# FORM 10-Q/A

Quarterly report pursuant to sections 13 or 15(d) [amend]

Filing Date: **1999-03-26** | Period of Report: **1998-10-03**
**SEC Accession No.** 0000927016-99-001131



## FILER

**LEARNING CO INC**

CIK:**719612**| IRS No.: **942562108** | State of Incorp.:**DE** | Fiscal Year End: **0104**
Type: **10-Q/A** | Act: **34** | File No.: **001-12375** | Film No.: **99573435**
SIC: **7372** Prepackaged software

Mailing Address
*ONE ATHENAEUM ST*
*CAMBRIDGE MA 02142*

Business Address
*ONE ATHENAEUM ST*
*CAMBRIDGE MA 02142*
*6174941200*

SECURITIES AND EXCHANGE COMMISSION
WASHINGTON, DC 20549

FORM 10-Q/A

AMENDMENT NO. 1 TO QUARTERLY REPORT PURSUANT TO SECTION 13 OR 15(d) OF THE SECURITIES EXCHANGE ACT OF 1934

For the quarterly period ended October 3, 1998

Commission File Number 1-12375

The Learning Company, Inc.
(Exact Name of Registrant as Specified in Its Charter)

| | |
|---|---|
| Delaware | 94-2562108 |
| (State or Other Jurisdiction of Incorporation or Organization) | (I.R.S. Employer Identification No.) |

One Athenaeum Street
Cambridge, Massachusetts 02142
(Address of Principal Executive Offices)

(617) 494-1200
(Registrant's Telephone Number, Including Area Code)

Indicate by check 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 X No ________

As of November 2, 1998, there were 85,556,631 outstanding shares of the issuer's common stock, par value $.01 per share.

Restatement of Financial Statements and Changes to Certain Information

The undersigned registrant hereby amends in its entirety Part I of its Quarterly Report on Form 10-Q for the quarterly period ended October 3, 1998.

In March 1998, The Learning Company, Inc. (the "Company") acquired Mindscape, Inc. and certain affiliated companies ("Mindscape") for approximately $152 million in a business combination accounted for as a purchase. The Company allocated $103 million of the purchase price to in-process technology. The Company believes that the amount recorded as an in-process technology charge at the date of its acquisition was measured in a manner consistent with appraisal practices utilized at the time of the acquisition. Subsequent to the acquisition, in a letter dated September 9, 1998 to the American Institute of Certified Public Accountants, the Chief Accountant of the Securities and Exchange Commission (the "SEC") reiterated the views of the staff of the SEC (the "Staff") on certain appraisal practices employed in the determination of the fair value of the in-process technology and other intangible assets.

The Company has had discussions with the Staff concerning the application of the methodology to the valuation of the in-complete technology and other intangible assets as detailed in the September 9, 1998 letter from the Chief Accountant of the SEC, and as a result of these discussions, the Company has implemented the methodology. The Company has restated its previously issued results to reflect the discussions with the Staff and to apply the appropriate guidance and policies. The purchase price of Mindscape has been allocated by the Company based upon the application of the recent guidance and, accordingly, the financial statements in this Quarterly Report on Form 10-Q/A have been restated. After applying the appropriate guidance and policy, the allocation of the Mindscape purchase price was changed for in-process technology from $103,000,000 to $40,000,000; for complete and core technology from $13,000,000 to $22,000,000; and for brands and trade names from $30,000,000 to $38,000,000, resulting in a change to goodwill from $9,854,000 to $55,854,000.

PART I. FINANCIAL INFORMATION

Item 1. Financial Statements.

THE LEARNING COMPANY, INC.
CONDENSED CONSOLIDATED BALANCE SHEETS
(in thousands)

<TABLE>
<CAPTION>

| <S> | September 30, 1998 (unaudited) (as restated) <C> | December 31, 1997 <C> |
|---|---|---|
| ASSETS | | |
| CURRENT ASSETS: | | |
| Cash and short-term investments | $234,796 | $188,956 |
| Accounts receivable (less allowances for returns of $46,637 and $47,643, respectively) | 117,247 | 161,927 |
| Inventories | 44,507 | 39,382 |
| Other current assets | 51,941 | 35,863 |
| | 448,491 | 426,128 |
| Intangible assets, net | 234,753 | 145,848 |
| Other long-term assets | 63,711 | 51,798 |
| | $746,955 | $623,774 |
| LIABILITIES & STOCKHOLDERS' EQUITY | | |
| Current liabilities | $252,997 | $220,192 |
| LONG-TERM OBLIGATIONS: | | |
| Long-term debt | 190,955 | 294,356 |
| Accrued and deferred income taxes | 70,586 | 75,167 |
| Other long-term obligations | 4,134 | 8,069 |
| | 265,675 | 377,592 |
| STOCKHOLDERS' EQUITY | 228,283 | 25,990 |
| | $746,955 | $623,774 |

</TABLE>

The accompanying notes are an integral part of these condensed consolidated financial statements.



THE LEARNING COMPANY, INC.
CONDENSED CONSOLIDATED STATEMENTS OF OPERATIONS
(in thousands, except share and per share data)
(unaudited)

<TABLE>
<CAPTION>

| | Three Months Ended September 30, | | Nine Months Ended September 30, | |
|---|---|---|---|---|
| <S> | 1998 (as restated) <C> | 1997 <C> | 1998 (as restated) <C> | 1997 <C> |
| REVENUES | $ 212,723 | $ 141,737 | $ 564,042 | $ 401,532 |
| COSTS AND EXPENSES: | | | | |
| Costs of production | 63,011 | 40,326 | 185,039 | 118,291 |
| Sales and marketing | 54,529 | 38,746 | 163,223 | 103,806 |
| General and administrative | 14,132 | 10,755 | 43,668 | 34,534 |
| Development and software costs | 24,947 | 25,041 | 72,809 | 65,991 |
| Amortization, merger and other charges | 67,186 | 148,400 | 227,503 | 403,058 |
| | 223,805 | 263,268 | 692,242 | 725,680 |
| OPERATING LOSS | (11,082) | (121,531) | (128,200) | (324,148) |

| | | | | |
|---|---|---|---|---|
| INTEREST EXPENSE AND OTHER, net | (1,215) | (4,798) | (4,006) | (12,355) |
| LOSS BEFORE TAXES | (12,297) | (126,329) | (132,206) | (336,503) |
| PROVISION FOR INCOME TAXES | 12,442 | (13,167) | 12,442 | (8,558) |
| NET LOSS | $ (24,739) | $ (113,162) | $ (144,648) | $ (327,945) |
| NET LOSS PER SHARE -- basic and diluted | $(0.28) | $(1.72) | $(1.84) | $(5.00) |
| WEIGHTED AVERAGE NUMBER OF BASIC AND DILUTED SHARES OUTSTANDING | 89,457,000 | 65,895,000 | 78,534,000 | 65,561,000 |

</TABLE>

The accompanying notes are an integral part of these condensed consolidated financial statements.



