carrying Amount		At December 31, 2017 Unamortized Discount and Deferred Financing Costs		Net Carrying Amount	
2017 TLA	\$	990	\$	(8)	\$	982
2021 Notes		650		(4)		646
2022 Notes		400		(4)		396
2023 Notes		750		(9)		741
2026 Notes		850		(9)		841
2027 Notes		400		(6)		394
2047 Notes		400		(10)		390
Total long-term debt	\$	4,440	\$	(50)	\$	4,390

Edgar Filing: Activision Blizzard, Inc. - Form 10-Q

Table of Contents

As of September 30, 2018, the scheduled maturities and contractual principal repayments of our debt for each of the five succeeding years and thereafter are as follows (amounts in millions):

For the year ending December 31,		
2018 (remaining three months)	\$	
2019		
2020		
2021		650
2022		400
Thereafter		1,650
Total	\$	2,700

On February 1, 2018, our Board of Directors authorized repayment of up to \$1.8 billion of the company's outstanding debt during 2018. As of September 30, 2018, we had utilized this entire authorization to repay our 2017 TLA and redeem our 2023 Notes, as described above.

Using Level 2 inputs (i.e., observable market prices in less-than-active markets) at September 30, 2018, the carrying values of the 2021 Notes and the 2022 Notes approximated their fair values, as the interest rates were similar to the current rates at which we could borrow funds over the selected interest periods. At September 30, 2018, based on Level 2 inputs, the fair values of the 2026 Notes, the 2027 Notes, and the 2047 Notes were \$809 million, \$379 million, and \$380 million, respectively.

Using Level 2 inputs at December 31, 2017, with the exception of the 2023 Notes and the 2047 Notes, the carrying values of our debt instruments approximated their fair values. At December 31, 2017, based on Level 2 inputs, the fair values of the 2023 Notes and the 2047 Notes were \$795 million and \$421 million, respectively.

11. Accumulated Other Comprehensive Income (Loss)

The components of accumulated other comprehensive income (loss) were as follows (amounts in millions):

	Foreign currency translation adjustments	For the Nine Months Ended September 30, 2018		Total
		Unrealized gain (loss) on forward contracts	Unrealized gain (loss) on available- for-sale securities	
Balance at December 31, 2017	\$ (623)	\$ (15)	\$	\$ (638)
Cumulative impact from adoption of new revenue accounting standard	3			3
Other comprehensive income (loss) before reclassifications	(7)	14	4	11
Amounts reclassified from accumulated other comprehensive income (loss) into earnings		11		11
Balance at September 30, 2018	\$ (627)	\$ 10	\$ 4	\$ (613)

Edgar Filing: Activision Blizzard, Inc. - Form 10-Q

	For the Nine Months Ended September 30, 2017			
	Foreign currency translation adjustments	Unrealized gain (loss) on forward contracts	Unrealized gain (loss) on available- for-sale securities	Total
Balance at December 31, 2016	\$ (659)	\$ 29	\$ 1	\$ (629)
Other comprehensive income (loss) before reclassifications	20	(38)	(2)	(20)
Amounts reclassified from accumulated other comprehensive income (loss) into earnings	16	(7)	(2)	7
Balance at September 30, 2017	\$ (623)	\$ (16)	\$ (3)	\$ (642)

Table of Contents

Income taxes were not previously provided for foreign currency translation items, as these were considered indefinite investments in non-U.S. subsidiaries. Due to the Tax Cuts and Jobs Act enacted on December 22, 2017 (the U.S. Tax Reform Act), we re-evaluated our indefinite reinvestment assertions and no longer consider these items to be indefinite investments. The corresponding tax impact for this change in assertion was not material.

12. Operating Segments and Geographic Region

Currently, we have three reportable segments. Our operating segments are consistent with the manner in which our operations are reviewed and managed by our Chief Executive Officer, who is our chief operating decision maker (CODM). The CODM reviews segment performance exclusive of: the impact of the change in deferred revenues and related cost of revenues with respect to certain of our online-enabled games; share-based compensation expense; amortization of intangible assets as a result of purchase price accounting; fees and other expenses (including legal fees, expenses, and accruals) related to acquisitions, associated integration activities, and financings; certain restructuring costs; and certain other non-cash charges. The CODM does not review any information regarding total assets on an operating segment basis, and accordingly, no disclosure is made with respect thereto.

Our operating segments are also consistent with our internal organizational structure, the way we assess operating performance and allocate resources, and the availability of separate financial information. We do not aggregate operating segments.

Information on reportable segment net revenues and operating income for the three months ended September 30, 2018 and 2017, are presented below (amounts in millions):

	Three Months Ended September 30, 2018			
	Activision	Blizzard	King	Total
Segment Net Revenues				
Net revenues from external customers	\$ 397	\$ 627	\$ 506	\$ 1,530
Intersegment net revenues (1)		8		8
Segment net revenues	\$ 397	\$ 635	\$ 506	\$ 1,538
Segment operating income	\$ 112	\$ 189	\$ 184	\$ 485
	Three Months Ended September 30, 2017			
	Activision	Blizzard	King	Total
Segment Net Revenues				
Net revenues from external customers	\$ 759	\$ 531	\$ 528	\$ 1,818
Intersegment net revenues (1)				
Segment net revenues	\$ 759	\$ 531	\$ 528	\$ 1,818
Segment operating income	\$ 261	\$ 168	\$ 208	\$ 637

Edgar Filing: Activision Blizzard, Inc. - Form 10-Q

Table of Contents

Information on reportable segment net revenues and operating income for the nine months ended September 30, 2018 and 2017, are presented below (amounts in millions):

	Nine Months Ended September 30, 2018			
	Activision	Blizzard	King	Total
Segment Net Revenues				
Net revenues from external customers	\$ 1,047	\$ 1,592	\$ 1,542	\$ 4,181
Intersegment net revenues (1)		14		14
Segment net revenues	\$ 1,047	\$ 1,606	\$ 1,542	\$ 4,195
Segment operating income	\$ 288	\$ 444	\$ 543	\$ 1,275
	Nine Months Ended September 30, 2017			
	Activision	Blizzard	King	Total
Segment Net Revenues				
Net revenues from external customers	\$ 1,291	\$ 1,539	\$ 1,482	\$ 4,312
Intersegment net revenues (1)				
Segment net revenues	\$ 1,291	\$ 1,539	\$ 1,482	\$ 4,312
Segment operating income	\$ 371	\$ 552	\$ 538	\$ 1,461

(1) Intersegment revenues reflect licensing and service fees charged between segments.

Reconciliations of total segment net revenues and total segment operating income to consolidated net revenues and consolidated income before income tax expense are presented in the table below (amounts in millions):

	Three Months Ended September 30,		Nine Months Ended September 30,	
	2018	2017	2018	2017
Reconciliation to consolidated net revenues:				
Segment net revenues	\$ 1,538	\$ 1,818	\$ 4,195	\$ 4,312
Revenues from other segments (1)	128	84	246	204
Net effect from recognition (deferral) of deferred net revenues	(146)	(284)	692	458
Elimination of intersegment revenues (2)	(8)		(14)	
Consolidated net revenues	\$ 1,512	\$ 1,618	\$ 5,119	\$ 4,974
Reconciliation to consolidated income before income tax expense:				
Segment operating income	\$ 485	\$ 637	\$ 1,275	\$ 1,461
Operating (loss) income from other segments (1)	7	(12)	(4)	(15)
Net effect from recognition (deferral) of deferred net revenues and related cost of revenues	(89)	(132)	468	370
Share-based compensation expense	(55)	(47)	(166)	(120)
Amortization of intangible assets	(83)	(187)	(279)	(571)
Fees and other expenses related to the acquisition of King (3)		(3)		(12)
Restructuring costs (4)				(11)
Other non-cash charges (5)		1		(14)
Consolidated operating income	265	257	1,294	1,088

Edgar Filing: Activision Blizzard, Inc. - Form 10-Q

Interest and other expense (income), net		13		37		67		109
Loss on extinguishment of debt		40				40		12
Consolidated income before income tax expense	\$	212	\$	220	\$	1,187	\$	967

(1) Includes other income and expenses from operating segments managed outside the reportable segments, including our Studios and Distribution businesses. Also includes unallocated corporate income and expenses.

(2) Intersegment revenues reflect licensing and service fees charged between segments.

Table of Contents

(3) Reflects fees and other expenses, such as legal, banking, and professional services fees, related to the acquisition of King and associated integration activities, inclusive of related debt financings.

(4) Reflects restructuring charges, primarily severance costs.

(5) Reflects a non-cash accounting charge to reclassify certain cumulative translation gains (losses) into earnings due to the substantial liquidation of certain of our foreign entities.

Due to requirements from our adoption of the new revenue accounting standard as discussed in Note 2, net revenues by distribution channel for the three and nine months ended September 30, 2018, include a reconciliation to our segment revenues as disclosed for each of our reportable segments above. Net revenues by distribution channel were as follows (amounts in millions):

	Three Months Ended September 30, 2018						Total
	Activision	Blizzard	King	Non-reportable segments	Elimination of intersegment revenues (3)		
Net revenues by distribution channel:							
Digital online channels (1)	\$ 299	\$ 480	\$ 505	\$	\$ (8)	\$ 1,276	
Retail channels	53	23				76	
Other (2)		35		125		160	
Total consolidated net revenues	\$ 352	\$ 538	\$ 505	\$ 125	\$ (8)	\$ 1,512	
Change in deferred revenues:							
Digital online channels (1)	\$ 57	\$ 101	\$ 1	\$	\$	\$ 159	
Retail channels	(12)	(2)				(14)	
Other (2)		(2)		3		1	
Total change in deferred revenues	\$ 45	\$ 97	\$ 1	\$ 3	\$	\$ 146	
Segment net revenues:							
Digital online channels (1)	\$ 356	\$ 581	\$ 506	\$	\$ (8)	\$ 1,435	
Retail channels	41	21				62	
Other (2)		33		128		161	
Total segment net revenues	\$ 397	\$ 635	\$ 506	\$ 128	\$ (8)	\$ 1,658	

Edgar Filing: Activision Blizzard, Inc. - Form 10-Q

Table of Contents

	Nine Months Ended September 30, 2018						
	Activision	Blizzard	King	Non-reportable segments	Elimination of intersegment revenues (3)	Total	
Net revenues by distribution channel:							
Digital online channels (1)	\$ 1,110	\$ 1,355	\$ 1,547	\$	\$ (14)	\$ 3,998	
Retail channels	707	57				764	
Other (2)		124		233		357	
Total consolidated net revenues	\$ 1,817	\$ 1,536	\$ 1,547	\$ 233	\$ (14)	\$ 5,119	
Change in deferred revenues:							
Digital online channels (1)	\$ (234)	\$ 79	\$ (5)	\$	\$	\$ (160)	
Retail channels	(536)	(10)				(546)	
Other (2)		1		13		14	
Total change in deferred revenues	\$ (770)	\$ 70	\$ (5)	\$ 13	\$	\$ (692)	
Segment net revenues:							
Digital online channels (1)	\$ 876	\$ 1,434	\$ 1,542	\$	\$ (14)	\$ 3,838	
Retail channels	171	47				218	
Other (2)		125		246		371	
Total segment net revenues	\$ 1,047	\$ 1,606	\$ 1,542	\$ 246	\$ (14)	\$ 4,427	

Net revenues by distribution channel for the three and nine months ended September 30, 2017, were as follows (amounts in millions):

	Three Months Ended September 30, 2017		Nine Months Ended September 30, 2017	
Net revenues by distribution channel:				
Digital online channels (1)	\$	1,354	\$	4,048
Retail channels		168		698
Other (2)		96		228
Total consolidated net revenues	\$	1,618	\$	4,974

(1) Net revenues from Digital online channels include revenues from digitally-distributed subscriptions, downloadable content, microtransactions, and products, as well as licensing royalties.

(2) Net revenues from Other include revenues from our Studios and Distribution businesses, as well as revenues from MLG and the Overwatch League.

(3) Intersegment revenues reflect licensing and service fees charged between segments.

Edgar Filing: Activision Blizzard, Inc. - Form 10-Q

Table of Contents

Geographic information presented below is based on the location of the paying customer. Net revenues by geographic region, including a reconciliation to each of our reportable segment's net revenues, for the three and nine months ended September 30, 2018, were as follows (amounts in millions):

	Three Months Ended September 30, 2018					Elimination of intersegment revenues (2)	Total
	Activision	Blizzard	King	Non-reportable segments			
Net revenues by geographic region:							
Americas	\$ 214	\$ 242	\$ 309	\$ 13	\$ (4)	\$ 774	
EMEA (1)	109	172	143	112	(2)	534	
Asia Pacific	29	124	53		(2)	204	
Total consolidated net revenues	\$ 352	\$ 538	\$ 505	\$ 125	\$ (8)	\$ 1,512	
Change in deferred revenues:							
Americas	\$ 33	\$ 43	\$	\$	\$	\$ 76	
EMEA (1)	8	48	1	3		60	
Asia Pacific	4	6				10	
Total change in deferred revenues	\$ 45	\$ 97	\$ 1	\$ 3	\$	\$ 146	
Segment net revenues:							
Americas	\$ 247	\$ 285	\$ 309	\$ 13	\$ (4)	\$ 850	
EMEA (1)	117	220	144	115	(2)	594	
Asia Pacific	33	130	53		(2)	214	
Total segment net revenues	\$ 397	\$ 635	\$ 506	\$ 128	\$ (8)	\$ 1,658	

	Nine Months Ended September 30, 2018					Elimination of intersegment revenues (2)	Total
	Activision	Blizzard	King	Non-reportable segments			
Net revenues by geographic region:							
Americas	\$ 1,074	\$ 716	\$ 945	\$ 13	\$ (8)	\$ 2,740	
EMEA (1)	613	497	448	220	(4)	1,774	
Asia Pacific	130	323	154		(2)	605	
Total consolidated net revenues	\$ 1,817	\$ 1,536	\$ 1,547	\$ 233	\$ (14)	\$ 5,119	
Change in deferred revenues:							
Americas	\$ (439)	\$ 43	\$ (3)	\$	\$	\$ (399)	
EMEA (1)	(287)	34	(2)	13		(242)	
Asia Pacific	(44)	(7)				(51)	
Total change in deferred revenues	\$ (770)	\$ 70	\$ (5)	\$ 13	\$	\$ (692)	
Segment net revenues:							
Americas	\$ 635	\$ 759	\$ 942	\$ 13	\$ (8)	\$ 2,341	
EMEA (1)	326	531	446	233	(4)	1,532	
Asia Pacific	86	316	154		(2)	554	
Total segment net revenues	\$ 1,047	\$ 1,606	\$ 1,542	\$ 246	\$ (14)	\$ 4,427	

Edgar Filing: Activision Blizzard, Inc. - Form 10-Q

Table of Contents

Net revenues by geographic region for the three and nine months ended September 30, 2017, were as follows (amounts in millions):

	Three Months Ended September 30, 2017		Nine Months Ended September 30, 2017	
Net revenues by geographic region:				
Americas	\$	798	\$	2,586
EMEA (1)		593		1,684
Asia Pacific		227		704
Total consolidated net revenues	\$	1,618	\$	4,974

(1) EMEA consists of the Europe, Middle East, and Africa geographic regions.

(2) Intersegment revenues reflect licensing and service fees charged between segments.

The Company's net revenues in the U.S. were 46% and 43% of consolidated net revenues for the three months ended September 30, 2018 and 2017, respectively. The Company's net revenues in the U.K. were 13% and 12% of consolidated net revenues for the three months ended September 30, 2018 and 2017, respectively. No other country's net revenues exceeded 10% of consolidated net revenues for either the three months ended September 30, 2018 or 2017.

