

ATARI



## Financial Highlights

(in thousands)

Year Ended December 31,

	1987	1986	1985
<i>Statement of Operations:</i>			
Net Sales	\$ 493,072	\$ 238,011	\$ 141,987
Income (loss) from operations	63,629	48,215	(21,519)
Net income (loss)	37,429	44,316	(14,314)
<i>Balance Sheet Data:</i>			
Working capital	188,499	196,454	11,749
Long-term debt (including current maturities)	135,556	2,531	37,282
Shareholders' equity (deficiency)	167,633	125,422	(19,477)

### Profile

Atari Corporation is one of the largest manufacturers of personal computers and video game systems in the world. Through creative application of advanced technologies, the company consistently offers customers "Power Without the Price." At the conclusion of the year the Corporation met the qualifications to be noted as one of the Fortune 500 companies.

The Corporation's products include the Mega and ST lines of advanced personal 16/32-bit computers, the XL line of 8-bit computers, and Atari XL, 7800, and 2600 video game systems, peripherals, accessories, and a growing library of computer and video game software. These are sold in almost every country in the world.

Atari is a multinational company employing more than 4,000 people. Corporate headquarters, including research, development, and product design are located in Sunnyvale, California. The Federated Group, Inc., acquired in October 1987, provides the company with electronic specialty retail stores throughout the western United States. Additionally, wholly owned subsidiaries are maintained in Australia, Benelux, Canada, Denmark, France, Italy, Japan, Norway, Mexico, Spain, Sweden, Switzerland, Taiwan, the United Kingdom, the United States, and West Germany.

## Financial Highlights

*in thousands*

*Year Ended December 31,*

	1987	1986	1985
<i>Statement of Operations:</i>			
Net Sales	\$ 493,172	\$ 258,131	\$ 141,987
Income (loss) from operations	65,629	48,215	(25,819)
Net income (loss)	57,429	44,516	(14,314)
<i>Balance Sheet Data:</i>			
Working capital	188,499	96,484	11,749
Long-term debt (including current maturities)	135,006	2,033	57,082
Shareholders equity (deficiency)	167,655	105,422	(19,477)

## **Profile**

**Atari Corporation is one of the largest manufacturers of personal computers and video game systems in the world. Through creative application of advanced technologies, the company consistently offers customers "Power Without the Price." At the conclusion of the year the Corporation met the qualifications to be noted as one of the Fortune 500 companies.**

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**o Our Shareholders:**

1987 has been an eventful and exciting year. It was a year that saw sales of Atari computers and video game systems reach new record highs; a year in which Atari introduced a number of new products; and it was a period in which the Corporation extended its vertically structured organization by acquiring the Federated Group, Inc., a chain of consumer electronic stores.

**Sales Growth** Net sales for the Corporation, with the Federated Group, Inc., were a record \$493,172,000 compared to \$258,131,000, an increase of 91% over the same period in 1986.

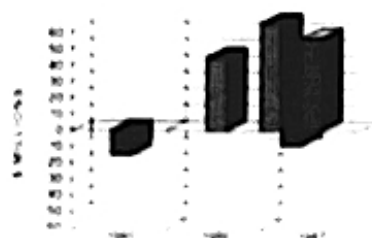
Operating income was \$65,629,000 compared to \$48,215,000, an increase of 36%, and income before extraordinary item rose to \$44,152,000 compared to \$25,050,000, an increase of 76%. Earnings per share for 1987, before extraordinary item, were \$.76 compared to \$.53 in 1986, an increase of 43%.

Results for the Corporation without Federated show net sales for 1987 were a record \$363,807,000 compared to \$258,131,000, an increase of 41% over 1986. Operating income was \$72,016,000 compared to \$48,215,000, an increase of 49%, and income before extraordinary item rose to \$46,610,000 from \$25,050,000, an increase of 86%. Earnings per share for 1987 before extraordinary item were \$.80 compared to \$.53 in 1986, an increase of 51%.

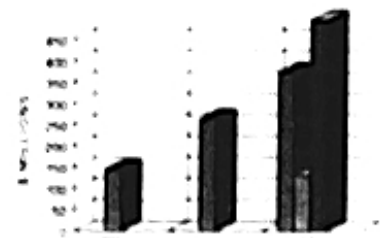
**Product Growth** During the first quarter of 1987, Atari released a new disk drive, model XT 551, for its 8-bit line of computers. In the third quarter the following products entered distribution channels:

- MEGA2 personal computer
- MEGA4 personal computer
- SIM804 laser printer
- PC1 personal computer
- PC 2 personal computer
- PCM124 monochrome monitor
- PC1 554 disk drive
- PC1204 hard drive
- SX212 modem
- XT Video Game System
- 79 Atari game and computer software products
- Plus many more 3rd party programs for business and personal use.

NET INCOME



NET SALES



■ Atari Corporation  
 ■ The Federated Group, Inc.  
 ■ Combined

**Market Growth** Our commitment to an international marketing strategy has resulted in a dramatic increase in European sales of the Atari 520ST and 1040ST personal computers. Demand for these products throughout Europe rose so sharply during 1987 that we were forced to postpone our marketing assault on the United States. We are striving to increase production capacity in order to meet demand. This situation is expected to improve during the second half of 1988, and we anxiously look forward to it because the largest market is still ahead of us.

**The Power of Atari** Inherent in every product we build is our promise of, "Power Without the Price," but behind each product is the real power of Atari—its people. The Atari team, many of whom have worked together for many years, share a unique understanding of our customers' product needs. The success of this philosophy can be seen in the design of every product we take to market.

The Musical Instrument Digital Interface (MIDI) ports, for example, are built into all ST and MEGA systems. The importance of these enhancements, which permit musicians to connect electronic synthesizers and instruments to their computers, has helped Atari gain a substantial market share of the music industry. Many artists in the commercial music business, as well as companies in the film and video community, are beginning to standardize on Atari ST systems to synchronize their video and audio sound tracks.

Today the ST is an essential instrument for such top recording artists as blues great B.B. King, jazz pianist and composer Oscar Peterson, the Pointer Sisters, Tangerine Dream, guitarists Lee Ritenour, Mick Fleetwood of Fleetwood Mac, and many more.

Jimmy Hotz, the professional musicians' MIDI expert, who has introduced numerous artists to the wonder of this technology, says, "Of all the computers I've used, Atari seems to react fastest and have the best MIDI timing to make it sound the most natural with what you put in there."

During 1987, video games were in overwhelming demand, particularly in North America. Sales of our new XT game system were impressive. A number of new software titles have been added to the thousands of programs already available for this high-resolution game system.

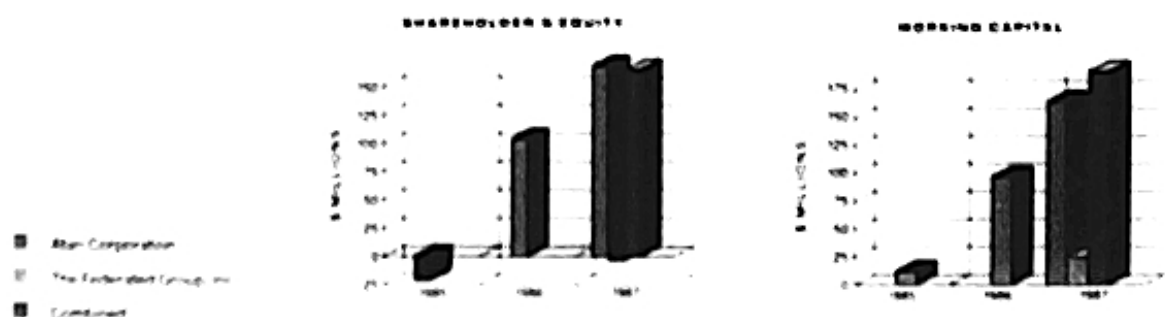
Our 7800 Prosystem game console, which plays both 2600 and 7800 games, was supported by a variety of exciting new titles introduced during the year. Our 2600 game system maintained its universal popularity. A new generation of young game players, coupled with the release of new software and the introduction of many proven classics, has helped to stimulate sales. Marketing efforts in the United States were supported by a series of television commercials targeted at parents and their children.

**Corporate Growth** Our marketing efforts, distribution channels, and plans for growth are constantly being evaluated on a global basis. During the past year, new sales subsidiaries were opened in Sweden, Spain, Australia, and Mexico.

On October 4, 1987, we acquired the Federated Group, Inc. This specialty chain of 68 electronic retail stores based in the Western United States offers a wide range of stereo, video, and other intelligent electronic products. The stores have sustained operating losses for the last two years. In an effort to reverse this trend, we have already begun to make significant reductions in the fixed overheads of this operation. However, in spite of our actions, we still anticipate operating losses for the first three quarters of 1988, when sales are seasonally low. Corrections are now being made to create a positive sales environment by improving margins and introducing a new range of private label products. We expect the Federated stores to close the year at break-even.

Atari's vertical integration plan is not yet complete. We are presently seeking to acquire, or form a strategic alliance with, a semiconductor manufacturing plant. There are many obvious reasons for this move. One example worthy of note concerns the present Dynamic Random Access Memory (DRAM) dilemma facing the entire consumer electronics industry.

