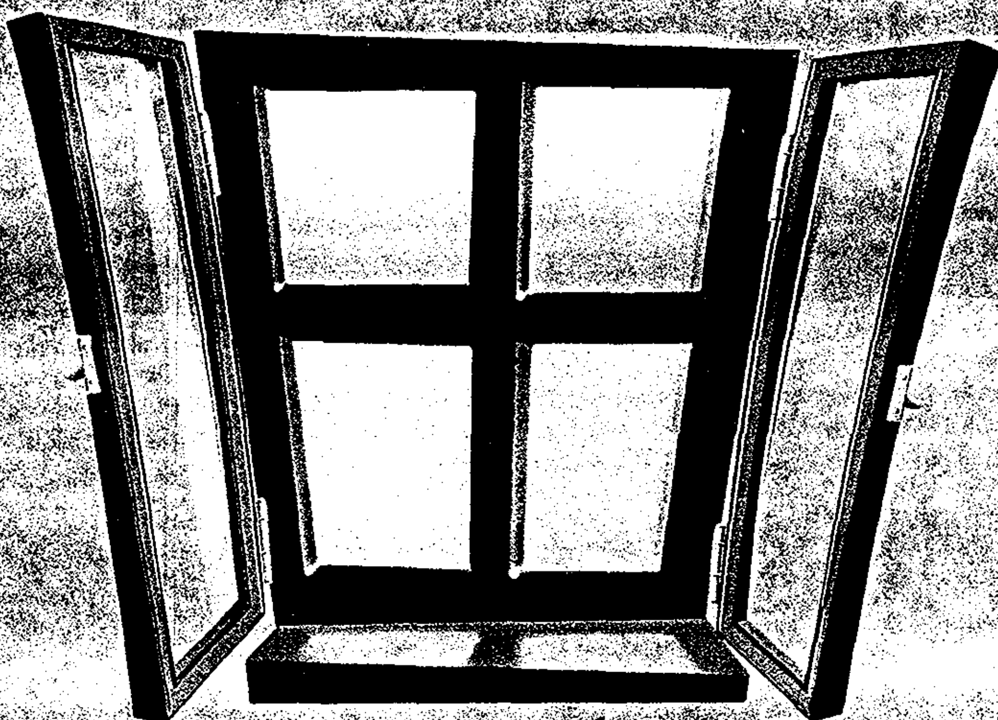
maxis games



You don't just play them. You live them.

Annual Report 1996

Maxis brings sophisticated technologies to personal computer users in a new generation of entertainment and learning software. Maxis is widely recognized for its successful Sim family of entertainment products which have sold over seven million copies worldwide.

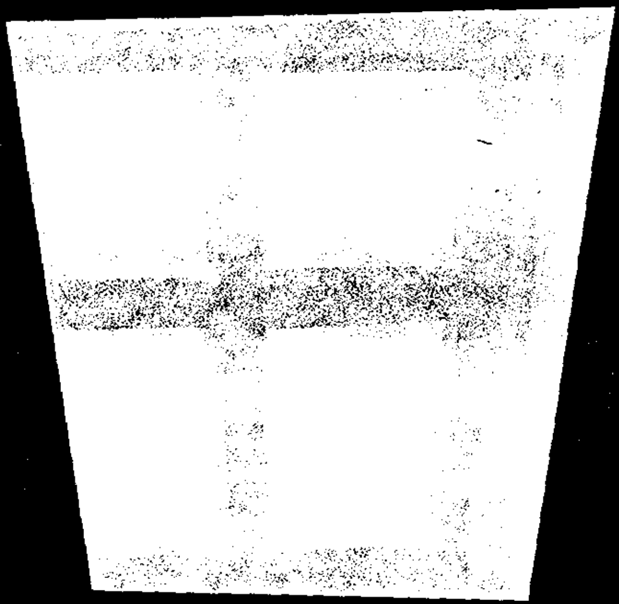
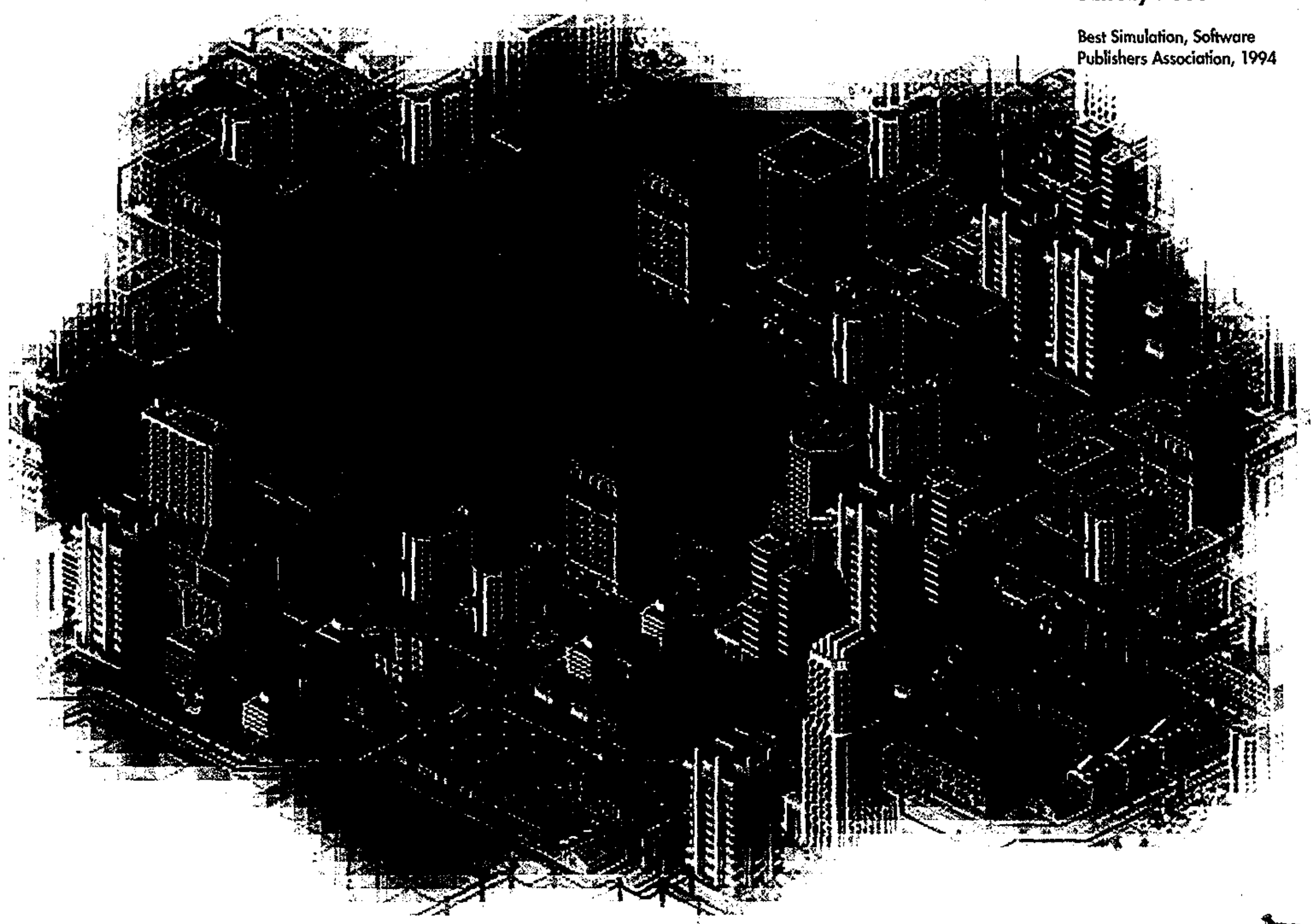


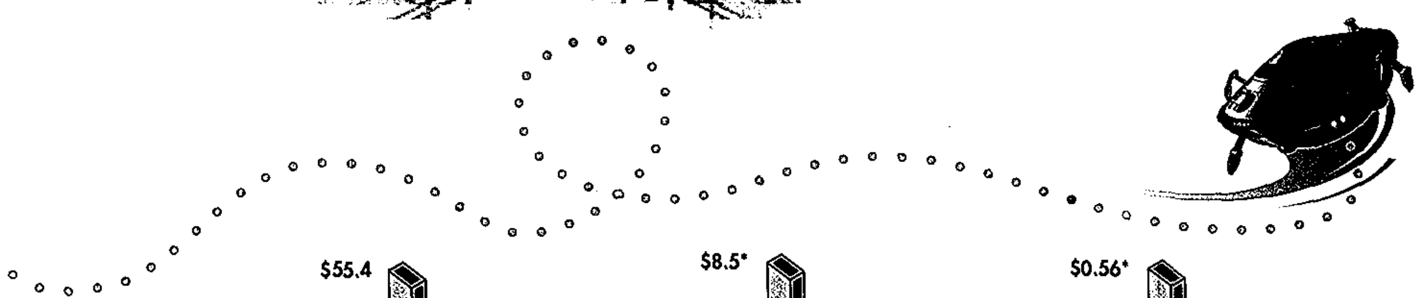
Table of Contents

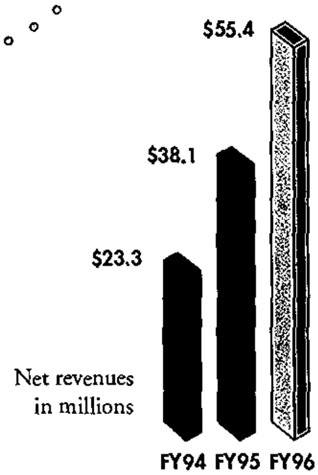
Certain statements in this Annual Report, including statements in the Letter to Stockholders regarding upcoming releases of new products, the favorable effect of increased international sales, and preparation and potential for growth, may constitute "forward-looking statements" as defined in Section 27A of the Securities Act of 1933 and Section 21E of the Securities Exchange Act of 1934, each as amended. Factors that may cause actual results to differ substantially from those described in such forward-looking statements include those set forth in "Management's Discussion and Analysis of Financial Condition and Results of Operations" (particularly in the subsection entitled "—Risk Factors Affecting Future Earnings and Stock Price"), in the Company's Annual Report on Form 10-K and in other sections of this Annual Report. The Company undertakes no obligation to release publicly any updates to such information in the future despite the occurrence of later events.

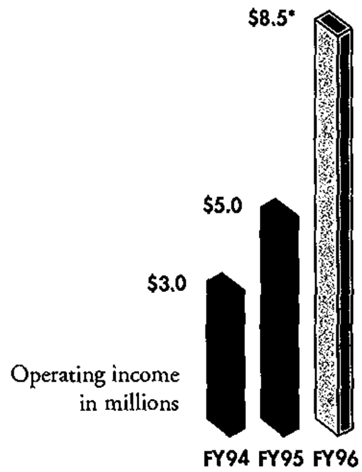


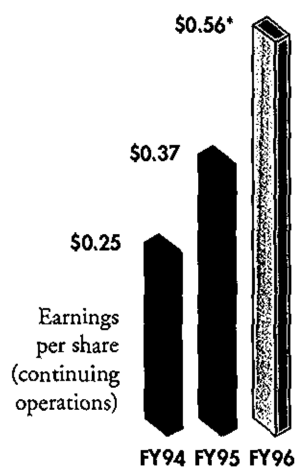
SimCity 2000

Best Simulation, Software Publishers Association, 1994









* Includes a one-time charge for Cinematronics acquisition.

To Our Stockholders:

This is a special Annual Report for Maxis—our first, since our initial public offering occurred in May 1995. We hope you'll appreciate this window into our world.

Fiscal 1996—our ninth year of operation—was a year of dramatic growth and significant international expansion for Maxis, Inc. Our initial public offering produced gratifying results, we launched exciting new products, and our revenues grew by nearly 50 percent. It was our most successful—and eventful—year by far.

Revenues for the fiscal year were $55.4 million, up 45 percent compared with $38.1 million reported the year before. Despite a one-time, pretax charge of $2.2 million for the acquisition of action game developer Cinematronics LLC, net income for the year rose to $6.2 million compared to $3.6 million last year. Earnings per share rose to 56 cents from 40 cents in the previous year.

The Sim Brand: Power and Longevity

Our ability to sustain rapid growth in the highly competitive consumer software field is a tribute to the power and longevity of the flagship Sim brand. In our entertainment line, the year's best-selling products were the *SimCity 2000* CD Collection, *SimTower* and *SimIsle*. In our growing children's entertainment/learning line—a segment that grew from 11 percent of revenues to 18 percent over the previous fiscal year—*SimTown* continues as a sales leader.