THE LEARNING COMPANY, INC.
CONDENSED CONSOLIDATED STATEMENTS OF CASH FLOWS (in thousands) (unaudited)

<TABLE>
<CAPTION>

| | Nine Months Ended September 30, | |
|---|---|---|
| | 1998 | 1997 |
| <S> | <C> (as restated) | <C> |
| CASH FLOWS FROM OPERATING ACTIVITIES: | | |
| Net loss | $(144,648) | $(327,945) |
| Adjustments to reconcile net loss to net cash provided by operating activities: | | |
| Depreciation, amortization and other | 177,834 | 386,538 |
| Provisions for returns and doubtful accounts | 76,484 | 52,819 |
| Charge for incomplete technology | 56,924 | 29,297 |
| Changes in operating assets and liabilities: | | |
| Accounts receivable | (25,395) | (22,959) |
| Accounts payable and accruals | (40,510) | (1,905) |
| Other | (20,585) | (53,056) |
| NET CASH PROVIDED BY OPERATING ACTIVITIES | 80,104 | 62,789 |
| CASH FLOWS FROM INVESTING ACTIVITIES: | | |
| Purchases of fixed assets and other | (26,694) | (13,171) |
| Businesses acquired, net of cash acquired | (99,135) | (89,486) |
| Acquisition related items | (66,195) | (604) |
| NET CASH USED FOR INVESTING ACTIVITIES | (192,024) | (103,261) |
| CASH FLOWS FROM FINANCING ACTIVITIES: | | |
| Principal payments under capital leases | (1,171) | (515) |
| Borrowings under line of credit | (2,300) | 10,000 |
| Repurchase of Senior Convertible Notes | (6,000) | (28,000) |
| Proceeds from issuance of common stock | 35,189 | 7,403 |
| Proceeds from the issuance of special warrants, net | 134,346 | -- |
| Other | (3,578) | (15,105) |
| NET CASH (USED FOR) PROVIDED BY FINANCING ACTIVITIES | 156,486 | (26,217) |
| EFFECT OF EXCHANGE RATE CHANGES ON CASH | 201 | (1,846) |
| EFFECT OF BRODERBUND EXCLUDED PERIOD | 1,073 | -- |
| NET CHANGE IN CASH AND SHORT-TERM INVESTMENTS | 45,840 | (68,535) |
| CASH AND SHORT-TERM INVESTMENTS, BEGINNING OF PERIOD | 188,956 | 259,223 |
| CASH AND SHORT-TERM INVESTMENTS, END OF PERIOD | $ 234,796 | $ 190,688 |

</TABLE>

The accompanying notes are an integral part of these condensed consolidated financial statements.

THE LEARNING COMPANY, INC.
CONDENSED CONSOLIDATED STATEMENTS OF CASH FLOWS
(Continued)
(in thousands)
(unaudited)

<TABLE>
<CAPTION>

| | Nine Months Ended September 30, | |
|---|---|---|
| | 1998 | 1997 |
| <S> | <C> | <C> |
| SUPPLEMENTAL SCHEDULE OF NON-CASH INVESTING AND FINANCING ACTIVITIES: | | |
| Common stock issued to acquire Mindscape | $30,000 | $ -- |
| Common stock issued to acquire Sofsource | 45,000 | -- |
| Common stock issued to settle earn-out agreements | 5,573 | -- |
| Common stock issued in exchange for Senior Notes | 96,695 | -- |
| Common stock issued to settle note payable to related party | -- | 3,053 |
| Common stock issued to acquire Living Books | -- | 7,321 |

</TABLE>

The accompanying notes are an integral part of these condensed consolidated financial statements.



THE LEARNING COMPANY, INC.
NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS
(in thousands, except share and per share amounts)
(unaudited)

1. BASIS OF PRESENTATION

The condensed consolidated financial statements of The Learning Company, Inc. ("TLC" or the "Company") for the Three Months and Nine Months Ended September 30, 1998 and 1997 are unaudited and reflect all adjustments, consisting of normal recurring adjustments, which are, in the opinion of management, necessary for a fair presentation of the results for the interim periods. These condensed consolidated financial statements should be read in conjunction with the audited consolidated financial statements previously filed with the Securities and Exchange Commission (the "SEC") in the Company's 1997 Annual Report on Forms 10-K and 10-K/A. The Company filed with the SEC on November 4, 1998 a Current Report on Form 8-K/A containing supplemental audited consolidated financial statements for the year ended December 31, 1997 to reflect its acquisition of Broderbund Software, Inc. ("Broderbund"), which was accounted for as a pooling-of-interests. The results of operations for the Three Months and Nine Months Ended September 30, 1998 are not necessarily indicative of the results for the entire year ending December 31, 1998.

The accompanying condensed consolidated financial statements as of September 30, 1998 have been restated to reflect a change in the original accounting for the purchase price allocation related to the March 1998 acquisition of Mindscape, Inc. and certain affiliated companies ("Mindscape", see Note 2). After discussions with the staff of the SEC (the "Staff"), the Company has revised the original accounting for the purchase price allocation and the related amortization of intangibles. The Company has restated its previously issued results to reflect the discussions with the Staff and to apply the appropriate guidance and policy as discussed in Note 2 to the Condensed Consolidated Financial Statements. This has resulted in a reduction in the amount of the charge for in-process technology from $103,000 to $40,000 and an increase in the amounts allocated to completed technology and products from $13,000 to $22,000; to brands and trademarks from $30,000 to $38,000 and to goodwill from $9,854 to $55,854. Amortization, merger and other charges has decreased for the Nine Months Ended September 30, 1998 from $282,852 to $227,503, and corresponding changes for the same amounts have been made to the balance of intangible assets and stockholders' equity. The restatement does not affect previously reported net cash flows for the periods or for future periods.

On August 31, 1998, the Company acquired Broderbund, a developer and publisher of consumer software for the home and school. This transaction was accounted for using the pooling-of-interests method of accounting. The accompanying financial statements have been restated to include the results and balances of Broderbund for all periods presented.

The table below details the previously reported results of the Company and the effect of the restatement as discussed above.

| | Three Months Ended September, 30, 1998 | | Nine Months Ended September, 30, 1998 | |
|---|---|---|---|---|
| | Previously reported | Restated | Previously reported | Restated |
| Revenues | $ 212,723 | $ 212,723 | $ 564,042 | $ 564,042 |
| Operating loss | (7,555) | (11,082) | (183,549) | (128,200) |
| Loss before income taxes | (8,770) | (12,297) | (187,555) | (132,206) |
| Net loss | (21,212) | (24,739) | (199,997) | (144,648) |
| Net loss per share | $ (.24) | $ (.28) | $ (2.55) | $ (1.84) |



The third quarter reporting period for 1998 ended on October 3, 1998 and the third quarter reporting period for 1997 ended on October 4, 1997. The periods from July 5, 1998 to October 3, 1998 and from July 7, 1997 to October 4, 1997 are referred to as the "Third Quarter 1998" and the "Third Quarter 1997" or the "Three Months Ended September 30, 1998" and the "Three Months Ended September 30, 1997," respectively. The periods from January 4, 1998 to October 3, 1998 and from January 7, 1997 to October 4, 1997 are referred to as the "Nine Months Ended September 30, 1998" and the "Nine Months Ended September 30, 1997," respectively, throughout these financial statements and Form 10-Q/A.