Recent governmental agreements have increased the cost of DRAMS which has had a direct effect on gross margins. This federal interference also caused a slowdown in production, and placed these critical devices in very short supply. Our desire to enter into a manufacturing arrangement



will help to accomplish a number of important objectives for us. Namely, it will assure Atari of a constant supply of components while insulating us against adverse market conditions. It will also accelerate the speed of getting new goods to market while allowing us to gain greater access to the research and development in this vital part of our business.

**Future Growth** In the year ahead, we will be expanding our ST line by introducing a 32-bit system driven by the 68030 Motorola microprocessor. We view this exceptionally powerful workstation as a logical extension of our 68000-based series of personal computers. The new 68030 unit will feature on-chip memory management and cache providing extremely fast internal RAM operations. With an industry-standard UNIX operating system, the 68030 will enter the marketplace in the fourth quarter, fully supported by existing software for office automation, engineering, database management, and scientific applications. This superb technology underscores our continuing commitment to develop the most advanced personal computers. And since we believe that the operative word is "personal," the technology we bring to the office today will be in the home in two years.

Two years ago Atari announced the CD-ROM as a computer peripheral for home and office use. Its application was extraordinary, but its cost was excessive. Today, this equipment can be manufactured to retail at a reasonable price, and we will be releasing our CD-ROM later in the year. Using compact disks as its media, this unit will offer both audio and read-only data for users requiring vast banks of information. Each condensed disk can hold up to 540 megabytes of information. That's enough storage space to contain eight 20-volume sets of encyclopedias, tax information, and any other reference material where instant, easy access is required.

I want to thank our many customers, suppliers, and dedicated employees for their contributions. I look forward to their continued efforts in making 1988 an even more profitable year.



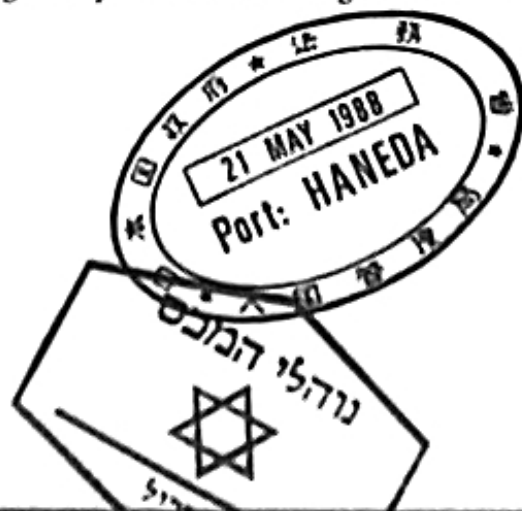
SAM TRAMMELL, President



**A**tari is a household name in every corner of the world. Throughout Europe, North and South America, the Middle East, and all across the Pacific Basin, Atari products are at work or at play.

In earlier years, youngsters everywhere spent many afterschool hours discovering the enjoyment Atari brought home. Fortunately or unfortunately, we all grow up. Today's men and women are now discovering that Atari has grown along with them. Last year alone, we broadened our hardware line by introducing multimegabyte computers and the new XE system. Every new product released bears the Atari hallmarks of cutting edge technology and affordability. Our new XE system, with its excellent resolution, is a versatile high-end game system as well as a home computer with over 65,000 bytes of RAM. The new MEGA series of personal computers is fully compatible with our Atari ST systems and built to handle vast amounts of information. The MEGA2, with 2 million bytes of RAM, and the MEGA4, with 4 million bytes of RAM, have DMA ports that transfer data at a blazing speed of 1.33 megabytes per second. The systems have a built-in BLITTER chip that accelerates screen graphics and text scrolling by a factor of ten. The new Atari SLM804 laser printer represents state-of-the-art desktop publishing technology. Because the printer uses the Atari MEGA computer's large RAM capacity and relies upon the system's exceptionally high data transfer rate, the process of publishing documents is many times faster than most other brands on the market today.

The powerful performance range and realistic pricing structure of Atari systems are continuing to attract the worldwide attention of important software developers such as Microsoft, Heymanns Verlag, Michtron, Hybrid Arts, Metacomco, Soft-Logik, G.O. Graphics, and many others. These leading companies have added unique software programs to the thousands of titles that are now being used by Atari owners throughout the world.



Last year in West Germany, Atari 520ST and 1040ST systems achieved a 30% share of the non-compatible personal computer market. The presence of these two computers is a familiar sight in the classrooms, labs, and dormitories of such Universities as Hamburg, Berlin, Bonn, Munich, Frankfurt, Mainz, Stuttgart, Konstanz, Karlsruhe, Freiburg, Ulm, Dortmund, Bremen, Hannover, and the list continues.

In the engineering and scientific communities of West Germany, companies such as DESY, one of the country's most important scientific research centers, and in the chemical labs of BASF, the medical labs of Bayer, the design centers at BMW, and the aircraft corporations of MBB and Dornier, Atari is right at home. In fact, Atari commands 15% of the entire market for computers retailing over 1000 Deutsch Marks.

Atari ST systems help keep track of mega loads of case data and courtroom battles for West Germany's busy judicial system. Battles on the chessboard are often equally challenging. Three-time world chess master Garry Kasparov uses his MEGA system with ChessBase, a technical chess database, to work through strategies and prepare his smashing assaults.

In Czechoslovakia, the German Democratic Republic, and Poland the Atari 800XT and 65XT computers have gained brand dominance and are among the most popular systems being sold in these countries.

In Switzerland, Atari ST systems have made impressive gains in the business and technical communities. Such leading companies as SRG, the Swiss broadcasting company; ASEA-Brown Boveri, one of the country's largest industrial research centers; GRD, the Department of Defense; and CERN, the European Organization for Nuclear Research, are now using Atari ST equipment. Atari STs have made impressive gains in the Swiss educational market, where they today occupy a 30% share of this vital area.



**1. Volumes of courtroom precedents and trial results are some of the data stored in the Admix system throughout West Germany's federal judicial system. The honorable Dr. Günter Krebs, presiding judge of the German Federal Supreme Court, uses Admix ST as the database for his IS4051. This information is then duplicated and issued to all justices, attorneys, and designated officials throughout the legal community by German publisher Heymanns Verlag.**

**2. Three-time and current world chess champion, Garry Kasparov, uses the powerful ChessBase program on his Star IS4051.**





1. Hewett, a creative  
ad copy in Milan, Italy,  
uses IBM's 585 with SC3274  
color monitors to lay  
out advertisements and  
create innovative  
graphics. The software  
is Design Elite from  
Electronic Arts and Copy-  
Draw from Bitgraph, Inc.  
2. At the City University  
of London students work  
at Atari ST workstations  
which are networked  
to their university's  
mainframe.

3. A transportation  
engineer at the French  
National Institute for  
Transportation Research  
and Planning (INRETS),  
tackles the universal  
problem of urban rush  
hour traffic on his  
Atari ST workstation.

The French press has taken to Atari ST systems as at work helping to generate articles on a daily basis at *Ouest France*, a major French newspaper, and *Paris Match*, the national news magazine. Atari STs are also part of the team at Radio France, S.F., the national television company, and at C.F.J., the Paris press training center. The popular French newspaper, *Libération*, has equipped its entire editorial staff with Atari 1042ST systems. Even the paper's in-house employee newsletter is produced on Atari ST systems using two Atari 51M804 laser printers. Our systems are at the Ministries of Culture, Army, Transportation, and Agriculture. They are also in place at C.I.A., the French Atomic Research Center, CNRS, the National Scientific Research Institute, and CNES, the French Space Center.

At INRETS, the National Institute for Transportation research, a large number of 1042STs are being used as economical workstations connected to a large mainframe. Through a special emulator, Atari STs are able to work directly with vector data, thereby freeing the central computer from this task. We are pleased that the French people have welcomed Atari so enthusiastically.

The United Kingdom's marketing strategy during 1987 called for greater distribution of Atari ST systems and "getting the Atari message to the people." By year end, retailers like Comet, Dixons, The John Lewis Partnership, and W. H. Smith, plus hundreds of independent stores, were providing a strong presence at the retail level. This exposure combined with television commercials and print advertising enabled Atari UK to gain a 40% share of the 16-bit computer market.

Major centers of higher learning such as the School of Thermodynamics at Strathclyde University in Glasgow, Kent College's Department of Computing and Mathematics, and the Universities of Southampton and Sussex selected Atari 520ST and 1042ST systems.



The Fermi National Accelerator Laboratory in Batavia, Illinois, is perhaps the world's leading particle research physics center. In study areas both above and below the ground, scientists from all over the world are engaged in the pure fundamental research of elementary particle division. Much of their work deals with imposing particle beams into a nucleus to determine the final components of matter. Computers are essential tools in this research. Dr. Helmut Braun, a visiting physicist from the University of Wuppertal in West Germany, is extremely pleased with the versatile performance of the many Atari STs being used as intelligent terminals networked to Control Data Corporation and Digital Equipment mainframes.

Primary school students enjoy the benefits of Atari as much as particle division experts. In over 1,000 schools across the United States students like those in Escambia County, Florida, use Atari 1040ST systems to learn math, reading, and language skills. The software is the CCC MICROTEST Instructional System offered by Computer Curriculum Corporation of Palo Alto, California. This software, which was created expressly for the Atari system, measures and reports student performance and adjusts the level and content for each pupil. According to CCC, "The Atari ST computer was selected for its excellent graphics capability, high memory capacity and affordable price." For this very same reason over 65% of all the Atari 520ST and 1040ST equipment sold in Canada last year was purchased for home use.