What's more, SimGames are reaching new audiences as they move onto new platforms. *SimCity 2000* was one of the first software games available for Windows 95. Since then we've released games for the Sega Saturn and the Sony PlayStation. And Sims are moving swiftly into cyberspace, with interactive Internet components planned for upcoming releases.

Diversification: High-Growth Categories

The Maxis success story, however, does not rely solely on SimGames. During the year, two products spearheaded our successful entry into new areas of endeavor.

Full Tilt! Pinball—offering authentic arcade action to pinball enthusiasts of all ages—represents a move into the fast-growing action entertainment field. Our subsequent acquisition of Cinematronics, the developer of *Full Tilt! Pinball*, brings a cadre of talented people onboard to develop exciting action games for Maxis.

In the kids-oriented learning field, we broke new ground with *Marty and The Trouble With Cheese*, a voice-activated storybook that lets preschoolers talk to on-screen characters who respond to speech and sound.

Expansion: Penetrating International Markets

International sales, as a percentage of revenues, reached a record 20 percent for the year, up from 15 percent last year. Our London office, opened three years ago, has greatly increased Maxis' penetration of the European market, and we recently began distributing our products there directly, which favorably affects margins.

Similarly, to better access the Asian market, we continued to expand our international presence by opening a Tokyo-based sales, marketing and development office.

Sam Poole

Distribution: Building New Channels

Since 1993, when we began distributing Maxis products directly in North America, we have increased our market penetration each year. Now, with an expanded sales force, we are establishing several new avenues of distribution—alternative channels such as booksrores, supermarkets, video stores and mass merchandisers. And as part of our overall strategy of making our products available to a wide range of consumers, we released the *Collector's Series*—a value-priced line featuring eight of our most popular titles for under $15 each.

In addition to Maxis products, we distribute selected products created by software developers without distribution networks of their own. Revenues from these affiliate products represented roughly the same proportion of total revenues as in the previous year—10 percent compared to 11 percent for fiscal year 1995.

Our Organization: Sound Management, Talented People

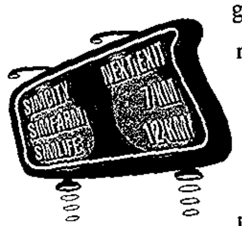
Earlier this year, we transferred our headquarters to Walnut Creek, California, a move necessitated by the fact that our total staff grew by nearly 50 percent during the year—from 150 to nearly 220. We believe it is a tribute to the strength of our organization, the experience of our management team and the resourcefulness of our people that we were able to accomplish this substantial transition while at the same time increasing employee productivity for the year by an impressive 45 percent.

Needless to say, we have recognized the importance of having procedures firmly in place to accommodate such rates of growth, including management information systems, electronic data interchange, compensation structures, support mechanisms and internal communications processes. All are systematically reviewed on a regular basis, looking for opportunities to provide the smooth-working environment needed to grow the company on the top *and* the bottom line.

During fiscal 1996, our Board of Directors was pleased to welcome Avram Miller, vice president of corporate development at Intel Corporation, and Eric Dunn, vice president and general manager of Intuit's Personal Finance Group.

A Window Into the Future

We believe that Maxis is well positioned to grow vigorously along with the consumer software market. We have in place a strong R & D team—now complemented by the talents of Cinematronics—and a dedicated sales and marketing group. Still, we exist in a fiercely competitive market, making our game designs, selections and timing of new product introductions vital.



We believe that our products are unique and singularly long-lived—because you don't just play them, you live them. And we believe that our employees have the talent, dedication and innovative spirit to fuel our performance in the years ahead. As we continue in this endeavor, we thank you for your support, and look forward to reporting to you again next year.

Jeff Braun
Chief Executive Officer

Sam Poole
President

SimTower

The Vertical Empire

Get a new outlook on upward mobility as you grow your business from a small office building to a self-contained city in a skyscraper ...

SimCity Classic

The Original City Simulator

This is the game that started it all—the original simulation that took the world by storm. Winner of numerous awards, SimCity has spawned add-ons, disaster scenarios, books, card games—and a whole raft of best-selling SimGames.

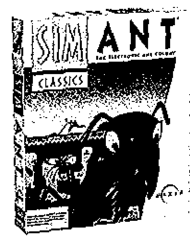
Hall of Fame, Computer Gaming World, 1991

SimEarth

The Living Planet

Forget about saving the planet—try starting a new one. Create new sea and land life forms. Move mountains. Shape oceans. Give your creatures intelligence and technology—and enjoy your global power trip.

Game Hall of Fame, Macworld, 1991

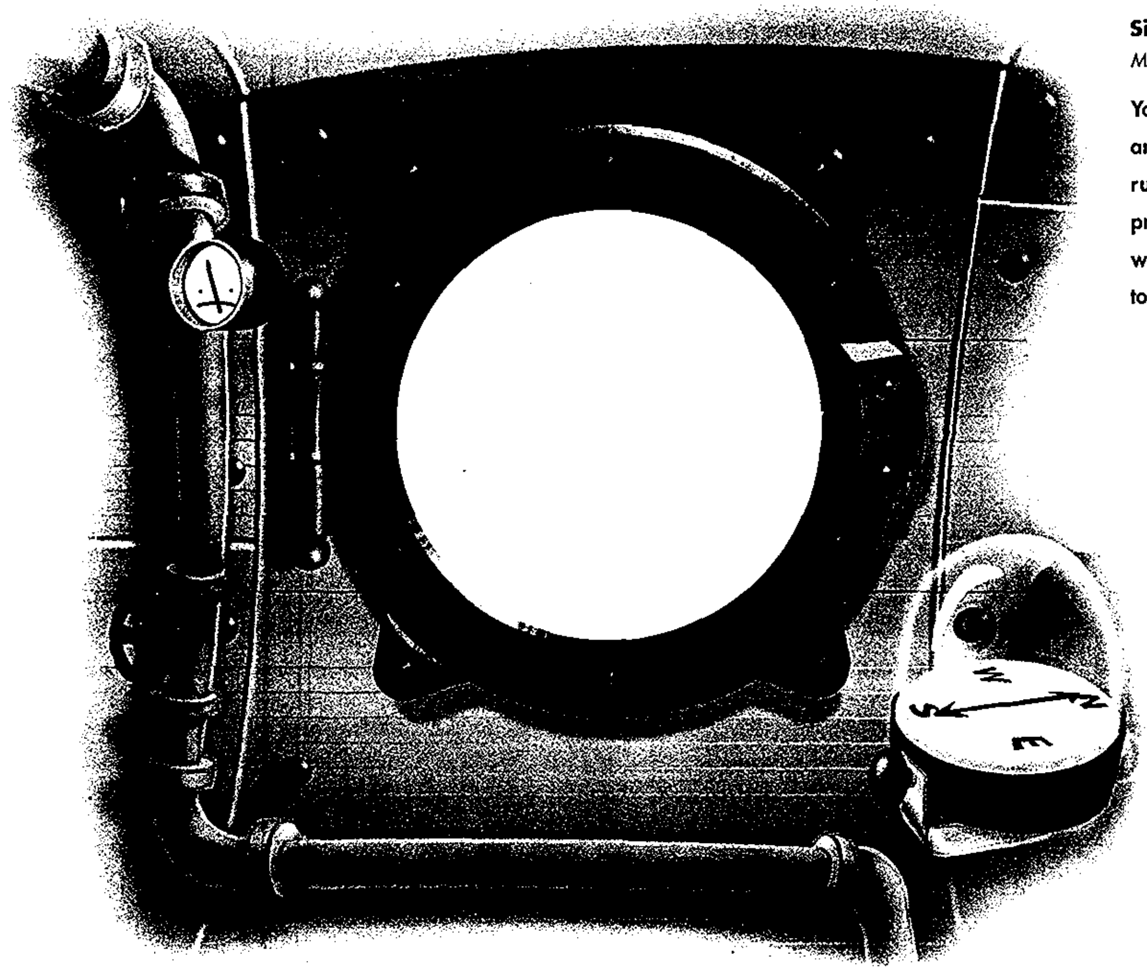


SimAnt

The Electronic Ant Colony

You're a commander of a backyard army—of black ants. Survive inter-insect attacks and lead your colony past all suburban weaponry (pesticides, lawnmowers, human feet). Then plan your ultimate military objective: home invasion.

Best Simulation, Software Publishers Association, 1991



SimIsle

Missions in the Rainforest

You don't just escape to an island paradise—you rule it. Develop it or protect it—you decide whether tourists or toucans will triumph ...

Maxis. The first click on a never-ending journey.

Something clicked in Jeff Braun's mind when he met Will Wright at a 1987 pizza party and heard about the simulation game Wright was creating. It fit well with Braun's vision of publishing computer games intriguing enough for adults to enjoy. Braun agreed to fund development and production of the game, which they called *SimCity*, and Maxis was born. But they couldn't persuade anyone to license it—no one was interested in a game you can't win or lose.

Nevertheless, *SimCity* was introduced in 1989 and generated $3 million in its first year. The response was phenomenal—game lovers had never seen anything like it. Maxis had nine employees.

The following year marked the debut of *SimEarth*, an even more intriguing concept that invited players to design a whole new planet of their own. By the end of the year, the company had sales of $5.3 million and 35 employees.

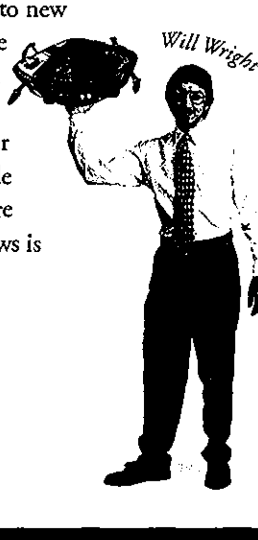
By 1991, *SimEarth* had joined *SimCity* on the best-seller list. Braun and Wright hired professional managers so that they could focus on creating games. And Maxis closed the year with sales of $10.6 million and nearly 50 employees.

In 1992, Maxis introduced *SimLife*—and E.M. Warburg, Pincus invested $10 million in the company.

And so it went. In 1993, Sam Poole, previously vice president of sales, was named president. Maxis had a product list of 10 titles and took over their distribution from Brøderbund Software, Inc. *SimFarm*, the first SimGame with an agricultural theme, gave testimony that the Sim line was truly expandable.

In fiscal 1995, the three-month sales of PC-based *SimCity 2000* outpaced the first two years of the original *SimCity*. Maxis ended the year with sales of $38.1 million and 149 employees.

Fiscal 1996 has been the most eventful in the company's history. Maxis completed an initial public offering, moved into new headquarters and onto the World Wide Web, posted sales of $55 million and finished the year with over 200 employees. And while there are challenges, we are convinced more good news is yet to come.

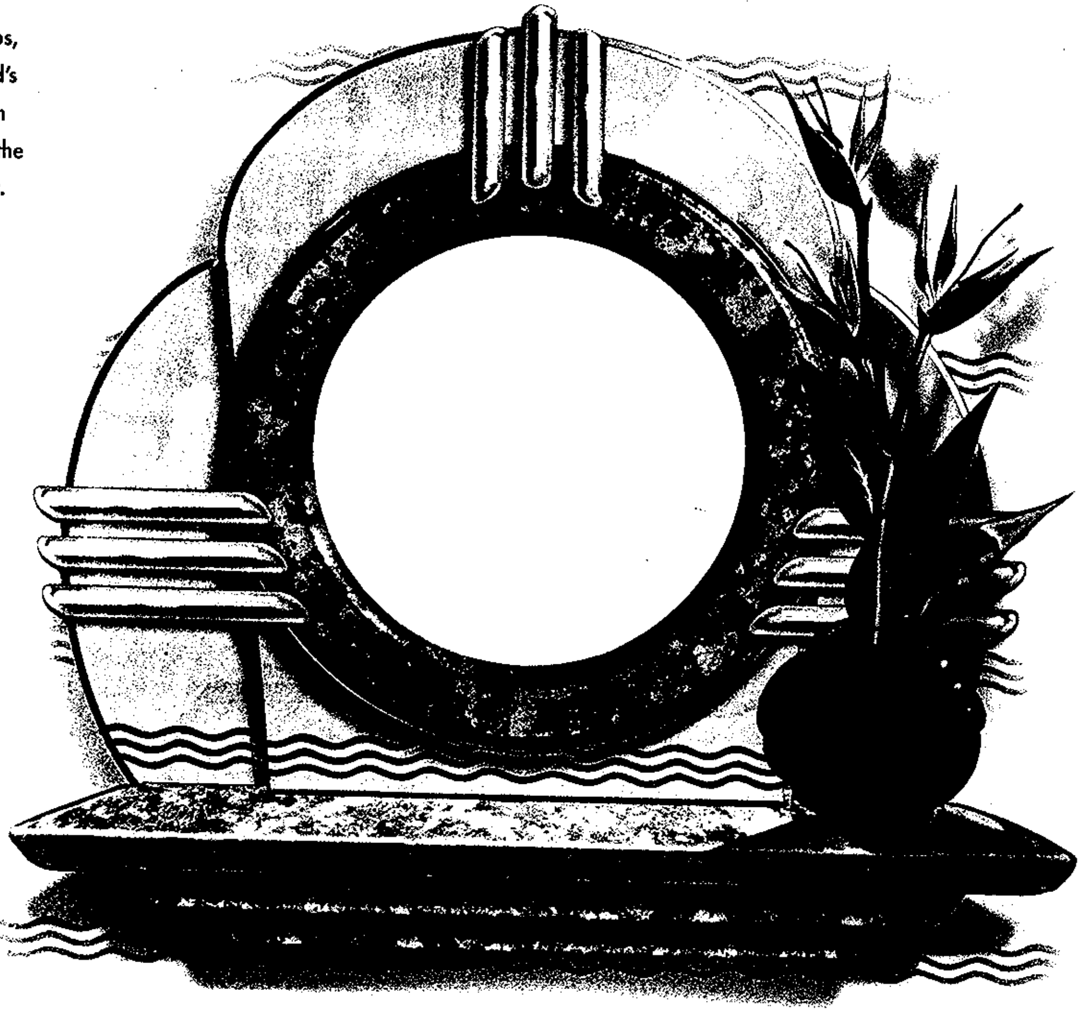

Will Wright

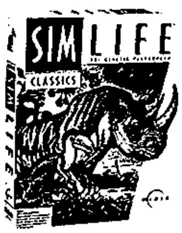
... Build a hotel, shops, restaurants, the world's largest cineplex—with room for 100 floors, the skyscraper is the limit.