The preparation of financial statements in conformity with generally accepted accounting principles requires management to make assumptions regarding items such as return reserves and allowances, net realizable value of intangible assets and valuation allowances for deferred tax assets that affect the reported amounts of assets and liabilities and disclosure of contingent assets and liabilities at the date of the financial statements and the reported amounts of revenues and expenses during the reporting period. Significant estimates in these financial statements include: return reserves, inventory reserves, valuation of deferred tax assets and valuation and useful lives of intangible assets. Actual results could differ from these estimates.

2. BUSINESS COMBINATIONS

Broderbund

On August 31, 1998, the Company acquired all of the issued and outstanding common stock of Broderbund in exchange for 16,848,753 shares of common stock of the Company pursuant to an agreement and plan of merger dated June 21, 1998 whereby each share of common stock of Broderbund was exchanged for 0.80 shares of the Company's common stock. This acquisition has been accounted for using the pooling-of-interests method of accounting. The balances as at December 31, 1997 and the results for the Nine Months Ended September 30, 1998 and 1997 have been restated to include the balances and results of Broderbund. The balance sheet of the Company as at December 31, 1997 has been combined with the balance sheet of Broderbund as at November 30, 1997. Retained earnings have been charged with the net income of $682 for the omitted period of December 31, 1997. Revenues, operating expenses and operating income for the excluded month of December 1997 were $28,712, $27,974 and $738, respectively. The financial results for the Nine Months Ended September 30, 1998 include the results of the previously separate businesses for the Six Months Ended June 30, 1998. Revenues and net loss from the previously separate operations of the Company and Broderbund were revenues of $242,853 and $108,466 and net loss of $154,159 and $24,636, respectively, in the Six Month Period Ended June 30, 1998, which are included in these financial statements.

Results of the previously separate entities for the Nine Months Ended September 30, 1997 were as follows:

| Nine Months Ended September 30, 1997 | TLC | Broderbund | Adjustments | Combined Restated |
|---|---|---|---|---|
| Revenues | $ 272,237 | $ 129,295 | $ -- | $ 401,532 |
| Operating loss | (291,815) | (39,083) | 6,750 | (324,148) |
| Net loss | (307,678) | (22,377) | 2,110 | (327,945) |

| | | | | |
|---|---|---|---|---|
| Net loss per share -- basic and diluted | $ (6.28) | $ (1.35) | | $ (5.00) |

</TABLE>

In order to conform the application of generally accepted accounting principles between the two separate entities, an adjustment to increase the valuation allowance for income tax assets of $3,601 and $4,640 was recorded in each of the Nine Month Periods Ended September 30, 1998 and 1997, respectively. The adjustments increase the valuation allowance for uncertainty of recoverability of income tax assets of Broderbund as it was determined that it was more likely than not that some or all of the assets would not be realized under the combined entity. There were no intercompany transactions between the two companies other than a termination fee of $18,000 paid by The Learning Company, a corporation that the Company acquired in 1995 (the "Former Learning Company"), to Broderbund in December 1995 related to the proposed merger between the two companies that was terminated. This amount was recorded as other



income by Broderbund and was included in the determination of the purchase price of the Former Learning Company by the Company. Accordingly, the merger termination fee was eliminated from the Broderbund net income for the year ended August 31, 1996 and the purchase price of the Former Learning Company was reduced, resulting in a reduction in amortization of goodwill in the Nine Months Ended September 30, 1997 of $6,750.

Mindscape
---------

On March 5, 1998, the Company acquired control of Mindscape, Inc., a consumer software company, and certain affiliated companies ("Mindscape") for a total purchase price of $152,557 paid in cash of $122,557 and the remainder through the issuance of 1,366,743 shares of common stock of the Company. The transaction was accounted for using the purchase method of accounting.

Summarized pro forma combined results of operations for the Nine Months Ended September 30, 1998 and 1997 are shown as if the transaction had occurred at the beginning of the period presented. Pro forma adjustments relate primarily to amortization of goodwill and complete technology. These pro forma combined results of operations include the historical results of Mindscape and do not reflect any reductions in operating costs derived from consolidation of functional departments. In addition, the pro forma combined operating loss includes pro forma amortization of acquired intangible assets resulting from the acquisition of Mindscape for the Nine Months Ended September 30, 1998 and 1997 of $3,450 and $15,525, respectively.

<TABLE>
<CAPTION>

| Nine Months Ended September 30, 1998 | The Learning Company, Inc. | Mindscape Including Pro Forma Adjustments | Pro Forma Combined |
|---|---|---|---|
| <S> | <C> | <C> | <C> |
| Revenues | $ 564,042 | $ 9,090 | $ 573,132 |
| Operating loss | (128,200) | (46,824) | (175,024) |
| Net loss | (144,648) | (47,884) | (192,532) |
| Net loss per share | $ ( 1.84) | | $ (2.29) |

</TABLE>

<TABLE>
<CAPTION>

| Nine Months Ended September 30, 1997 | The Learning Company, Inc. | Mindscape Including Pro Forma Adjustments | Pro Forma Combined |
|---|---|---|---|
| <S> | <C> | <C> | <C> |
| Revenues | $ 401,532 | $ 71,621 | $ 473,153 |
| Operating loss | (324,148) | (42,075) | (366,223) |
| Net loss | (327,945) | (42,075) | (370,020) |
| Net loss per share | $ (5.00) | | $ (4.95) |

</TABLE>

Sofsource, Inc.
---------------

On June 2, 1998, the Company acquired control of Sofsource, Inc. an educational software company, for a total purchase price of $45,000, which was settled through the issuance of 1,641,138 shares of common stock. Pro forma results for Sofsource were not material. This acquisition was accounted for using the purchase method of accounting.

The purchase price for the 1998 acquisitions accounted for using the purchase method of accounting was allocated as follows:

<TABLE>
<CAPTION>

| <S> | Mindscape | Sofsource | Total |
|---|---|---|---|
| Purchase price | $152,557 | $45,000 | $197,557 |
| Plus: fair value of net liabilities assumed | 3,297 | 2,287 | 5,584 |
| Excess to allocate | 155,854 | 47,287 | 203,141 |
| Less: excess allocated to | | | |
| Incomplete technology | 40,000 | 14,924 | 54,924 |
| Completed technology and products | 22,000 | -- | 22,000 |
| Brands and trade names | 38,000 | 3,322 | 41,322 |
| | 100,000 | 18,246 | 118,246 |
| Goodwill | $ 55,854 | $29,041 | $ 84,895 |

</TABLE>

The Staff has recently issued guidance related to the valuation of in-process technology as set forth in its letter dated September 9, 1998 from the Chief Accountant of the SEC to the American Institute of Certified Public Accountants. The Company has had discussions with the Staff concerning the application of the methodology to the valuation of the incomplete technology and other intangible assets and has implemented the methodology. As a result of the application of the valuation methodology the purchase price was allocated to incomplete technology, brands and trade names and complete technology and products. Among the factors considered by the Company to determine the allocation of the purchase price were an estimation of the stage of completion of development of each product at the date of acquisition, an estimation of cash flows that would be achieved by any buyer resulting from the expected revenues generated from such projects, a discounting of the net cash flows from the products using an effective industry-based tax rate of 35% (net of any tax benefits from the acquired assets) and a risk adjusted discount rate (which ranged from 20% to 22%) and an estimation of market royalty rates to value the brands and trade names. The in-process development consisted of consumer software products in the games, productivity and education segments. On average the in-process development projects were approximately 55% complete at the time of acquisition. The Company expects to complete the majority of the development projects within the twelve months of the acquisition date and expects to spend approximately $25,000 to complete the development. The Company expects that it will begin to receive the benefits of these in-process development projects during 1998. There were no anticipated material changes from historical pricing, margins or expense levels in the projects under development. In order to complete the development on schedule the Company must continue to retain key development personnel. In the event that these in-process development projects are not completed or replaced with similar projects the Company may experience lower future revenues, operating margins and cash flows.