During the fall of 1987, Atari systems also began to enter Canada's business and educational centers. At Waterloo University's Center for Ground Research, where hydrogeologists, geochemists, and biologists study worldwide water distribution analysis and sources of supply, over 25 Atari ST and MEGA systems have been installed. The equipment is networked to the school's IBM 4341 main-



**1. Dr. Helmut Brann,**  
physicist at the Fermi  
Accelerator Laboratory,  
Batavia, Illinois, uses  
an Atari 1040ST to control  
precision electronic  
experiments.

**2. Atari STs handle data  
management and desktop  
publishing with painless  
effort at the American  
Dental Association Head-  
quarters, Chicago, Illinois.**

**3. & 4. Escambia County  
Florida students learn the  
three "E's" of their own  
pace thanks to Atari  
1040ST computers and  
the CCC MICROST  
Instructional System  
software.**





1. Interational jazz  
maestro Oscar Peterson  
at home with his music  
and his Atari II/286.  
Using his computer along  
with other equipment,  
Peterson creates and  
arranges film scores,  
ballads, and jazz material  
in his own fully equipped  
studio.

2. Two Atari II systems  
are part of the Peterson  
Sisters' backup team.  
3. Atari II/286 with  
both an HD14 and Atari  
SC1124 color monitor:  
"a powerful music maker."



frame and the Cray XMT-22 Super Computer. Dr. Edward Sudicky, at the center explained that because the school required a powerful and flexible system, "The standard 640K IBM MS-DOS computer was no match for the Atari 1040ST."

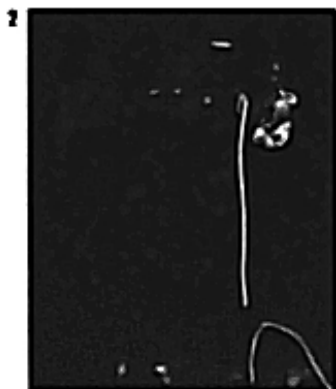
In Lakefield, Ontario, Wayne Snide, general manager of the town's only newspaper, designs, composes, writes, and edits the Lakefield Community Newspaper on an Atari 1040ST. The software he uses is Publishing Partner. In his own words, "Not only is the newspaper much more economical to produce, but with the help of our ST we've cut our production time in half."

At the World Chess Festival in Saint John, Nova Scotia, the pressure was challenging and fierce. Yet every morning the Grandmasters, their seconds, and the international press corps received graphically illustrated and detailed bulletins of the previous day's tournament events. The newsletter was generated on Atari ST systems using ChessBase as the software.

Music is an international language, and happily Atari has been recognized the world over for its ability to allow musicians and artists to mix, arrange, and compose their music.

Audiences throughout the world do not have to be told that Canadian jazz pianist Oscar Peterson is recognized as an acoustic genius and chosen as the "Best Jazz Pianist" by *Downbeat* magazine twelve times, and *Plyboy* magazine 13 times. What his fans may not know is that Oscar Peterson's work place is a marvel of engineering technology. Among his electronic instruments is just one powerful computer. The Atari 51604. With the help of his Atari, Mr. Peterson is now able to compose, score, and arrange everything from his jazz trio work to the full orchestrations of his film scores, ballets, and suites, right at home.

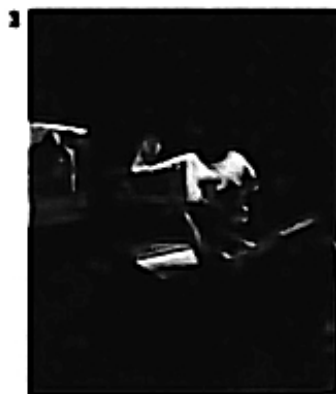
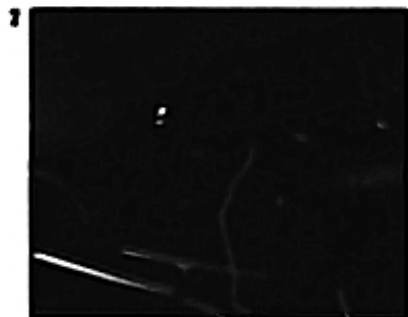
The next time you have an opportunity to attend a Pointer Sisters concert, force yourself to look past those three talented ladies to the keyboard artists on stage with them. Greg Welchel and



Marc Ritter are working with Atari ST systems. "We researched everything out there, and felt that the Atari ST offered the most flexibility. We use it for everything. On stage, for sequencing, and synthesizer patch library storage. In the studio we use it to print lead sheets, and at home we use it for business. The Pointer Sisters have composing setups at home so we all use the same system."

There are many more Atari systems under spotlights around the world. In France, progressive jazz artist Jean Michel Jarre composes on his Atari ST; in Germany the progressive rock group, Tangerine Dream, rely on their Atari computer; along with the American blues great B.B. King, jazz guitarist Lee Ritenour, Scott Gershwin at Todd AO studios, and many others. In New York City, Ed Kizer of SitCom Services, Inc. makes what you hear on television sound perfect. "I use ADAP software from Hybrid Arts, Inc. on my MEGA4 to store, enhance, and trigger sound effects during live tapings." It's called "sweetening," and one of Kizer's sweet projects is the Bill Cosby Show.

Musicians and youngsters, university students, scientists, and business people in almost every country in the world have begun to fully understand how much they can depend upon an Atari ST to accomplish their particular work faster, easier, and more economically.





**1 & 2.** At the computer center of a local Federated Group electronic store, the beginner and the computing expert can discover an extensive range of Atari Systems, from introductory material to the most advanced business and engineering applications.

**3.** Youngsters love the versatility of keyboard, joystick, and "light" gun play action all available on the new Atari II system.

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**Consolidated Balance Sheets***(dollars in thousands)*

	<i>December 31,</i>	
	1987	1986
<b>Assets</b>		
<b>CURRENT ASSETS:</b>		
Cash and temporary cash investments	\$ 103,481	\$ 70,779
Restricted cash held in escrow fund (Note 2)	-	1,675
Trade receivables (less allowance: 1987, \$16,371; 1986, \$1,527)	101,632	37,109
Inventories (Notes 2 and 4)	196,898	64,834
Prepaid expenses and supplies	3,687	841
Total current assets	<u>405,702</u>	<u>175,238</u>
PROPERTY-net (Notes 2 and 5)	66,522	5,839
GOODWILL	13,054	-
OTHER ASSETS	33,076	3,099
TOTAL	<u>\$ 518,354</u>	<u>\$ 184,176</u>
<b>Liabilities and Shareholders' Equity</b>		
<b>CURRENT LIABILITIES:</b>		
Current maturities of long-term obligations	\$ 1,510	\$ 2,033
Notes payable	9,153	-
Accounts payable (Note 6)	131,870	38,420
Income taxes payable	16,391	2,242
Accrued liabilities (Note 9)	58,279	36,059
Total current liabilities	<u>217,203</u>	<u>78,754</u>
LONG-TERM OBLIGATIONS (Note 7)	<u>133,496</u>	<u>-</u>
COMMITMENTS (Note 8) AND CONTINGENT LIABILITIES (Note 14)		
<b>SHAREHOLDERS' EQUITY (Note 11):</b>		
Preferred stock, \$.01 par value-authorized 10,000,000 shares; none outstanding	-	-
Common stock, \$.01 par value-authorized, 100,000,000 shares; outstanding: 1987, 57,702,518 shares; 1986, 57,787,466 shares	577	578
Additional paid-in capital	142,247	142,476
Notes receivable from sale of common stock	(1,417)	(2,299)
Retained earnings (deficit)	24,873	(32,556)
Accumulated translation adjustments	1,375	(2,777)
Total shareholders' equity	<u>167,655</u>	<u>105,422</u>
TOTAL	<u>\$ 518,354</u>	<u>\$ 184,176</u>

See notes to consolidated financial statements.

# Consolidated Statements of Operations

(in thousands, except per share data)

Year Ended December 31,

	1987	1986	1985
<b>NET SALES:</b>			
New and redesigned products	\$ 358,003	\$ 215,002	\$ 47,817
Purchased products (Note 2)	4,605	43,129	94,170
Retail operations	130,564	-	-
<b>Total</b>	<b>493,172</b>	<b>258,131</b>	<b>141,987</b>
<b>COSTS AND EXPENSES:</b>			
<b>Cost of sales:</b>			
New and redesigned products	201,170	112,942	28,666
Purchased products	3,763	36,280	100,133
Retail operations	98,984	-	-
Liquidation and transition costs (Note 2)	-	-	4,966
Research and development	18,046	14,496	9,452
Marketing and distribution	91,777	34,009	17,516
General and administrative	13,703	12,189	7,053
<b>Total</b>	<b>427,543</b>	<b>209,916</b>	<b>167,806</b>
<b>OPERATING INCOME (LOSS)</b>	<b>65,629</b>	<b>48,215</b>	<b>(25,819)</b>
Other income - net	7,262	5,201	19,904
Interest income	7,121	1,866	741
Interest expense	(5,179)	(8,049)	(9,140)
<b>Income (loss) before income taxes and extraordinary credit</b>	<b>74,833</b>	<b>47,233</b>	<b>(14,314)</b>
Provision for income taxes (Note 10)	30,681	22,183	-
<b>Income (loss) before extraordinary credit</b>	<b>44,152</b>	<b>25,050</b>	<b>(14,314)</b>
Extraordinary credit - tax reduction from use of net operating loss carryforwards	13,277	19,466	-
<b>NET INCOME (LOSS)</b>	<b>\$ 57,429</b>	<b>\$ 44,516</b>	<b>\$ (14,314)</b>
<b>EARNINGS (LOSS) PER COMMON AND COMMON EQUIVALENT SHARE:</b>			
<b>Primary:</b>			
Income (loss) before extraordinary credit	\$ .76	\$ .53	\$ (.31)
Net income (loss)	\$ .99	\$ .95	\$ (.31)
<b>Fully diluted:</b>			
Income (loss) before extraordinary credit	\$ .74	\$ .53	\$ (.31)
Net income (loss)	\$ .96	\$ .91	\$ (.31)
<b>Number of shares used in the computation:</b>			
Primary	58,052	48,974	46,066
Fully diluted	61,500	49,130	46,066

See notes to consolidated financial statements.