SimTower

The Vertical Empire

Best Simulation, Software Publishers Association, 1995





SimLife

The Genetic Playground

Get a life—in fact, get a few thousand of them as you create your own ecosystem. You've got the power to experiment with genetics and evolution—we'll even throw in control of time and physics as a bonus.

Best Simulation, Software Publishers Association, 1993

SimFarm

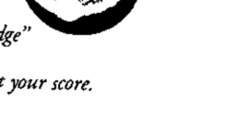
SimCity's Country Cousin

Go hog-wild! Turn your plot of land into a cash cow with 24 different crops, and fight the never-ending battle of soil depletion. Actual back-breaking labor not included.

Best Secondary Educational Program, Software Publishers Association, 1994

Full Tilt! Pinball

You're a pinball wizard—and you don't need a pocketful of quarters. Three different "tables" feature all the bumpers, targets and traps of real pinball. Accurately modeled ball physics, realistic sounds and 3-D graphics increase the arcade ambiance. You can even "nudge" your virtual table to boost your score.



FamilyPC Recommended, 1996

... In your equatorial empire you'll face developers planning hotels, ivory poachers running wild and a movie crew shooting on location. Not to mention terrorists and natural disasters, all vying for your attention—and your resources.

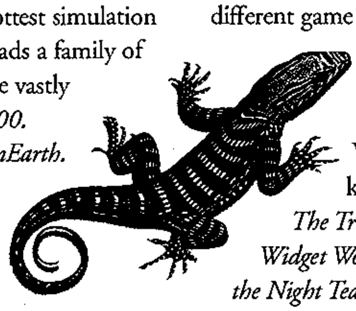
SimIsle
Missions in the Rainforest

FamilyPC Recommended, 1996

The games people play for hours. And for years.

Call it SimConcept. The concept of a game you never win or lose. A game without end. A game in which you're lord and master, planner and builder, creator and owner of your own vividly imagined world. A game that's absorbing, all-encompassing, immersive. A game in which you create a virtual world and then move right in. You're more than a SimPlayer; you're a SimCitizen.

SimCity—the hottest simulation game of all time—heads a family of 10 Sims, including the vastly expanded *SimCity 2000.* There's *SimTower. SimEarth. SimFarm. SimLife. SimAnt. SimHealth. SimIsle.* And, of course, *SimTown* for kids. The SimGames have six times in a row been named Best Simulation by the Software Publishers Association—a clear indication of their uniqueness in the marketplace.



But Maxis does not live by Sims alone. We publish other games, all with the same originality and wit that characterize the SimGames. There's *Full Tilt! Pinball,* Maxis' recent entry into the action game field, whose different game tables are so exciting that one was chosen for the Microsoft Plus! companion for Windows 95. And for kids, there's *Marty and The Trouble With Cheese, Widget Workshop* and *Zaark and the Night Team.*

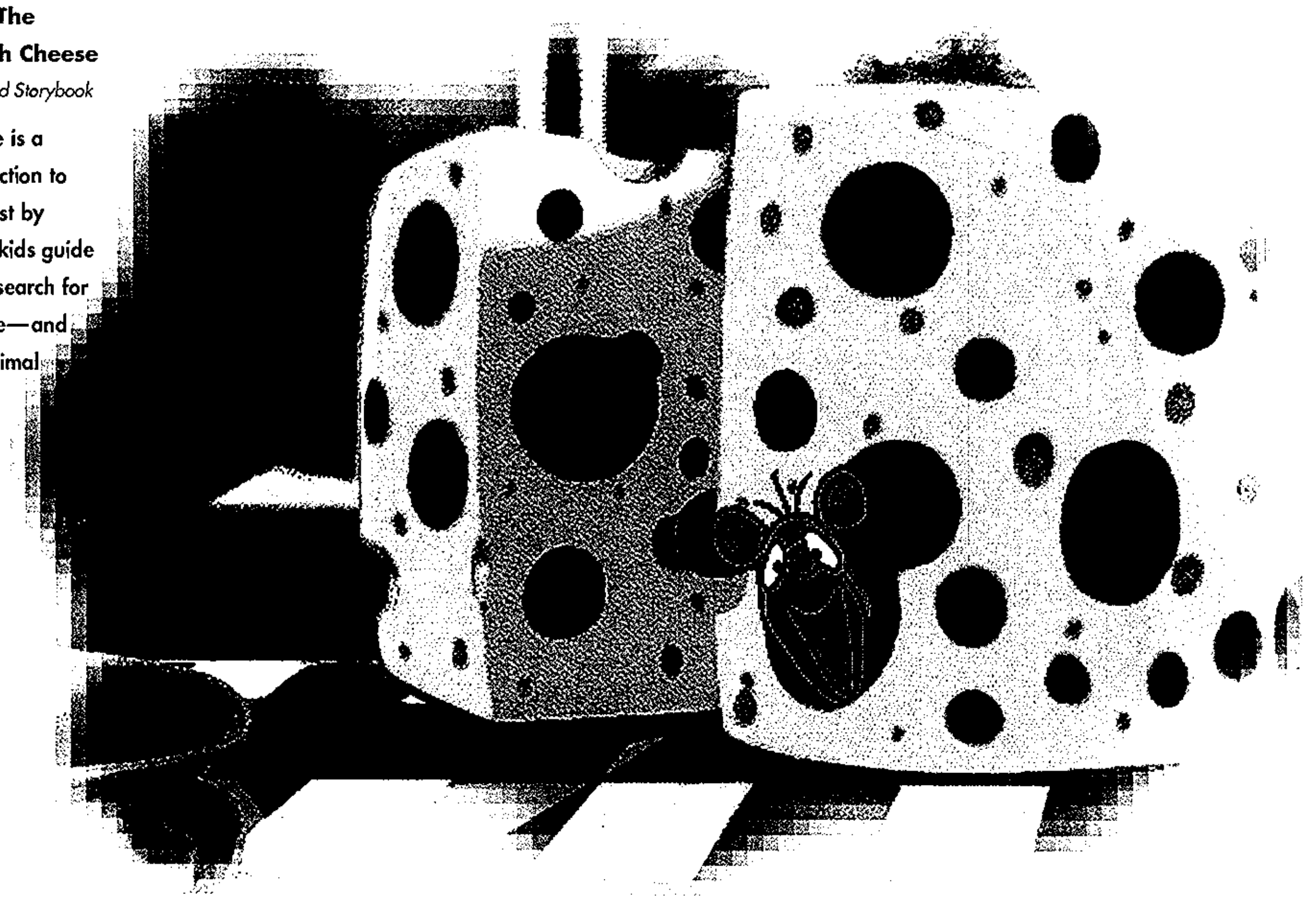
Maxis also sells and distributes software developed by our affiliate partners—emerging companies without software distribution resources of their own.

They offer such varied fare as *ScruTiny in the Great Round* by Calliope Media, *RedShift 2* by Maris Multimedia Ltd., *A Passion For Art* by Corbis Publishing and *Baseball for Windows Broadcast Blast* by Miller Associates, Inc. For kids, there's *GeoSafari Multimedia* by Educational Insights Interactive, *3001—A Reading & Math Odyssey* by GemMedia, *Wrath of the Gods* by SOME Interactive, Inc. and the Zurk series by Soleil Software, Inc.

Marty and The Trouble With Cheese

A Voice-Activated Storybook

This adventure is a sound introduction to computing. Just by speaking up, kids guide Marty on his search for the lost cheese—and meet other animal friends along the way ...

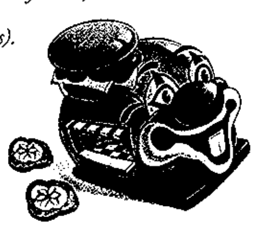


SimTown

The Town You Build Yourself

Welcome to the first game that lets kids build their own town—and build their confidence. As junior city planners, they learn about supply (pizza) and demand (hungry Sims), economics (more toy stores) and ecology (more trees).

Editor's Choice Award, Newsweek, 1995



Widget Workshop

The Mad Scientist's Laboratory

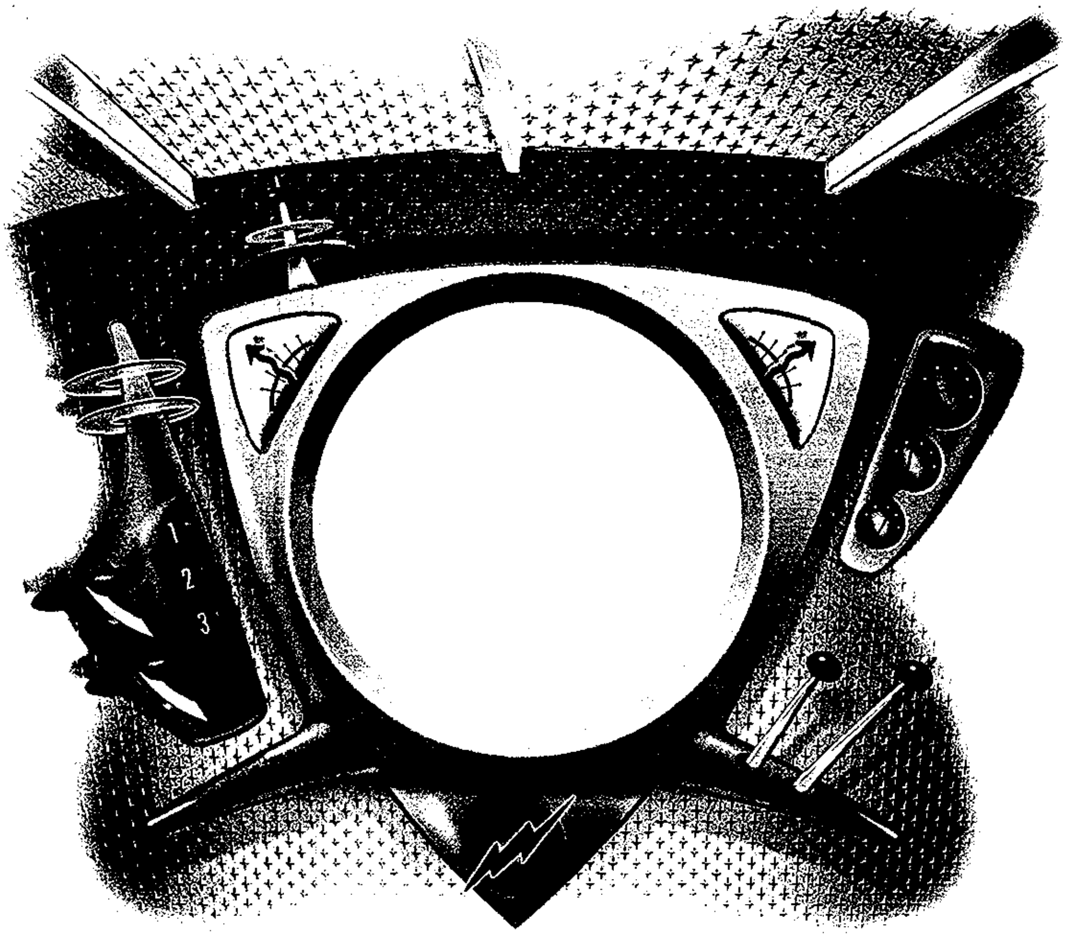
A few minutes in this inventor's attic and kids are exploring the laws of gravity, counting calories and building a better mousetrap. Widget Workshop teaches kids the principles of science in a unique, open-ended setting.