The Company's net revenues in the U.S. were 47% and 46% of consolidated net revenues for the nine months ended September 30, 2018 and 2017, respectively. The Company's net revenues in the U.K. were 11% and 10% of consolidated net revenues for the nine months ended September 30, 2018 and 2017, respectively. No other country's net revenues exceeded 10% of consolidated net revenues for either the nine months ended September 30, 2018 or 2017.

Net revenues by platform, including a reconciliation to each of our reportable segment's net revenues, for the three and nine months ended September 30, 2018, were as follows (amounts in millions):

	Three Months Ended September 30, 2018					Elimination of intersegment revenues (3)	Total					
	Activision	Blizzard	King	Non- reportable segments								
Net revenues by platform:												
Console	\$	307	\$	40	\$		\$	347				
PC		40		414		36	(8)	482				
Mobile and ancillary (1)		5		49		469		523				
Other (2)				35		125		160				
Total consolidated net revenues	\$	352	\$	538	\$	505	\$	125	\$	(8)	\$	1,512
Change in deferred revenues:												
Console	\$	29	\$	(9)	\$		\$		\$		\$	20
PC		16		101								117

Edgar Filing: Activision Blizzard, Inc. - Form 10-Q

Mobile and ancillary (1)			7		1				8			
Other (2)			(2)				3		1			
Total change in deferred revenues	\$	45	\$	97	\$	1	\$	3	\$	146		
Segment net revenues:												
Console	\$	336	\$	31	\$		\$		\$	367		
PC		56		515		36		(8)		599		
Mobile and ancillary (1)		5		56		470				531		
Other (2)				33				128		161		
Total segment net revenues	\$	397	\$	635	\$	506	\$	128	\$	(8)	\$	1,658

Edgar Filing: Activision Blizzard, Inc. - Form 10-Q

Table of Contents

	Nine Months Ended September 30, 2018						
	Activision	Blizzard	King	Non-reportable segments	Elimination of intersegment revenues (3)		Total
Net revenues by platform:							
Console	\$ 1,597	\$ 133	\$	\$	\$		\$ 1,730
PC	208	1,140	118		(14)		1,452
Mobile and ancillary (1)	12	139	1,429				1,580
Other (2)		124		233			357
Total consolidated net revenues	\$ 1,817	\$ 1,536	\$ 1,547	\$ 233	\$ (14)		\$ 5,119
Change in deferred revenues:							
Console	\$ (695)	\$ (25)	\$	\$	\$		\$ (720)
PC	(76)	96					20
Mobile and ancillary (1)	1	(2)	(5)				(6)
Other (2)		1		13			14
Total change in deferred revenues	\$ (770)	\$ 70	\$ (5)	\$ 13	\$		\$ (692)
Segment net revenues:							
Console	\$ 902	\$ 108	\$	\$	\$		\$ 1,010
PC	132	1,236	118		(14)		1,472
Mobile and ancillary (1)	13	137	1,424				1,574
Other (2)		125		246			371
Total segment net revenues	\$ 1,047	\$ 1,606	\$ 1,542	\$ 246	\$ (14)		\$ 4,427

Net revenues by platform for the three and nine months ended September 30, 2017, were as follows (amounts in millions):

	Three Months Ended September 30, 2017		Nine Months Ended September 30, 2017	
Net revenues by platform:				
Console	\$	527	\$	1,710
PC		461		1,534
Mobile and ancillary (1)		534		1,502
Other (2)		96		228
Total consolidated net revenues	\$	1,618	\$	4,974

(1) Net revenues from Mobile and ancillary include revenues from mobile devices, as well as non-platform specific game-related revenues, such as standalone sales of toys and accessories from our Skylanders® franchise and other physical merchandise and accessories.

(2) Net revenues from Other include revenues from our Studios and Distribution businesses, as well as revenues from MLG and the Overwatch League.

(3) Intersegment revenues reflect licensing and service fees charged between segments.

Table of Contents

Long-lived assets by geographic region were as follows (amounts in millions):

	At September 30, 2018	At December 31, 2017
Long-lived assets (1) by geographic region:		
Americas	\$ 202	\$ 197
EMEA	61	75
Asia Pacific	18	22
Total long-lived assets by geographic region	\$ 281	\$ 294

(1) The only long-lived assets that we classify by region are our long-term tangible fixed assets, which consist of property, plant, and equipment assets; all other long-term assets are not allocated by location.

13. Income Taxes

We account for our provision for income taxes in accordance with Accounting Standards Codification (ASC) 740, *Income Taxes*, which requires an estimate of the annual effective tax rate for the full year to be applied to the interim period, taking into account year-to-date amounts and projected results for the full year. The provision for income taxes represents federal, foreign, state, and local income taxes. Our effective tax rate differs from the statutory U.S. income tax rate due to the effect of state and local income taxes, tax rates that apply to our foreign income (including U.S. tax on foreign income), research and development credits, and certain nondeductible expenses. Our effective tax rate could fluctuate significantly from quarter to quarter based on recurring and nonrecurring factors including, but not limited to: variations in the estimated and actual level of pre-tax income or loss by jurisdiction (including changes in the mix of income by tax jurisdiction); changes in enacted tax laws and regulations, and interpretations thereof, including with respect to tax credits and state and local income taxes; developments in tax audits and other matters; recognition of excess tax benefits and tax deficiencies from share-based payments; and certain nondeductible expenses. Changes in judgment from the evaluation of new information resulting in the recognition, derecognition, or remeasurement of a tax position taken in a prior annual period are recognized separately in the quarter of the change.

On June 27, 2018, the Company entered into a closing agreement with the Internal Revenue Service (IRS) to resolve certain intercompany transfer pricing arrangements for tax periods starting in 2009 (the Closing Agreement). The primary adjustments related to the Closing Agreement that were recognized in the second quarter of 2018 were a tax expense of \$70 million and a reduction in unrecognized tax benefits of \$437 million. In addition, we recognized \$185 million of tax benefits related to other tax adjustments resulting from the changes in U.S. tax attributes and taxable income caused by the primary adjustments. The Closing Agreement results in federal and state cash tax payments totaling approximately \$345 million, of which we made federal tax payments of \$334 million in October 2018.

We evaluate deferred tax assets each period for recoverability. We record a valuation allowance for assets that do not meet the threshold of more likely than not to be realized in the future. To make that determination, the Company evaluates the likelihood of realization based on the weight of all positive and negative evidence available. As of December 31, 2017, the Company had a deferred tax asset for California research and development credit carryforwards (CA R&D Credits), which can be carried forward indefinitely. The Closing Agreement impacts historical and prospective filings in certain states, including California, and after considering the impact of the Closing Agreement on its prospective California taxable income, the Company determined that its remaining CA R&D Credits no longer met the threshold of more likely than not of being realized in the future. Accordingly, during the three months ended June 30, 2018, we recorded a full valuation allowance of \$57 million. Additionally, the Company has not recognized a tax benefit for current-year CA R&D Credits in its year-to-date tax expense. We will reassess this determination quarterly and record a tax benefit if future evidence allows for a partial or full release of this valuation allowance.

Edgar Filing: Activision Blizzard, Inc. - Form 10-Q

On December 22, 2017, the U.S. Tax Reform Act was enacted. The U.S. Tax Reform Act, among other things, reduced the U.S. corporate income tax rate from 35% to 21% beginning in 2018 and implemented a modified territorial tax system that imposed a one-time tax on deemed repatriated earnings of foreign subsidiaries (the Transition Tax).

Edgar Filing: Activision Blizzard, Inc. - Form 10-Q

Table of Contents

On December 22, 2017, the SEC staff issued Staff Accounting Bulletin No. 118 (SAB 118), which provides guidance on how to account for the effects of the U.S. Tax Reform Act under ASC 740. SAB 118 enables companies to record a provisional amount for the effects of the U.S. Tax Reform Act based on a reasonable estimate, subject to adjustment during a measurement period of up to one year, until accounting is complete. During the fourth quarter of 2017, we recorded provisional amounts for the effects of the U.S. Tax Reform Act in accordance with SAB 118. In addition, as of December 31, 2017, we no longer considered the available cash balances related to undistributed earnings held outside of the U.S. by our foreign subsidiaries to be indefinitely reinvested. We continue to analyze the effects of the U.S. Tax Reform Act on our condensed consolidated financial statements. Accounting for the income tax effects of the U.S. Tax Reform Act requires complex new calculations to be performed and significant judgments in interpreting the legislation. Additional guidance may be issued on how the provisions of the U.S. Tax Reform Act will be applied or otherwise administered that is different from our interpretation. We may make adjustments to the provisional amounts as we collect and prepare the data necessary to finalize our calculations, interpret the U.S. Tax Reform Act and any additional guidance issued, and consider the effects of any additional actions we may take as a result of the U.S. Tax Reform Act.

During the three months ended June 30, 2018, the Company obtained additional information, including adjustments related to the Closing Agreement, and the evaluation of the impact of changing our indefinite reinvestment assertion, which affected the provisional amount initially recorded for the U.S. Tax Reform Act in the fourth quarter of 2017. As a result, the Company recorded an additional tax expense of \$34 million in the three months ended June 30, 2018, reflecting the effects of the U.S. Tax Reform Act.

In conjunction with the filing of our 2017 federal tax return, during the three months ended September 30, 2018, the Company prepared and analyzed additional information, which affected the provisional amounts initially recorded for the U.S. Tax Reform Act in the fourth quarter of 2017. As result, the Company recorded a tax benefit of \$80 million related to the Transition Tax and remeasurement of deferred taxes in the three months September 30, 2018, reflecting the effects of the U.S. Tax Reform Act.

We continue to evaluate the ongoing impacts of the U.S. Tax Reform Act, including provisions impacting certain foreign income, such as a tax on global intangible low-taxed income of foreign subsidiaries (GILTI) and a deduction for foreign derived intangible income. These provisions are complex and subject to continuing regulatory interpretation by the IRS. While we have included an estimate of GILTI in our estimated effective tax rate for 2018, we may make adjustments as we interpret the U.S. Tax Reform Act and any additional guidance issued and consider the effects of any additional actions we may take as a result of the U.S. Tax Reform Act.

The income tax benefit of \$48 million for the three months ended September 30, 2018, reflects an effective tax rate of (23)%, which is lower than the effective tax rate of 15% for the three months ended September 30, 2017. The decrease is due to a discrete tax benefit resulting from adjustments made to the provisional amount initially recorded for U.S. Tax Reform Act described above and the benefit from the lower U.S. corporate income tax rate in the current year. This decrease was partially offset by lower excess tax benefits from share-based payments.

The income tax expense of \$25 million for the nine months ended September 30, 2018, reflects an effective tax rate of 2%, which is lower than the effective tax rate of 11% for the nine months ended September 30, 2017. The decrease is due to a discrete net tax benefit resulting from the Closing Agreement, a discrete tax benefit resulting from adjustments made to the provisional amount initially recorded for U.S. Tax Reform Act and the benefit from the lower U.S. corporate income tax rate in the current year, net of the impact of GILTI. This decrease was partially offset by the valuation allowance recorded with regard to CA R&D Credits and lower excess tax benefits from share-based payments.

The effective tax rate of (23)% and 2% for the three and nine months ended September 30, 2018, respectively, is lower than the U.S. statutory rate of 21%, primarily due to a discrete net tax benefit resulting from the Closing Agreement, a discrete tax benefit resulting from adjustments made to the provisional amount initially recorded for U.S. Tax Reform Act, foreign earnings taxed at relatively lower statutory rates, the recognition of excess tax benefits from share-based payments, and recognition of federal research and development credits, partially offset by

the valuation allowance recorded with regard to CA R&D Credits.

Table of Contents

Activision Blizzard's 2009 through 2016 tax years remain open to examination by certain major taxing jurisdictions to which we are subject. During February 2018, the Company was notified by the IRS that its tax returns for 2012 through 2016 tax years will be subject to examination. In September 2018, the IRS concluded its examination of our 2009 through 2011 tax years. The Company also has several state and non-U.S. audits pending, including the French audit discussed below. In addition, as part of purchase price accounting for our 2016 acquisition of King, the Company assumed \$74 million of uncertain tax positions primarily related to pre-acquisition transfer pricing matters. The Company is currently in negotiations with the tax authorities in the relevant jurisdictions, which include the UK and Sweden, with respect to King's transfer pricing for both pre- and post-acquisition tax years. While the outcome of these negotiations remains uncertain, they could result in an agreement that changes the allocation of profits and losses between these and other relevant jurisdictions or a failure to reach agreement that results in unilateral adjustments to the amount and timing of taxable income in the jurisdictions in which King operates.

On October 25, 2018, we received a proposal from the Swedish Tax Agency (STA) informing us of their intent to issue an audit assessment to a Swedish subsidiary of King for the 2016 tax year. The STA proposal described the basis for issuing a transfer pricing assessment of approximately 3.5kr billion (approximately \$400 million) primarily concerning an alleged intercompany asset transfer. We disagree with the STA's proposal and, if they proceed with issuing a formal tax assessment, intend to vigorously contest it. We would plan to pursue all remedies available to us to successfully resolve the matter, including administrative remedies with the STA, multilateral procedures with other relevant taxing jurisdictions, and, if necessary, judicial remedies. While we believe our tax provisions at September 30, 2018 are appropriate, until such time as this matter is ultimately resolved we could be subject to significant additional tax liabilities.

On December 28, 2017, we received a Notice of Reassessment from the French Tax Authority (FTA) related to transfer pricing concerning intercompany transactions involving one of our French subsidiaries for the 2011 through 2013 tax years. The total assessment, including penalties and interest, was approximately 571 million (approximately \$660 million). We disagree with the proposed assessment and intend to vigorously contest it. We plan to pursue all remedies available to us to successfully resolve this matter, including administrative remedies with the FTA, and, if necessary, judicial remedies. While we believe our tax provisions at September 30, 2018 are appropriate, until such time as this matter is ultimately resolved we could be subject to significant additional tax liabilities. In addition to the risk of additional tax for years 2011 through 2013, if litigation regarding this matter were adversely determined and/or if the FTA were to seek adjustments of a similar nature for subsequent years, we could be subject to significant additional tax liabilities.

In addition, certain of our subsidiaries are under examination or investigation, or may be subject to examination or investigation, by tax authorities in various jurisdictions. These proceedings may lead to adjustments or proposed adjustments to our taxes or provisions for uncertain tax positions. Such proceedings may have a material adverse effect on the Company's consolidated financial position, liquidity or results of operations in the period or periods in which the matters are resolved or in which appropriate tax provisions are taken into account in our financial statements. If we were to receive a materially adverse assessment from a taxing jurisdiction, we would plan to vigorously contest it and consider all of our options, including the pursuit of judicial remedies.

We regularly assess the likelihood of adverse outcomes resulting from these examinations and monitor the progress of ongoing discussions with tax authorities in determining the appropriateness of our tax provisions. The final resolution of the Company's global tax disputes is uncertain. There is significant judgment required in the analysis of disputes, including the probability determination and estimation of the potential exposure. Based on current information, in the opinion of the Company's management, the ultimate resolution of these matters is not expected to have a material adverse effect on the Company's consolidated financial position, liquidity or results of operations, except as noted above.