## Consolidated Statements of Shareholders' Equity

For the Years Ended December 31, 1985, 1986 and 1987 (in thousands)

	Common Stock		WCI Stock Right	Additional Paid-in Capital	Non- Retainable From Sale of Common Stock	Retained Earnings (Deficit)	Accumulated Translation Adjustments	Total
	Shares	Amount						
BALANCES, JANUARY 1, 1985	30,070	\$ 301	\$27,500	\$ 29,769	\$ (1,257)	\$ (62,758)	\$ (454)	\$ (6,899)
Common stock sold	2,832	28		2,881	(568)			2,341
Common stock repurchased	(219)	(2)		(218)	33			(187)
Payment on notes receivable					150			150
Translation adjustments							(568)	(568)
Net loss						(14,314)		(14,314)
<b>BALANCES, DECEMBER 31, 1985</b>	<b>32,683</b>	<b>327</b>	<b>27,500</b>	<b>32,432</b>	<b>(1,642)</b>	<b>(77,072)</b>	<b>(1,022)</b>	<b>(19,477)</b>
Common stock sold (net of issuance costs of \$698)	11,038	110		55,746	(1,613)			54,243
Conversion of WCI stock right into common stock	7,100	71	(27,500)	27,429				-
Common stock exchanged for 10.5% notes and accrued interest due WCI	7,100	71		27,095				27,166
Common stock repurchased	(133)	(1)		(226)				(227)
Payments on notes receivable					956			956
Translation adjustments							(1,755)	(1,755)
Net income						44,516		44,516
<b>BALANCES, DECEMBER 31, 1986</b>	<b>57,788</b>	<b>578</b>	<b>-</b>	<b>142,476</b>	<b>(2,299)</b>	<b>(32,556)</b>	<b>(2,777)</b>	<b>105,422</b>
Stock options exercised	26	1		126				127
Common stock repurchased	(111)	(2)		(355)	123			(234)
Payments on notes receivable					759			759
Translation adjustments							4,352	4,352
Net income						57,429		57,429
<b>BALANCES, DECEMBER 31, 1987</b>	<b>57,703</b>	<b>\$ 577</b>	<b>\$ -</b>	<b>\$142,247</b>	<b>\$ (1,417)</b>	<b>\$ 24,873</b>	<b>\$ 1,375</b>	<b>\$167,655</b>

See notes to consolidated financial statements.

**Consolidated Statements of Changes in Financial Position**
*(in thousands, except per share data)*
*Year Ended December 31,*

	1987	1986	1985
<b>FUNDS PROVIDED FROM:</b>			
<b>Operations:</b>			
Income (loss) before extraordinary credit	\$ 44,352	\$ 25,050	\$ (14,314)
Items not requiring working capital:			
Depreciation and amortization	4,357	1,234	2,516
Write-down of other assets	-	2,769	-
Total from (used by) operations	48,509	29,053	(11,798)
Extraordinary credit	13,277	19,466	-
Common stock sold - net	652	54,972	2,304
Working capital included in net assets of acquired business	31,509	-	-
Common stock issued for conversion of wci stock right	-	27,500	-
Common stock exchanged for 10.5% notes and accrued interest due wci	-	27,166	-
Disposal of property	599	996	6,068
Additions to long-term obligations	75,000	31,428	4,283
<b>Total</b>	<b>169,546</b>	<b>190,581</b>	<b>857</b>
<b>FUNDS USED FOR:</b>			
Net assets of acquired business	64,078	-	-
wci stock right converted to common stock	-	27,500	-
Notes and accrued interest due wci exchanged for common stock	-	27,166	-
Repayment of long-term obligations	5,511	50,443	-
Property purchases	4,054	860	1,906
Effect of exchange rate changes on working capital	(4,472)	2,306	1,022
Other assets	8,360	-	-
<b>Total</b>	<b>77,531</b>	<b>108,275</b>	<b>2,928</b>
<b>INCREASE (DECREASE) IN WORKING CAPITAL</b>	<b>\$ 92,015</b>	<b>\$ 82,306</b>	<b>\$ (2,071)</b>
<b>INCREASE (DECREASE) IN WORKING CAPITAL BY COMPONENT</b> (1987 includes amounts from business acquired):			
Cash and temporary cash investments and restricted cash	\$ 31,031	\$ 46,040	\$ 5,662
Warrants	-	-	(4,000)
Trade receivables	64,523	14,868	(33,604)
Inventories	132,064	(12,347)	(7,662)
Prepaid expenses and supplies	2,846	159	(391)
Current maturities of long-term debt	523	11,297	(11,542)
Notes payable	(9,153)	-	-
Accounts payable	(93,450)	17,565	30,551
Income taxes payable	(14,149)	(2,242)	-
Accrued liabilities	(22,220)	6,966	18,915
<b>INCREASE (DECREASE) IN WORKING CAPITAL</b>	<b>\$ 92,015</b>	<b>\$ 82,306</b>	<b>\$ (2,071)</b>

See notes to consolidated financial statements.



**Note 1. Organization And Significant Accounting Policies**

**Organization** The Company was formed on May 17, 1984 to design, manufacture, sell and service personal computers and related software and peripheral products. The principal methods of distribution are through computer specialty dealers and mass market retailers. In October 1987, the Company became a retailer of consumer electronics and home entertainment products through its acquisition of The Federated Group, Inc. (see Note 3).

**Principles of consolidation** The consolidated financial statements include the Company and its subsidiaries. All transactions and balances between the companies are eliminated.

**Inventories** are valued at the lower of cost or market. Cost for merchandise inventories is computed using average cost; for other inventories, using standard costs which approximate cost on a first-in, first-out basis.

**Property** is stated at cost (see Note 2 and Note 3). Depreciation is computed using the straight-line method based on estimated useful lives of the assets of 2 to 30 years. Video rental tapes are amortized over 3 years. Capitalized leases and leasehold improvements are amortized over the estimated useful life or lease term, as appropriate.

**Revenue recognition** Sales are recognized upon shipment or at point of sale.

**Research and development expenditures** are expensed as incurred.

**Income taxes** Deferred taxes are provided for timing differences between pretax accounting income and taxable income and relate primarily to depreciation and amortization, leveraged leases and certain accruals. Investment tax credits reduce the provision for income taxes when realizable.

Provisions are made for estimated United States and foreign taxes which may be incurred on remittance of undistributed earnings of the Company's subsidiaries where such remittances are normally expected. Deferred taxes on undistributed earnings beyond those provided would not be material. Undistributed earnings of foreign subsidiaries of approximately \$8 million are included in consolidated retained earnings at December 31, 1987.

**Foreign currency translation** Assets and liabilities of operations outside the United States, except for operations that are highly integrated with operations of the Company (principally in Taiwan), are translated into United States dollars using current exchange rates, and the effects of foreign currency translation adjustments are deferred and included as a component of shareholders' equity. For operations that are highly integrated, foreign currency translation adjustments are included in operations. Exchange and translation gains included in operations for the years 1987, 1986 and 1985 were \$3,828,000, \$4,419,000 and \$1,884,000, respectively.

**Earnings (loss) per common and equivalent share** Net income per share is computed based on the weighted average number of common and equivalent shares outstanding during the period. Net loss per share is computed based on the weighted average number of shares of common stock outstanding and excludes common stock equivalents as they would be anti-dilutive. Under rules of the Securities and Exchange Commission, common stock issued to WCI (14,200,000 shares, see Note 2) either was outstanding or has been treated as outstanding for all periods in calculating earnings per common and equivalent share because such shares were issued at prices substantially below the underwritten public offering price. Interest expense of \$1,918,000 or \$.04 per share (\$1,017,000 net of income taxes or \$.02 per share) related to the 10.5% notes due WCI (see Note 2 and Note 11) has been added to net income and income before extraordinary credit, respectively, in calculating earnings per share for 1986. Fully diluted

earnings per share assumes both the conversion of the 5½% convertible debentures for the period they were outstanding (see Note 7) and the additional dilutive effect of stock options. Interest expense of \$2,625,000 or \$.04 per share (\$1,548,750 net of income taxes or \$.03 per share) related to the 5½% convertible debentures has been added to net income and income before extraordinary credit, respectively, in calculating fully diluted earnings per share for 1987.

*Change in Fiscal Year* During 1987 the Company changed its annual accounting period from a calendar year to a fiscal year ending on the last Saturday closest to the end of December. The fiscal year 1987 ended January 2, 1988 and was comprised of 52 weeks. For simplicity of presentation, the date December 31, is used to represent the fiscal year end.