Golden Apple Award, National Educational Media Network, 1996

Zaark and the Night Team

Two amazing adventures in one package. In The Quest for Patterns, *kids find shapes and patterns everywhere—on a tropical beach, in a jazz melody, in an art masterpiece. In* The Search for Symbols, *they decode symbols in math, language arts and social science, then help a king create a new flag.*

Editor's Choice, PC World, 1995



Visit the Maxis Web site and play a Marty demo, take a look at upcoming releases, download a SimIsle video or pick up tips on your favorite games ...

The latest technology on the hottest platforms.

The popular success of Maxis games lies with the company's ability to make artificial life and simulation technologies accessible and entertaining, with stunningly realistic graphics and intuitive interfaces that make the games as easy to play as they are engrossing. CD-ROM storage technology allows us to package games of unprecedented complexity on a single disk. And new 3-D modeling techniques are bringing our games ever closer to virtual reality.

Our pulse-racing new action game, *Full Tilt! Pinball*—like the SimGames—is available on an ever-expanding range of platforms. Windows 95 plug-and-play versions make Maxis games easier to enjoy than ever. With the growing popularity of console platforms, *SimCity 2000* for the Sega Saturn and *A-Train* for the Sony PlayStation were released this year. Most exciting, we're moving toward offering multiplayer versions of some of our most popular games on the Internet.

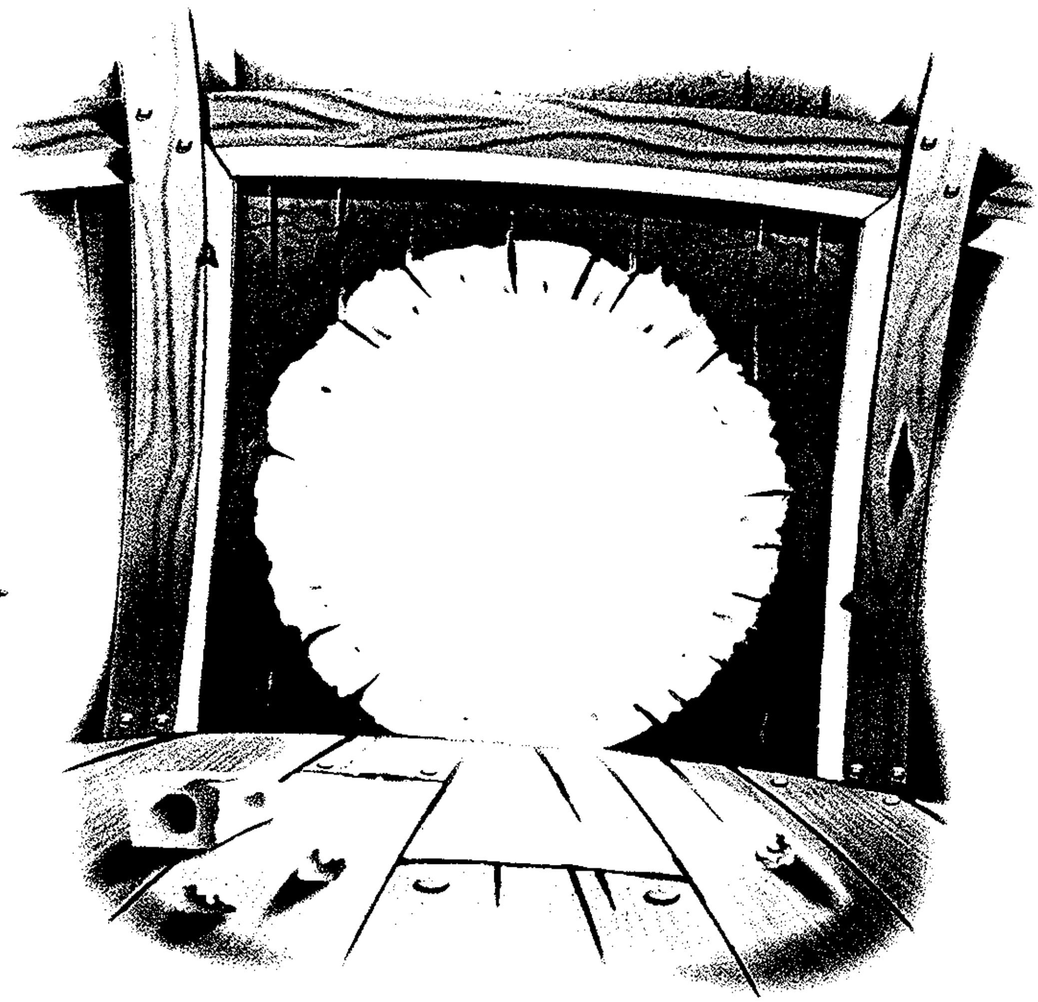
In our first move onto the information superhighway, we launched the Maxis Web site (http://www.maxis.com) in December. This user-friendly site, where viewers can download videos, enter contests, order merchandise or pick up tips and hints about their favorite Maxis games, has already garnered several awards. We see our Web site as an initial step into a future of interactive multimedia games, allowing many players to simultaneously build the Sim of their imagination.

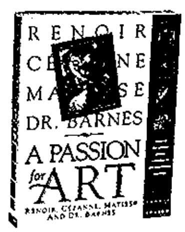
... Marty is the newest character in Maxis' kids entertainment/learning software line—a category that includes extraordinary educational experiences from affiliate partners as well.

Marty and The Trouble With Cheese

A Voice-Activated Storybook

Top 100 Software Award, Home PC, 1996





A Passion For Art

by Corbis Publishing

This exciting multimedia CD-ROM explores the long-hidden Barnes collection of impressionist and post-impressionist paintings. It features a virtual gallery with breathtaking details of some of the world's greatest masterpieces, intriguing guided tours and more.

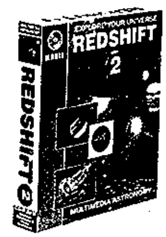
Excellence in Software, Software Publishers Association, 1996

GeoSafari Multimedia

by Educational Insights Interactive

Over 40 dazzling games bring geography, history and science to life in an adventure the whole family can share. Up to four players can enjoy multiple modes of play, earn medals and trophies, learn thousands of facts and smile as Richie Havens calls players by name.

Best of the Best, Ladies Home Journal, 1995

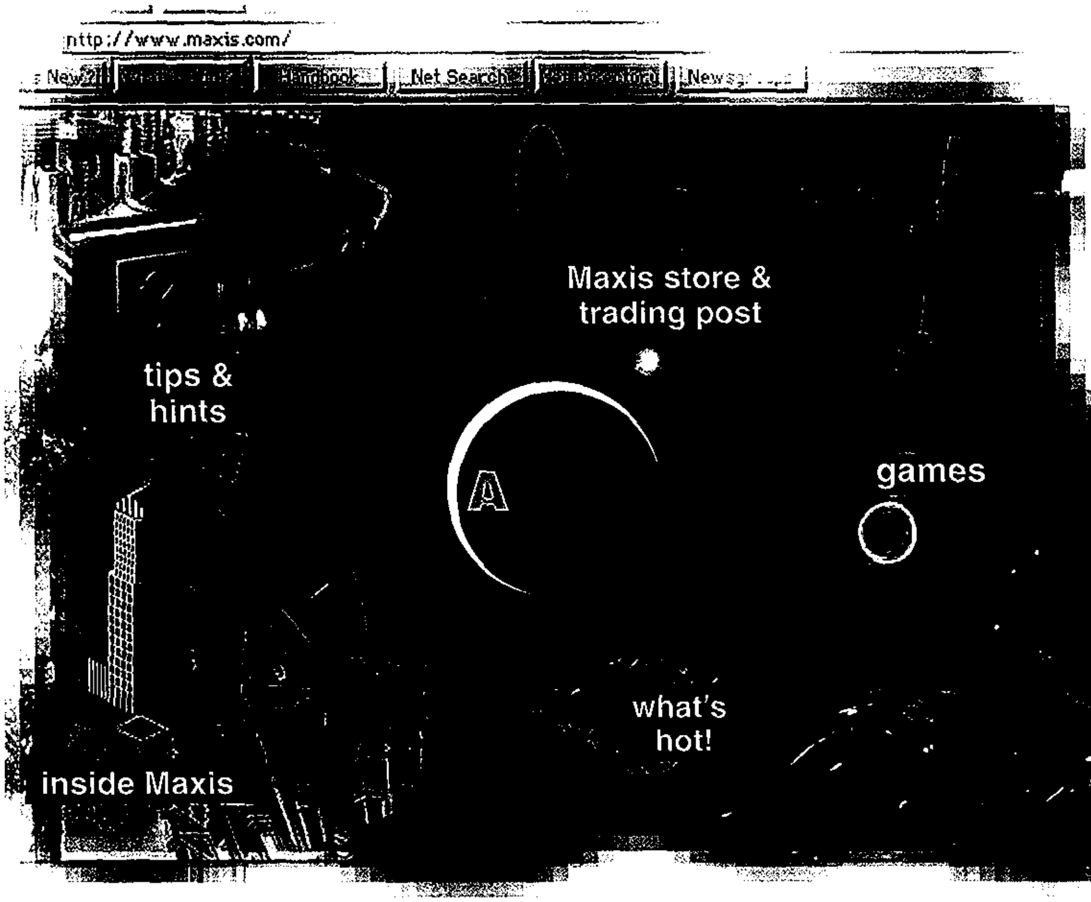


RedShift 2

by Maris Multimedia Ltd.

RedShift 2 puts the Solar System on your desktop—and takes you on a cosmic journey. Narrated 3-D animated tours, virtual reality simulations, interactive tutorials and video make astronomy accessible to the beginner, while delivering the highest level of accuracy and depth for the enthusiast.

Parents' Choice Award, 1996



Web Site Awards

NetGuide
✪✪✪✪

Magellan
✪✪✪✪

Yahoo!
Cool Site

USA Today
Hotsite

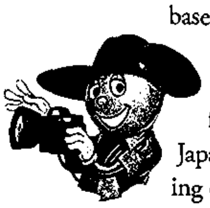
Microsoft Network
Pick of the Week

Point Communications
Top 5% of All Web Sites

A clear view of tomorrow ... and beyond.

As Maxis expands onto new platforms, we're also moving into new markets and distribution channels that should provide robust revenue streams for the company.

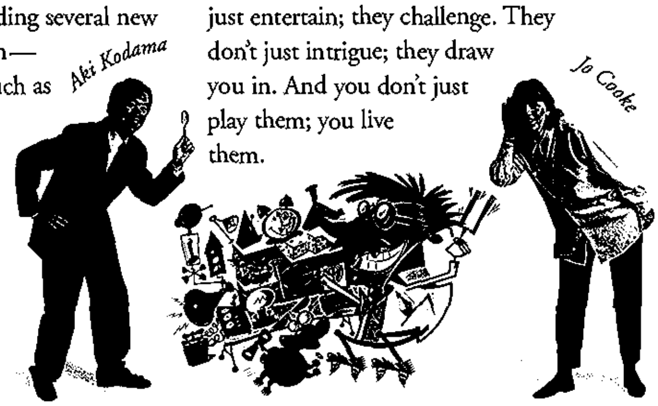
International sales are playing an increasingly significant role in our profit picture. Our London office, which opened three years ago under the direction of Jo Cooke as European general manager, has greatly increased our penetration of the European market. We are expanding into the Asian market by opening a Tokyo-based sales and marketing office, and we're pleased to report that Aki Kodama, formerly president of 3DO Japan, has joined us as managing director. Mr. Kodama worked with Sim products for years as managing director of Imagineer, our Japanese distributor.