The Company believes that the incomplete products under development had not reached technical feasibility at the date of the acquisition, have no alternative future use and additional development is required to ensure their commercial viability. In order to develop the acquired incomplete technology into commercially viable products the Company will be required to complete development of proprietary code, development of the artistic and graphic works and design of the remaining storyboards.

The remaining identified intangibles, including the value of completed technology and products and brands and trade names, will be amortized on a straight-line basis over their estimated useful lives of two and ten years, respectively. Goodwill resulting from the acquisition is being amortized using the straight-line method over ten years.

PF. Magic, Inc.
---------------

On April 30, 1998, the Company acquired PF. Magic, Inc. ("PF.Magic"), a virtual life software company, in exchange for the issuance of 521,021 shares of common stock. This transaction was accounted for using the pooling-of-interests method of accounting. The consolidated financial statements of the Company for



the periods prior to consummation do not include the results and balances of PF.Magic as it was deemed to be immaterial to the consolidated financial statements.

3. ISSUANCE OF SPECIAL WARRANTS

On March 12, 1998, the Company's Canadian subsidiary, SoftKey Software Products Inc. ("SoftKey"), issued in a private placement in Canada 8,687,500 special warrants for net proceeds of approximately $134,000. On July 9, 1998 each special warrant was exchanged into one exchangeable non-voting share of SoftKey (an "Exchangeable Share") without additional payment. The Exchangeable Shares are exchangeable at the option of the holder on a one-for-one basis for common stock of the Company without additional payment.

4. BORROWINGS

On August 7, 1998, the Company amended its revolving line of credit (the "Line") to provide a maximum availability of $147,500, of which $40,000 is outstanding at September 30, 1998, which was subsequently repaid. Borrowings under the line are due July 1, 2000 and bear interest at variable rates. The Line is subject to certain financial covenants, is secured by a general security interest in certain operating subsidiaries of the Company and by a pledge of the stock of certain of its subsidiaries.

5. COMPREHENSIVE LOSS

Effective January 4, 1998, the Company adopted Statement of Financial Accounting Standard No. 130, "Reporting Comprehensive Income." The Company's comprehensive loss was as follows:

| | Three Months Ended September 30, | | Nine Months Ended September 30, | |
|---|---|---|---|---|
| | 1998 | 1997 | 1998 | 1997 |
| Net loss | $(24,739) | $(113,162) | $(144,648) | $(327,945) |
| Other comprehensive loss | (592) | (1,978) | (6,236) | (5,099) |
| Total comprehensive loss | $(25,331) | $(115,140) | $(150,884) | $(333,044) |

Other comprehensive loss includes losses on foreign currency translation and the unrealized gain (loss) on investment securities held for resale.

6. INVENTORIES

Inventories are stated at the lower of weighted average cost or net realizable value and include third-party assembly costs, CD-ROM discs, manuals and an allocation of fixed overhead.

| | September 30, 1998 | December 31, 1997 |
|---|---|---|
| Components | $ 1,802 | $ 8,333 |
| Finished goods | 42,705 | 31,049 |
| | $44,507 | $39,382 |

7. COMPUTATION OF EARNINGS PER SHARE

For the year ended December 31, 1997, the Company adopted Statement of Accounting Standard No. 128 ("FAS 128"), which requires the presentation of Basic and Dilutive earnings per share, which replaces primary and fully diluted earnings per share. Basic net loss per share is computed using the weighted average number of common shares outstanding during the period. Dilutive net loss per share is computed using the weighted average number of common shares outstanding during the period, plus the dilutive effect of common stock equivalents. Common



stock equivalents consist of convertible debentures, preferred stock, stock options and warrants. The dilutive computations do not include common stock equivalents for the Three and Nine Months Ended September 30, 1998 and 1997 as their inclusion would be antidilutive. Dilutive elements would include the 750,000 shares of Series A Preferred Stock (which is ultimately convertible into 15,000,000 shares of common stock) issued on December 5, 1997 and employee stock options totaling 16,269,038 and 13,641,086 at September 30, 1998 and 1997, respectively.

8. SALE OF INCOME TAX SOFTWARE BUSINESS

On July 9, 1998, the Company sold its Canadian income tax software business for approximately $45,000 in cash. The net gain on sale was not material.

9. AMORTIZATION, MERGER AND OTHER CHARGES

During the Third Quarter 1998, the Company announced a restructuring plan related to the merger with Broderbund. A total of $67,186 was charged in the Third Quarter 1998 as amortization, merger and other charges. Included in the charge are termination benefits of $17,962 related to the termination of approximately 600 employees at Broderbund and the Company in areas of administration, development, manufacturing, sales and marketing. The charge also includes facility closure costs of $22,050, professional fees and other transaction costs of $10,128, amortization of intangible assets of $7,776 and discontinued product costs of $9,270. The amortization, merger and other charges for the Nine Months Ended September 30, 1998 includes a charge for incomplete technology related primarily to the acquisitions of Mindscape and Sofsource totaling $56,924.

10. EFFECT OF NEW ACCOUNTING PRONOUNCEMENTS

In June, 1998, the Financial Accounting Standards Board issued Statement of Financial Accounting Standards ("SFAS") No. 133 "Accounting for Derivative Instruments and Hedging Activities." This statement establishes accounting and reporting standards for derivative instruments, including certain derivative instruments embedded in other contracts (collectively referred to as derivatives), and for hedging activities. The statement requires companies to recognize all derivatives as either assets or liabilities, with the instruments measured at fair value. The accounting for changes in fair value, gains or losses, depends on the intended use of the derivative and its resulting designation. The statement is effective for all fiscal quarters of fiscal years beginning after June 15, 1999. The Company will adopt SFAS No. 133 by January 1, 2000 and does not expect SFAS No. 133 to have a material impact on its financial statements.

In June 1997, the FASB issued SFAS No. 131, "Disclosure about Segments of an Enterprise and Related Information" which changes the way public companies report information about operating segments. SFAS No. 131 which is based on the management approach to segment reporting establishes requirements to report selected segment information quarterly and to report entity wide disclosures about products and services major customers and the material countries in which the entity holds assets and reports revenue. Management is currently evaluating the effects of this change on its reporting of segment information. The Company will adopt SFAS No. 131 for its fiscal year ending December 31, 1998.