Table of Contents**14. Computation of Basic/Diluted Earnings Per Common Share**

The following table sets forth the computation of basic and diluted earnings per common share (amounts in millions, except per share data):

	For the Three Months Ended September 30,		For the Nine Months Ended September 30,	
	2018	2017	2018	2017
Numerator:				
Consolidated net income	\$ 260	\$ 188	\$ 1,162	\$ 858
Denominator:				
Denominator for basic earnings per common share weighted-average common shares outstanding	763	755	761	753
Effect of potential dilutive common shares under the treasury stock method employee stock options and awards	8	11	10	11
Denominator for basic earnings per common share weighted-average dilutive common shares outstanding	771	766	771	764
Basic earnings per common share	\$ 0.34	\$ 0.25	\$ 1.53	\$ 1.14
Diluted earnings per common share	\$ 0.34	\$ 0.25	\$ 1.51	\$ 1.12

The vesting of certain of our employee-related restricted stock units and options is contingent upon the satisfaction of pre-defined performance measures. The shares underlying these equity awards are included in the weighted-average dilutive common shares only if the performance measures are met as of the end of the reporting period. Approximately 6 million shares are not included in the computation of diluted earnings per share for both the three and nine months ended September 30, 2018, as their underlying performance measures had not yet been met. Approximately 9 million and 8 million shares are not included in the computation of diluted earnings per share for the three and nine months ended September 30, 2017, respectively, as their underlying performance measures had not yet been met.

Potential common shares are not included in the denominator of the diluted earnings per common share calculation when the inclusion of such shares would be anti-dilutive. Therefore, approximately 1 million and 2 million options to purchase shares of common stock were not included in the calculation of diluted earnings per common share for the three and nine months ended September 30, 2018, respectively, and 1 million options to purchase shares of common stock were not included in the calculation of diluted earnings per common share for both the three and nine months ended September 30, 2017, as the effect of their inclusion would be anti-dilutive.

15. Capital Transactions***Repurchase Program***

On February 2, 2017, our Board of Directors authorized a stock repurchase program under which we are authorized to repurchase up to \$1 billion of our common stock during the two-year period from February 13, 2017 through February 12, 2019. As of September 30, 2018, we have

not repurchased any shares under this program.

Dividends

On February 1, 2018, our Board of Directors approved a cash dividend of \$0.34 per common share. On May 9, 2018, we made an aggregate cash dividend payment of \$259 million to shareholders of record at the close of business on March 30, 2018.

On February 2, 2017, our Board of Directors approved a cash dividend of \$0.30 per common share. On May 10, 2017, we made an aggregate cash dividend payment of \$226 million to shareholders of record at the close of business on March 30, 2017.

Table of Contents

16. Commitments and Contingencies

Legal Proceedings

We are party to routine claims, suits, investigations, audits, and other proceedings arising from the ordinary course of business, including with respect to intellectual property rights, contractual claims, labor and employment matters, regulatory matters, tax matters, unclaimed property matters, compliance matters, and collection matters. In the opinion of management, after consultation with legal counsel, such routine claims and lawsuits are not significant and we do not expect them to have a material adverse effect on our business, financial condition, results of operations, or liquidity.

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

Business Overview

Activision Blizzard, Inc. is a leading global developer and publisher of interactive entertainment content and services. We develop and distribute content and services on video game consoles, personal computers (PC), and mobile devices. We also operate esports events and leagues and create film and television content based on our intellectual property. The terms Activision Blizzard, the Company, we, us, and our are used to refer collectively to Activision Blizzard, Inc. and its subsidiaries.

The Company was originally incorporated in California in 1979 and was reincorporated in Delaware in December 1992. In connection with the 2008 business combination by and among the Company (then known as Activision, Inc.), Vivendi S.A. (Vivendi), and Vivendi Games, Inc., then an indirect wholly-owned subsidiary of Vivendi, we were renamed Activision Blizzard, Inc.

The common stock of Activision Blizzard is traded on The Nasdaq Stock Market under the ticker symbol ATVI.

Our Segments

Based on our organizational structure, we conduct our business through three reportable segments, as follows:

(i) *Activision Publishing, Inc.*

Edgar Filing: Activision Blizzard, Inc. - Form 10-Q

Activision Publishing, Inc. (Activision), is a leading global developer and publisher of interactive software products and entertainment content, particularly for the console platforms. Activision primarily delivers content through retail and digital channels, including full-game and in-game sales, as well as by licensing software to third-party or related-party companies that distribute Activision products. Activision develops, markets, and sells products based on our internally developed intellectual properties, as well as some licensed properties. We have also established a long-term alliance with Bungie to publish its game universe, Destiny.

Activision's key product franchises include: Call of Duty®, a first-person shooter for the console and PC platforms; and Destiny, an online universe of first-person action gameplay (which we call a shared-world shooter) for the console and PC platforms.

Table of Contents

(ii) Blizzard Entertainment, Inc.

Blizzard Entertainment, Inc. (*Blizzard*) is a leading global developer and publisher of interactive software products and entertainment content, particularly for the PC platform. Blizzard primarily delivers content through retail and digital channels, including subscriptions, full-game, and in-game sales, as well as by licensing software to third-party or related-party companies that distribute Blizzard products. Blizzard also maintains a proprietary online gaming service, *Blizzard Battle.net®*, which facilitates digital distribution of Blizzard content and selected Activision content, online social connectivity, and the creation of user-generated content. Blizzard also includes the activities of the *Overwatch League™*, the first major global professional esports league with city-based teams, and our *Major League Gaming (MLG)* business, which is responsible for various esports events and serves as a multi-platform network for Activision Blizzard esports content.

Blizzard's key product franchises include: *World of Warcraft®*, a subscription-based massive multi-player online role-playing game for the PC platform; *StarCraft®*, a real-time strategy franchise for the PC platform; *Diablo®*, an action role-playing franchise for the PC and console platforms; *Hearthstone®*, an online collectible card franchise for the PC and mobile platforms; *Heroes of the Storm®*, a free-to-play team brawler for the PC platform; and *Overwatch®*, a team-based first-person shooter for the PC and console platforms.

(iii) King Digital Entertainment

King Digital Entertainment (*King*) is a leading global developer and publisher of interactive entertainment content and services, particularly on mobile platforms, such as Google Inc. (*Google*) Android and Apple Inc. (*Apple*) iOS. King also distributes its content and services on the PC platform, primarily via Facebook. King's games are free to play, however, players can acquire in-game items, either with virtual currency or directly using real currency.

King's key product franchises, all of which are for the mobile and PC platforms, include: *Candy Crush*, which features match three games; *Farm Heroes*, which also features match three games; and *Bubble Witch*, which features bubble shooter games.

Other

We also engage in other businesses that do not represent reportable segments, including:

- the Activision Blizzard Studios (*Studios*) business, which is devoted to creating original film and television content based on our library of globally recognized intellectual properties, and which, in September 2018, released the third season of the animated TV series *Skylanders Academy* on Netflix; and

- the Activision Blizzard Distribution (Distribution) business, which consists of operations in Europe that provide warehousing, logistics, and sales distribution services to third-party publishers of interactive entertainment software, our own publishing operations, and manufacturers of interactive entertainment hardware.

Business Results and Highlights

Financial Results

The Company's financial results for 2018 are presented in accordance with a new revenue accounting standard that was adopted in the first quarter of 2018. Prior period results have not been restated to reflect this change in accounting standards. Further information about our adoption of the new standard is provided in Notes 2 and 3 of the notes to condensed consolidated financial statements included in Item 1 of this Quarterly Report on Form 10-Q.

During the three months ended September 30, 2018:

- consolidated net revenues decreased 7% to \$1.51 billion, while consolidated operating income increased 3% to \$265 million, as compared to consolidated net revenues of \$1.62 billion and consolidated operating income of \$257 million for the three months ended September 30, 2017;

Table of Contents

- revenues from digital online channels were \$1.28 billion, or 84% of consolidated net revenues, as compared to \$1.35 billion, or 84% of consolidated net revenues, for the three months ended September 30, 2017;
- operating margin was 17.5%, as compared to 15.9% for the three months ended September 30, 2017;
- consolidated net income increased 38% to \$260 million, as compared to \$188 million for the three months ended September 30, 2017; net income for the 2018 period included \$72 million of net tax benefits from discrete tax items primarily related to updates to our accounting for the Tax Cuts and Jobs Act (U.S. Tax Reform Act) (see Consolidated Results discussion below for additional details); and
- diluted earnings per common share increased 36% to \$0.34, as compared to \$0.25 for the three months ended September 30, 2017.

During the nine months ended September 30, 2018:

- consolidated net revenues increased 3% to \$5.12 billion, and consolidated operating income increased 19% to \$1.29 billion, as compared to consolidated net revenues of \$4.97 billion and consolidated operating income of \$1.09 billion for the nine months ended September 30, 2017;
- revenues from digital online channels were \$4.00 billion, or 78% of consolidated net revenues, as compared to \$4.05 billion, or 81% of consolidated net revenues, for the nine months ended September 30, 2017;
- operating margin was 25.3%, as compared to 21.9% for the nine months ended September 30, 2017;
- cash flows from operating activities were \$791 million, a decrease of 25%, as compared to \$1.06 billion for the nine months ended September 30, 2017;
- consolidated net income increased 35% to \$1.16 billion, as compared to \$858 million for the nine months ended September 30, 2017; net income for the 2018 period included \$97 million of net tax benefits from several discrete tax items, primarily related to updates to our accounting for the U.S. Tax Reform Act, the settlement with the Internal Revenue Service (IRS) with respect to intercompany transfer pricing arrangements, and the establishment of a

valuation allowance on California research and development credit carryforwards (see Consolidated Results discussion below for additional details); and

- diluted earnings per common share increased 35% to \$1.51, as compared to \$1.12 for the nine months ended September 30, 2017.

Since certain of our games are hosted online or include significant online functionality that represents a separate performance obligation, we defer the transaction price allocable to the online functionality from the sale of these games and recognize the attributable revenues over the relevant estimated service periods, which are generally less than a year. Net revenues and operating income for the three months ended September 30, 2018, include a net effect of \$146 million and \$89 million, respectively, from the deferral of net revenues and related cost of revenues. Net revenues and operating income for the nine months ended September 30, 2018, include a net effect of \$692 million and \$468 million, respectively, from the recognition of deferred net revenues and related cost of revenues.

Content Release and Event Highlights

Games and downloadable content that were released during the three months ended September 30, 2018, include:

- Activision's *United Front*, the third downloadable content pack for *Call of Duty: WWII*, on Xbox One and PC;
- Activision's *Shadow War*, the fourth downloadable content pack for *Call of Duty: WWII*;

Table of Contents

- Activision's *Forsaken*, the third expansion to *Destiny 2*;
- Blizzard's latest expansion to *Hearthstone Boomsday*; and
- Blizzard's *World of Warcraft: Battle for Azeroth*, the seventh expansion to World of Warcraft.

Operating Metrics

The following operating metrics are key performance indicators that we use to evaluate our business.

Net Bookings

We monitor net bookings as a key operating metric in evaluating the performance of our business. Net bookings is defined as the net amount of products and services sold digitally or sold-in physically in the period, and includes license fees, merchandise, and publisher incentives, among others. Net bookings is equal to net revenues excluding the impact from deferrals.

Net bookings were as follows (amounts in millions):

	September 30, 2018	September 30, 2017	Increase (Decrease)
Net bookings			
Three Months Ended	\$ 1,658	\$ 1,902	\$ (244)
Nine Months Ended	\$ 4,427	\$ 4,516	\$ (89)

Q3 2018 vs. Q3 2017

The decrease in net bookings for the three months ended September 30, 2018, as compared to the three months ended September 30, 2017, was primarily due to:

- lower net bookings from the Destiny franchise, primarily due to lower net bookings from *Forsaken*, the third expansion to *Destiny 2*, which was released in September 2018, as compared to the full game release of *Destiny 2* in

September 2017;

- lower net bookings from *Call of Duty: Infinite Warfare*™ (which, when referred to herein, is inclusive of *Call of Duty: Modern Warfare*® *Remastered*), which was released in November 2016, in its second year after release, as compared to *Call of Duty: Black Ops III*, which was released in November 2015, in its second year after release; and
- lower net bookings from *Crash Bandicoot N. Sane Trilogy*, which was released in June 2017 on the PlayStation 4 platform, and in June 2018 on the Xbox One, PC, and Nintendo Switch platforms.

The decrease was partially offset by higher net bookings from *World of Warcraft*, driven by *World of Warcraft: Battle for Azeroth*, which was released in August 2018, with no comparable release in 2017.

YTD Q3 2018 vs. YTD Q3 2017

The decrease in net bookings for the nine months ended September 30, 2018, as compared to the nine months ended September 30, 2017, was primarily due to:

- lower net bookings from *Call of Duty: Infinite Warfare* in its second year after release, as compared to *Call of Duty: Black Ops III* in its second year after release;

Table of Contents

- lower net bookings from *Overwatch*, which was released in May 2016, and *Hearthstone*;
- lower net bookings from the Destiny franchise, primarily due to lower net bookings from the *Forsaken* expansion, as compared to the full-game release of *Destiny 2*; and
- lower net bookings due to fewer content releases in 2018 from our Diablo and Bubble Witch franchises as compared to 2017.

The decrease was partially offset by:

- higher net bookings from *World of Warcraft*, driven by *World of Warcraft: Battle for Azeroth*;
- higher net bookings from *Call of Duty: WWII*, which was released in November 2017, as compared to *Call of Duty: Infinite Warfare*, which was released in November 2016;
- higher net bookings from the Candy Crush franchise due to increased monetization, primarily through in-game features and events; and
- net bookings from the Overwatch League, which started its inaugural regular season in January 2018.

Monthly Active Users

We monitor monthly active users (MAUs) as a key measure of the overall size of our user base. MAUs are the number of individuals who accessed a particular game in a given month. We calculate average MAUs in a period by adding the total number of MAUs in each of the months in a given period and dividing that total by the number of months in the period. An individual who accesses two of our games would be counted as two users. In addition, due to technical limitations, for Activision and King, an individual who accesses the same game on two platforms or devices in the relevant period would be counted as two users. For Blizzard, an individual who accesses the same game on two platforms or devices in the relevant period would generally be counted as a single user.

The number of MAUs for a given period can be significantly impacted by the timing of new content releases, since new releases may cause a temporary surge in MAUs. Accordingly, although we believe that overall trending in the number of MAUs can be a meaningful performance

Edgar Filing: Activision Blizzard, Inc. - Form 10-Q

metric, period-to-period fluctuations may not be indicative of longer-term trends. The following table details our average MAUs on a sequential quarterly basis for each of our reportable segments (amounts in millions):

	September 30, 2018	June 30, 2018	March 31, 2018	December 31, 2017	September 30, 2017	June 30, 2017
Activision	46	45	51	55	49	47
Blizzard	37	37	38	40	42	46
King	262	270	285	290	293	314
Total	345	352	374	385	384	407

Average MAUs decreased by 7 million, or 2%, for the three months ended September 30, 2018, as compared to the three months ended June 30, 2018. The sequential decrease in King's average MAUs is due to minor decreases across franchises from less engaged users leaving the network.

Average MAUs decreased by 39 million, or 10%, for the three months ended September 30, 2018, as compared to the three months ended September 30, 2017. The year-over-year decrease in King's average MAUs is due to decreases across King's franchises from less engaged users leaving the network. King MAUs were also negatively impacted by technical system changes in the prior quarter made by some third-party partners in response to data initiatives, which inadvertently impacted some users' ability to play and spend money in King games. The year-over-year decrease in Blizzard's average MAUs is due to lower MAUs for *Hearthstone* and *Overwatch*.

Table of Contents

Management's Overview of Business Trends

Interactive Entertainment and Mobile Gaming Growth

Our business participates in the global interactive entertainment industry. Games have become an increasingly popular form of entertainment, and we estimate the total industry grew, on average, 18% from 2014 to 2017. The industry continues to benefit from additional players entering the market as interactive entertainment becomes more commonplace across age groups and as more developing regions gain access to this form of entertainment.