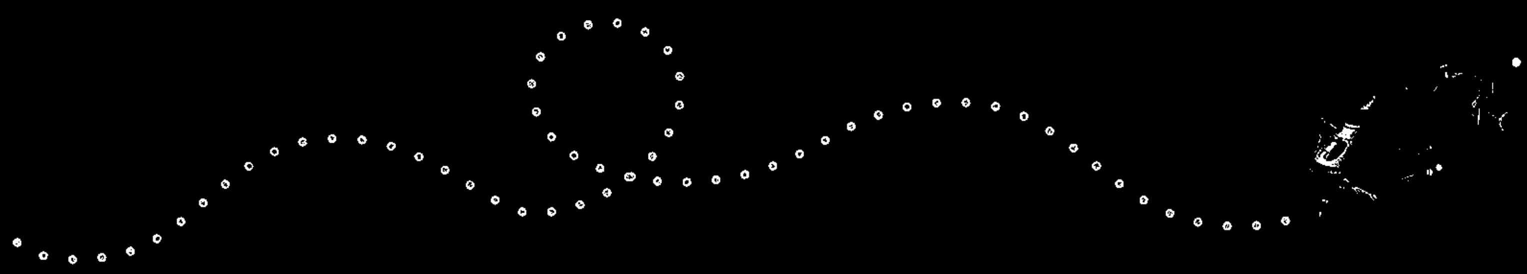


For three years now, Maxis has been distributing our products in North America, providing us with better control and significantly higher margins. As our overseas operations expand, we intend to move beyond our current affiliate arrangements and take over direct distribution internationally. We've successfully implemented this model in Europe and we intend to replicate it in other major world markets.

We've expanded our sales force and are currently building several new avenues of distribution—alternative channels such as bookstores, supermarkets, video stores and mass merchandisers. And as part of Maxis' overall strategy of making our products available to a wide range of consumers, we released the new *Collector's Series*—a value-priced line featuring eight of our most popular titles for under $15 each.

Maxis' corporate vision is the same one that inspired our founders over their first pizza—to develop software games that introduce not only a new way of playing but a new way of thinking, a new way of seeing. Maxis games are—in the best sense of the word—educational. They don't just entertain; they challenge. They don't just intrigue; they draw you in. And you don't just play them; you live them.





Just the beginning.

1996 Financials

Selected Financial Data

	Fiscal Years Ended March 31,				
	1996	**1995**	**1994**	**1993**	**1992**
Income Statement Data:	(in thousands, except per share amounts)				
Net revenues	$55,412	$38,147	$23,332	$13,864	$10,582
Cost of revenues	17,897	14,186	8,367	5,323	4,338
Gross profit	37,515	23,961	14,965	8,541	6,244
Operating expenses:					
Research and development	8,416	6,008	3,299	2,440	1,991
Acquisition-related charge	2,232	—	—	—	—
Sales and marketing	12,843	8,813	5,407	2,591	1,395
General and administrative	5,504	4,184	3,225	2,669	2,088
Total operating expenses	28,995	19,005	11,931	7,700	5,474
Income from operations	8,520	4,956	3,034	841	770
Interest income	1,493	226	114	197	66
Income from continuing operations before income taxes	10,013	5,182	3,148	1,038	836
Provision for income taxes	3,825	1,879	1,021	368	89
Income from continuing operations	6,188	3,303	2,127	670	747
Discontinued operations:					
Loss from discontinued operations (net of income tax benefit of $251 in fiscal 1994 and $203 in fiscal 1993)	—	—	(376)	(600)	—
Gain on disposal of discontinued operations (net of income tax expense of $173 in fiscal 1995)	—	303	—	—	—
Net income	**$ 6,188**	**$ 3,606**	**$ 1,751**	**$ 70**	**$ 747**
Per share amounts:					
Income from continuing operations	**$ .56**	**$ .37**	**$ .25**	**$ .08**	**$ .12**
Net income per share	**$ .56**	**$ .40**	**$ .20**	**$ .01**	**$ .12**
Shares used in per share calculations	**11,051**	**8,915**	**8,621**	**8,061**	**6,171**

	March 31,				
	1996	**1995**	**1994**	**1993**	**1992**
Balance Sheet Data:					
Cash, cash equivalents and short-term marketable securities	$42,890	$ 8,655	$ 4,932	$ 6,932	$ 1,538
Working capital	45,265	11,457	8,208	6,913	200
Total assets	67,300	19,142	14,427	10,168	3,718
Redeemable preferred stock	—	11,363	10,849	10,335	—
Stockholders' equity (deficit)	57,234	2,388	(1,239)	(2,480)	1,019

Management's Discussion and Analysis of Financial Condition and Results of Operations

RESULTS OF OPERATIONS

Net revenues (in thousands)

1996	Increase	1995	Increase	1994
$55,412	45.3%	$38,147	63.5%	$23,332

Net revenues include revenues from sales of software products less allowances for returns and promotional discounts, licensing revenues and, provided the Company has completed all significant performance obligations under the terms of the license agreement and any amounts paid are nonrefundable, royalty advances. Licensing revenues are derived from international licensing arrangements, OEM arrangements and licenses to third parties to develop the Company's products for use on particular hardware platforms.

The increase in net revenues from fiscal 1995 to fiscal 1996 was due primarily to continued demand for the Company's products, especially the Sim family of products. Maxis' top three selling products for fiscal 1996 were *SimCity 2000, SimTower* and *SimIsle. SimCity 2000,* initially released in October 1993, continued to be the Company's best-selling product. *SimCity, SimCity 2000* and related add-on products accounted for 52% of fiscal 1996 net revenues. During fiscal 1995, the same family of products accounted for 59% of net revenues. *SimTown* was the Company's best-selling product in its learning line, a segment that grew to 18% of net revenues in fiscal 1996 from 11% in fiscal 1995.

During fiscal 1996, the Company's product releases included *SimCity 2000 Special Edition, SimIsle, SimTower* for Windows, *SimTown* for Windows and *Full Tilt! Pinball,* as well as several affiliate partner products. The Company also introduced its first products for 32-bit game consoles: *A-Train* for the Sony PlayStation and *SimCity 2000* for the Sega Saturn.

International expansion also contributed to overall revenue growth with international sales, including foreign licensing, increasing from 15% of net revenues in fiscal 1995 to 20% of net revenues in fiscal 1996. Major territories contributing to the Company's international growth were Japan and Europe. International revenues increased from 10% in fiscal 1994 to 15% in fiscal 1995 due primarily to a change from a licensing to a distribution arrangement in the Company's principal European markets. A portion of the Company's international sales are denominated in foreign currencies and, accordingly, the Company is subject to foreign currency exchange risk. During fiscal 1997, the Company expects that international sales will increase in absolute dollars and could increase as a percentage of net revenues.

The increase in net revenues from fiscal 1994 to fiscal 1995 was primarily due to a number of new product introductions. Major product introductions during fiscal 1995 included *SimCity 2000* for Windows, *Widget Workshop, SimTower, SimTown* for Macintosh and *Klik & Play* for Windows. The Company also continued to benefit from strong sales of products released during the latter half of fiscal 1994. Sales of *SimCity 2000* for Macintosh and DOS, released in October 1993 and December 1993, respectively, and *Print Artist* (a product the Company no longer distributes) for DOS and Windows, released in March 1994, contributed significantly to the Company's fiscal 1995 revenues.

Affiliate partner sales were 10%, 11% and 5% of net revenues in fiscal 1996, 1995 and 1994, respectively. The Company's top-selling affiliate partner products for fiscal 1996 were *RedShift 2* by Maris Multimedia Ltd., *GeoSafari Multimedia* by Educational Insights Interactive and *A Passion For Art* by Corbis Publishing.

Sales of products on CD-ROM represented 75% of net revenues compared to 30% in fiscal 1995 and 2% in fiscal 1994. The Company plans to offer all new products on CD-ROM while also continuing to offer some of its products on floppy disk.

Cost of revenues (in thousands)

	1996	Increase	1995	Increase	1994
Cost of revenues	$17,897	26.2%	$14,186	69.5%	$8,367
Gross profit	67.7%		62.8%		64.1%

The Company's cost of revenues includes all costs of media, manuals, duplication, packaging materials, assembly and freight. In addition, royalties are included in cost of revenues. The Company's gross profit is affected by the mix of sales among products that are developed or licensed by Maxis and affiliate partner products that are developed by third parties and distributed by the Company. Gross profit and operating expenses are significantly lower for affiliate partner products because the Company's services are generally limited to sales, distribution and related functions.

The increase in gross profit percentage from fiscal 1995 to fiscal 1996 was primarily due to a greater mix of products with lower royalty rates. The decrease in gross profit percentage for fiscal 1995 as compared to fiscal 1994 was primarily due to a higher level of affiliate partner product sales, on which the Company receives a significantly lower gross profit. Affiliate partner products represented 11% of net revenues in fiscal 1995 as compared to 5% in fiscal 1994.

The Company's gross profit percentage has fluctuated significantly on a quarterly basis. During fiscal 1996, the gross profit percentage ranged from 64.2% in the third fiscal quarter to 72.5% in the second fiscal quarter. Quarterly gross profit is affected by the mix of sales among products that are developed or licensed by Maxis and affiliate partner products that are developed by third parties and distributed by the Company. During fiscal 1997 the Company expects gross profit to continue to fluctuate on a quarterly basis and further expects significantly lower gross profit in the first and second fiscal quarters relative to the third and fourth fiscal quarters due primarily to the expected timing of certain Maxis-published product releases.

Operating expenses (in thousands)

	1996	Increase	1995	Increase	1994
Research and development	$ 8,416	40.1%	$6,008	82.1%	$3,299
Percentage of net revenues	15.2%		15.7%		14.1%
Acquisition-related charge	$ 2,232	100%	—	0%	—
Percentage of net revenues	4.0%		—		—
Sales and marketing	$12,843	45.7%	$8,813	63.0%	$5,407
Percentage of net revenues	23.2%		23.1%		23.2%
General and administrative	$ 5,504	31.5%	$4,184	29.7%	$3,225
Percentage of net revenues	9.9%		11.0%		13.8%

Research and development

Research and development expenses consist primarily of personnel and equipment costs required to conduct the Company's development efforts and to fund third-party software development costs. Third-party software development costs may include advance product development payments, which are expensed as paid. The Company believes that significant investments in research and development are required to remain competitive and has therefore greatly increased the absolute amount of spending for research and development. These expenses as a percentage of net revenues for fiscal 1996 as compared to fiscal 1995 remained relatively unchanged. The increase in research and development expenses in fiscal 1995 over fiscal 1994 was primarily due to expenses incurred for the development of new products and additional personnel and related costs. During fiscal 1997, the Company intends to continue its investment in research and development and therefore expects these expenses to increase in absolute dollars and could increase as a percentage of net revenues.

Research and development expenditures are charged to operations as incurred. Statement of Financial Accounting Standards No. 86, "Accounting for the Costs of Computer Software to be Sold, Leased or Otherwise Marketed," requires capitalization of certain software development costs subsequent to the establishment of technological feasibility. Based on the Company's product development process, technological feasibility is established upon completion of a working model. Costs incurred by the Company between completion of the working model and the point at which the product is ready for general release have been insignificant.

Acquisition of Cinematronics LLC

In March 1996 the Company acquired for cash Cinematronics LLC, an independent developer of entertainment software based in Austin, Texas. The business combination was recorded as a purchase for accounting purposes. In connection therewith, the Company recorded a nonrecurring acquisition-related charge of approximately $2.2 million for acquired in-process technology. The acquisition of Cinematronics represents an element of the Company's strategy to further expand into the action category of the entertainment market. Over the next 24 months, the Company expects the delivery of new products from this group and has provided financial incentives to encourage the timely delivery of the specified products.

Sales and marketing

Sales and marketing expenses, which include customer support services, have increased significantly primarily due to the growth of the Company's sales and marketing organizations in connection with the expansion of the Company's product lines, diversification of the Company's distribution channels and introduction of new merchandising and promotional programs. Additionally, in October 1993, the Company opened an office in the United Kingdom to provide marketing and sales support for the Company's European operations. On a year-to-year basis, sales and marketing expenses as a percentage of revenues remained relatively unchanged. The Company intends to continue to increase its investment in sales and marketing and expects these expenses to increase in absolute dollars and as a percentage of net revenues in fiscal 1997.

General and administrative

General and administrative expenses have increased in absolute dollars each year primarily due to increased staffing and related costs necessary to support the Company's growth. General and administrative expenses as a percentage of net revenues have declined over these same periods primarily due to the Company's revenue growth. The Company expects the level of general and administrative expenses to increase in absolute dollars in fiscal 1997.

Interest income (in thousands)

	1996	Increase	1995	Increase	1994
Interest income	$1,493	560.6%	$226	98.2%	$114
Percentage of net revenues	2.7%		0.6%		0.5%

Interest income increased in absolute dollars and as a percentage of net revenues due to higher average invested cash balances. The significant increase in interest income from fiscal 1995 to fiscal 1996 was due to cash received in the Company's May 1995 initial public offering.