*Note 2. Acquisition And WCI Transactions*

Effective July 2, 1984, the Company acquired certain assets and assumed certain liabilities of certain associated entities of Warner Communications Inc.'s (collectively referred to as "WCI") Atari home computer and home video game product lines and received warrants (valued at \$4,000,000) to buy 1,000,000 shares of WCI common stock at \$22 per share through July 1, 1989 (the "WCI warrants"). Pursuant to the assets purchase agreement, the Company's securities given in exchange for those net assets were subject to adjustment based upon the Company's and WCI's subsequent evaluation of the nature and extent of the assets acquired and the liabilities assumed by the Company. In August 1986, the Company and WCI completed such evaluation and agreed upon the adjusted consideration for the net assets acquired. Such consideration consisted of a \$24.7 million obligation due in June 1994 and a stock right (valued at \$27.5 million) convertible into 7,100,000 shares of common stock (see Note 11 regarding conversion in November 1986). This acquisition was accounted for as a purchase.

The fair value assigned to assets acquired and liabilities assumed were as follows:

	(in thousands)
Warrants	\$ 4,000
Accounts receivable	44,911
Inventories	135,371
Property	14,921
Other assets	9,840
Current liabilities	(143,326)
Other long-term liabilities	(13,512)
	<u>\$ 32,165</u>

In November 1985, WCI repurchased the WCI warrants for \$15 million, of which \$13.9 million was placed in escrow to cover certain claims and pending actions against the Company arising from the product lines acquired from WCI. The gain of \$11,000,000 from sale of the WCI warrants is included in other income in 1985.

As part of the acquisition agreement, WCI agreed to loan to the Company up to \$25 million at 10.5% to pay down liabilities assumed. Pursuant to this agreement, the outstanding borrowings plus accrued interest (a total of \$27.2 million) were exchanged for an additional 7,100,000 shares of common stock upon completion of the Company's underwritten public offering in November 1986. The \$24.7 million obligation due in June 1994 plus accrued interest of \$11.5 million was paid from the proceeds of this offering.

In connection with this acquisition, the Company obtained certain products which were not consistent with its long-range business strategy. Accordingly, the Company instituted a plan to liquidate the inventory and a portion of the manufacturing and distribution facilities acquired; the related product sales and costs are classified as purchased products in the consolidated statements of operations. In addition, certain employment and occupancy costs incurred by the Company in the liquidation of the assets acquired have been classified as liquidation and transition costs in the consolidated statements of operations.

Note 3. Acquisition Of The Federated Group

On October 4, 1987, the Company acquired all the outstanding capital stock of The Federated Group, Inc. (Federated), a retailer of consumer electronic and home entertainment products with stores in Arizona, California, Kansas, New Mexico and Texas for \$64,078,000 in cash. This transaction was accounted for by the purchase method and accordingly, the results of operations include Federated from the date of acquisition.

The fair values assigned to assets acquired and liabilities assumed were as follows:

	(in thousands)
Trade receivables	\$ 10,629
Inventories	78,493
Prepaid expenses and supplies	918
Property	61,480
Goodwill	13,479
Favorable facility operating leases	10,500
Net investment in leveraged leases	9,281
Other assets	1,836
Current portion of long-term obligations	(1,460)
Accounts payable	(50,139)
Accrued liabilities	(6,932)
Long-term debt	(64,007)
Total	<u>\$ 64,078</u>

The excess of cost over the fair value of net assets acquired was \$13,479,000 and is being amortized on a straight line basis over 10 years.

The following summarizes the unaudited consolidated pro forma results of operations, assuming the acquisition had occurred at the beginning of 1987 and 1986:

(in thousands, except per share amounts) (unaudited)

	1987	1986
Revenues	\$ 806,835	\$ 686,397
Income before extraordinary credit	15,489	7,723
Net income	\$ 28,299	\$ 13,473
Primary earnings per common and equivalent share:		
Income before extraordinary credit	\$ .37	\$ .16
Net income	<u>\$ .49</u>	<u>\$ .28</u>

The unaudited 1987 and 1986 pro forma operating results include Federated's results of operations for the year ended December 31, 1987 and its fiscal year ended March 1, 1987, respectively, less amortization of goodwill, elimination of intercompany transactions and related income tax effects. The pro forma information does not purport to be indicative of the results that actually would have been obtained if the combined operations had been conducted during the years presented and is not intended to be a projection of future results.

## Notes To Consolidated Financial Statements

### Note 4. Inventories

Inventories at December 31 consist of the following:

<i>(in thousands)</i>	<u>1987</u>	<u>1986</u>
Merchandise inventories	\$ 73,142	\$ -
Finished goods	76,219	42,502
Raw materials and work-in-process	47,537	22,332
Total	<u>\$ 196,898</u>	<u>\$ 64,834</u>

### Note 5. Property

Property at December 31 consists of:

<i>(in thousands)</i>	<u>1987</u>	<u>1986</u>
Land	\$ 14,606	\$ 2,528
Buildings	11,850	1,935
Machinery and equipment	13,887	2,166
Furniture and fixtures	11,147	1,357
Video rental tapes	7,460	-
Leasehold improvements	14,066	170
Construction in progress	376	-
Total	73,392	8,156
Accumulated depreciation and amortization	(6,870)	(2,317)
Property-net	<u>\$ 66,522</u>	<u>\$ 5,839</u>

### Note 6. Accounts Payable

At December 31, 1987, accounts payable included approximately \$10 million due to companies ("flooring companies") to whom vendors assign accounts arising from purchases of inventory by the Company. The flooring companies have a purchase money security interest in any unsold inventory arising from such purchase.

Note 7. Debt Obligations

At December 31, 1987, short-term notes payable of \$9,153,000 at 4.5% were outstanding under a 1.65 billion Yen (\$13,600,000) borrowing facility. These borrowings are 100% collateralized by cash.

Long-term obligations at December 31 consist of:

<i>(in thousands)</i>	1987	1986
5 1/4% convertible subordinated debentures, due 2002	\$ 75,000	\$ -
7 1/4% convertible subordinated debentures, due 2010 (net of \$17.5 million discount)	22,500	-
Notes due principal shareholder (interest at 12%, see Note 13)	-	388
Bank loan agreement	30,250	-
Term loan payable	5,730	-
Capital lease obligations	23	-
Other obligations	1,303	1,645
Total	133,006	2,033
Current maturities	(1,510)	(2,033)
Long-term obligations	\$ 131,496	\$ -

In April 1987, the Company sold \$75,000,000 principal amount of 5 1/4% convertible subordinated debentures due April 29, 2002. The debentures may be redeemed subsequent to April 29, 1990, at the Company's option, upon payment of a premium. Holders may convert their debentures into common stock at \$16.31 per share. At December 31, 1987 4,597,700 shares of common stock are reserved for the conversion of debentures. Default with respect to other indebtedness of the Company in an aggregate amount exceeding \$5,000,000 would result in an event of default whereby the outstanding debentures may be due and payable immediately.

Federated's 7 1/4% convertible subordinated debentures (face amount \$40,000,000) are due April 15, 2010. The discount recorded at the acquisition date is being amortized over the remaining term of the debentures, resulting in an effective 13.9% interest rate. The debentures provide for mandatory sinking fund payments commencing in 1996, are redeemable at par plus a declining premium by the Company and are convertible into \$6.25 in cash for each of the 1,714,531 shares of common stock into which the debentures were convertible at the acquisition date. Default with respect to other indebtedness of the Company in an aggregate amount exceeding \$1,000,000 would result in an event of default whereby the outstanding debentures may be due and payable immediately.

Federated's bank loan agreement (as amended in October 1987) with five commercial banks provides for a term loan (payable through 1993) based on appraised values of certain real estate owned by Federated, and borrowings under a revolving credit arrangement to August 1989 on inventories, receivables and other assets. Borrowings up to \$48,000,000 are available with interest rates ranging from prime plus 1/2% to prime plus 3%. At December 31, 1987, all borrowings were outstanding under the revolving credit arrangement. The amended agreement limits intercompany transactions and requires maintenance of specified current ratios and amounts of tangible net worth, as defined.

At December 31, 1987, an aggregate of \$30,722,000 in multicurrency bank credit arrangements was available to the Company and its subsidiaries with various interest rates and security arrangements. This amount includes \$17,750,000 available under the bank loan agreement referred to above. Average borrowings for the three months since acquisition under the bank loan agreement described above were \$38,710,000 and the weighted average interest rate was 12%. Average borrowings under the Company's remaining credit arrangements were minimal during 1987.

Federated is obligated on a term loan payable in connection with the investment in leveraged leases (Note 8). Interest is at a rate of 1% above the London Inter-Bank Offering Rate ("LIBOR"). Principal is payable \$631,900 semi-annually.

Maturities of long-term obligations at December 31, 1987 for each of the next five years are as follows:

	<i>(in thousands)</i>
1988	\$ 1,310
1989	22,524
1990	2,273
1991	2,273
1992	1,685

#### Note 8. Commitments

The Company leases various facilities and equipment under noncancellable operating lease arrangements. The major facilities leases are for terms of one to 27 years and are accounted for as operating leases. These leases generally provide renewal options of five additional years. Minimum future lease payments under all noncancellable operating leases as of December 31, 1987 are as follows:

	<i>(in thousands)</i>
1988	\$ 14,236
1989	13,975
1990	12,648
1991	11,573
1992	11,185
Later years	149,980
Total minimum lease payments	<u>\$ 213,597</u>

Rent expense for all operating leases was \$6,136,000, \$3,132,000 and \$3,670,000 for the years 1987, 1986 and 1985.