11. SUBSEQUENT EVENT

On December 13, 1998, the Company entered into a merger agreement with Mattel, Inc. ("Mattel") (the "Merger Agreement") pursuant to which each share of common stock of the Company will be exchanged for not less than 1.0 nor more than 1.2 shares of Mattel common stock, and the Company will be merged with and into Mattel. Subject to the minimum and maximum, the exact number of shares of Mattel common stock to be issued to stockholders of the Company will be determined by dividing $33.00 by an average of the closing prices of Mattel common stock on the New York Stock Exchange in accordance with the procedures set forth in the Merger Agreement (the "Exchange Ratio"). Each share of Series A Preferred Stock will be converted into the right to receive a number of shares of Mattel common stock equal to the Exchange Ratio multiplied by twenty (the rate at which each share of Series A Preferred Stock is convertible into shares of common stock of the Company). Each exchangeable non-voting share of the Company's subsidiary, SoftKey Software Products Inc., will become exchangeable for one share of Mattel common stock multiplied by the Exchange Ratio. The transaction is expected to be accounted for using the pooling-of-interests method of accounting. The closing of the transaction is subject to certain conditions, including regulatory and stockholder approvals of each company.



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

The following information should be read in conjunction with the consolidated financial statements and the notes thereto and in conjunction with Management's Discussion and Analysis of Financial Condition and Results of Operations in the Company's audited consolidated financial statements previously filed with the Securities and Exchange Commission (the "SEC") in the Company's 1997 Annual Report on Forms 10-K and 10-K/A. The Company filed with the SEC Current Reports on Form 8-K/A on November 4, 1998 and March 26, 1999 containing supplemental audited consolidated financial statements for the year ended December 31, 1997 (the "1997 Supplemental Financial Statements") to reflect its acquisition of Broderbund Software, Inc. ("Broderbund"), which was accounted for as a pooling of interests. All dollar amounts presented in this Management's Discussion and Analysis of Financial Condition and Results of Operations are presented in thousands, except per share amounts. Certain of the information contained in this Quarterly Report on Form 10-Q which are not historical facts may include "forward-looking statements" within the meaning of Section 21E of the Securities Exchange Act of 1934, as amended (the "Exchange Act"). The Company's actual results may differ materially from those set forth in such forward-looking statements. Certain risks and uncertainties including, but not limited to, those discussed below in "Factors Affecting Future Operating Results," as well as in the Company's Annual Report on Form 10-K and 10-K/A and in the 1997 Supplemental Financial Statements, as well as other factors, may also cause actual results to differ materially from those projected. The Company assumes no obligation to update these forward-looking statements to reflect actual results or changes in factors or assumptions affecting such forward-looking statements. The information contained in this Management's Discussion and Analysis of Financial Condition and Results of Operations is provided pursuant to applicable regulations of the SEC and is not intended to serve as a basis for projections of future events.

## INTRODUCTION

The Learning Company, Inc. ("TLC" or the "Company") develops and publishes a broad range of high quality branded consumer software for personal computers ("PCs") that educate and entertain across every age category, from young children to adults. The Company's primary emphasis is in educational, productivity and reference software, but it also offers a selection of lifestyle and entertainment products, both in North America and internationally.

The Company distributes its products through retail channels, including direct sales to computer electronics stores, office superstores, mass merchandisers, discount warehouse stores and software specialty stores, which control over 23,000 North American storefronts. The Company also sells its products directly to consumers through the mail, telemarketing and the Internet, and directly to schools. The Company's international sales are conducted from subsidiaries in Germany, France, Holland, Ireland, the United Kingdom, Australia and Japan. The Company also derives revenue from licensing its products to original equipment manufacturers ("OEMs"), which bundle the Company's products for sale with computer systems or components and through on-line offerings.

## Business Combinations

### Proposed Merger with Mattel

On December 13, 1998, the Company entered into a merger agreement with Mattel, Inc. ("Mattel") (the "Merger Agreement") pursuant to which each share of common stock of the Company will be exchanged for not less than 1.0 nor more than 1.2 shares of Mattel common stock, and the Company will be merged with and into Mattel. Subject to the minimum and maximum, the exact number of shares of Mattel common stock to be issued to stockholders of the Company will be determined by dividing $33.00 by an average of the closing prices of Mattel common stock on the New York Stock Exchange in accordance with the procedures set forth in the Merger Agreement (the "Exchange Ratio"). Each share of Series A Preferred Stock will be converted into the right to receive a number of shares of Mattel common stock



equal to the Exchange Ratio multiplied by twenty (the rate at which each share of Series A Preferred Stock is convertible into shares of common stock of the Company). Each exchangeable non-voting share of the Company's subsidiary, SoftKey Software Products Inc., will become exchangeable for one share of Mattel common stock multiplied by the Exchange Ratio. The transaction is expected to be accounted for using the pooling-of-interests method of accounting. The closing of the transaction is subject to certain conditions, including regulatory and stockholder approvals of each company.

### Broderbund

On August 31, 1998, the Company acquired Broderbund, a publisher and developer of consumer software for the home and school market, in exchange for 16,848,753 shares of the Company's common stock pursuant to an agreement and plan of merger dated June 21, 1998 whereby each share of Broderbund common stock was exchanged for 0.80 shares of the Company's common stock. This transaction was accounted for using the pooling-of-interests method of accounting. The accompanying Consolidated Financial Statements of the Company have been restated to include the results and balances of Broderbund for all periods presented.

### Mindscape

On March 5, 1998, the Company acquired control of Mindscape, Inc., a consumer software company, and certain affiliated companies ("Mindscape") for a purchase price of $152,557 payable in cash of $122,557 and the remainder through the issuance of 1,366,743 shares of common stock. This transaction was accounted for using the purchase method of accounting.

### Sofsource

On June 2, 1998, the Company acquired control of Sofsource, Inc., an educational software company, for a purchase price of $45,000, which was settled through the issuance of 1,641,138 shares of common stock. This transaction was accounted for using the purchase method of accounting.

Other Business Combinations

On May 14, 1998, the Company acquired P.F. Magic, Inc. ("PF Magic"), a virtual life entertainment software company, in exchange for the issuance of 521,021 shares of common stock. On December 3, 1998, the Company acquired Palladium Interactive, Inc. ("Palladium"), a genealogy and children's software company, in exchange for the issuance of 788,754 shares of common stock. Each of these transactions was accounted for using the pooling-of-interests method of accounting. The Consolidated Financial Statements for years prior to December 31, 1998 do not include the results and balances of these companies as they were deemed to be immaterial to the Consolidated Financial Statements for those periods.

RESULTS OF OPERATIONS

Net Loss. The Company incurred a net loss of $24,739 ($.28 per share) and $144,648 ($1.84 per share) on revenues of $212,723 and $564,042 in the Third Quarter 1998 and the Nine Months Ended September 30, 1998 as compared to a net loss of $113,162 ($1.72 per share) and $327,945 ($5.00 per share) on revenues of $141,737 and $401,532 in the Third Quarter 1997 and the Nine Months Ended September 30, 1997. The net loss in the Third Quarter 1998, the Nine Months Ended September 30, 1998, the Third Quarter 1997 and the Nine Months Ended September 30, 1997 is a result of the effect of the amortization, merger and other charges of $67,186, $227,503, $148,400 and $403,058, respectively.