Provision for income taxes (in thousands)

	1996	Increase	1995	Increase	1994
Provision for income taxes	$3,825	103.6%	$1,879	84.0%	$1,021
Effective income tax rate	38%		36%		31%

The year-to-year increases in the provision for income taxes and the effective income tax rate reflect the Company's income growth and adjustments to the valuation allowance for deferred tax assets. The effective annual income tax rate is primarily a function of the level of pretax income in relation to tax-exempt interest income. See Note 6 to Consolidated Financial Statements.

Discontinued operations

During fiscal 1994, the Company discontinued certain unprofitable operations related to the development of software for commercial purposes that had been initiated in fiscal 1993. In connection with the discontinuance of these activities, the Company incurred net losses of $600,000 and $376,000 for fiscal 1993 and fiscal 1994, respectively, and a net gain on disposal of the related assets of $303,000 in fiscal 1995. See Note 10 to Consolidated Financial Statements.

Recently issued accounting standard

In October 1995 the Financial Accounting Standards Board issued Statement No. 123 (SFAS No. 123), "Accounting for Stock-Based Compensation," which is effective for years beginning after December 15, 1995. SFAS No. 123 permits a company to choose either a new fair value-based method or the current Accounting Principles Board Opinion No. 25 intrinsic value-based method of accounting for its stock-based compensation arrangements. The Company has elected to continue to follow current practice, but SFAS No. 123 requires pro forma disclosures of net income and earnings per share computed as if the fair value-based method had been applied.

Liquidity and capital resources

On June 1, 1995, the Company consummated an initial public offering of 3,450,000 shares of common stock, of which 2,450,000 were sold by the Company. The Company raised approximately $35,500,000 net of expenses. As of March 31, 1996, the Company's principal sources of liquidity included cash and short-term investments of $42.9 million and an available unsecured bank line of credit in the amount of $1.0 million, which the Company has not used to date. The line of credit expires on August 30, 1996. The Company also has longer-term investments totaling approximately $6.1 million. The Company's cash, short-term investments and unused bank line of credit are available to meet seasonal working capital requirements. Seasonally higher revenues during the year-end holiday buying season generally result in increased accounts receivable and working capital during the fourth calendar quarter.

The Company uses its working capital to finance ongoing operations, fund the development and introduction of new products and acquire capital equipment. The Company's operating activities provided cash of $8.1 million and $5.2 million in fiscal 1996 and 1995, respectively, and used cash of $1.6 million in fiscal 1994.

In June 1995, the Company entered into a seven-year lease, commencing in September 1995, for new office space to house its corporate headquarters. The lease agreement provides for monthly payments beginning at $75,000 and escalating to $86,600 during the term of the lease. The Company may shorten the term of the lease to five years and six months in exchange for a one-time payment equal to three months' rent. During fiscal 1997, the Company expects to incur approximately $2.6 million in capital expenditures.

From time to time, the Company evaluates acquisitions of businesses, products or technologies that complement the business of Maxis, such as the acquisition of Cinematronics LLC. The Company has no present understandings, commitments or agreements with respect to any material acquisitions of other businesses, products or technologies. Any such transactions, if consummated, may use a portion of the Company's working capital or require the issuance of equity.

The Company believes that existing working capital and cash from operations will satisfy its liquidity and capital requirements for at least the next year.

Risk factors affecting future earnings and stock price

Preceding sections of this Report, particularly statements regarding the Company's potential for future success, the potential of the Company's World Wide Web site or World Wide Web-oriented products, the revenue potential of new markets and distribution channels, changes in international distribution operations, revenues from international operations, offering products on new media, such as CD-ROMs, seasonal trends and profitability on a quarterly basis, research and development expenses, the Company's potential expansion of its action category of products, sales and marketing expenses, general and administrative expenses and the Company's ability to satisfy its liquidity and capital requirements for the next year, contain forward-looking statements within the meaning of Section 27A of the Securities Act of 1933 and Section 21E of the Securities Exchange Act of 1934. Actual results could differ materially from those projected in the forward-looking statements as a result of the risk factors set forth below and elsewhere in this report.

The Company has experienced, and expects to continue to experience, significant fluctuations in operating results due to a variety of factors, including the size and rate of growth of the consumer software market, market acceptance of the Company's products and those of its competitors, development and promotional expenses relating to the introduction of new products or new versions of existing products, projected and actual changes in computing platforms, the timing and success of product introductions, product returns, changes in pricing policies by the Company and its competitors, the accuracy of retailers' forecasts of consumer demand, the timing of orders from major customers and order cancellations.

The Company's operating results may also fluctuate significantly due to changes in product plans or delays in shipment. For example, in April 1996, the Company decided to reevaluate *The Mindwarp,* an action game it had planned to ship during fiscal 1997. The Company is assessing the product's design and game play. There can be no assurance that *The Mindwarp* will be released during fiscal 1997 or that the product will ever be commercially released. Furthermore, even if *The Mindwarp* is released, there can be no assurance that it will contribute revenues to the Company sufficient to recoup the development and marketing costs incurred. Such risks apply to all of the Company's products under development.

The consumer software business is highly seasonal. Net revenues are typically significantly higher during the third fiscal quarter, due primarily to the increased demand for consumer software during the calendar year-end holiday buying season. Net revenues in other quarters are generally lower and vary significantly as a result of new product introductions and other factors. The Company expects its net revenues and operating results to continue to reflect significant seasonality and further expects the first quarter, and possibly the second quarter, of fiscal 1997 to result in losses due to the delay or possible cancellation of *The Mindwarp,* seasonality and increased operating expenses. There can be no assurance that the Company will achieve consistent profitability on a quarterly or annual basis.

In response to competitive pressures, the Company may take certain pricing or marketing actions that could materially adversely affect the Company's business, operating results and financial condition. The Company may be required to pay fees in advance or to guarantee royalties, which may be substantial, to obtain licenses to intellectual properties from third parties before products incorporating such properties have been introduced or achieved market acceptance.

Products are generally shipped as orders are received, and accordingly the Company operates with little backlog. The Company's expense levels are based, in part, on its expectations regarding future sales and, as a result, operating results would be disproportionately adversely affected by a decrease in sales or a failure to meet the Company's sales expectations. Defective products may result in higher customer support costs and product returns.

The Company's gross profit is affected by the mix of sales among products that are developed or licensed by Maxis and affiliate partner products that are developed by third parties and distributed by the Company. Gross profit and operating expenses are significantly lower on affiliate partner products because the Company's services are generally limited to sales, distribution and related functions. Effective April 1, 1996, the Company changed the offered terms of its affiliate partner program granting, among other things, a greater share of receipts on affiliate sales to affiliate partners. There can be no assurance that the Company's current share of receipts on affiliate sales for distribution services or the current mix of affiliate partner sales will be sustained.

The market price of the Company's common stock could be subject to significant fluctuations in response to variations in quarterly operating results and other factors, such as announcements of new products by the Company or its competitors and changes in financial estimates by securities analysts or other events. The stock market and many technology companies have recently been trading at or near historic highs and reflect price/earning ratios above historic norms. Moreover, the stock market has experienced extreme volatility that has particularly affected the market prices of equity securities of many high technology companies and that has often been disproportionate to the operating performance of such companies. Broad market fluctuations, as well as economic conditions generally and in the software industry specifically, may adversely affect the market price of the Company's common stock. There can be no assurance that the Company's stock price will remain at or near its current level.

Consolidated Balance Sheets

(In thousands, except per share amounts)

	March 31,	
Assets	**1996**	**1995**
Current assets:		
Cash and cash equivalents	$20,102	$ 2,610
Marketable securities	22,788	6,045
Accounts receivable, less allowances for returns and doubtful accounts of $5,607 in 1996 and $2,911 in 1995	6,991	3,773
Inventories	1,543	1,691
Income taxes refundable	227	—
Deferred income taxes	2,808	2,366
Other current assets	872	363
Total current assets	55,331	16,848
Furniture and equipment, net	3,243	1,771
Deferred income taxes	2,023	515
Long-term marketable securities	6,119	—
Other assets	584	8
Total assets	**$67,300**	**$19,142**

Liabilities and stockholders' equity		
Current liabilities:		
Accounts payable	$ 1,607	$ 1,418
Payable to affiliate partners	631	186
Royalties payable	1,373	1,211
Accrued compensation	1,685	1,171
Accrued advertising	1,538	699
Income taxes payable	—	127
Other accrued liabilities	2,585	579
Accrued rent	647	—
Total current liabilities	10,066	5,391
Commitments		
Redeemable preferred stock, $.0001 par value; authorized shares, 5,000,000; issued and outstanding shares, none in 1996 and 2,000,000 in 1995	—	11,363
Stockholders' equity:		
Common stock, $.0001 par value; authorized shares, 40,000,000; issued and outstanding, 10,989,906 in 1996 and 6,309,651 in 1995	50,514	2,266
Notes receivable from stockholders	(269)	(415)
Retained earnings	7,128	1,027
Deferred compensation	(139)	(490)
Total stockholders' equity	57,234	2,388
Total liabilities and stockholders' equity	**$67,300**	**$19,142**

See accompanying notes.

Consolidated Statements of Income

(In thousands, except per share amounts)

	Fiscal Years Ended March 31,		
	1996	**1995**	**1994**
Net revenues	$55,412	$38,147	$23,332
Cost of revenues	17,897	14,186	8,367
Gross profit	37,515	23,961	14,965
Operating expenses:			
Research and development	8,416	6,008	3,299
Acquisition-related charge	2,232	—	—
Sales and marketing	12,843	8,813	5,407
General and administrative	5,504	4,184	3,225
Total operating expenses	28,995	19,005	11,931
Income from operations	8,520	4,956	3,034
Interest income	1,493	226	114
Income from continuing operations before income taxes	10,013	5,182	3,148
Provision for income taxes	3,825	1,879	1,021
Income from continuing operations	6,188	3,303	2,127
Discontinued operations:			
Loss from discontinued operations (net of income tax benefit of $251 in fiscal 1994)	—	—	(376)
Gain on disposal of discontinued operations (net of income tax expense of $173 in fiscal 1995)	—	303	—
Net income	**$ 6,188**	**$ 3,606**	**$ 1,751**
Per share amounts:			
Income from continuing operations	**$ .56**	**$ .37**	**$ .25**
Net income per share	**$ .56**	**$ .40**	**$ .20**
Shares used in per share calculations	**11,051**	**8,915**	**8,621**

See accompanying notes.

Consolidated Statements of Stockholders' Equity (Deficit)

Fiscal Years Ended March 31, 1994, 1995 and 1996 (in thousands)

	Common stock Shares	Common stock Amount	Notes receivable from stockholders	Retained earnings (deficit)	Deferred compensation	Total stockholders' equity (deficit)
Balances at March 31, 1993	5,400	$ 822	$ —	$(3,302)	$ —	$(2,480)
Common stock options exercised	14	4	—	—	—	4
Issuance of common stock for notes receivable	392	118	(118)	—	—	—
Net income	—	—	—	1,751	—	1,751
Accretion of preferred stock	—	—	—	(514)	—	(514)
Balances at March 31, 1994	5,806	944	(118)	(2,065)	—	(1,239)
Common stock options exercised	115	89	—	—	—	89
Issuance of common stock for notes receivable	410	303	(303)	—	—	—
Repurchase of common stock	(21)	(10)	6	—	—	(4)
Deferred compensation resulting from grant of options	—	940	—	—	(940)	—
Amortization of deferred compensation	—	—	—	—	450	450
Net income	—	—	—	3,606	—	3,606
Accretion of preferred stock	—	—	—	(514)	—	(514)
Balances at March 31, 1995	6,310	2,266	(415)	1,027	(490)	2,388
Accretion of preferred stock	—	—	—	(87)	—	(87)
Conversion of preferred stock into common stock	2,094	11,449	—	—	—	11,449
Issuance of common stock in initial public offering, net of issuance costs	2,450	35,508	—	—	—	35,508
Common stock issued under stock option and stock purchase plans	153	406	—	—	—	406
Tax benefits resulting from employee stock transactions	—	897	—	—	—	897
Repurchases of common stock	(17)	(12)	—	—	—	(12)
Repayment of notes receivable	—	—	146		—	146
Net income	—	—	—	6,188	—	6,188
Amortization of deferred compensation	—	—	—	—	351	351
Balances at March 31, 1996	**10,990**	**$50,514**	**$ (269)**	**$ 7,128**	**$ (139)**	**$57,234**

See accompanying notes.