Through its acquisition of Federated, the Company is the lessor in leveraged lease agreements entered into in 1985 under which commercial aircraft and data processing equipment were leased for terms of 7 to 12½ years, respectively. In each transaction Federated's equity investment was paid from the proceeds of long-term obligations and represented 20.2% (aircraft) and 35% (equipment) of the purchase price; the remaining amounts were furnished by third-party financing in the form of long-term debt secured by a first lien on the property.

At the end of the lease term, the property is turned back to Federated. The residual value at that time for each transaction is estimated to be 23% (aircraft) and 5% (data processing equipment) of cost.

The net investment in leveraged leases at December 31, 1987 consists of the following:

	<i>(in thousands)</i>
Rental receivable, net of principal and interest on installment promissory notes	\$ 7,286
Estimated residual value of leased assets	2,433
Less unearned and deferred income	(320)
Investment in leveraged leases	9,399
Less deferred taxes arising from leveraged leases	-
Net investment in leveraged leases	<u>\$ 9,399</u>

Note 9. *Accrued Liabilities*

Accrued liabilities at December 31 consist of the following:

<i>(in thousands)</i>	1987	1986
Accrued royalties	\$ 6,189	\$ 6,527
Accrued customer allowances	16,964	18,849
Other	35,126	10,683
<b>Total</b>	<b>\$ 58,279</b>	<b>\$ 36,059</b>

Note 10. *Income Taxes*

The provision for income taxes in 1987 and 1986 consists of:

<i>(in thousands)</i>	1987	1986
<b>Current:</b>		
Federal	\$ 12,564	\$ -
Foreign	3,827	1,542
State	-	700
<b>Total current</b>	<b>16,391</b>	<b>2,242</b>
<b>Deferred:</b>		
Federal	864	-
State	149	475
<b>Total deferred</b>	<b>1,013</b>	<b>475</b>
<b>Charge equal to reduction in income taxes from use of net operating loss carryforward:</b>		
Federal	11,956	19,044
Foreign	1,321	422
<b>Total charge</b>	<b>13,277</b>	<b>19,466</b>
<b>Provision for income taxes</b>	<b>\$ 30,681</b>	<b>\$ 22,183</b>

Deferred taxes are current and are included in accrued liabilities. Income (loss) before income taxes for the years 1987, 1986 and 1985 includes income (losses) of \$8,646,000, \$1,416,000 and \$(12,463,000), respectively, from the Company's foreign subsidiaries.

The effective income tax rates for 1987 and 1986 were 41% and 47%, respectively, and differ from the federal statutory rates of 40% and 46% as follows:

<i>(in thousands)</i>	1987	1986
Computed at statutory rates	\$ 29,933	\$ 21,727
Effect of foreign losses providing no tax benefit	955	2,013
Tax benefit of write-off of foreign investment	-	(1,509)
Other	(207)	(48)
<b>Provision for income taxes</b>	<b>\$ 30,681</b>	<b>\$ 22,183</b>

In the fourth quarter of 1987 the Company reduced its effective tax rate from 44% to 41% due to tax benefits achieved from additional tax credits realized in the fourth quarter. This resulted in a 36% effective tax rate for the fourth quarter.

The net operating loss carryforward for tax purposes acquired in the Federated acquisition is \$30 million, is limited in use to the taxable income generated by Federated's operations, and expires in 2001.

Statement of Financial Accounting Standards No. 96, "Accounting for Income Taxes" (FAS 96) was issued in December 1987. Although the adoption of these new tax accounting rules is not required until the Company's fiscal 1989, early and retroactive application is permitted. The Company has not completed its analysis of the potential effects of adopting FAS 96 or determined when it will adopt FAS 96, however, it is not expected to have a material effect on the Company's financial position, results of operations, or its liquidity.

#### Note 11. Shareholders' Equity

All share and per share amounts have been adjusted to reflect a 2-for-1 stock split effected in the form of a 100% common stock dividend distributed on June 19, 1987.

In November 1986, the Company sold 10,165,000 shares of common stock at \$5.75 per share (net proceeds of \$54,243,000) in an underwritten public offering. As a result of the offering, the WCI stock right was automatically converted into 7,100,000 common shares and an additional 7,100,000 common shares were issued to WCI in exchange for the outstanding 10.5% notes (see Note 2).

#### Common Stock

Founders and employees of the Company have purchased 33,422,466 common shares under stock purchase agreements at fair market value as determined by the Board of Directors. The employees' shares generally vest 20% at the end of each of the initial five years of employment. At December 31, 1987, 2,202,300 unvested shares were subject to repurchase.

In 1986, the Company adopted a stock option plan and a restricted stock plan. The plans provide for the issuance of up to 2,000,000 shares of common stock through the issuance of incentive stock options to employees, non-qualified stock options and restricted stock to employees, directors and consultants. Under the plans, stock options or restricted stock may be granted at not less than fair market value as determined by the Board of Directors. Stock options become exercisable as established by the Board (generally ratably over 5 years) and expire up to 10 years from date of grant. The Company's right to repurchase restricted stock lapses over a maximum period of five years. At December 31, 1987, options for approximately 174,699 shares were exercisable and options for 468,384 shares were available for future grant. At December 31, 1987, no restricted stock under the restricted stock plan had been issued.

At December 31, 1987, the Company had reserved 6,571,648 shares of common stock for issuance under stock plans and for conversion of the 5 1/4% debentures.

Additional information with respect to the stock option plan is as follows:

	Number of Shares	Option Price Range Per Share		Total
		Low	High	
Granted in 1986	193,000	\$ 1.00-	\$ 6.50	\$ 783,250
Outstanding, December 31, 1986	193,000	1.00-	6.50	783,250
Granted	1,674,978	5.75-	13.87	12,623,451
Exercised	26,052	5.75-	6.94	151,021
Cancelled	336,362	2.50-	13.25	3,243,555
Outstanding, December 31, 1987	1,505,564	\$ 1.00-	\$ 13.87	\$ 10,014,125



As a result of the Federated acquisition (see Note 3), all outstanding options granted under Federated's 1983 Stock Option Plan remain in effect in accordance with their terms, except that upon exercise of each option, the holder will receive \$6.25 for each common share issuable upon exercise of such option. At December 31, 1987, options to purchase 138,200 shares at \$3.75 per share were outstanding and vest over a period of 3 years, none of which were vested.

*Note 12. Segment Information*

The Company operates in two industry segments—the design, manufacture, sale and servicing of consumer electronic products and consumer electronic product retail operations.

The Company operates retail stores in Arizona, California, Kansas, New Mexico, and Texas. The Company's foreign operations consist of manufacturing facilities in the Far East and distribution facilities in Europe, Australia, Canada and Mexico. Transfers between geographic areas are accounted for at amounts generally above cost. Corporate assets are cash and temporary cash investments. The following tables present a summary of operations by geographic region and industry segment.

*Industry Segments*

<i>(in thousands)</i>	<i>Year Ended December 31,</i>		
	<i>1987</i>	<i>1986</i>	<i>1985</i>
Revenues from unaffiliated customers:			
Consumer electronic products	\$ 362,608	\$ 258,231	\$ 141,987
Retail operations	130,564	-	-
<b>Total</b>	<b>\$ 493,172</b>	<b>\$ 258,231</b>	<b>\$ 141,987</b>
Transfers from industry segments (eliminated in consolidation)	\$ 1,200	\$ -	\$ -
Operating income (loss):			
Consumer electronic products	\$ 72,016	\$ 48,215	\$ (25,819)
Retail operations	(6,387)	-	-
<b>Total</b>	<b>\$ 65,629</b>	<b>\$ 48,215</b>	<b>\$ (25,819)</b>
Identifiable assets at December 31:			
Consumer electronic products	\$ 234,798	\$ 111,722	\$ 112,630
Retail operations	180,071	-	-
Corporate assets	103,485	72,454	26,414
<b>Total</b>	<b>\$ 518,354</b>	<b>\$ 184,176</b>	<b>\$ 139,044</b>
Depreciation and amortization:			
Consumer electronic products	\$ 1,817	\$ 1,234	\$ 2,516
Retail operations	2,540	-	-
<b>Total</b>	<b>\$ 4,357</b>	<b>\$ 1,234</b>	<b>\$ 2,516</b>
Capital expenditures:			
Consumer electronic products	\$ 3,135	\$ 860	\$ 1,906
Retail operations	919	-	-
<b>Total</b>	<b>\$ 4,054</b>	<b>\$ 860</b>	<b>\$ 1,906</b>

Geographic Areas

(in thousands)	Year Ended December 31,		
	1987	1986	1985
Revenues from unaffiliated customers:			
North America:			
United States and Canada	\$ 267,022	\$ 120,874	\$ 56,599
Export sales	19,768	34,464	33,745
Europe	203,772	102,707	47,213
Other	2,610	86	4,430
<b>Total</b>	<b>\$ 493,172</b>	<b>\$ 258,131</b>	<b>\$ 141,987</b>
Transfers from geographic areas (eliminated in consolidation):			
North America	\$ 289,441	\$ 135,807	\$ 53,281
Europe	10,355	3,918	32,694
Other	233,697	128,497	143,332
<b>Total</b>	<b>\$ 533,493</b>	<b>\$ 268,222</b>	<b>\$ 229,307</b>
Operating income (loss):			
North America	\$ 48,509	\$ 37,283	\$ (10,967)
Europe	8,330	7,643	(9,511)
Other	8,790	3,289	(5,341)
<b>Total</b>	<b>\$ 65,629</b>	<b>\$ 48,215</b>	<b>\$ (25,819)</b>
Identifiable assets at December 31:			
North America	\$ 223,549	\$ 50,873	\$ 63,483
Europe	108,577	35,810	27,623
Other	82,743	25,039	21,524
Corporate assets	103,485	72,454	26,414
<b>Total</b>	<b>\$ 518,354</b>	<b>\$ 184,176</b>	<b>\$ 139,044</b>

Note 13. Related Party Transactions

In 1985, the Company entered into an agreement with its principal shareholder which provided the Company with additional working capital. The maximum amounts outstanding under this arrangement for the years 1986 and 1985 were \$8,024,000 and \$10,152,000, respectively. Interest was charged at 12%. All amounts were repaid in 1986.