Further, the wide adoption of smart phones globally and the free-to-play business model on the mobile platform has increased the total addressable market for gaming significantly by introducing gaming to new age groups and new regions and allowing gaming to occur more widely outside the home. Mobile gaming is estimated to be larger than both console and PC gaming and continues to grow at a significant rate. King is a leading developer of mobile and free-to-play games and our other business units have mobile efforts underway that present the opportunity for us to expand the reach of, and drive additional player investment from, our franchises.

Opportunities to Expand Franchises Outside of Games

Our fans spend significant time investing in our franchises through purchases of our game content, whether through purchases of full games or downloadable content or via microtransactions. Given the passion our players have for our franchises, we believe there are emerging opportunities to drive additional engagement and investment in our franchises outside of games. These opportunities include esports, film and television, and consumer products. Our efforts to build these adjacent opportunities are still relatively nascent, but we view them as potentially significant sources of future revenues.

As part of our efforts to take advantage of the esports opportunity, during 2017 we completed the sale of 12 teams for the Overwatch League, the first major global professional esports league with city-based teams, which completed its inaugural season in July 2018. During 2018, we have completed the sale of eight additional teams, which are expected to compete in the league's second season.

Concentration of Sales Among the Most Popular Franchises

The concentration of retail revenues among key titles has continued as a trend in the overall interactive entertainment industry. According to The NPD Group, the top 10 titles accounted for 36% of the retail sales in the U.S. interactive entertainment industry in 2017. Similarly, a significant portion of our revenues has historically been derived from video games based on a few popular franchises and these video games were responsible for a disproportionately high percentage of our profits. For example, the Call of Duty, Candy Crush, World of Warcraft, and Overwatch franchises, collectively, accounted for 66% of our consolidated net revenues and a significantly higher percentage of our operating income for 2017.

Edgar Filing: Activision Blizzard, Inc. - Form 10-Q

The top titles in the industry are also becoming more consistent as players and revenues concentrate more heavily in established franchises. The top 10 console franchises in 2017 were all established franchises. Similarly, according to U.S. rankings for the Apple App Store and Google Play store per App Annie Intelligence, as of December 2017, the top 10 mobile games have an average tenure of 22 months.

In addition to investing in, and developing sequels and content for, our top franchises, we are continually exploring additional ways to expand those franchises. Further, while there is no guarantee of success, we invest in new properties in an effort to develop future top franchises. In 2014, we released *Hearthstone* and *Destiny*; in 2015, we released *Heroes of the Storm*; and in 2016, we released *Overwatch*. Additionally, to diversify our portfolio of key franchises and increase our presence in the mobile market, in 2016 we acquired King.

Overall, we do expect that a limited number of popular franchises will continue to produce a disproportionately high percentage of our, and the industry's, revenues and profits in the near future. Accordingly, our ability to maintain our top franchises and our ability to successfully compete against our competitors' top franchises can significantly impact our performance.

Recurring Revenue Business Models

Increased consumer online connectivity has allowed us to offer players new investment opportunities and to shift our business further towards a more consistently recurring and year-round model. Offering downloadable content and microtransactions, in addition to full games, allows our players to access and invest in new content throughout the year. This incremental content not only provides additional high-margin revenues, it can also increase player engagement. Also, mobile games, and free-to-play games more broadly, are generally less seasonal than games developed primarily for the console or PC platforms.

Table of Contents**Consolidated Statements of Operations Data**

The following table sets forth condensed consolidated statements of operations data for the periods indicated in dollars (amounts in millions) and as a percentage of total net revenues, except for cost of revenues, which are presented as a percentage of associated revenues:

	For the Three Months Ended September 30,				For the Nine Months Ended September 30,			
	2018		2017		2018		2017	
Net revenues								
Product sales	\$ 263	17%	\$ 384	24%	\$ 1,447	28%	\$ 1,373	28%
Subscription, licensing, and other revenues	1,249	83	1,234	76	3,672	72	3,601	72
Total net revenues	1,512	100	1,618	100	5,119	100	4,974	100
Costs and expenses:								
Cost of revenues product sales:								
Product costs	127	48	149	39	416	29	422	31
Software royalties, amortization, and intellectual property licenses	20	8	37	10	214	15	200	15
Cost of revenues subscription, licensing, and other revenues:								
Game operations and distribution costs	257	21	249	20	777	21	717	20
Software royalties, amortization, and intellectual property licenses	109	9	117	9	278	8	359	10
Product development	263	17	273	17	776	15	750	15
Sales and marketing	263	17	345	21	741	14	899	18
General and administrative	208	14	191	12	623	12	539	11
Total costs and expenses	1,247	82	1,361	84	3,825	75	3,886	78
Operating income	265	18	257	16	1,294	25	1,088	22
Interest and other expense (income), net	13	1	37	2	67	1	109	3
Loss on extinguishment of debt (1)	40	3			40	1	12	
Income before income tax expense (benefit)	212	14	220	14	1,187	23	967	19
Income tax expense (benefit)	(48)	(3)	32	2	25		109	2
Net income	\$ 260	17%	\$ 188	12%	\$ 1,162	23%	\$ 858	17%

(1) Represents the loss on extinguishment of debt we recognized associated with our debt financing activities. The 2018 loss on extinguishment is comprised of a \$25 million premium payment and an \$8 million write-off of unamortized discount and deferred financing costs associated with the redemption of our 2023 Notes, along with a \$7 million write-off of unamortized discount and deferred financing costs associated with the extinguishment of our outstanding tranche of term loans A. The 2017 loss on extinguishment is comprised of a \$12 million write-off of unamortized discount and deferred financing costs associated with refinancing activities related to our tranche of term loans A.

Table of Contents**Consolidated Net Revenues**

The following table summarizes our consolidated net revenues and the increase (decrease) in deferred net revenues recognized (amounts in millions):

	For the Three Months Ended September 30,				For the Nine Months Ended September 30,			
	2018	2017	Increase (decrease)	% Change	2018	2017	Increase (decrease)	% Change
Consolidated net revenues	\$ 1,512	\$ 1,618	\$ (106)	(7)%	\$ 5,119	\$ 4,974	\$ 145	3%
Net effect from recognition (deferral) of deferred net revenues	(146)	(284)	138		692	458	234	

Consolidated Net RevenuesQ3 2018 vs. Q3 2017

The decrease in consolidated net revenues for the three months ended September 30, 2018, as compared to the three months ended September 30, 2017, was primarily due to a decrease of \$133 million in revenues recognized from Activision, primarily due to lower revenues recognized from *Call of Duty: Infinite Warfare*, which was released in November 2016, in its second year after release, as compared to *Call of Duty: Black Ops III*, which was released in November 2015, in its second year after release, and lower revenues from *Crash Bandicoot N. Sane Trilogy*, which was released in June 2017 on the PlayStation 4 platform, and in June 2018 on the Xbox One, PC, and Nintendo Switch platforms.

The decrease was partially offset by a \$20 million increase in revenues recognized from Blizzard, primarily due to higher revenues recognized from *World of Warcraft*, driven by *World of Warcraft: Battle for Azeroth*, which was released in August 2018, with no comparable release in 2017, partially offset by lower revenues recognized from *Overwatch*, which was released in May 2016.

YTD Q3 2018 vs. YTD Q3 2017

The increase in consolidated net revenues for the nine months ended September 30, 2018, as compared to the nine months ended September 30, 2017, was primarily due to:

- an increase of \$226 million in revenues recognized from Activision, primarily due to (1) higher revenues recognized from *Call of Duty: WWII*, which was released in November 2017, as compared to *Call of Duty: Infinite Warfare*, which was released in November 2016, and (2) higher revenues recognized from the Destiny franchise, driven by *Destiny 2*, which was released in September 2017, partially offset by lower revenues recognized from *Call*

of Duty: Infinite Warfare in its second year after release, as compared to *Call of Duty: Black Ops III* in its second year after release; and

- an increase of \$81 million in revenues from King, primarily driven by the Candy Crush franchise's increased monetization, primarily through in-game features and events.

The increase was partially offset by a decrease of \$164 million in revenues recognized from Blizzard, primarily due to lower revenues recognized from *Overwatch*, partially offset by revenues from the Overwatch League, which started its inaugural regular season in January 2018.

Change in Deferred Revenues Recognized

Q3 2018 vs. Q3 2017

The increase in net deferred revenues recognized for the three months ended September 30, 2018, as compared to the three months ended September 30, 2017, was primarily due to an increase of \$229 million in net deferred revenues recognized from Activision, primarily due to lower net deferrals of revenues from the Destiny franchise, as a result of lower net deferrals for *Forsaken*, the third expansion to *Destiny 2*, which was released in September 2018, as compared to net deferrals for the full game release of *Destiny 2* in September 2017.

Table of Contents

The increase was partially offset by a decrease of \$84 million in net deferred revenues recognized from Blizzard, primarily due to a higher net deferral of revenues for *World of Warcraft*, driven by *World of Warcraft: Battle for Azeroth*, which was released in August 2018, with no comparable release in 2017.

YTD Q3 2018 vs. YTD Q3 2017

The increase in net deferred revenues recognized for the nine months ended September 30, 2018, as compared to the nine months ended September 30, 2017, was primarily due to an increase of \$470 million in net deferred revenues recognized from Activision, primarily due to higher net deferred revenues recognized from the Destiny franchise, driven by *Destiny 2*, and its associated in-game content, with no comparable release in 2016.

The increase was partially offset by a decrease of \$231 million in net deferred revenues from Blizzard, primarily due to a net deferral of revenues for *World of Warcraft*, driven by *World of Warcraft: Battle for Azeroth*, which was released in August 2018, with no comparable release in 2017.

Foreign Exchange Impact

Changes in foreign exchange rates had a negative impact of \$14 million and a positive impact of \$146 million on our consolidated net revenues for the three and nine months ended September 30, 2018, respectively, as compared to the same periods in the previous year. The changes are primarily due to changes in the value of the U.S. dollar relative to the euro and the British pound.

Operating Segment Results

Currently, we have three reportable segments. Our operating segments are consistent with the manner in which our operations are reviewed and managed by our Chief Executive Officer, who is our chief operating decision maker (CODM). The CODM reviews segment performance exclusive of: the impact of the change in deferred revenues and related cost of revenues with respect to certain of our online-enabled games; share-based compensation expense; amortization of intangible assets as a result of purchase price accounting; fees and other expenses (including legal fees, expenses, and accruals) related to acquisitions, associated integration activities, and financings; certain restructuring costs; and certain other non-cash charges. The CODM does not review any information regarding total assets on an operating segment basis, and accordingly, no disclosure is made with respect thereto.

Our operating segments are also consistent with our internal organizational structure, the way we assess operating performance and allocate resources, and the availability of separate financial information. We do not aggregate operating segments.

Edgar Filing: Activision Blizzard, Inc. - Form 10-Q

Table of Contents

Information on reportable segment net revenues and operating income for the three months ended September 30, 2018 and 2017, are presented below (amounts in millions):

	Three Months Ended September 30, 2018				Activision	\$ Increase / (Decrease)		Total
	Activision	Blizzard	King	Total		Blizzard	King	
Segment Net Revenues								
Net revenues from external customers	\$ 397	\$ 627	\$ 506	\$ 1,530	\$ (362)	\$ 96	\$ (22)	\$ (288)
Intersegment net revenues (1)		8		8		8		8
Segment net revenues	\$ 397	\$ 635	\$ 506	\$ 1,538	\$ (362)	\$ 104	\$ (22)	\$ (280)
Segment operating income	\$ 112	\$ 189	\$ 184	\$ 485	\$ (149)	\$ 21	\$ (24)	\$ (152)

	Three Months Ended September 30, 2017			
	Activision	Blizzard	King	Total
Segment Net Revenues				
Net revenues from external customers	\$ 759	\$ 531	\$ 528	\$ 1,818
Intersegment net revenues (1)				
Segment net revenues	\$ 759	\$ 531	\$ 528	\$ 1,818
Segment operating income	\$ 261	\$ 168	\$ 208	\$ 637

Information on reportable segment net revenues and operating income for the nine months ended September 30, 2018 and 2017, are presented below (amounts in millions):

	Nine Months Ended September 30, 2018				Activision	\$ Increase / (Decrease)		Total
	Activision	Blizzard	King	Total		Blizzard	King	
Segment Net Revenues								
Net revenues from external customers	\$ 1,047	\$ 1,592	\$ 1,542	\$ 4,181	\$ (244)	\$ 53	\$ 60	\$ (131)
Intersegment net revenues (1)		14		14		14		14
Segment net revenues	\$ 1,047	\$ 1,606	\$ 1,542	\$ 4,195	\$ (244)	\$ 67	\$ 60	\$ (117)
Segment operating income	\$ 288	\$ 444	\$ 543	\$ 1,275	\$ (83)	\$ (108)	\$ 5	\$ (186)

	Nine Months Ended September 30, 2017			
	Activision	Blizzard	King	Total
Segment Net Revenues				
Net revenues from external customers	\$ 1,291	\$ 1,539	\$ 1,482	\$ 4,312
Intersegment net revenues (1)				
Segment net revenues	\$ 1,291	\$ 1,539	\$ 1,482	\$ 4,312
Segment operating income	\$ 371	\$ 552	\$ 538	\$ 1,461

- (1) Intersegment revenues reflect licensing and service fees charged between segments.

Edgar Filing: Activision Blizzard, Inc. - Form 10-Q

Table of Contents

Reconciliations of total segment net revenues and total segment operating income to consolidated net revenues and consolidated income before income tax expense are presented in the table below (amounts in millions):

	For the Three Months Ended September 30,		For the Nine Months Ended September 30,	
	2018	2017	2018	2017
Reconciliation to consolidated net revenues:				
Segment net revenues	\$ 1,538	\$ 1,818	\$ 4,195	\$ 4,312
Revenues from other segments (1)	128	84	246	204
Net effect from recognition (deferral) of deferred net revenues	(146)	(284)	692	458
Elimination of intersegment revenues (2)	(8)		(14)	
Consolidated net revenues	\$ 1,512	\$ 1,618	\$ 5,119	\$ 4,974
Reconciliation to consolidated income before income tax expense:				
Segment operating income	\$ 485	\$ 637	\$ 1,275	\$ 1,461
Operating (loss) income from other segments (1)	7	(12)	(4)	(15)
Net effect from recognition (deferral) of deferred net revenues and related cost of revenues	(89)	(132)	468	370
Share-based compensation expense	(55)	(47)	(166)	(120)
Amortization of intangible assets	(83)	(187)	(279)	(571)
Fees and other expenses related to the acquisition of King		(3)		(12)
Restructuring costs				(11)
Other non-cash charges		1		(14)
Consolidated operating income	265	257	1,294	1,088
Interest and other expense (income), net	13	37	67	109
Loss on extinguishment of debt	40		40	12
Consolidated income before income tax expense	\$ 212	\$ 220	\$ 1,187	\$ 967

(1) Includes other income and expenses from operating segments managed outside the reportable segments, including our Studios and Distribution businesses. Also includes unallocated corporate income and expenses.

(2) Intersegment revenues reflect licensing and service fees charged between segments.

Segment Net Revenues

Activision

Q3 2018 vs. Q3 2017

Edgar Filing: Activision Blizzard, Inc. - Form 10-Q

The decrease in Activision's net revenues for the three months ended September 30, 2018, as compared to the three months ended September 30, 2017, was primarily due to:

- lower revenues from the Destiny franchise, primarily due to lower revenues from *Forsaken*, the third expansion to *Destiny 2*, which was released in September 2018, as compared to the full game release of *Destiny 2* in September 2017;
- lower revenues from *Call of Duty: Infinite Warfare*, which was released in November 2016, in its second year after release, as compared to *Call of Duty: Black Ops III*, which was released in November 2015, in its second year after release; and
- lower revenues from *Crash Bandicoot N. Sane Trilogy*, which was released in June 2017 on the PlayStation 4 platform, and in June 2018 on the Xbox One, PC, and Nintendo Switch platforms.