Consolidated Statements of Cash Flows

(in thousands)

	Fiscal Years Ended March 31,		
	1996	1995	1994
Operating activities			
Net income	$ 6,188	$ 3,606	$ 1,751
Adjustments to reconcile net income to net cash provided by (used in) operating activities:			
Provision for returns and doubtful accounts	2,696	930	1,263
Depreciation	991	572	388
Acquisition-related charge	2,232	—	—
Deferred income taxes	(1,950)	(1,765)	(1,116)
Gain on disposal of discontinued operations	—	(303)	—
Amortization of deferred compensation	351	450	—
Changes in operating assets and liabilities:			
Accounts receivable	(5,914)	1,558	(6,103)
Inventories	148	(582)	(460)
Income taxes refundable/payable	(354)	(908)	1,224
Other current assets	(509)	(275)	138
Other assets	(576)	244	1
Accounts payable	189	905	(215)
Payable to affiliate partners	445	(311)	497
Royalties payable	162	92	387
Accrued compensation	514	551	287
Accrued advertising	839	327	261
Other accrued liabilities	2,653	107	63
Net cash provided by (used in) operating activities	8,105	5,198	(1,634)
Investing activities			
Purchases of held-to-maturity securities	(24,989)	(7,280)	(10,976)
Maturities of held-to-maturity securities	5,183	7,162	12,377
Purchases of available-for-sale securities	(9,000)	(3,424)	—
Maturities of available-for-sale securities	5,944	1,481	—
Additions to fixed assets, net	(2,354)	(1,560)	(370)
Net cash paid for acquisition	(2,342)	—	—
Net cash provided by (used in) investing activities	(27,558)	(3,621)	1,031
Financing activities			
Repayment of notes receivable to shareholders	146	—	—
Proceeds from issuance of common stock	35,508	—	—
Proceeds from issuance of ESPP stock	302	—	—
Repurchase of common stock	(12)	(4)	—
Proceeds from exercise of options	104	89	4
Tax benefit from exercise of stock options	897	—	—
Net cash provided by financing activities	36,945	85	4
Net increase (decrease) in cash and cash equivalents	17,492	1,662	(599)
Cash and cash equivalents at beginning of year	2,610	948	1,547
Cash and cash equivalents at end of year	**$20,102**	**$ 2,610**	**$ 948**
Supplemental disclosure of noncash financing activities:			
Accretion of preferred stock	$ 87	$ 514	$ 514
Conversion of preferred stock to common stock	$11,449	$ —	$ —
Issuance of common stock for notes receivable	$ —	$ 303	$ 118
Repurchase of common stock in exchange for reduction of notes receivable	$ —	$ (6)	$ —
Supplemental disclosure of cash flow information:			
Income tax payments	$ 5,232	$ 4,809	$ 575

See accompanying notes.

1. THE COMPANY AND SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES

Company

Maxis, Inc. ("Maxis" or the "Company"), a Delaware corporation, develops, publishes and markets entertainment and learning software for personal computers and 32-bit game consoles. The Company currently sells its software products, including affiliate partner products, in North America through software distributors, major computer and software retailing organizations, consumer electronics stores, discount warehouse stores and mail order companies. Internationally, the Company sells its products through a combination of distribution, direct retail and licensing arrangements.

Basis of presentation

The accompanying consolidated financial statements include the accounts of the Company and its wholly-owned subsidiaries. All significant intercompany transactions and balances have been eliminated. The preparation of financial statements in conformity with generally accepted accounting principles requires management to make estimates and assumptions that affect the amounts reported in the financial statements and accompanying notes. Actual results could differ from those estimates.

Revenue recognition

Product sales

Revenue from product sales is recognized upon shipment of product to the customer, net of appropriate allowances for returns, provided that no significant vendor obligations remain and collection is deemed probable. Costs associated with certain post-sales customer obligations are accrued. The Company's revenue recognition policy is in accordance with the provisions of the American Institute of Certified Public Accountants' Statement of Position 91-1, "Software Revenue Recognition."

Software licenses

Software license revenue and royalty advances are recognized as revenue at the time the Company has completed all significant performance obligations under the terms of the license agreement and any amounts paid are nonrefundable. Amounts received prior to revenue recognition are recorded as deferred revenue. Continuing royalties received under the terms of licensing agreements are recognized as revenue when the amount of royalties is determinable. Revenue from software license agreements totaled $5,479,000, $2,643,000 and $1,148,000 for the fiscal years ended March 31, 1996, 1995 and 1994, respectively.

Major customers

Net revenues from sales to three major customers accounted for 12%, 11% and 10% of net revenues for the fiscal year ended March 31, 1996. Net revenues from sales to one customer accounted for 19% of net revenues for the fiscal year ended March 31, 1995 (no customer represented 10% or more of net revenues for the fiscal year ended March 31, 1994).

Cash and cash equivalents

Cash and cash equivalents consist of cash and highly liquid short-term cash investments with original maturities of three months or less.

Marketable securities

Effective April 1, 1994, the Company adopted Statement of Financial Accounting Standards No. 115 ("SFAS No. 115"), "Accounting for Certain Investments in Debt and Equity Securities." Management determines the appropriate classification of its debt and equity securities at the time of purchase and reevaluates such designation as of each balance sheet date. Debt securities are classified as held-to-maturity when the Company has the positive intent and ability to hold the securities to maturity. Debt securities classified as held-to-maturity are carried at amortized cost, which is adjusted for amortization of premiums and accretion of discounts to maturity. Such amortization is included in interest income. Debt securities not classified as held-to-maturity are classified as available-for-sale and are carried at amounts which approximate fair value. Realized gains and losses during fiscal 1996 on available-for-sale securities were not material.

Accounts receivable

The Company's accounts receivable are principally from distributors and retailers of the Company's products. Accounts receivable are recorded net of allowances for potential credit losses ($564,000 and $439,000 at March 31, 1996 and 1995, respectively), and sales returns ($5,043,000 and $2,472,000 at March 31, 1996 and 1995, respectively). The Company performs periodic credit evaluations of its customers and generally does not require collateral. Actual losses may differ from the Company's estimates, which could have a material impact on the Company's future results of operations.

Inventories

Inventories are valued at the lower of standard cost, which approximates cost, determined using the first-in, first-out method, or market. The Company evaluates the quantities on hand relative to current selling prices and historical and forecasted sales volume. Based on these evaluations, provisions are made to write inventories down to net realizable value.

1. THE COMPANY AND SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES continued

Furniture and equipment

Furniture and equipment are stated at cost. Depreciation is calculated using the straight-line method over the estimated useful lives of the assets which range from three to seven years.

Capitalized software costs

Financial accounting standards provide for the capitalization of certain software development costs after technological feasibility of the software is established. No such costs have been capitalized because the impact on the financial statements would be immaterial.

Royalties expense

Royalties are recognized as cost of revenues based on actual net product sales or software license revenue. Royalty costs, which are included in cost of revenues, were $3,291,000, $2,304,000 and $1,939,000 in fiscal 1996, 1995 and 1994, respectively. Royalties paid to a director and stockholder of the Company who is the developer of some of the Company's software product, totaled $243,000, $323,000 and $364,000 in fiscal 1996, 1995 and 1994, respectively.

Income taxes

The Company accounts for income taxes using the liability method required by statement of Financial Accounting Standards No. 109, "Accounting for Income Taxes." Deferred income taxes reflect the net tax effects of temporary differences between the carrying amounts of assets and liabilities for financial reporting purposes and the amounts used for income tax purposes.

Per share data

Per share data is based on the weighted average number of common shares and dilutive common stock equivalents outstanding for the period. Pursuant to Securities and Exchange Commission Staff Accounting Bulletin (SAB) No. 83, options to purchase common stock (using the treasury stock method) granted by the Company during the 12 months immediately preceding the initial public offering date have been included in the calculation of weighted average number of common shares outstanding as if the underlying shares were outstanding for the years ended March 31, 1995 and 1994.

Recently issued accounting standard

In October 1995 the Financial Accounting Standards Board issued Statement No. 123 (SFAS No. 123), "Accounting for Stock-Based Compensation," which is effective for years beginning after December 15, 1995. SFAS No. 123 permits a company to choose either a new fair value-based method or the current Accounting Principles Board Opinion No. 25 intrinsic value-based method of accounting for its stock-based compensation arrangements.

The Company has elected to continue to follow current practice, but SFAS No. 123 requires pro forma disclosures of net income and earnings per share computed as if the fair value-based method had been applied.

2. MARKETABLE SECURITIES

At March 31, 1996, the Company's held-to-maturity and available-for-sale debt securities consist of the following (in thousands):

	Cost	Gross unrealized gains	Gross unrealized losses	Estimated fair value
Municipal bonds	$20,906	$ 278	—	$21,184
Municipal notes	3,001	48	—	3,049
Total held-to-maturity securities	$23,907	$ 326	—	$24,233
Market auction preferreds	$22,475	$ 17	—	$22,492
Money market funds	258	—	—	258
Total available-for-sale securities	22,733	17	—	22,750
Total marketable securities	**$46,640**	**$ 343**	**—**	**$46,983**

Such debt securities have been recorded as cash and cash equivalents ($17,733,000), short-term marketable securities ($22,788,000) and long-term marketable securities ($6,119,000). The contractual maturities of held-to-maturity and available-for-sale debt securities at March 31, 1996, are all two years or less. For all periods presented, realized gains and losses on available-for-sale securities were not material.

3. INVENTORIES

Inventories consist primarily of software media, manuals and related packaging materials as follows (in thousands):

	March 31, 1996	1995
Raw materials and work in process	$ 356	$ 630
Finished goods	1,187	1,061
	$ 1,543	**$ 1,691**

4. FURNITURE AND EQUIPMENT

Furniture and equipment consists of the following (in thousands):

	March 31, 1996	1995
Computer equipment and software	$3,099	$1,911
Furniture	955	393
Office equipment	892	684
Leasehold improvements	581	16
	5,527	3,004
Less accumulated depreciation	2,284	1,233
	$ 3,243	**$ 1,771**

5. BANK LINE OF CREDIT

The Company has an unsecured revolving line of credit for borrowing up to $1.0 million, which expires on August 30, 1996. Borrowings under the line of credit bear interest, payable monthly, at a reference rate determined by the bank (8.25% at March 31, 1996). The agreement also requires the Company to maintain a minimum quick ratio and minimum net worth. There were no outstanding borrowings under the line of credit at March 31, 1996.

6. INCOME TAXES

Significant components of the provision for income taxes, including the tax effect of the losses from discontinued operations, are as follows (in thousands):

	Fiscal Years Ended March 31,		
	1996	1995	1994
Current:			
Federal	$ 4,006	$ 2,753	$ 1,444
State	1,347	876	379
Foreign	422	188	63
Total current	5,775	3,817	1,886
Deferred:			
Federal	(1,540)	(964)	(639)
State	(410)	(296)	(117)
Effect of valuation allowance adjustment	—	(505)	(360)
Total deferred	(1,950)	(1,765)	(1,116)
Total current and deferred provision	**$ 3,825**	**$ 2,052**	**$ 770**

The reconciliation of income taxes attributable to income from continuing operations and the loss from discontinued operations computed at the U.S. federal statutory tax rates to the effective tax rate of the provision for income taxes is:

	Fiscal Years Ended March 31,		
	1996	1995	1994
Tax at U.S. statutory rates	35%	34%	34%
State income taxes	6	7	7
Tax exempt interest	(4)	—	—
Other	1	4	4
Effect of valuation allowance adjustment	—	(9)	(14)
	38%	36%	31%

Significant components of the Company's deferred tax assets are as follows (in thousands):

	March 31,	
	1996	1995
Deferred tax assets:		
Reserve for allowances for returns and doubtful accounts	$ 2,214	$ 1,260
Expenses not currently deductible for income tax purposes	2,189	1,406
Other	428	215
Total deferred tax assets	**$ 4,831**	**$ 2,881**

7. STOCKHOLDERS' EQUITY (Deficit)

Common stock

In April 1995, the Company was reincorporated in the State of Delaware. As part of this reincorporation, each outstanding share of the former California corporation no par common stock was converted to one share of Delaware corporation $.0001 par value common stock and each share of the former California corporation no par preferred stock was converted to two shares of the Delaware corporation $.0001 par value preferred stock. All preferred shares and per share information has been restated to reflect the effect of the conversion.

On June 1, 1995, the Company consummated an initial public offering of 3,450,000 shares of common stock that raised approximately $35.5 million net of expenses. Of the 3,450,000 shares of common stock, 2,450,000 shares were sold by the Company and 1,000,000 shares were sold by selling stockholders.