In November 1984, the Company and its principal shareholder entered into a research and development agreement whereby the Company received \$500,000 to develop the ST line of computers. In February 1986, the Company exercised its option under the agreement and acquired the principal shareholder's interest for \$575,000.

In 1986 the Company issued promissory notes to a supplier for \$3,816,480. The notes were due within one year and did not bear interest. The Company's principal shareholder purchased these notes from the supplier at a 12% discount. At December 31, 1986 \$388,000 of these notes were outstanding and classified as notes due principal shareholder. The notes were paid in full in 1987.

In 1987, the Company purchased approximately 284,000 shares of Federated common stock at various prices (approximating \$5 per share representing actual cost plus broker margin interest cost, a total of \$1,455,000) directly from the principal shareholder of Atari Corporation.

Note 14. *Contingent Liabilities*

Certain claims and suits arising in the ordinary course of business have been filed or are pending against the Company. In the opinion of management, all such matters have been adequately provided for, are without merit, or are such that, if disposed of unfavorably, they would not have a material adverse effect on the Company's consolidated financial position.

Note 15. *Quarterly Financial Data (Unaudited)*

Summarized quarterly financial data for 1987 and 1986 are as follows:

<i>(in thousands, except per share data)</i>	<i>Year Ended December 31, 1987</i>			
	<i>First Quarter</i>	<i>Second Quarter</i>	<i>Third Quarter</i>	<i>Fourth Quarter</i>
Net sales	\$ 61,133	\$ 70,685	\$ 80,398	\$ 276,956
Gross margin	28,439	29,856	35,012	95,848
Income before extraordinary credit	9,365	7,773	8,313	18,702
Net income	15,258	13,537	9,933	18,702
Earnings per common and common equivalent share:				
Primary:				
Income before extraordinary credit:	.16	.14	.15	.32
Net income	.26	.24	.19	.31
Fully diluted:				
Income before extraordinary credit:	.16	.13	.14	.32
Net income	.26	.23	.17	.31

<i>(in thousands, except per share data)</i>	<i>Year Ended December 31, 1986</i>			
	<i>First Quarter</i>	<i>Second Quarter</i>	<i>Third Quarter</i>	<i>Fourth Quarter</i>
Net sales	\$ 44,877	\$ 60,709	\$ 59,878	\$ 92,667
Gross margin	15,065	25,208	24,787	43,849
Income before extraordinary credit	1,831	6,636	4,633	11,950
Net income	2,682	9,718	9,119	22,997
Earnings per common and common equivalent share:				
Primary:				
Income before extraordinary credit:	.04	.15	.10	.23
Net income	.06	.22	.21	.43
Fully diluted:				
Income before extraordinary credit:	.04	.15	.10	.23
Net income	.06	.22	.21	.43

## Opinion of Independent Public Accountants

To the Shareholders and Board of Directors of  
Atari Corporation:

We have examined the consolidated balance sheets of Atari Corporation and subsidiaries as of December 31, 1987 and 1986 and the related consolidated statements of operations, shareholders' equity and changes in financial position for each of the three fiscal years in the period ended December 31, 1987. Our examinations were made in accordance with generally accepted auditing standards and, accordingly, included such tests of the accounting records and such other auditing procedures as we considered necessary in the circumstances.

In our opinion, such consolidated financial statements present fairly the financial position of the companies at December 31, 1987 and 1986 and the results of their operations and the changes in their financial position for each of the three fiscal years in the period ended December 31, 1987, in conformity with generally accepted accounting principles applied on a consistent basis.

*Deloitte Haskins & Sells*

DELOITTE HASKINS & SELLS  
San Jose, California  
March 2, 1988

## Management's Discussion And Analysis Of Financial Condition and Results Of Operations

### Introduction

The Company commenced operations in May 1984, and in July 1984, it acquired certain computer and video game system assets from, and assumed certain liabilities of WCI. See Notes to Financial Statements. The Company's net sales from its inception through June 1985 consisted primarily of the liquidation of the inventories that were acquired from WCI. These inventories are referred to as the "purchased products" in the Company's financial statements.

The Company commenced sales of its reengineered and redesigned products in the last quarter of 1984, and began introducing new products in the second quarter of 1985. These products, including video game systems, computers and related peripherals, are referred to as the "new and redesigned products" in the Company's financial statements.

During the fourth quarter of 1987, the Company acquired The Federated Group, Inc., a chain of consumer electronics retail stores. See Notes 1, 3 and 12 to the Financial Statements.

### Results of Operations for the Year Ended December 31, 1987

The improvement in net income of \$12.9 million or 29% for the year ended December 31, 1987, over 1986, is attributable to higher sales of computers and video games. Computer and video game product sales were \$362.6 million in 1987, compared to \$258.1 million in 1986, an increase of \$104.5 million or 41%. Net sales include \$130.6 million from retail operations, representing results of The Federated Group, Inc., which was acquired during the fourth quarter of 1987. Retail operations resulted in an operating loss of \$6.4 million.

Sales of new and redesigned products represented 99% of 1987 sales excluding retail operations. The decrease in purchased products from \$43.1 million to \$4.6 million reflects the winding down of sales of such products principally during the first quarter of 1987. Subsequent sales were immaterial.

Gross margins decreased to 38% in 1987 from 42% in 1986 primarily due to the inclusion of retail operations whose margins are below those of the computer and video game segment. On a comparable basis to last year, gross margins for the computer and video game business segment were 43% in 1987 compared to 42% in 1986. Retail gross margin for the period from acquisition, October 4, 1987, to December 31, 1987, was 24%.

Research and development expense increased \$3.6 million or 24% in 1987 compared to 1986. Substantially all of the funds were expended on new products, many of which were introduced during the year including the Mega 2 and 4, SLM 804 laser printer, Atari PC family and the XT Game System. On a comparable basis, excluding the retail segment, research and development expenditures as a percent of sales were 5% in 1987 as compared to 6% in 1986, and are expected to continue at this level.

Marketing and distribution expenses increased \$57.8 million or 170%. The increase attributable to the computer product and video game system segments was \$19.8 million or 58% over last year's expense of \$34.0 million. As a percent of computer and video game segments sales, marketing and distribution expenses increased from 13% in 1986 to 15% in 1987. The principal reason for the increase relates to launching several new products such as the Mega 2 and 4, the SLM 804 laser printer, Atari PC's and new software. Distribution costs were proportionately higher as substantial air freight costs were incurred in order to get the new products to market for the Christmas season. Major television and print campaigns were launched in all major markets. Additionally, new sales operations were established in Australia, Denmark, Mexico, Norway, Spain and Sweden.

Retail segment marketing and distribution expense of \$37.9 million consists primarily of seasonally higher advertising and sales commissions and salary expenses in support of the prime selling period.

General and administrative expenses were \$13.7 million in 1987 compared to \$12.2 million in 1986, an increase of \$1.5 million or 12%. The absolute increase is mainly attributable to higher costs from the addition of new sales subsidiaries during 1987. As a percent of total sales, they declined from 5% in 1986 to 3% in 1987 largely due to the peak seasonal effect of retail sales in the last quarter of 1987.

In 1987 and 1986, other income of \$7.3 million and \$5.2 million consists primarily of exchange gains of \$3.8 million and \$4.4 million respectively. Interest income increased by \$1.3 million to \$7.1 million in 1987. The increase is attributable to higher cash deposits resulting from the proceeds of the \$75 million 5% convertible subordinated debentures issued during the second quarter of 1987.

Interest expense in 1987 decreased by \$2.8 million to \$5.1 million. Interest incurred in the retail segment totalled \$2.0 million with the balance attributable to the computer product and video game system segment. Most of the \$8.0 million in interest expense incurred in 1986 was attributable to loans related to acquisition indebtedness and working capital requirements.

The provision for income taxes in 1987 was \$30.7 million, an effective rate of 41%. The benefit realized from net operating loss carryforwards used was \$13.3 million in 1987. At December 31, 1987, operating loss carryforwards of approximately \$40 million are available for tax purposes to offset future taxable income. In 1986, the provision for income taxes was \$22.2 million, an effective rate of 47%, and realized credits for net operating loss carryforwards were \$19.5 million. In December 1987, the Financial Accounting Standards Board issued Statement of Financial Accounting Standards No. 96, "Accounting for Income Taxes." The Company plans to adopt this new statement by 1989, however, it is not expected to have a material effect on the Company's financial position, results of operations or its liquidity.