The decrease was partially offset by higher revenues from the continued strength of *Call of Duty: Black Ops III*, as compared to prior catalog releases.

Table of Contents

YTD Q3 2018 vs. YTD Q3 2017

The decrease in Activision's net revenues for the nine months ended September 30, 2018, as compared to the nine months ended September 30, 2017, was primarily due to:

- lower revenues from *Call of Duty: Infinite Warfare* in its second year after release, as compared to *Call of Duty: Black Ops III* in its second year after release; and
- lower revenues from the Destiny franchise, primarily due to lower revenues from the release of the *Forsaken* expansion, as compared to the full-game release of *Destiny 2*.

The decrease was partially offset by:

- higher revenues from *Call of Duty: WWII*, which was released in November 2017, as compared to *Call of Duty: Infinite Warfare*, which was released in November 2016; and
- higher revenues from the continued strength of *Call of Duty: Black Ops III*, as compared to prior catalog releases.

Blizzard

Q3 2018 vs. Q3 2017

The increase in Blizzard's net revenues for the three months ended September 30, 2018, as compared to the three months ended September 30, 2017, was primarily due to:

- higher revenues from *World of Warcraft*, driven by *World of Warcraft: Battle for Azeroth*, which was released in August 2018, with no comparable release in 2017; and

Edgar Filing: Activision Blizzard, Inc. - Form 10-Q

- revenues from the Overwatch League, which started its inaugural regular season in January 2018.

The increase was partially offset by:

- lower revenues from *Overwatch*, which was released in May 2016; and
- lower revenues from *Hearthstone*, primarily due to lower revenues from the *Boomsday* expansion, which was released in August 2018, as compared to *Knights of the Frozen Throne*, which was released in August 2017.

YTD Q3 2018 vs. YTD Q3 2017

The increase in Blizzard's net revenues for the nine months ended September 30, 2018, as compared to the nine months ended September 30, 2017, was primarily due to the same drivers and partially offsetting factors as those for the three months ended September 30, 2018 discussed above, in addition to lower revenues from the Diablo franchise due to the release of *Rise of the Necromancer*, a downloadable content pack for *Diablo III*, which was released in June 2017, with no comparable release in 2018.

Table of Contents

King

Q3 2018 vs. Q3 2017

The decrease in King's net revenues for the three months ended September 30, 2018, as compared to the three months ended September 30, 2017, was primarily due to decreases in revenues across various title offerings.

YTD Q3 2018 vs. YTD Q3 2017

The increase in King's net revenues for the nine months ended September 30, 2018, as compared to the nine months ended September 30, 2017, was primarily due to higher revenues from the Candy Crush franchise's increased monetization, primarily through in-game features and events. The increase was partially offset by lower revenues from the Bubble Witch franchise due to the release of *Bubble Witch 3 Saga* at the beginning of 2017, with no comparable release in 2018.

Segment Income from Operations

Activision

Q3 2018 vs. Q3 2017

The decrease in Activision's operating income for the three months ended September 30, 2018, as compared to the three months ended September 30, 2017, was primarily due to lower revenues, as discussed above. The decrease was partially offset by:

- lower software royalties, amortization, and intellectual property licenses and lower sales and marketing costs, both primarily driven by the Destiny franchise;
- lower product costs due to the lower revenues noted above and a higher proportion of net revenues coming from digital online channels, which typically have a higher profit margin; and
- higher capitalization of software development costs due to the timing of the game development cycle.

YTD Q3 2018 vs. YTD Q3 2017

The decrease in Activision's operating income for the nine months ended September 30, 2018, as compared to the nine months ended September 30, 2017, was primarily due to:

- lower revenues, as discussed above; and
- higher developer costs to support existing and upcoming title releases, partially offset by higher capitalization of software development costs.

The decrease was partially offset by:

- lower software royalties, amortization, and intellectual property licenses and lower sales and marketing costs, both primarily driven by the Destiny franchise; and
- lower product costs due to the lower revenues noted above and a higher proportion of net revenues coming from digital online channels, which typically have a higher profit margin.

Table of Contents

Blizzard

Q3 2018 vs. Q3 2017

The increase in Blizzard's operating income for the three months ended September 30, 2018, as compared to the three months ended September 30, 2017, was primarily due to higher revenues, as discussed above. The increase was partially offset by:

- higher costs to operate and support Blizzard's existing business and adjacent areas of opportunity; and
- higher software royalties, amortization, and intellectual property licenses and higher sales and marketing costs, both primarily driven by *World of Warcraft: Battle for Azeroth*, which was released in August 2018, with no comparable release in 2017.

YTD Q3 2018 vs. YTD Q3 2017

The decrease in Blizzard's operating income for the nine months ended September 30, 2018, as compared to the nine months ended September 30, 2017, was primarily due to:

- higher costs to operate and support Blizzard's existing business and adjacent areas of opportunity; and
- higher software royalties, amortization, and intellectual property licenses, and higher sales and marketing costs, both primarily driven by *World of Warcraft: Battle for Azeroth*.

The decrease was partially offset by higher revenues, as discussed above, and higher capitalization of software development costs due to the timing of the game development cycle.

King

Q3 2018 vs. Q3 2017

The decrease in King's operating income for the three months ended September 30, 2018, as compared to the three months ended September 30, 2017, was primarily due to lower revenues, as discussed above, partially offset by lower digital storefront fees (e.g. fees retained by Apple and Google for our sales on their platforms) due to those lower revenues.

YTD Q3 2018 vs. YTD Q3 2017

King's operating income for the nine months ended September 30, 2018, was comparable to the nine months ended September 30, 2017, primarily due to higher revenues, as discussed above, offset by higher marketing and product development costs for King franchises.

Foreign Exchange Impact

Changes in foreign exchange rates had a negative impact of \$16 million and a positive impact of \$92 million on reportable segment net revenues for the three and nine months ended September 30, 2018, respectively, as compared to the same periods in the previous year. The changes are primarily due to changes in the value of the U.S. dollar relative to the euro and the British pound.

Table of Contents**Consolidated Results***Net Revenues by Distribution Channel*

The following table details our consolidated net revenues by distribution channel (amounts in millions):

	For the Three Months Ended September 30,			For the Nine Months Ended September 30,		
	2018	2017	Increase (decrease)	2018	2017	Increase (decrease)
Net revenues by distribution channel:						
Digital online channels (1)	\$ 1,276	\$ 1,354	\$ (78)	\$ 3,998	\$ 4,048	\$ (50)
Retail channels	76	168	(92)	764	698	66
Other (2)	160	96	64	357	228	129
Total consolidated net revenues	\$ 1,512	\$ 1,618	\$ (106)	\$ 5,119	\$ 4,974	\$ 145

(1) Net revenues from Digital online channels include revenues from digitally-distributed subscriptions, downloadable content, microtransactions, and products, as well as licensing royalties.

(2) Net revenues from Other include revenues from our Studios and Distribution businesses, as well as revenues from MLG and the Overwatch League.

*Digital Online Channel Net Revenues*Q3 2018 vs. Q3 2017

The decrease in net revenues from digital online channels for the three months ended September 30, 2018, as compared to the three months ended September 30, 2017, was primarily due to:

- lower revenues recognized from *Call of Duty: Infinite Warfare*, which was released in November 2016, in its second year after release, as compared to *Call of Duty: Black Ops III*, which was released in November 2015, in its second year after release; and

Edgar Filing: Activision Blizzard, Inc. - Form 10-Q

- lower revenues recognized from *Overwatch*, which was released in May 2016.

The decrease was partially offset by higher revenues recognized from *World of Warcraft*, driven by *World of Warcraft: Battle for Azeroth*, which was released in August 2018, with no comparable release in 2017.

YTD Q3 2018 vs. YTD Q3 2017

The decrease in net revenues from digital online channels for the nine months ended September 30, 2018, as compared to the nine months ended September 30, 2017, was primarily due to:

- lower revenues recognized from *Call of Duty: Infinite Warfare* in its second year after release, as compared to *Call of Duty: Black Ops III* in its second year after release; and
- lower revenues recognized from *Overwatch*.

The decrease was partially offset by:

- higher revenues recognized from the *Destiny* franchise, driven by *Destiny 2*, which was released in September 2017, and its associated in-game content, with no comparable release in 2016;
- higher revenues from the *Candy Crush* franchise due to increased monetization, primarily through in-game features and events; and
- higher revenues recognized from *Call of Duty: WWII*, which was released in November 2017, as compared to *Call of Duty: Infinite Warfare*, which was released in November 2016.

Table of Contents

Retail Channel Net Revenues

Q3 2018 vs. Q3 2017

The decrease in net revenues from retail channels for the three months ended September 30, 2018, as compared to the three months ended September 30, 2017, was primarily due to:

- lower revenues from *Crash Bandicoot N. Sane Trilogy*, which was released in June 2017 on the PlayStation 4 platform, and in June 2018 on the Xbox One, PC, and Nintendo Switch platforms;
- lower revenues recognized from the Destiny franchise, primarily due to lower revenues recognized for *Forsaken*, the third expansion to *Destiny 2*, which was released in September 2018, as compared to the full game release of *Destiny 2* in September 2017; and
- lower revenues recognized from *Call of Duty: Infinite Warfare*, which was released in November 2016, in its second year after release, as compared to *Call of Duty: Black Ops III*, which was released in November 2015, in its second year after release.

YTD Q3 2018 vs. YTD Q3 2017

The increase in net revenues from retail channels for the nine months ended September 30, 2018, as compared to the nine months ended September 30, 2017, was primarily due to:

- higher revenues recognized from *Call of Duty: WWII*, which was released in November 2017, as compared to *Call of Duty: Infinite Warfare*, which was released in November 2016; and
- higher revenues recognized from the Destiny franchise, driven by *Destiny 2*.

The increase was partially offset by lower revenues recognized from *Overwatch*, which was released in May 2016.

Net Revenues by Geographic Region

The following table details our consolidated net revenues by geographic region (amounts in millions):

	For the Three Months Ended September 30,			For the Nine Months Ended September 30,		
	2018	2017	Increase (decrease)	2018	2017	Increase (decrease)
Net revenues by geographic region:						
Americas	\$ 774	\$ 798	\$ (24)	\$ 2,740	\$ 2,586	\$ 154
EMEA (1)	534	593	(59)	1,774	1,684	90
Asia Pacific	204	227	(23)	605	704	(99)
Consolidated net revenues	\$ 1,512	\$ 1,618	\$ (106)	\$ 5,119	\$ 4,974	\$ 145

(1) EMEA consists of the Europe, Middle East, and Africa geographic regions.

Table of Contents

Americas

Q3 2018 vs. Q3 2017

The decrease in net revenues from the Americas region for the three months ended September 30, 2018, as compared to the three months ended September 30, 2017, was primarily due to lower revenues recognized from *Call of Duty: Infinite Warfare*, which was released in November 2016, in its second year after release, as compared to *Call of Duty: Black Ops III*, which was released in November 2015, in its second year after release. The decrease was partially offset by higher revenues recognized from *World of Warcraft*, driven by *World of Warcraft: Battle for Azeroth*, which was released in August 2018, with no comparable release in 2017.

YTD Q3 2018 vs. YTD Q3 2017

The increase in net revenues from the Americas region for the nine months ended September 30, 2018, as compared to the nine months ended September 30, 2017, was primarily due to:

- higher revenues recognized from the Destiny franchise, driven by *Destiny 2*, which was released in September 2017, and its associated in-game content, with no comparable release in 2016;
- higher revenues recognized from *Call of Duty: WWII*, which was released in November 2017, as compared to *Call of Duty: Infinite Warfare*, which was released in November 2016; and
- higher revenues from the Candy Crush franchise due to increased monetization, primarily through in-game features and events.

The increase was partially offset by lower revenues recognized from *Call of Duty: Infinite Warfare* in its second year after release, as compared to *Call of Duty: Black Ops III* in its second year after release.

EMEA

Q3 2018 vs. Q3 2017

Edgar Filing: Activision Blizzard, Inc. - Form 10-Q

The decrease in net revenues from the EMEA region for the three months ended September 30, 2018, as compared to the three months ended September 30, 2017, was primarily due to:

- lower revenues recognized from *Call of Duty: Infinite Warfare* in its second year after release, as compared to *Call of Duty: Black Ops III* in its second year after release; and
- lower revenues from *Crash Bandicoot N. Sane Trilogy*, which was released in June 2017 on the PlayStation 4 platform, and in June 2018 on the Xbox One, PC, and Nintendo Switch platforms.

The decrease was partially offset by higher revenues recognized from *World of Warcraft*, driven by *World of Warcraft: Battle for Azeroth*, which was released in August 2018, with no comparable release in 2017.

YTD Q3 2018 vs. YTD Q3 2017

The increase in net revenues from the EMEA region for the nine months ended September 30, 2018, as compared to the nine months ended September 30, 2017, primarily due to higher revenues recognized from *Call of Duty: WWII*, which was released in November 2017, as compared to *Call of Duty: Infinite Warfare*, which was released in November 2016.

Table of Contents*Asia Pacific*Q3 2018 vs. Q3 2017

The decrease in net revenues from the Asia Pacific region for the three months ended September 30, 2018, as compared to the three months ended September 30, 2017, was primarily due to lower revenues recognized from *Overwatch*, which was released in May 2016, partially offset by higher revenues recognized from *World of Warcraft*, driven by *World of Warcraft: Battle for Azeroth*, which was released in August 2018, with no comparable release in 2017.

YTD Q3 2018 vs. YTD Q3 2017

The decrease in net revenues from the Asia Pacific region for the nine months ended September 30, 2018, as compared to the nine months ended September 30, 2017, was primarily due to lower revenues recognized from *Overwatch*.

Net Revenues by Platform

The following table details our consolidated net revenues by platform (amounts in millions):

	For the Three Months Ended September 30,			For the Nine Months Ended September 30,		
	2018	2017	Increase (Decrease)	2018	2017	Increase (Decrease)
Net revenues by platform:						
Console	\$ 347	\$ 527	\$ (180)	\$ 1,730	\$ 1,710	\$ 20
PC	482	461	21	1,452	1,534	(82)
Mobile and ancillary (1)	523	534	(11)	1,580	1,502	78
Other (2)	160	96	64	357	228	129
Total consolidated net revenues	\$ 1,512	\$ 1,618	\$ (106)	\$ 5,119	\$ 4,974	\$ 145

(1) Net revenues from Mobile and ancillary include revenues from mobile devices, as well as non-platform-specific game-related revenues, such as standalone sales of toys and accessories from our Skylanders® franchise and other physical merchandise and accessories.

(2) Net revenues from Other include revenues from our Studios and Distribution businesses, as well as revenues from MLG and the Overwatch League.

Console

Q3 2018 vs. Q3 2017

The decrease in net revenues from the console platform for the three months ended September 30, 2018, as compared to the three months ended September 30, 2017, was primarily due to:

- lower revenues recognized from *Call of Duty: Infinite Warfare*, which was released in November 2016, in its second year after release, as compared to *Call of Duty: Black Ops III*, which was released in November 2015, in its second year after release;
- lower revenues from *Crash Bandicoot N. Sane Trilogy*, which was released in June 2017 on the PlayStation 4 platform, and in June 2018 on the Xbox One, PC, and Nintendo Switch platforms; and
- lower revenues recognized from *Overwatch*, which was released in May 2016.

The lower revenues above were partially offset by higher revenues recognized from *Call of Duty: WWII*, which was released in November 2017, as compared to *Call of Duty: Infinite Warfare*, which was released in November 2016.