Revenues. Revenues by distribution channel for the Third Quarter 1998 as compared to the Third Quarter 1997 and the Nine Months Ended September 30, 1998 as compared to the Nine Months Ended September 30, 1997 are as follows:

<TABLE>
<CAPTION>

| | Three Months Ended September 30, | | | | Nine Months Ended September 30, | | | |
|---|---|---|---|---|---|---|---|---|
| | 1998 | % | 1997 | % | 1998 | % | 1997 | % |
| <S> | <C> | <C> | <C> | <C> | <C> | <C> | <C> | <C> |
| Retail | $117,848 | 56% | $ 71,091 | 50% | $289,619 | 51% | $199,004 | 50% |
| OEM | 11,347 | 5% | 9,873 | 7% | 30,964 | 5% | 24,163 | 6% |
| School | 19,769 | 9% | 16,175 | 11% | 56,968 | 10% | 46,031 | 11% |
| Direct response | 24,801 | 12% | 19,244 | 14% | 81,716 | 15% | 56,283 | 14% |
| On-line | 5,126 | 2% | -- | -- | 9,521 | 2% | -- | -- |
| International | 33,832 | 16% | 22,380 | 16% | 86,511 | 15% | 63,195 | 16% |
| Tax software and services | -- | -- | 2,974 | 2% | 8,744 | 2% | 12,855 | 3% |
| | $212,723 | 100% | $141,737 | 100% | $564,043 | 100% | $401,531 | 100% |

</TABLE>

Revenues increased in dollars and as a percentage of total revenue for the Three and Nine Months Ended September 30, 1998 as compared to the Three and Nine Months Ended September 30, 1997 primarily due to growth in the demand for consumer software. Retail revenues also were higher than the prior year due to the acquisitions of Mindscape and Sofsource and the launch of several new and upgraded products, which included: Reader Rabbit's Math Ages 4-6, The American Girls Premiere - 2nd Edition, Compton's Encyclopedia 1999 Deluxe, Cosmopolitan Virtual Makeover, National Geographic Maps, Dr. Seuss: Preschool, Rugrats Adventure Game, among others. OEM sales increased in dollars for the Three and Nine Months Ended September 30, 1998 as compared to the Three and Nine Months Ended September 30, 1997 primarily due to additional demand from PC manufacturers across the industry. International sales increased in dollars for the Three and Nine Months Ended September 30, 1998 as compared to the Three and Nine Months Ended September 30, 1997 primarily as a result of the higher PC sales in Europe and revenues from the acquisition of Mindscape. Direct response revenues increased in dollars for the Three and Nine Months Ended September 30, 1998 as compared to the Three and Nine Months Ended September 30, 1997 due to growth in the Company's catalog based sales to end users and due to revenues from Mindscape. School sales increased in dollars for the Three and Nine Months Ended September 30, 1998 as compared to the Three and Nine Months Ended September 30, 1997 due to the increasing demand for software in American schools. The tax software business was sold on July 9, 1998.

Costs and Expenses. The Company's costs and expenses and the respective percentages of revenues for the Third Quarter 1998 as compared to the Third Quarter 1997 and the Nine Months Ended September 30, 1998 as compared to the Nine Months Ended September 30, 1997 are as follows:

<TABLE>
<CAPTION>

| | Three Months ended September 30, | | | | Nine Months Ended September 30, | | | |
|---|---|---|---|---|---|---|---|---|
| | 1998 | % | 1997 | % | 1998 | % | 1997 | % |
| <S> | <C> | <C> | <C> | <C> | <C> | <C> | <C> | <C> |
| Costs of production | $ 63,011 | 30% | $ 40,326 | 28% | $185,039 | 33% | $118,291 | 29% |
| Sales and marketing | 54,529 | 26% | 38,746 | 27% | 163,223 | 29% | 103,806 | 26% |
| Development and software costs | 24,947 | 12% | 25,041 | 18% | 72,809 | 13% | 65,991 | 16% |
| General and administrative | 14,132 | 7% | 10,755 | 8% | 43,668 | 8% | 34,534 | 9% |
| | $156,619 | 75% | $114,868 | 81% | $464,739 | 83% | $322,622 | 80% |

</TABLE>

Costs of production includes the cost of manuals, packaging, diskettes, duplication, assembly and fulfillment charges. In addition, costs of production includes royalties paid to third-party developers and inventory obsolescence reserves. Costs of production as a percentage of revenues increased in the Third Quarter 1998 and the Nine Months Ended September 30, 1998 as compared to the Third Quarter 1997 and



the Nine Months Ended September 30, 1997 from 28% and 29% to 30% and 33%, respectively. The increase in costs of production as a percentage of revenues in Third Quarter 1998 and the Nine Months Ended September 30, 1998 from Third Quarter 1997 and the Nine Months Ended September 30, 1997 was caused by sale of products from the acquisitions of Mindscape, Sofsource, and Creative Wonders that have higher production costs and royalty rates and was also due to a higher proportion of sales of entertainment and affiliate label products in the first nine months of the year over prior years.

Sales and marketing expenses decreased to 26% of revenues in the Third Quarter 1998 as compared to 27% of revenues in the Third Quarter 1997 and increased to 29% of revenues in the Nine Months Ended September 30, 1998 as compared to 26% in the Nine Months ended September 30, 1997. The decrease in the Third Quarter 1998 is due to a lower spending level on entertainment titles, which had in the past comprised a greater proportion of the product mix. In addition, the Company began to realize savings from the integration of the Broderbund sales and marketing operations.

Development and software costs decreased to 12% of revenues in the Third Quarter 1998 and to 13% of revenues in the Nine Months Ended September 30, 1998 as compared to 18% and 16% of revenues in the Third Quarter 1997 and the Nine Months Ended September 30, 1997 due to the timing of product introduction and a decrease in spending on entertainment development projects, which typically have a higher cost of development.

General and administrative expenses decreased to 7% of revenues in the Third Quarter 1998 and to 8% of revenues in the Nine Months Ended September 30, 1998 as compared to 8% and 9% of revenues in the Second Quarter 1997 and the Nine Months Ended September 30, 1997 due to continued efforts to reduce both fixed costs and employee headcount related to the integration of the Company's acquisitions. In absolute dollars general and administrative expenses increased in the Third Quarter 1998 and the Nine Months Ended September 30, 1998 as compared to the Third Quarter 1997 and the Nine Months Ended September 30, 1997 due to the costs from the Mindscape operations, the acquisition of which was accounted for using the purchase method of accounting.