#### *Results of Operations for the Years Ended December 31, 1986 and December 31, 1985*

The improvement from an operating loss of \$25.8 million in the year ended December 31, 1985 to operating income of \$48.2 million in the year ended December 31, 1986 was primarily attributable to the 82% increase in net sales in 1986. That increase in turn resulted from the 350% increase in sales of the Company's new and redesigned products, which represented 34% of net sales in 1985 and 83% of net sales in 1986.

The 54% decline in sales of purchased products from 1985 to 1986 resulted principally from two factors: during 1986, the Company focused primary attention on developing independent computer specialty dealer distribution channels for its 5205T and newly introduced 10405T computers; and during the first six months of 1986 several key national retailers, the primary source of the Company's sales of purchased products, continued to reduce

or eliminate video game and 8-bit microcomputer system purchases because of excess inventories. At December 31, 1986 remaining inventories of purchased products were approximately \$3 million. The Company believes that revenues from liquidation of the remaining inventories of these purchased products will not be material after 1986.

Gross margins improved to 42% in 1986 from 9% for 1985. The principal reason for the improved margins was increased sales of new and redesigned products, which have higher profit margins than purchased products in 1986. The increase in the Company's gross profit margin on sales of its new and redesigned products to 47% in 1986 from 40% in 1985 reflects higher costs associated with initial production in 1985 and cost of sales increasing more slowly than net sales, resulting from manufacturing efficiencies and economies of scale attendant to materially increased production in 1986. In addition, although sales of purchased products decreased significantly from 1985, gross margins associated with purchased products increased as such products continued to be sold at prices in excess of those anticipated when purchased inventories were reduced to estimated net realizable value at the end of 1984.

Liquidation and transition costs of \$5.0 million incurred in 1985 include certain employment, occupancy and administrative costs incurred by the Company in the liquidation of purchased products, excess plant, equipment and other operating assets, the collection of receivables and settlement of liabilities, all acquired in the wci transaction.

All of the Company's research and development expense in the 1985 and 1986 periods related to development of its new and redesigned products. Research and development expenses increased by \$5.0 million in 1986 as compared to the prior period.

Marketing and distribution and general and administrative expenses increased 85% in absolute terms from 1985 to 1986, but increased only slightly as a percentage of net sales because of the substantial increase in net sales in 1986. The increase in marketing and distribution expenses is attributable to increased advertising, both television and print, and additional sales and marketing staff to support increased sales.

Interest income was \$1.9 million versus \$ .7 million for 1986 and 1985, respectively. The increase is primarily attributable to larger average cash balances and investment of the net proceeds of the public offering. The decrease in interest expense from 1985 to 1986 resulted from repayment of the acquisition indebtedness to wci in November 1986 and substantially reduced working capital loans from the principal shareholder.

For 1986, other income of \$5.2 million consisted primarily of exchange gains of \$4.4 million. In 1985, other income totalled \$19.9 million, consisting primarily of \$11.0 million gain on the sale of wci warrants, and \$6.9 million on sales of excess fixed assets acquired from wci.

The 1986 provision for income taxes of \$22.2 million was an effective rate of 47%. The unused book net operating loss carryforward was \$30.7 million at December 31, 1986. No income taxes were provided in 1985 due to operating losses.

### *International Sales*

Net sales outside North America for fiscal 1985, 1986 and 1987 were \$85.4 million, \$117.3 million and \$226.2 million (60%, 53% and 46% of net sales), respectively. For additional operations information by geographic region, see Note 12 to Financial Statements. The Company's international operations were subject to the risks of fluctuation of the values of the U.S. dollar and foreign currencies. For information concerning the effect of foreign currency transactions on the Company's results of operations through December 31, 1987, see Note 1 to the Financial Statements.

### *Liquidity and Capital Resources*

Working capital increased by \$92.0 million from \$96.5 million in 1986 to \$188.5 million in 1987 primarily due to cash receipts from the addition of the \$75 million 5% convertible subordinated debentures, issued during the second quarter of 1987, and the balance from operating profits.

The Company believes that existing cash balances together with further facilities of approximately \$31 million of multicurrency bank credit agreements, and funds anticipated to be generated from operations, will be sufficient to meet its cash requirements through 1988, and that it will not be necessary to raise additional funds to meet expenditures required to operate the Company's business during that period. However, the Company intends to seek additional bank or institutional credit lines for use in connection with future working capital and capital asset development needs. No negotiations have commenced with prospective lenders, and no assurance can be given that any such credit lines can be established on terms acceptable to the Company. No specific uses of any such future borrowings have been identified.

The selected financial data for the years ended December 31, 1985, 1986, and 1987 have been derived from financial statements examined by Deloitte Haskins & Sells, independent public accountants. The information set forth below should be read in conjunction with the Company's financial statements and related notes and with Management's Discussion and Analysis of Financial Condition and Results of Operations.

<i>In Thousands, Except Per Share Data</i>	<i>Year Ended December 31,</i>		
	<i>1987</i>	<i>1986</i>	<i>1985</i>
<i>Statement of Operations Data:</i>			
Net sales:			
New and redesigned products	\$ 358,003	\$ 215,002	\$ 47,817
Purchased products	4,605	43,129	94,170
Retail operations	130,546	-	-
	<u>493,172</u>	<u>258,131</u>	<u>141,987</u>
Operating income (loss)	65,629	48,215	(25,819)
Income (loss) before extraordinary credit	44,152	25,050	(14,314)
Net income (loss)	<u>\$ 57,429</u>	<u>\$ 44,516</u>	<u>\$ (14,314)</u>
<i>Per Share Data:</i>			
Primary:			
Income (loss) before extraordinary credit	\$ .76	\$ .53	\$ (.31)
Net income (loss)	\$ .99	\$ .95	\$ (.31)
Fully Diluted:			
Income (loss) before extraordinary credit	\$ .74	\$ .53	\$ (.31)
Net income (loss)	\$ .96	\$ .95	\$ (.31)
<i>Balance Sheet Data:</i>			
Working capital	\$ 188,499	\$ 96,484	\$ 11,749
Total assets	518,354	184,176	139,044
Long-term obligations (including current portion)	135,006	2,033	57,082
Stockholders' equity (deficiency)	<u>167,655</u>	<u>105,422</u>	<u>(19,477)</u>

See Note 1 to Financial Statements.

**Directors**

- JACK TRAMIEL**  
Chairman of the Board, Chief  
Executive Officer
- SAM TRAMIEL**  
President, Chief Operating Officer
- SAMUEL W. L. CHIN**  
Vice President
- LEONARD I. SCHREIBER**  
Partner-Schreiber and McBride
- GREGORY A. PRATT**  
Vice President-Finance, Chief  
Financial Officer
- MICHAEL ROSENBERG**  
Chairman and Chief Executive  
Officer-Ross & Roberts, Inc.

**Officers**

- JACK TRAMIEL**  
Chairman of the Board, Chief  
Executive Officer
- SAM TRAMIEL**  
President, Chief Operating Officer
- SAMUEL W. L. CHIN**  
Vice President
- GREGORY A. PRATT**  
Vice President-Finance, Chief  
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- TARO TOKAI**  
Vice President
- GARRY TRAMIEL**  
Vice President-Administration  
and Secretary
- LEONARD TRAMIEL**  
Vice President-Software  
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- STEVEN M. KAWALICK**  
Treasurer
- ELTON SOUTHARD**  
Vice President-Semiconductor  
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**Corporate Information**

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**ANNUAL MEETING**  
The Annual Meeting of Share-  
holders will be held on Tuesday,  
May 17, 1988 at 2:00 p.m. at the  
Atari corporate headquarters,  
1196 Borregas Avenue, Sunnyvale,  
California 94086.

**FORM 10-K ANNUAL REPORT**  
A copy of the Company's Annual  
Report on Form 10-K (exclusive  
of exhibits) as filed with the  
Securities and Exchange Commis-  
sion, will be furnished, without  
charge, to stockholders upon  
written request to: Chief Financial  
Officer, Atari Corporation,  
1196 Borregas Avenue, Sunnyvale,  
CA 94086.

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The following companies, organizations, and their products have been cited in this Annual Report. Atari Corporation expresses thanks for their support and acknowledges their legal ownership of all company product copyrights and trademarks that might be implied or mentioned in this report.

ABB (ABB Brown Boveri), ADI software GmbH (producer of Adams ST), BASF (Badebe, Adler und Sadel Fabriken AG), Bayer (Bayer AG), BMW (Bayerische Motorenwerke AG), Control Data Corporation, CIA (Centre d'Etudes Atomiques), CERN, CIG, CNRS (Centre National d'Etudes Spéciales), CNRS (Centre National de Recherches Scientifiques), Comex Group plc, DESY (Deutscher Elektronen Synchrotron), Disney Ltd., Dornier (Dornier Raum- und Luftfahrt AG), GDD (Geymann Verlag), INRIS (Institut National de Recherche et d'Etudes sur les Transports et les Systèmes), John Lewis Partnership, MBB (Messerschmitt Böhler Blohm AG), Metacomput, Newtec, NCG (Network Services Inc.), SFP, SGC, Todd MO Studios, W.H. Smith Ltd., and Mathias Willemer (producer of Christbase).

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