Table of Contents

YTD Q3 2018 vs. YTD Q3 2017

The increase in net revenues from the console platform for the nine months ended September 30, 2018, as compared to the nine months ended September 30, 2017, was primarily due to:

- higher revenues recognized from *Call of Duty: WWII*, as compared to *Call of Duty: Infinite Warfare*; and
- higher revenues recognized from the Destiny franchise, driven by *Destiny 2*, which was released in September 2017, and its associated in-game content, with no comparable release in 2016.

The higher revenues above were partially offset by lower revenues recognized from *Call of Duty: Infinite Warfare* in its second year after release, as compared to *Call of Duty: Black Ops III* in its second year after release.

PC

Q3 2018 vs. Q3 2017

The increase in net revenues from the PC platform for the three months ended September 30, 2018, as compared to the three months ended September 30, 2017, was primarily due to higher revenues recognized from *World of Warcraft*, driven by *World of Warcraft: Battle for Azeroth*, which was released in August 2018, with no comparable release in 2017, partially offset by lower revenues recognized from *Overwatch*, which was released in May 2016.

YTD Q3 2018 vs. YTD Q3 2017

The decrease in net revenues from the PC platform for the nine months ended September 30, 2018, as compared to the nine months ended September 30, 2017, was primarily due to lower revenues recognized from *Overwatch*, partially offset by revenues recognized from *Destiny 2*, which was released on the PC platform in October 2017, and its associated in-game content, with no comparable release in 2016.

Mobile and Ancillary

Edgar Filing: Activision Blizzard, Inc. - Form 10-Q

Q3 2018 vs. Q3 2017

The decrease in net revenues from mobile and ancillary for the three months ended September 30, 2018, as compared to the three months ended September 30, 2017, was primarily due to decreases in revenues across various title offerings by King.

YTD Q3 2018 vs. YTD Q3 2017

The increase in net revenues from mobile and ancillary for the nine months ended September 30, 2018, as compared to the nine months ended September 30, 2017, was primarily due to higher revenues from the Candy Crush franchise s increased monetization, primarily through in-game features and events.

Table of Contents*Costs and Expenses**Cost of Revenues*

The following table details the components of cost of revenues in dollars (amounts in millions) and as a percentage of associated net revenues:

	Three Months Ended September 30, 2018	% of associated net revenues	Three Months Ended September 30, 2017	% of associated net revenues	Increase (Decrease)
Cost of revenues product sales:					
Product costs	\$ 127	48%	\$ 149	39%	\$ (22)
Software royalties, amortization, and intellectual property licenses	20	8	37	10	(17)
Cost of revenues subscription, licensing, and other revenues:					
Game operations and distribution costs	257	21	249	20	8
Software royalties, amortization, and intellectual property licenses	109	9	117	9	(8)
Total cost of revenues	\$ 513	34%	\$ 552	34%	\$ (39)

	Nine Months Ended September 30, 2018	% of associated net revenues	Nine Months Ended September 30, 2017	% of associated net revenues	Increase (Decrease)
Cost of revenues product sales:					
Product costs	\$ 416	29%	\$ 422	31%	\$ (6)
Software royalties, amortization, and intellectual property licenses	214	15	200	15	14
Cost of revenues subscription, licensing, and other revenues:					
Game operations and distribution costs	777	21	717	20	60
Software royalties, amortization, and intellectual property licenses	278	8	359	10	(81)
Total cost of revenues	\$ 1,685	33%	\$ 1,698	34%	\$ (13)

*Cost of Revenues Product Sales:*Q3 2018 vs. Q3 2017

The decrease in product costs for the three months ended September 30, 2018, as compared to the three months ended September 30, 2017, was in-line with the decrease in product sales, partially offset by higher product sales from our lower margin distribution business.

Edgar Filing: Activision Blizzard, Inc. - Form 10-Q

The decrease in software royalties, amortization, and intellectual property licenses related to product sales for the three months ended September 30, 2018, as compared to the three months ended September 30, 2017, was primarily due to a decrease of \$19 million in software amortization and royalties from Activision, driven by the Destiny franchise.

YTD Q3 2018 vs. YTD Q3 2017

The decrease in product costs for the nine months ended September 30, 2018, as compared to the nine months ended September 30, 2017, was primarily due to a decrease of \$11 million in product costs from Activision, primarily related to there being no title releases for the Guitar Hero and Skylanders franchises, largely offset by higher product costs from our lower margin distribution business driven by increased product sales.

The increase in software royalties, amortization, and intellectual property licenses related to product sales for the nine months ended September 30, 2018, as compared to the nine months ended September 30, 2017, was primarily due to an increase of \$37 million in software amortization and royalties from Activision, primarily due to the Destiny franchise, driven by the release of *Destiny 2*, which was released in September 2017, with no comparable release in 2016, partially offset by lower software amortization and royalties from *Call of Duty: WWII*, which was released in November 2017, as compared to *Call of Duty: Infinite Warfare*, which was released in November 2016. The increase from Activision was partially offset by a decrease of \$22 million in software amortization and royalties from Blizzard, driven by *World of Warcraft*, due to *World of Warcraft: Legion*, which was released in August 2016, with no comparable release in 2017.

Table of Contents

Cost of Revenues Subscription, Licensing, and Other Revenues:

Q3 2018 vs. Q3 2017

The increase in game operations and distribution costs for the three months ended September 30, 2018, as compared to the three months ended September 30, 2017, was primarily due to an increase of \$20 million in personnel, facilities, and equipment costs associated with our online games and broadcasting operations, partially offset by a decrease of \$14 million in digital storefront fees (e.g. fees retained by Apple and Google for our sales on their platforms), primarily associated with the decrease in our mobile game revenues.

The decrease in software royalties, amortization, and intellectual property licenses related to subscription, licensing, and other revenues for the three months ended September 30, 2018, as compared to the three months ended September 30, 2017, was primarily due to a decrease of \$30 million in amortization of internally-developed franchise intangible assets acquired as part of our acquisition of King.

The decrease was partially offset by:

- amortization of capitalized film costs associated with the third season of the animated TV series, *Skylanders Academy*, which was released in September 2018, as compared to the second season, which was released in October 2017; and
- an \$8 million increase in software amortization and royalties from Activision, primarily due to higher software amortization and royalties from expansion releases to *Destiny 2*, with no comparable releases in 2017.

YTD Q3 2018 vs. YTD Q3 2017

The increase in game operations and distribution costs for the nine months ended September 30, 2018, as compared to the nine months ended September 30, 2017, was primarily due to higher personnel, facilities, and equipment costs of \$52 million associated with our online games and broadcasting operations.

The decrease in software royalties, amortization, and intellectual property licenses related to subscription, licensing, and other revenues for the nine months ended September 30, 2018, as compared to the nine months ended September 30, 2017, was primarily due to a decrease of \$105 million in amortization of internally-developed franchise intangible assets acquired as part of our acquisition of King. The decrease was partially offset by an increase of \$11 million in software amortization and royalties from Activision, primarily due to the software amortization and royalties from expansion releases on *Destiny 2*.

Edgar Filing: Activision Blizzard, Inc. - Form 10-Q

Product Development (amounts in millions)

	September 30, 2018	% of consolidated net revenues	September 30, 2017	% of consolidated net revenues	Increase (Decrease)
Three Months Ended	\$ 263	17%	\$ 273	17%	\$ (10)
Nine Months Ended	\$ 776	15%	\$ 750	15%	\$ 26

Q3 2018 vs. Q3 2017

The decrease in product development costs for the three months ended September 30, 2018, as compared to the three months ended September 30, 2017, was primarily due to an increase of \$28 million in capitalization of software development costs due to increased product development costs and the timing of the game development cycle. The decrease was partially offset by an \$18 million increase in personnel and external developer costs to support existing and upcoming title releases.

Edgar Filing: Activision Blizzard, Inc. - Form 10-Q

Table of Contents

YTD Q3 2018 vs. YTD Q3 2017

The increase in product development costs for the nine months ended September 30, 2018, as compared to the nine months ended September 30, 2017, was primarily due to a \$102 million increase in personnel and external developer costs to support existing and upcoming title releases. The increase was partially offset by an increase of \$76 million in capitalization of software development costs due to the increased costs previously noted and timing of the game development cycle.

Sales and Marketing (amounts in millions)

	September 30, 2018	% of consolidated net revenues	September 30, 2017	% of consolidated net revenues	Increase (Decrease)
Three Months Ended	\$ 263	17%	\$ 345	21%	\$ (82)
Nine Months Ended	\$ 741	14%	\$ 899	18%	\$ (158)

Q3 2018 vs. Q3 2017

The decrease in sales and marketing expenses for the three months ended September 30, 2018, as compared to the three months ended September 30, 2017, was primarily due to a decrease of \$76 million in amortization of the customer base intangible asset acquired as part of our acquisition of King, as the asset was fully amortized during the first quarter of 2018.

YTD Q3 2018 vs. YTD Q3 2017

The decrease in sales and marketing expenses for the nine months ended September 30, 2018, as compared to the nine months ended September 30, 2017, was primarily due to a decrease of \$187 million in amortization of the customer base intangible asset acquired as part of our acquisition of King, as the asset was fully amortized during the first quarter of 2018. The decrease was partially offset by a \$30 million increase in marketing spending and personnel costs, primarily associated with the Candy Crush franchise, *World of Warcraft*, and the Overwatch League, the last of which started its inaugural regular season in January 2018, partially offset by (1) reduced marketing costs for the Destiny franchise, due to lower marketing for *Forsaken*, the third expansion to *Destiny 2*, which was released in September 2018, as compared to marketing for the full game release of *Destiny 2* in September 2017, and (2) reduced marketing costs for the Bubble Witch franchise, as *Bubble Witch 3 Saga*™ was released during the first quarter of 2017, with no comparable release in 2018.

General and Administrative (amounts in millions)

	September 30, 2018	% of consolidated net revenues	September 30, 2017	% of consolidated net revenues	Increase (Decrease)
--	-----------------------	--------------------------------------	-----------------------	--------------------------------------	------------------------

Edgar Filing: Activision Blizzard, Inc. - Form 10-Q

Three Months Ended	\$	208	14%	\$	191	12%	\$	17
Nine Months Ended	\$	623	12%	\$	539	11%	\$	84

Q3 2018 vs. Q3 2017

The increase in general and administrative expenses for the three months ended September 30, 2018, as compared to the three months ended September 30, 2017, was primarily due to an \$11 million increase in personnel costs, including stock-based compensation expense, professional fees, and facilities costs to support the growth of our existing business and adjacent areas of opportunity.

Edgar Filing: Activision Blizzard, Inc. - Form 10-Q

Table of Contents

YTD Q3 2018 vs. YTD Q3 2017

The increase in general and administrative expenses for the nine months ended September 30, 2018, as compared to the nine months ended September 30, 2017, was primarily due to an \$81 million increase in personnel costs, including stock-based compensation expense, professional fees, and facilities costs to support the growth of our existing business and adjacent areas of opportunity.

Interest and Other Expense (Income), Net (amounts in millions)

	September 30, 2018	% of consolidated net revenues	September 30, 2017	% of consolidated net revenues	Increase (Decrease)
Three Months Ended	\$ 13	1%	\$ 37	2%	\$ (24)
Nine Months Ended	\$ 67	1%	\$ 109	3%	\$ (42)

Q3 2018 vs. Q3 2017

The decrease in interest and other expense (income), net, for the three months ended September 30, 2018, as compared to the three months ended September 30, 2017, was primarily due to a \$12 million increase in interest income from our cash and cash equivalents and higher interest rates compared to the prior-year period.

YTD Q3 2018 vs. YTD Q3 2017

The decrease in interest and other expense (income), net, for the nine months ended September 30, 2018, as compared to the nine months ended September 30, 2017, was primarily due to a \$35 million increase in interest income from our cash and cash equivalents and higher interest rates as compared to the prior-year period.

Income Tax Expense (amounts in millions)

	September 30, 2018	% of pretax income	September 30, 2017	% of pretax income	Increase (Decrease)
Three Months Ended	\$ (48)	(23)%	\$ 32	15%	\$ (80)
Nine Months Ended	\$ 25	2%	\$ 109	11%	\$ (84)

The income tax benefit of \$48 million for the three months ended September 30, 2018, reflects an effective tax rate of (23)%, which is lower than the effective tax rate of 15% for the three months ended September 30, 2017. The decrease is due to a discrete tax benefit resulting from adjustments made to the provisional amount initially recorded for the U.S. Tax Reform Act described below and the benefit from the lower U.S.

Edgar Filing: Activision Blizzard, Inc. - Form 10-Q

corporate income tax rate in the current year. This decrease was partially offset by lower excess tax benefits from share-based payments.

The income tax expense of \$25 million for the nine months ended September 30, 2018, reflects an effective tax rate of 2%, which is lower than the effective tax rate of 11% for the nine months ended September 30, 2017. The decrease is due to a discrete net tax benefit resulting from a closing agreement the Company entered into with the IRS to resolve certain intercompany transfer pricing arrangements for tax periods starting in 2009 (the Closing Agreement), a discrete tax benefit resulting from adjustments made to the provisional amount initially recorded for the U.S. Tax Reform Act and the benefit from the lower U.S. corporate income tax rate in the current year, net of the impact of global intangible low-taxed income of foreign subsidiaries (GILTI). This decrease was partially offset by the valuation allowance recorded with regard to California research and development credit carryforwards (CA R&D Credits) and lower excess tax benefits from share-based payments.

Edgar Filing: Activision Blizzard, Inc. - Form 10-Q

Table of Contents

The effective tax rates of (23)% and 2% for the three and nine months ended September 30, 2018, respectively, are lower than the U.S. statutory rate of 21%, primarily due to a discrete net tax benefit resulting from the Closing Agreement, a discrete tax benefit resulting from adjustments made to the provisional amount initially recorded for U.S. Tax Reform Act, foreign earnings taxed at relatively lower statutory rates, the recognition of excess tax benefits from share-based payments, and recognition of federal research and development credits, partially offset by the valuation allowance recorded with regard to CA R&D Credits.

On June 27, 2018, the Company entered into the Closing Agreement. The primary adjustments related to the Closing Agreement that were recognized in the second quarter of 2018 were a tax expense of \$70 million and a reduction in unrecognized tax benefits of \$437 million. In addition, we recognized \$185 million of tax benefits related to other tax adjustments resulting from the changes in U.S. tax attributes and taxable income caused by the primary adjustments. The Closing Agreement results in federal and state cash tax payments totaling approximately \$345 million, of which we made federal tax payments of \$334 million in October 2018.

We evaluate deferred tax assets each period for recoverability. We record a valuation allowance for assets that do not meet the threshold of more likely than not to be realized in the future. To make that determination, the Company evaluates the likelihood of realization based on the weight of all positive and negative evidence available. As of December 31, 2017, the Company had a deferred tax asset for CA R&D Credits, which can be carried forward indefinitely. The Closing Agreement impacts historical and prospective filings in certain states, including California, and after considering the impact of the Closing Agreement on its prospective California taxable income, the Company determined that its remaining CA R&D Credits no longer met the threshold of more likely than not of being realized in the future. Accordingly, during the three months ended June 30, 2018, we recorded a full valuation allowance of \$57 million. Additionally, the Company has not recognized a tax benefit for current-year CA R&D Credits in its year-to-date tax expense. We will reassess this determination quarterly and record a tax benefit if future evidence allows for a partial or full release of this valuation allowance.

On December 22, 2017, the U.S. Tax Reform Act was enacted. The U.S. Tax Reform Act, among other things, reduced the U.S. corporate income tax rate from 35% to 21% beginning in 2018 and implemented a modified territorial tax system that imposed a one-time tax on deemed repatriated earnings of foreign subsidiaries (the Transition Tax).