The Company reported amortization, merger and other charges in the Third Quarter 1998 and the Nine Months Ended September 30, 1998 and the Third Quarter 1997 and the Nine Months Ended September 30, 1997 of $67,186, $227,503, $148,400, and $403,058, resulting primarily from the acquisitions. The charges in the Third Quarter 1998 include costs of severance, facility closure, discontinued product costs, professional fees and printing costs related to the merger with Broderbund. The charges in the Nine Months Ended September 30, 1998 include $56,924 of incomplete technology write-offs related to the acquisitions of Mindscape and Sofsource, with the remainder relating to amortization of goodwill, amortization of acquired technology related assets and other expenses. The Staff has recently issued guidance related to the valuation of in-process technology as set forth in its letter dated September 9, 1998 from the Chief Accountant of the SEC to the American Institute of Certified Public Accountants. The Company has had discussions with the Staff concerning the application of the methodology to the valuation of the incomplete technology and other intangible assets and has implemented the methodology. As a result of the application of the valuation methodology the purchase price was allocated to incomplete technology, brands and trade names and complete technology and products. Among the factors considered by the Company to determine the allocation of the purchase price using the methodology were an estimation of the stage of completion of development of each product at the date of acquisition, an estimation of cash flows that would be achieved by any buyer resulting from the expected revenues generated from such projects, a discounting of the net cash flows from the products using an effective industry-based tax rate of 35% (net of any tax benefits from the acquired assets) and a risk adjusted discount rate (which ranged from 20% to 22%) and an estimation of market royalty rates to value the brands and trade names. The in-process development consisted of consumer software products in the games, productivity and education segments. On average the in-process development projects were approximately 55% complete at the time of acquisition. The Company expects to complete the majority of the development projects within the twelve months of the acquisition date and expects to spend approximately $25,000 to complete the development. The Company expects that it will begin to receive the benefits of these in-process development projects during 1998. There were no anticipated material changes from historical pricing, margins or expense levels in the projects under development. In order to complete the development on schedule the Company must continue to retain key development personnel. In the event that these in-process development projects are not completed or



replaced with similar projects the Company may experience lower future revenues, operating margins and cash flows. In order to develop the acquired incomplete technology into commercially viable products, the Company will be required to complete development of proprietary code, development of the artistic and graphic works and design of the remaining storyboards.

LIQUIDITY AND CAPITAL RESOURCES

Cash and short-term investments increased from $188,956 at December 31, 1997 to $234,796 at September 30, 1998. This increase was attributable to the issuance by the Company's Canadian subsidiary, SoftKey Software Products Inc. ("SoftKey"), of 8,687,500 special warrants in a private placement for proceeds of approximately $134,000 offset by the cash paid to acquire Mindscape of approximately $120,000. Other financing activities generated a further $22,486 and investing activities used $72,024, offset by cash generated from operating activities of $80,104.

As of October 3, 1998, the Company has outstanding $200,955 principal amount Senior Convertible Notes ($10,000 is included as current). The Senior Convertible Notes will be redeemable by the Company on or after November 2, 1998 at declining redemption prices. Should the Senior Convertible Notes not convert under their terms into common stock, there can be no assurances that the Company will have sufficient cash flows from future operations to meet payment requirements under the debt or be able to refinance the notes under favorable terms or at all.

On August 7, 1998, the Company amended its revolving line of credit (the "Line") to provide a maximum availability of $147,500, of which $40,000 was outstanding at September 30, 1998, which was subsequently repaid. Borrowings under the line are due July 1, 2000 and bear interest at variable rates. The Line is subject to certain financial covenants, is secured by a general security interest in certain operating subsidiaries of the Company and by a pledge of the stock of certain of its subsidiaries.

The Company, through its wholly owned subsidiary, The Learning Company Funding, Inc. (a separate special purpose corporation), is party to a receivables purchase agreement whereby it can sell without recourse undivided interests in eligible pools of trade accounts receivable on a revolving basis during a five year period ending September 30, 2002 of up to $100,000, of which $75,000 was used as of October 3, 1998. The Company acts as servicing agent for the sold receivables in the collection and administration of the accounts. In addition, the Company has a European accounts receivable factoring facility where it can sell up to $25,000 of European accounts receivable on a recourse basis to its banks, of which $25,000 was used as of October 3, 1998.

Income generated by the Company's subsidiaries in certain foreign countries cannot be repatriated to the Company in the United States without payment of additional taxes since the Company does not currently receive a U.S. tax credit with respect to income taxes paid by the Company (including its subsidiaries) in those foreign countries.

At the present time, the Company expects that its cash flows from operations will be sufficient to finance the Company's operations for at least the next twelve months. Longer-term cash requirements are dictated by a number of external factors, which include the Company's ability to launch new and competitive products, the strength of competition in the consumer software industry and the growth of the home computer and software markets. In addition, the Company's Senior Convertible Notes mature November 1, 2000. If not converted to common stock, the Company may be required to secure alternative financing sources. There can be no assurance that alternative financing sources will be available on terms acceptable to the Company in the future or at all.

The Company continuously evaluates products and technologies for acquisitions, however no estimation of short-term or long-term cash requirements for such acquisitions can be made at this time.



FUTURE OPERATING RESULTS

The Company operates in a rapidly changing environment that is subject to many risks and uncertainties. Some of the important risks and uncertainties which may cause the Company's operating results to differ materially or adversely are discussed below, in the Company's Annual Report on Form 10-K and Form-10-K/A and in the 1997 Supplemental Financial Statements.

The Company's future operating results are subject to a number of uncertainties, including its ability to develop and introduce new products, the introduction of competitive products and general economic conditions. In addition, the Company competes for retail shelf space and general consumer awareness with a number of companies that market consumer software, including competitors and potential competitors that possess significantly greater capital, marketing resources and brand recognition than the Company. Furthermore, the rapid changes in the market and the increasing number of new products available to consumers have increased, and are expected to continue to increase, the degree of consumer acceptance risk with respect to any specific title that the Company may publish.

YEAR 2000 COMPLIANCE

Many existing computer systems use only the last two digits to identify a year. Consequently, as the year 2000 approaches, many systems do not yet recognize the difference in a year that begins with "20" instead of "19." Unless corrected, this, as well as other date-related processing issues, may result in systems failures or miscalculations causing disruptions of operations, including, among other things, a temporary inability to process transactions, send invoices, or engage in similar normal business activities. The Year 2000 issue also may affect the Company's products.

The Company has appointed a Year 2000 project team to develop and implement a comprehensive four-phase Year 2000 readiness plan for its worldwide operations relating to the following three areas: (1) the Company's internal systems (including information technology such as financial and order entry systems and non-information technology systems such as facilities); (2) third party customers, vendors and others with whom the Company does business and (3) the Company's products. The project team includes members of senior management and prepares progress reports to the board of directors on a regular basis. Phase One (inventory) consists of identifying all the Company's systems, relationships and products that may be impacted by Year 2000. Phase Two (assessment) involves determining the Company's current state of Year 2000 readiness for those areas identified in the inventory phase and prioritizing the areas that need to be fixed. Phase Three (remediation) will consist of developing a plan for those areas identified as needing correction in the assessment phase. Phase Four (implementation) will consist of executing the action plan and completing the steps identified to attain Year 2000 readiness. The Company is currently in the inventory phase of the plan for both its internal systems and its third party relationships, although, for certain known critical internal systems, the Company has completed the assessment and remediation phases. For the Company's products, it is either in the inventory or assessment phase of the plan. The Company has not yet determined a date by which it expects to complete implementation for all of the targeted areas, but it intends to complete such implementation well in advance of January 1, 2000.