1993 Stock Option Plan

In June 1993, the Company established a stock option plan ("1993 Plan") under which incentive and nonqualified stock options may be granted to employees, directors and consultants of the Company to purchase up to 1,854,000 shares of common stock. The options may be granted at an exercise price not less than 85% of the fair market value of the common stock at the date of grant. The fair market value of the common stock was determined by the Board of Directors. All options currently outstanding are immediately exercisable upon grant and generally vest over various periods as determined by the Board of Directors at the time of grant. The Company retains the right to repurchase (at the original purchase price) nonvested shares held at the time of termination of employment. At March 31, 1996, 311,000 shares were subject to the Company's right of repurchase. In June 1995, the 1993 Plan was superseded by the 1995 stock option plan. At that time, the remaining 354,000 options available for grant under the 1993 Plan were cancelled.

1995 Stock Option Plan

In May 1995, the Company established a stock option plan ("1995 Plan") that provides for grants of options to employees and consultants of the Company and its subsidiaries to purchase up to 575,000 shares of common stock. With respect to incentive stock options granted under the 1995 Plan, the exercise price must be at least equal to the fair market value per share of common stock at the grant date. Options under the 1995 Plan generally vest and become exercisable at a rate of 25% of the shares subject to option on the first anniversary of the commencement of vesting and 25% of the shares each year thereafter. As of March 31, 1996, no outstanding options were exercisable.

7. STOCKHOLDERS' EQUITY (Deficit) continued

Changes in options outstanding from inception of the 1993 Stock Option Plan to March 31, 1996, are as follows:

	Number of shares	Price per share
Outstanding at March 31, 1993	—	—
Options granted	500,000	$ 0.30 – $ 0.33
Options exercised	(406,000)	0.30
Options canceled	(82,000)	0.30
Outstanding at March 31, 1994	12,000	$ 0.30 – $ 0.33
Options granted	1,072,000	0.73 – 9.00
Options exercised	(525,000)	0.30 – 0.80
Options canceled	(11,000)	0.30 – 0.80
Outstanding at March 31, 1995	548,000	$ 0.30 – $ 9.00
Options granted	272,000	11.00 – 48.00
Options exercised	(131,000)	0.73 – 0.80
Options canceled	(26,000)	0.73 – 39.75
Outstanding at March 31, 1996	**663,000**	$ 0.33 – $48.00
Options vested at March 31, 1996	**176,000**	
Options available for grant at March 31, 1996	**350,000**	

During fiscal 1994, included in options granted and exercised are options granted to the Company's senior management team to purchase 392,000 shares of common stock at $0.30 per share. These options were exercised and common stock was issued in exchange for notes receivable. The notes receivable are for terms of either three or nine years, bear interest at rates ranging from 3.69% to 5.97% with interest payable semiannually and principal due at maturity. The notes are secured by the common stock purchased and are reflected as a reduction of stockholders' equity.

During fiscal 1995, included in options granted and exercised are options granted to the Company's senior management team to purchase 410,000 shares of common stock at prices from $0.73 to $0.80 per share. These options were exercised and common stock was issued in exchange for notes receivable. The notes receivable are for terms from two to nine years, bear interest at rates ranging from 6.24% to 8.01% with interest payable semiannually and principal due at maturity.

During fiscal 1995, the Company issued options to purchase 1,072,000 shares of common stock. The Company recorded deferred compensation of $940,000 for financial reporting purposes with respect to such option grants to reflect the difference between the exercise price and deemed fair value, for financial statement presentation purposes, of the Company's common shares. Amortization of deferred compensation for the fiscal years ended March 31, 1996 and 1995, totaled $351,000 and $450,000, respectively.

Redeemable preferred stock

Prior to the Company's initial public offering, the Company's redeemable preferred stock consisted of 5,000,000 authorized shares of no par redeemable preferred stock of which 2,000,000 shares of redeemable preferred stock were issued in June 1992 at $5.00 per share amounting to $10,000,000 less issuance costs of approximately $92,000. The redeemable preferred stock was noncumulative, fully participating and was entitled to a dividend rate of $0.25 per share. In connection with the Company's initial public offering all outstanding shares of the Company's redeemable preferred stock were converted into 2,094,000 shares of common stock.

8. 1995 EMPLOYEE STOCK PURCHASE PLAN

In May 1995 the Company established an employee stock purchase plan ("ESPP") and has reserved an aggregate of 100,000 shares of common stock. The ESPP is intended to qualify under Section 423 of the Code and permits eligible employees of the Company to purchase common stock through payroll deductions of up to 10% of their compensation provided that no employee may purchase more than $25,000 worth of stock in any calendar year. The ESPP is implemented with six-month purchase periods as components of 24-month offering periods. The first such purchase period commenced upon the date of the offering and ended on the last market trading day on December 29, 1995. The price of common stock purchased under the ESPP is 85% of the lower of the fair market value of the common stock on the first day of each offering period or last day of each purchase period. The ESPP will expire in the year 2005. In fiscal 1996, a total of 22,000 shares were issued under the plan at $13.60 per share. At March 31, 1996, a total of 78,000 shares were available for issuance under the plan.

9. EMPLOYEE RETIREMENT AND BENEFIT PLAN

The Company has a defined contribution retirement plan covering substantially all employees which operates under Section 401(k) of the Internal Revenue Code. Eligible employees may contribute amounts to the plan subject to certain limitations. The Company matches contributions by plan participants up to 5% of the participant's pretax compensation. Retirement plan expense for fiscal 1996, 1995 and 1994 was $321,000, $209,000 and $186,000, respectively.

10. DISCONTINUED OPERATIONS

In December 1993, the Company sold an unprofitable commercial software division ("Division") to the Division's management. Although a legal transfer of the assets of the Division occurred in December 1993, the sale could not be recognized as a divestiture for accounting purposes at that time because there was an absence of a significant financial investment in the business by management of the Division.

In September 1994, the Company received full payment of the note receivable from the management of the Division at which date the divestiture was accounted for as discontinued operations.

10. DISCONTINUED OPERATIONS continued

The results of the Division for the fiscal year ended March 31, 1995, were accounted for as discontinued operations in the accompanying consolidated statements of income. The sale resulted in a gain, net of applicable income taxes, of $303,000. Revenues related to this Division were $361,000 in fiscal year 1994. There were no revenues in subsequent periods.

11. COMMITMENTS

In June 1995 the Company entered into a seven-year lease for new office space to house its principal corporate headquarters. The lease agreement provides for monthly payments beginning at $75,000, escalating to $86,600 during the term of the lease. The lease is noncancelable for the first five years and six months with the option, at the Company's election, to shorten the term of the lease for a one-time payment equal to three months' rent.

Future minimum lease payments under the Company's operating leases for the periods ended March 31, pursuant to leases outstanding as of March 31, 1996, are due as follows (in thousands):

1997	$1,014
1998	977
1999	901
2000	901
2001	624
	$4,417

Rent expense under all leases was $1,021,000, $486,000 and $324,000 for fiscal 1996, 1995 and 1994, respectively.

12. INFORMATION BY GEOGRAPHIC AREA

Information regarding the Company's operations, including its foreign subsidiary and export sales, by geographic area for fiscal 1996, 1995 and 1994 is as follows (in thousands):

	Fiscal Years Ended March 31,		
	1996	**1995**	**1994**
Net revenues:			
North America	$43,564	$32,614	$21,152
Europe	7,197	4,135	1,478
Asia/Pacific and other	4,651	1,398	702
	$55,412	$38,147	$23,332

13. BUSINESS COMBINATION

In March 1996, the Company acquired for cash Cinematronics LLC, an independent developer of entertainment software, with headquarters in Austin, Texas. The acquisition was accounted for under the purchase method. This purchase resulted in a nonrecurring acquisition-related charge of $2,232,000 for acquired in-process technology. During fiscal 1996, the operations of Cinematronics LLC were not material to the Company.

14. QUARTERLY FINANCIAL INFORMATION (Unaudited)

	Quarter Ended				
	June 30	**September 30**	**December 31**	**March 31**	**Year**
(In thousands, except per share amounts)					
Fiscal year 1996:					
Net revenues	$11,332	$11,779	$20,111	$12,190	$55,412
Gross profit	7,742	8,536	12,912	8,325	37,515
Net income (loss)	1,132	1,722	3,541	(207)	6,188
Net income (loss) per share	0.12	0.15	0.31	(0.02)	0.56
Fiscal year 1995:					
Net revenues	$ 6,977	$ 6,645	$15,526	$ 8,999	$38,147
Gross profit	4,417	3,928	9,399	6,217	23,961
Income from continuing operations	692	48	2,385	178	3,303
Gain on disposal of discontinued operations	—	303	—	—	303
Net income	692	351	2,385	178	3,606
Income from continuing operations per share	0.08	0.01	0.27	0.02	0.37
Net income per share	0.08	0.04	0.27	0.02	0.40

Report of Independent Auditors

The Board of Directors and Stockholders
Maxis, Inc.

We have audited the accompanying consolidated balance sheets of Maxis, Inc. as of March 31, 1996 and 1995, and the related consolidated statements of income, stockholders' equity (deficit), and cash flows for each of the three years in the period ended March 31, 1996. These financial statements are the responsibility of the Company's management. Our responsibility is to express an opinion on these financial statements based on our audits.

We conducted our audits in accordance with generally accepted auditing standards. Those standards require that we plan and perform the audit to obtain reasonable assurance about whether the financial statements are free of material misstatement. An audit includes examining, on a test basis, evidence supporting the amounts and disclosures in the financial statements. An audit also includes assessing the accounting principles used and significant estimates made by management, as well as evaluating the overall financial statement presentation. We believe that our audits provide a reasonable basis for our opinion.

In our opinion, the financial statements referred to above present fairly, in all material respects, the consolidated financial position of Maxis, Inc. at March 31, 1996 and 1995, and the consolidated results of its operations and its cash flows for each of the three years in the period ended March 31, 1996, in conformance with generally accepted accounting principles.

Ernst + Young LLP

Walnut Creek, California
April 23, 1996

Board of Directors

Jeff Braun
Chairman and Chief Executive Officer
Maxis, Inc.

Will Wright
Co-Founder and Chief Technical Officer
Maxis, Inc.

Charles Gaylord
Consultant

Eric Dunn
Vice President and General Manager, Personal Finance Group
Intuit, Inc.

William Janeway
Managing Director
E.M. Warburg, Pincus and Co., Inc.

Dr. Henry Kressel
Managing Director
E.M. Warburg, Pincus and Co., Inc.

Avram Miller
Vice President
Intel Corporation

Sam Poole
President
Maxis, Inc.

Management Team

Jeff Braun
Chairman and Chief Executive Officer

Sam Poole
President

Bob Derber
Vice President and General Counsel

Val Garcia
Vice President, Operations

Fred Gerson
Vice President and Chief Financial Officer

Deborah Gross
Vice President, Human Resources

Robin Harper
Vice President, Marketing

Doug Litke
Vice President, Business Development

Joe Scirica
Vice President, Product Development

Ileana Seander
Vice President, Sales

Headquarters Address

Maxis, Inc.
2121 N. California Blvd.
Walnut Creek, CA 94596-3572
http://www.maxis.com

Transfer Agent

Harris Trust Company of California
601 South Figueroa, Suite 4900
Los Angeles, CA 90017
(213) 239-0671

Independent Auditors

Ernst & Young LLP
1331 N. California Blvd.
Walnut Creek, CA 94596

Legal Counsel

Wilson, Sonsini, Goodrich & Rosati
650 Page Mill Road
Palo Alto, CA 94304-1050

Corporate Information

Copies of this Annual Report and Form 10-K are available upon request by calling (510) 933-5630.

COMMON STOCK PROFILE

The Company's common stock is traded on the Nasdaq National Market under the symbol MXIS. The following table sets forth, for the periods indicated, the high and low closing prices for the Company's common stock as reported on Nasdaq:

Fiscal Year 1996	High	Low
First quarter (from May 25, 1995)	$30 1/2	$19 1/2
Second quarter	49 1/2	23
Third quarter	44 1/2	29 1/4
Fourth quarter	37 1/2	20 1/4

The Company has not paid cash dividends and has no current plan to do so. There were 133 stockholders of record on March 31, 1996, excluding stockholders whose stock is held in nominee or street name by brokers.

ANNUAL MEETING

Shareholders are invited to attend Maxis' Annual Meeting at 10 a.m. on August 21, 1996, at The Dean Lesher Regional Center for the Arts, Dean Lesher Theatre, 1601 Civic Drive, Walnut Creek, CA 94596.

MAXIS

2121 N. California Blvd., Suite 600
Walnut Creek, CA 94596-3572