On December 22, 2017, the Securities and Exchange Commission (SEC) staff issued Staff Accounting Bulletin No. 118 (SAB 118), which provides guidance on how to account for the effects of the U.S. Tax Reform Act under Accounting Standards Codification (ASC) 740. SAB 118 enables companies to record a provisional amount for the effects of the U.S. Tax Reform Act based on a reasonable estimate, subject to adjustment during a measurement period of up to one year, until accounting is complete. During the fourth quarter of 2017, we recorded provisional amounts for the effects of the U.S. Tax Reform Act in accordance with SAB 118. In addition, as of December 31, 2017, we no longer considered the available cash balances related to undistributed earnings held outside of the U.S. by our foreign subsidiaries to be indefinitely reinvested. We continue to analyze the effects of the U.S. Tax Reform Act on our condensed consolidated financial statements. Accounting for the income tax effects of the U.S. Tax Reform Act requires complex new calculations and significant judgments in interpreting the legislation. Additional guidance may be issued on how the provisions of the U.S. Tax Reform Act will be applied or otherwise administered that is different from our interpretation. We may make adjustments to the provisional amounts as we collect and prepare the data necessary to finalize our calculations, interpret the U.S. Tax Reform Act and any additional guidance issued, and consider the effects of any additional actions we may take as a result of the U.S. Tax Reform Act.

During the three months ended June 30, 2018, the Company obtained additional information, including adjustments related to the Closing Agreement, and the evaluation of the impact of changing our indefinite reinvestment assertion, which affected the provisional amount initially recorded for the U.S. Tax Reform Act in the fourth quarter of 2017. As a result, the Company recorded an additional tax expense of \$34 million in the three months ended June 30, 2018, reflecting the effects of the U.S. Tax Reform Act.

Edgar Filing: Activision Blizzard, Inc. - Form 10-Q

In conjunction with the filing of our 2017 federal tax return, during the three months ended September 30, 2018, the Company prepared and analyzed additional information, which affected the provisional amounts initially recorded for the U.S. Tax Reform Act in the fourth quarter of 2017. As result, the Company recorded a tax benefit of \$80 million related to the Transition Tax and remeasurement of deferred taxes in the three months September 30, 2018, reflecting the effects of the U.S. Tax Reform Act.

Table of Contents

We continue to evaluate the ongoing impacts of the U.S. Tax Reform Act, including provisions impacting certain foreign income, such as a tax on GILTI and a deduction for foreign derived intangible income. These provisions are complex and subject to continuing regulatory interpretation by the IRS. While we have included an estimate of GILTI in our estimated effective tax rate for 2018, we may make adjustments as we interpret the U.S. Tax Reform Act and any additional guidance issued and consider the effects of any additional actions we may take as a result of the U.S. Tax Reform Act.

Our effective tax rate differs from the statutory U.S. income tax rate due to the effect of state and local income taxes, tax rates that apply to our foreign income (including U.S. tax on foreign income), research and development credits, and certain nondeductible expenses. Our effective tax rate could fluctuate significantly from quarter to quarter based on recurring and nonrecurring factors including, but not limited to: variations in the estimated and actual level of pre-tax income or loss by jurisdiction (including changes in the mix of income by tax jurisdiction); changes in enacted tax laws and regulations, and interpretations thereof, including with respect to tax credits and state and local income taxes; developments in tax audits and other matters; recognition of excess tax benefits and tax deficiencies from share-based payments; and certain nondeductible expenses. Changes in judgment from the evaluation of new information resulting in the recognition, derecognition, or remeasurement of a tax position taken in a prior annual period are recognized separately in the quarter of the change.

Further information about our income taxes is provided in Note 13 of the notes to condensed consolidated financial statements included in Item 1 of this Quarterly Report on Form 10-Q.

Liquidity and Capital Resources

We believe our ability to generate cash flows from operating activities is one of our fundamental financial strengths. In the near term, we expect our business and financial condition to remain strong and to continue to generate significant operating cash flows, which, we believe, in combination with our existing balance of cash and cash equivalents and short-term investments of \$3.4 billion, our access to capital, and the availability of our \$1.5 billion revolving credit facility, will be sufficient to finance our operational and financing requirements for the next 12 months. Our primary sources of liquidity, which are available to us to fund cash outflows such as our anticipated dividend payments, share repurchases, and scheduled debt maturities, include our cash and cash equivalents, short-term investments, and cash flows provided by operating activities.

As of September 30, 2018, the amount of cash and cash equivalents held outside of the U.S. by our foreign subsidiaries was \$1.1 billion, as compared to \$3.0 billion as of December 31, 2017. Following the enactment of the U.S. Tax Reform Act and the current period expense on unrepatriated earnings, we no longer consider these available cash balances, which primarily relate to undistributed earnings of our most significant foreign subsidiaries, to be indefinitely reinvested.

Our cash provided from operating activities is somewhat impacted by seasonality. Working capital needs are impacted by weekly sales, which are generally highest in the fourth quarter due to seasonal and holiday-related sales patterns. We consider, on a continuing basis, various transactions to increase shareholder value and enhance our business results, including acquisitions, divestitures, joint ventures, share repurchases, and other structural changes. These transactions may result in future cash proceeds or payments.

Table of Contents*Sources of Liquidity (amounts in millions)*

	September 30, 2018	December 31, 2017	Increase (Decrease)
Cash and cash equivalents	\$ 3,308	\$ 4,713	\$ (1,405)
Short-term investments	123	62	61
	\$ 3,431	\$ 4,775	\$ (1,344)
Percentage of total assets	21%	26%	

	For the Nine Months Ended September 30,		Increase (Decrease)
	2018	2017	
Net cash provided by operating activities	\$ 791	\$ 1,055	\$ (264)
Net cash used in investing activities	(160)	(163)	3
Net cash used in financing activities	(2,020)	(640)	(1,380)
Effect of foreign exchange rate changes	(15)	72	(87)
Net increase (decrease) in cash and cash equivalents and restricted cash	\$ (1,404)	\$ 324	\$ (1,728)

Net Cash Provided by Operating Activities

The primary driver of net cash flows associated with our operating activities is the collection of customer receivables generated from the sale of our products and services. These collections are typically partially offset by: payments to vendors for the manufacturing, distribution, and marketing of our products; payments for customer service support for our consumers; payments to third-party developers and intellectual property holders; payments for interest on our debt; payments for software development; payments for tax liabilities; and payments to our workforce.

Net cash provided by operating activities for the nine months ended September 30, 2018, was \$791 million, as compared to \$1.06 billion for the nine months ended September 30, 2017. The decrease was primarily due to changes in our working capital resulting from the timing of collections and payments. The decrease was partially offset by higher net income for the nine months ended September 30, 2018, as compared to the nine months ended September 30, 2017.

Net Cash Used in Investing Activities

The primary drivers of net cash flows associated with investing activities typically include capital expenditures, purchases and sales of investments, changes in restricted cash balances, and cash used for acquisitions.

Net cash used in investing activities for the nine months ended September 30, 2018, was \$160 million, as compared to net cash used in investing activities of \$163 million for the nine months ended September 30, 2017. The decrease in the cash used in investing activities was primarily due to lower purchases of available-for-sale investments of \$59 million for the nine months ended September 30, 2018, as compared to \$80 million in the prior-year period, partially offset by higher capital expenditures of \$97 million for the nine months ended September 30, 2018, as

compared to \$86 million in the prior-year period.

Net Cash (Used in) Provided by Financing Activities

The primary drivers of net cash flows associated with financing activities typically include the proceeds from, and repayments of, our long-term debt and transactions involving our common stock, including the issuance of shares of common stock to employees upon the exercise of stock options, as well as the payment of dividends.

Table of Contents

Net cash used in financing activities for the nine months ended September 30, 2018, was \$2.0 billion, as compared to net cash used in financing activities of \$640 million for the nine months ended September 30, 2017. The change was primarily attributed to our debt financing activities. For the nine months ended September 30, 2018, we had debt repayments, inclusive of premium payments, of \$1.8 billion as compared to net debt repayments of \$500 million for the nine months ended September 30, 2017. The increase in cash used in financing activities was further impacted by:

- lower proceeds from stock option exercises of \$91 million for the nine months ended September 30, 2018, as compared to \$150 million for the nine months ended September 30, 2017;
- higher tax payments made for net share settlements on restricted stock units of \$85 million for the nine months ended September 30, 2018, as compared to \$44 million for the nine months ended September 30, 2017; and
- higher dividends paid of \$259 million for the nine months ended September 30, 2018, as compared to \$226 million for the nine months ended September 30, 2017.

Effect of Foreign Exchange Rate Changes

Changes in foreign exchange rates had a negative impact of \$15 million on our cash and cash equivalents and restricted cash for the nine months ended September 30, 2018, as compared to a positive impact of \$72 million for the nine months ended September 30, 2017. The change was primarily due to changes in the value of the U.S. dollar relative to the euro and the British pound.

Debt

As of September 30, 2018 and December 31, 2017, our total outstanding debt was \$2.7 billion and \$4.4 billion, respectively, bearing interest at a weighted average rate of 3.18% and 3.58%, respectively. During the nine months ended September 30, 2018, we had the following significant activity associated with our debt instruments:

- on August 16, 2018, using available cash on hand, we redeemed the 2023 Notes in full at a redemption price equal to 100% of the principal amount of the 2023 Notes plus a make-whole premium calculated as set forth in the indenture governing the 2023 Notes and accrued and unpaid interest to the redemption date, resulting in a Loss on extinguishment of debt recorded in the condensed consolidated statement of operations of \$33 million, comprised of premium payments of \$25 million and a write-off of unamortized discount and financing costs of \$8 million;

- on August 24, 2018, using available cash on hand, we made a voluntary prepayment of \$990 million to fully repay and extinguish the 2017 TLA resulting in a write-off of unamortized discount and deferred financing costs of \$7 million, which is included in Loss on extinguishment of debt in the condensed consolidated statement of operations; and
- on August 24, 2018, we also entered a Seventh Amendment (the Amendment) to our Credit Agreement for which the Amendment, among other things replaced our prior revolving credit facility of \$250 million with a new revolving credit facility with commitments in an aggregate principal amount of \$1.5 billion, which is scheduled to mature on August 24, 2023.

Edgar Filing: Activision Blizzard, Inc. - Form 10-Q

Table of Contents

A summary of our outstanding debt is as follows (amounts in millions):

	Gross Carrying Amount	At September 30, 2018 Unamortized Discount and Deferred Financing Costs	Net Carrying Amount
2021 Notes	\$ 650	\$ (4)	\$ 646
2022 Notes	400	(3)	397
2026 Notes	850	(8)	842
2027 Notes	400	(5)	395
2047 Notes	400	(10)	390
Total long-term debt	\$ 2,700	\$ (30)	\$ 2,670

	Gross Carrying Amount	At December 31, 2017 Unamortized Discount and Deferred Financing Costs	Net Carrying Amount
2017 TLA	\$ 990	\$ (8)	\$ 982
2021 Notes	650	(4)	646
2022 Notes	400	(4)	396
2023 Notes	750	(9)	741
2026 Notes	850	(9)	841
2027 Notes	400	(6)	394
2047 Notes	400	(10)	390
Total long-term debt	\$ 4,440	\$ (50)	\$ 4,390

Refer to Note 10 of the notes to condensed consolidated financial statements included in Item 1 of this Quarterly Report on Form 10-Q for further disclosures regarding our debt obligations.

Dividends

On February 1, 2018, our Board of Directors approved a cash dividend of \$0.34 per common share. On May 9, 2018, we made an aggregate cash dividend payment of \$259 million to shareholders of record at the close of business on March 30, 2018.

Capital Expenditures

For the year ending December 31, 2018, we anticipate total capital expenditures of approximately \$125 million, primarily for leasehold improvements, computer hardware, and software purchases. During the nine months ended September 30, 2018, capital expenditures were \$97 million.

Off-Balance Sheet Arrangements

At each of September 30, 2018 and December 31, 2017, Activision Blizzard had no significant relationships with unconsolidated entities or financial parties, often referred to as structured finance or special purpose entities, established for the purpose of facilitating off-balance sheet arrangements or other contractually narrow or limited purposes, that have or are reasonably likely to have a material current or future effect on our financial condition, changes in financial condition, revenues or expenses, results of operations, liquidity, capital expenditures, or capital resources.

Table of Contents

Critical Accounting Policies and Estimates

Our condensed consolidated financial statements are prepared in accordance with accounting principles generally accepted in the United States of America (U.S. GAAP). These accounting principles require us to make certain estimates, judgments, and assumptions. We believe that the estimates, judgments, and assumptions upon which we rely are reasonable based upon information available to us at the time that they are made. These estimates, judgments, and assumptions can affect the reported amounts of assets and liabilities at the date of the financial statements, as well as the reported amounts of revenues and expenses during the periods presented. To the extent there are material differences between these estimates, judgments, or assumptions and actual results, our financial statements will be affected. The accounting policies that reflect our more significant estimates, judgments, and assumptions, and which we believe are the most critical to aid in fully understanding and evaluating our reported financial results, include the following:

- Revenue Recognition;
- Allowances for Returns and Price Protection;
- Software Development Costs;
- Income Taxes;
- Fair Value Estimates (including Business Combinations and Assessment of Impairment of Assets); and
- Share-Based Payments.

During the nine months ended September 30, 2018, there were no significant changes to the above critical accounting policies and estimates, with the exception of our adoption of ASC 606: *Revenue from Contracts with Customers*. Refer to Note 2 of the notes to condensed consolidated financial statements included in Item 1 of this Quarterly Report on Form 10-Q for disclosures regarding our updated revenue recognition accounting policies and see *Recently Issued Accounting Pronouncements* below for the financial statement impact as a result of our adoption of the new standard. Refer to Management's Discussion and Analysis of Financial Condition and Results of Operations contained in Part II, Item 7 of our Annual Report on Form 10-K for the year ended December 31, 2017, for a more complete discussion of our other critical accounting policies and estimates.

Recently Issued Accounting Pronouncements

Below are recently issued accounting pronouncements that were most significant to our accounting policy activities. For a detailed discussion of all relevant recently issued accounting pronouncements, see Note 3 of the notes to condensed consolidated financial statements included in Item 1 of this Quarterly Report on Form 10-Q.

Recently Adopted Accounting Pronouncements

Revenue Recognition

As discussed in Note 2 of the notes to condensed consolidated financial statements included in Item 1 of this Quarterly Report on Form 10-Q, in May 2014, the Financial Accounting Standards Board (FASB) issued new accounting guidance related to revenue recognition and on January 1, 2018, we adopted the new accounting standard and related amendments (collectively, the new revenue accounting standard), utilizing the modified retrospective method. Additionally, we elected to apply the new revenue accounting standard only to contracts not completed as of the adoption date. For contracts that were modified before the period of adoption, we elected to reflect the aggregate effect of all modifications when (1) identifying the satisfied and unsatisfied performance obligations, (2) determining the transaction price, and (3) allocating the transaction price to the satisfied and unsatisfied performance obligations. We recognized the cumulative effect of initially applying the new revenue accounting standard as an adjustment to the opening balance of retained earnings. The comparative information has not been restated and continues to be reported under the accounting standards in effect for those periods. The cumulative effect adjustment recorded to our retained earnings at January 1, 2018 was \$88 million.