Internal Systems and Third Party Issues

The Company for some time has been taking, and will continue to take, actions intended to resolve Year 2000 issues through planned replacement or upgrades of its internal computer equipment and software systems. For this purpose, the term "computer equipment and software" includes systems that are commonly considered IT systems, including accounting, data processing and telephone/PBX systems, as well as systems that are not commonly considered IT systems such as security systems, fax machines or other miscellaneous systems. Both IT and non-IT systems may contain embedded technology, which complicates the Company's Year 2000 inventory, and implementation efforts.

The Company currently believes that the cost of its Year 2000 inventory, assessment, remediation and implementation efforts with respect to internal systems, as well as the costs to be incurred with respect to Year 2000 issues of third parties, should not exceed $1,000, which expenditures will be funded from operating cash flows. Because the Company is still in the inventory phase of its readiness plan with respect



to many of its internal systems and with respect to third parties, it is difficult to estimate with certainty the ultimate amount of such costs. As discussed below, the Company believes that a substantial portion of its remediation and implementation efforts with respect to internal systems will be conducted in connection with the integration of the businesses acquired by the Company in 1998 with the Company's operations. As of August 31, 1998 the Company estimates that it has incurred costs of approximately $350 related to its Year 2000 inventory, assessment, remediation and implementation efforts with respect to internal systems. All of the $350 relates to analysis, repair or replacement of existing software, upgrades of existing software, evaluation of information received from significant vendors, service providers or customers, or consulting advisory agents. Other non-Year 2000 IT efforts have not been materially delayed or impacted by Year 2000 initiatives.

In 1998 the Company acquired Mindscape, Sofsource, PF.Magic and Broderbund, as well as their respective subsidiaries. None of these companies had made substantial progress in its own Year 2000 readiness plans with respect to internal systems or third parties. While the Company is in the process of integrating these businesses into its Year 2000 readiness plan, their addition complicates the Company's Year 2000 inventory, assessment, remediation and implementation efforts. This effect is mitigated somewhat because the Company intends in most instances to move, or in certain cases has moved or is in the process of moving, most accounting, data processing, telephone/PBX and other IT processes of these businesses to the Company's systems, which are to a greater extent already Year 2000 ready. For example, the Company's primary software package for sales order processing, distribution, manufacturing and finance is the JD Edwards software package for Sales Order Processing, Distribution, Manufacturing and Finance version 7.3, which the Company has been informed by JD Edwards and believes is Year 2000 ready. In connection with the planned integration of the operations of Company's recently acquired businesses, these businesses will operate from the same JD Edwards system.

While the Company is dedicating substantial resources toward attaining Year 2000 readiness, there is no assurance that the Company will be successful in its efforts to address all Year 2000 systems issues. If all Year 2000 issues are not properly identified, or assessment, remediation or implementation are not effected timely with respect to Year 2000 issues that are identified, there can be no assurance that the Year 2000 issue will not materially adversely impact the Company's results of operations or adversely affect the Company's relationships with customers, vendors or others. For example, failure to achieve Year 2000 readiness for the Company's internal systems could delay its ability to manufacture and ship products, disrupt customer service and technical support facilities, or interrupt customer access to online products and services. The Company also relies heavily on third parties such as manufacturing suppliers, service providers and a large retail distribution channel. If these or other third parties experience Year 2000 failures or malfunctions, there could be a material adverse impact on the Company's ability to conduct ongoing operations. For example, the ability to manufacture and ship products into the retail channel, to receive retail sales information necessary to maintain proper inventory levels, or to complete online transactions dependent upon third party service providers could be affected.

Products

The Company and its subsidiaries currently sell hundreds of different software products primarily for use in homes and schools, and have sold over the last few years many hundreds of additional products that have been discontinued but may still be used by consumers. As a matter of course, products currently under development are being designed to be Year 2000 compliant. The Company is also in the process of testing certain of its products for Year 2000 compliance.

Because the Company's products tend to have few time-sensitive components, the Company is able to use existing internal staff to identify and test its products, and the resources necessary to test its products are not significant. Because the Company is still in the inventory and assessment phases of its readiness plan with respect to its products, it is difficult to estimate with certainty the ultimate cost of its Year 2000 inventory, assessment, remediation and implementation efforts with respect to products. Due to the nature of the Company's products, however, the Company does not currently believe that such costs will be material.



If the Company's products are not Year 2000 ready, the Company could suffer increased costs, lost sales or other negative consequences resulting from customer dissatisfaction, including litigation. The Company is aware of the potential for claims against it and other companies for damages arising from products that are or were not Year 2000 ready. In addition, because of the large number of products sold by the Company currently and in the past, the Company could face lawsuits relating to the Year 2000 readiness of products that it no longer sells and that it no longer supports. The Company believes, however, that any such claims with respect to its current or past products would be without merit.

The Company does not currently have any Year 2000 related contingency plans. The Company expects to institute appropriate contingency planning at the completion of the assessment phase of its Year 2000 readiness plan.

The above discussion regarding costs, risks and estimated completion dates for the Year 2000 is based on the Company's best estimates given information that is currently available, and is subject to change. Actual results will differ materially from these estimates.



SIGNATURES

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.

THE LEARNING COMPANY, INC.

/s/ R. Scott Murray
----------------------------------------
R. Scott Murray
Executive Vice President and Chief Financial Officer
(principal financial and accounting officer)

March 25, 1999

<TABLE> <S> <C>

<ARTICLE> 5
<CIK> 0000719612
<NAME> THE LEARNING COMPANY
<MULTIPLIER> 1,000
<CURRENCY> U.S. CURRENCY

| <S> | <C> |
|---|---|
| <PERIOD-TYPE> | 3-MOS |
| <FISCAL-YEAR-END> | JAN-02-1999 |
| <PERIOD-START> | JUL-05-1998 |
| <PERIOD-END> | OCT-03-1998 |
| <EXCHANGE-RATE> | 1 |
| <CASH> | 234,796 |
| <SECURITIES> | 0 |
| <RECEIVABLES> | 117,247 |
| <ALLOWANCES> | 46,637 |
| <INVENTORY> | 44,507 |
| <CURRENT-ASSETS> | 51,941 |
| <PP&E> | 63,711 |
| <DEPRECIATION> | 0 |
| <TOTAL-ASSETS> | 746,955 |
| <CURRENT-LIABILITIES> | 252,997 |
| <BONDS> | 190,955 |
| <PREFERRED-MANDATORY> | 0 |
| <PREFERRED> | 0 |
| <COMMON> | 0 |
| <OTHER-SE> | 228,283 |
| <TOTAL-LIABILITY-AND-EQUITY> | 746,955 |
| <SALES> | 212,723 |
| <TOTAL-REVENUES> | 212,723 |
| <CGS> | 63,011 |
| <TOTAL-COSTS> | 223,805 |
| <OTHER-EXPENSES> | 0 |
| <LOSS-PROVISION> | 0 |
| <INTEREST-EXPENSE> | (1,215) |
| <INCOME-PRETAX> | (12,297) |
| <INCOME-TAX> | 12,442 |
| <INCOME-CONTINUING> | (24,739) |
| <DISCONTINUED> | 0 |
| <EXTRAORDINARY> | 0 |
| <CHANGES> | 0 |
| <NET-INCOME> | (24,739) |
| <EPS-PRIMARY> | (.28) |
| <EPS-DILUTED> | (.28) |

</TABLE>