The most significant impacts of the new revenue accounting standard for us are:

- *The accounting for our sales of our games with significant online functionality for which we do not have vendor-specific objective evidence (VSOE) for unspecified future updates and ongoing online services provided.* Under the prior accounting standards, VSOE for undelivered elements was required. This requirement was eliminated

Table of Contents

under the new revenue accounting standard. Accordingly, we are required to recognize as revenue a portion of the sales price upon delivery of this software, as compared to recognizing the entire sales price ratably over an estimated service period, as previously required. This difference in accounting primarily impacts revenues from our Call of Duty franchise, where approximately 20% of the sales price is now recognized as revenue upon delivery of the games to our customers. The amount of revenue recognized upon delivery of games to our customers is analyzed on a title-by-title basis and may change in the future. For example, we expect the entire sales price from our *Call of Duty: Black Ops 4* release to be recognized ratably over an estimated service period, as the gameplay has an increased focus towards the online competitive and cooperative game modes with no single-player campaign mode. Many of our other franchises, such as Destiny, Overwatch, World of Warcraft, and Candy Crush, are online hosted arrangements, and the accounting for our sales of these games under the new standard is relatively unchanged; and

- *The accounting for certain of our software licensing arrangements.* While the impact of the new revenue accounting standard may differ on a contract-by-contract basis (as the actual revenue recognition treatment required under the standard will depend on contract-specific terms), the new revenue accounting standard generally results in earlier revenue recognition for these arrangements.

For additional discussion regarding the impact of our adoption of the new revenue accounting standard, including the impacts to our condensed consolidated balance sheet and statement of operations, see Note 3 of the notes to condensed consolidated financial statements included in Item 1 of this Quarterly Report on Form 10-Q.

Statement of Cash Flows-Restricted Cash

In November 2016, the FASB issued new guidance related to the classification of restricted cash in the statement of cash flows. The new standard requires that a statement of cash flows explain any change during the period in total cash, cash equivalents, and restricted cash. Therefore, restricted cash will be included with Cash and cash equivalents when reconciling the beginning-of-period and end-of-period total amounts shown on the statement of cash flows. The new standard is effective for fiscal years beginning after December 15, 2017, and should be applied retrospectively.

We adopted the new standard during the first quarter of 2018 and applied the standard retrospectively for all periods presented. The application of this new standard did not have a material impact on our condensed consolidated statements of cash flows for the nine months ended September 30, 2018 and 2017.

In our Annual Report on Form 10-K for the year ending December 31, 2018, there will be a significant impact to the consolidated statements of cash flows for 2016, as this period includes, as an investing activity, the \$3.6 billion movement in restricted cash resulting from the transfer of cash into escrow at December 31, 2015 to facilitate the acquisition of King, and the subsequent release of that cash in 2016 to complete the acquisition. Under this new standard, the restricted cash balance will be included in the beginning and ending total cash, cash equivalents, and restricted cash balances and, hence, will not be included as an investing activity in the statement of cash flows.

Derivatives and Hedging

Edgar Filing: Activision Blizzard, Inc. - Form 10-Q

In August 2017, the FASB issued new guidance related to the accounting for derivatives and hedging. The new guidance expands and refines hedge accounting for both financial and non-financial risk components, aligns the recognition and presentation of the effects of hedging instruments and hedged items in the financial statements, and includes certain targeted improvements to ease the application of current guidance related to the assessment of a hedge's effectiveness. The new standard is effective for fiscal years beginning after December 15, 2018. Early adoption is permitted. We adopted the standard during the first quarter of 2018. The adoption of the standard did not have a material impact to our condensed consolidated financial statements.

Table of Contents

Recent Accounting Pronouncements Not Yet Adopted

Leases

In February 2016, the FASB issued new guidance related to the accounting for leases. The new standard will replace all current U.S. GAAP guidance on this topic. The new standard, among other things, requires a lessee to classify a lease as either an operating or financing lease, and to recognize a lease liability and a right-of-use asset for its leases. Classification will be based on criteria that are largely similar to those applied in current lease accounting. The lease liability will be equal to the present value of lease payments. The asset will be based on the lease liability, subject to adjustment for initial direct costs, lease incentives received, and any prepaid lease payments. Operating leases will result in a straight-line expense pattern, while finance leases will result in a front-loaded expense pattern. The standard is effective for fiscal years, and interim periods within those fiscal years, beginning after December 15, 2018. Early adoption is permitted. When the new standard was initially issued, it was required to be adopted using a modified retrospective transition that required application of the new guidance at the beginning of the earliest comparative period presented, subject to certain transition practical expedients available to provide relief in connection with the adoption. In July 2018, the FASB issued guidance to provide for an optional adoption method that allows companies to use the effective date of the new lease standard as the initial date of application on transition, and therefore does not require prior periods to be restated.

Although we continue to evaluate the impact of this new accounting guidance on our financial statements, we expect it to have a significant impact on our consolidated balance sheet as a result of establishing lease liabilities and right-of-use assets for our operating leases. As part of our evaluation process, we have established a project implementation team that is evaluating our lease portfolio and system solutions, as well as identifying required process and policy changes, which include consideration of internal controls. We have made progress in gathering the necessary data elements for our lease population, have selected a system provider, and system configuration and implementation is underway. We do not plan to early adopt this new standard but do expect to elect and apply the available transition practical expedients, including the optional adoption method discussed above.

Item 3. Quantitative and Qualitative Disclosures about Market Risk

Market risk is the potential loss arising from fluctuations in market rates and prices. Our market risk exposures primarily include fluctuations in foreign currency exchange rates and interest rates.

Foreign Currency Exchange Rate Risk

We transact business in many different foreign currencies and may be exposed to financial market risk resulting from fluctuations in foreign currency exchange rates. Revenues and related expenses generated from our international operations are generally denominated in their respective local currencies. Primary currencies include euros, British pounds, Australian dollars, South Korean won, Chinese yuan, and Swedish krona. To the extent the U.S. dollar strengthens against foreign currencies, the translation of these foreign currency-denominated transactions will result in reduced revenues, operating expenses, net income, and cash flows from our international operations. Similarly, our revenues, operating expenses, net income, and cash flows will increase for our international operations if the U.S. dollar weakens against foreign currencies. Since we have significant international sales, but incur the majority of our costs in the United States, the impact of foreign currency fluctuations, particularly the strengthening of the U.S. dollar, may have an asymmetric and disproportional impact on our business. We monitor currency volatility throughout the year.

To mitigate our foreign currency risk resulting from our foreign currency-denominated monetary assets, liabilities, and earnings and our foreign currency risk related to functional currency-equivalent cash flows resulting from our intercompany transactions, we periodically enter into currency derivative contracts, principally forward contracts. These forward contracts generally have a maturity of less than one year. The counterparties for our currency derivative contracts are large and reputable commercial or investment banks.

Edgar Filing: Activision Blizzard, Inc. - Form 10-Q

Table of Contents

The fair values of our foreign currency contracts are estimated based on the prevailing exchange rates of the various hedged currencies as of the end of the period.

We do not hold or purchase any foreign currency forward contracts for trading or speculative purposes.

Foreign Currency Forward Contracts Designated as Hedges (Cash Flow Hedges)

The total gross notional amounts and fair values of our Cash Flow Hedges are as follows (amounts in millions):

	As of September 30, 2018		As of December 31, 2017	
	Notional amount	Fair value gain (loss)	Notional amount	Fair value gain (loss)
Foreign Currency:				
Buy USD, Sell Euro	\$ 843	\$ 7	\$ 521	\$ (5)

At September 30, 2018, our Cash Flow Hedges have remaining maturities of 15 months or less. Additionally, \$3 million of net realized but unrecognized gains are recorded within Accumulated other comprehensive income (loss) at September 30, 2018 for Cash Flow Hedges that had settled but were deferred and will be amortized into earnings, along with the associated hedged revenues. Such amounts will be reclassified into earnings within the next 12 months.

The amount of pre-tax net realized gains (losses) associated with our Cash Flow Hedges that were reclassified out of Accumulated other comprehensive income (loss) and into earnings was as follows (amounts in millions):

	For the Three Months Ended September 30,		For the Nine Months Ended September 30,		Statement of Operations Classification
	2018	2017	2018	2017	
Cash Flow Hedges	\$ 3	\$ (2)	\$ (11)	\$ 7	Net revenues

Foreign Currency Forward Contracts Not Designated as Hedges

The total gross notional amounts and fair values of our foreign currency forward contracts not designated as hedges are as follows (amounts in millions):

	As of September 30, 2018		As of December 31, 2017	
	Notional amount	Fair value gain (loss)	Notional amount	Fair value gain (loss)
Foreign Currency:				
Buy Euro, Sell USD	\$ 119	\$ (5)	\$	\$

For the three and nine months ended September 30, 2018 and 2017, pre-tax net gains associated with these forward contracts were recorded in General and administrative expenses and were not material.

In the absence of hedging activities for the nine months ended September 30, 2018, a hypothetical adverse foreign currency exchange rate movement of 10% would have resulted in a theoretical decline of our net income of approximately \$90 million. This sensitivity analysis assumes a parallel adverse shift of all foreign currency exchange rates against the U.S. dollar; however, all foreign currency exchange rates do not always move in this manner and actual results may differ materially.

Interest Rate Risk

Our exposure to market rate risk for changes in interest rates relates primarily to our investment portfolio, as our outstanding debt is all at fixed rates. Our investment portfolio consists primarily of money market funds and government securities with high credit quality and short average maturities. Because short-term securities mature relatively quickly and must be reinvested at the then-current market rates, interest income on a portfolio consisting of cash, cash equivalents, or short-term securities is more subject to market fluctuations than a portfolio of longer-term securities. Conversely, the fair value of such a portfolio is less sensitive to market fluctuations than a portfolio of longer-term securities. At September 30, 2018, our \$3.31 billion of cash and cash equivalents was comprised primarily of money market funds.

The Company has determined that, based on the composition of our investment portfolio as of September 30, 2018, there was no material interest rate risk exposure to the Company's consolidated financial condition, results of operations, or liquidity as of that date.

Table of Contents

Item 4. Controls and Procedures

Definition and Limitations of Disclosure Controls and Procedures

Our disclosure controls and procedures (as such term is defined in Rules 13a-15(e) and 15d-15(e) under the Securities Exchange Act of 1934 (the Exchange Act)) are designed to reasonably ensure that information required to be disclosed in our reports filed under the Exchange Act is: (1) recorded, processed, summarized, and reported within the time periods specified in the SEC's rules and forms, and (2) accumulated and communicated to management, including our principal executive officer and principal financial officer, as appropriate, to allow timely decisions regarding required disclosures. A control system, no matter how well designed and operated, can provide only reasonable assurance that it will detect or uncover failures within the Company to disclose material information otherwise required to be set forth in our periodic reports. Inherent limitations to any system of disclosure controls and procedures include, but are not limited to, the possibility of human error and the circumvention or overriding of such controls by one or more persons. In addition, we have designed our system of controls based on certain assumptions, which we believe are reasonable, about the likelihood of future events, and our system of controls may therefore not achieve its desired objectives under all possible future events.

Evaluation of Disclosure Controls and Procedures

Our management, with the participation of our principal executive officer and principal financial officer, has evaluated the effectiveness of our disclosure controls and procedures at September 30, 2018, the end of the period covered by this report. Based on this evaluation, the principal executive officer and principal financial officer concluded that, at September 30, 2018, our disclosure controls and procedures were effective to provide reasonable assurance that information required to be disclosed by the Company in the reports that it files or submits under the Exchange Act is (i) recorded, processed, summarized, and reported on a timely basis, and (ii) accumulated and communicated to our management, including our principal executive officer and principal financial officer, as appropriate to allow timely decisions regarding required disclosures.

Changes in Internal Control Over Financial Reporting

Our management, with the participation of our principal executive officer and principal financial officer, has evaluated any changes in our internal control over financial reporting that occurred during the fiscal quarter ended September 30, 2018. Based on this evaluation, the principal executive officer and principal financial officer concluded that, at September 30, 2018, there have not been any changes in our internal control over financial reporting during the most recent fiscal quarter that have materially affected, or are reasonably likely to materially affect, our internal control over financial reporting.

PART II. OTHER INFORMATION

Item 1. Legal Proceedings

Edgar Filing: Activision Blizzard, Inc. - Form 10-Q

We are party to routine claims, suits, investigations, audits, and other proceedings arising from the ordinary course of business, including with respect to intellectual property rights, contractual claims, labor and employment matters, regulatory matters, tax matters, unclaimed property matters, compliance matters, and collection matters. In the opinion of management, after consultation with legal counsel, such routine claims and lawsuits are not significant and we do not expect them to have a material adverse effect on our business, financial condition, results of operations, or liquidity.

Table of Contents

Item 1A. Risk Factors

Various risks associated with our business are described in Part I, Item 1A, Risk Factors, of our Annual Report on Form 10-K for the year ended December 31, 2017.

Item 6. Exhibits

The exhibits listed on the accompanying Exhibit Index are hereby incorporated by reference into this Quarterly Report on Form 10-Q.

Table of Contents

EXHIBIT INDEX

Exhibit Number	Exhibit
3.1	<u>Third Amended and Restated Certificate of Incorporation of Activision Blizzard, Inc., dated June 5, 2014 (incorporated by reference to Exhibit 3.1 of the Company's Form 8-K, filed June 6, 2014).</u>
3.2	<u>Fourth Amended and Restated Bylaws of Activision Blizzard, Inc., adopted as of February 1, 2018 (incorporated by reference to Exhibit 3.1 of the Company's Form 8-K/A, filed March 21, 2018).</u>
10.1	<u>Seventh Amendment, dated as of August 24, 2018, to the Credit Agreement, dated as of October 11, 2013, by and among Activision Blizzard, Inc., the guarantors from time to time party thereto, the lenders from time to time party thereto, Bank of America, N.A., as administrative agent and collateral agent, and the several other agents party thereto (incorporated by reference to Exhibit 10.1 of the Company's Form 8-K, filed August 29, 2018).</u>
31.1	<u>Certification of Robert A. Kotick pursuant to Rule 13a-14(a) under the Securities and Exchange Act of 1934, as adopted pursuant to Section 302 of the Sarbanes-Oxley Act of 2002.</u>
31.2	<u>Certification of Spencer Neumann pursuant to Rule 13a-14(a) under the Securities and Exchange Act of 1934, as adopted pursuant to Section 302 of the Sarbanes-Oxley Act of 2002.</u>
32.1	<u>Certification of Robert A. Kotick pursuant to Section 906 of the Sarbanes-Oxley Act of 2002.</u>
32.2	<u>Certification of Spencer Neumann pursuant to Section 906 of the Sarbanes-Oxley Act of 2002.</u>
101.INS	XBRL Instance Document.
101.SCH	XBRL Taxonomy Extension Schema Document.
101.CAL	XBRL Taxonomy Extension Calculation Linkbase Document.
101.LAB	XBRL Taxonomy Extension Labels Linkbase Document.
101.PRE	XBRL Taxonomy Extension Presentation Linkbase Document.
101.DEF	XBRL Taxonomy Extension Definition Linkbase Document.

Attached as Exhibit 101 to this report are the following formatted in XBRL (Extensible Business Reporting Language): (i) condensed consolidated balance sheets at September 30, 2018 and December 31, 2017, (ii) condensed consolidated statements of operations for the three and nine months ended September 30, 2018 and September 30, 2017, (iii) condensed consolidated statements of comprehensive income (loss) for the three and nine months ended September 30, 2018 and September 30, 2017, (iv) condensed consolidated statements of cash flows for the nine months ended September 30, 2018 and September 30, 2017; (v) condensed consolidated statement of changes in shareholders' equity for the nine months ended September 30, 2018; and (vi) notes to condensed consolidated financial statements.

Table of Contents

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.

Date: November 8, 2018

ACTIVISION BLIZZARD, INC.

/s/ SPENCER NEUMANN
Spencer Neumann
*Chief Financial Officer and
Principal Financial Officer of
Activision Blizzard, Inc.*

/s/ STEPHEN WEREB
Stephen Werek
*Deputy Chief Financial Officer, Chief Accounting Officer,
and Principal Accounting Officer of
Activision Blizzard, Inc.*