RADICA GAMES LTD
Form 20-F
April 16, 2003

UNITED STATES
SECURITIES AND EXCHANGE COMMISSION
Washington, D.C. 20549

# FORM 20-F

[ ] REGISTRATION STATEMENT PURSUANT TO SECTION 12(b) or (g) OF THE SECURITIES EXCHANGE ACT OF 1934

OR

[X] ANNUAL REPORT PURSUANT TO SECTION 13 OR 15(d) OF THE SECURITIES EXCHANGE ACT OF 1934

For the Fiscal Year Ended December 31, 2002.

OR

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

For the Transition period from ________________________ to _____________________
Commission File Number: 0-23696

RADICA GAMES LIMITED
(Exact name of registrant as specified in its charter)

BERMUDA
(Jurisdiction of incorporation or organization)

SUITE R, 6/FL. 2-12 AU PUI WAN ST.
FO TAN, HONG KONG
(Address of principal executive offices)

Securities Registered Pursuant to Section 12(b) of the Act:

None

Securities registered pursuant to section 12(g) of the Act:

Common Stock, Par Value $.01

Securities for which there is a reporting obligation pursuant to Section 15(d) of the Act.

None

Indicate the number of outstanding shares of each of the issuer's classes of capital or common stock as of the close of the period covered by the annual report.

| Title of each class | Amount Outstanding |
|---|---|
| Common Stock, Par Value $.01 | 17,796,131 |

Indicate by check mark whether the registrant (1) has filed all reports required to be filed by Section 13 or 15(d) of the Securities Exchange Act of 1934 during the preceding 12 months (or for such shorter period that the registrant was required to file such reports), and (2) has been subject to such filing requirements for the past 90 days.

Yes X No

Indicate by check mark which financial statement item the registrant has elected to follow:

Item 17 Item 18 X

RADICA GAMES LIMITED

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YEAR ENDED DECEMBER 31, 2002

ITEMS IN FORM 20-F

DISCLOSURE REGARDING FORWARD-LOOKING STATEMENTS

This report includes "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. For example, statements included in this report regarding our financial position, business strategy and other plans and objectives for future operations, and assumptions and predictions about future product demand, supply, manufacturing, costs, marketing and pricing factors are all forward-looking statements. We believe that the assumptions and expectations reflected in such forward-looking statements are reasonable, based on information available to us on the date hereof, but we cannot assure you that these assumptions and expectations will prove to have been correct or that we will take any action that we may presently be planning. Forward-looking statements involve risks and uncertainties that could cause actual results to differ materially from projected results. These risks include those set forth elsewhere in this Annual Report on Form 20-F for the fiscal year ended December 31, 2002. See "Item 3. Key Information - Risk Factors" in this report on Form 20-F. We are not undertaking to publicly update or revise any forward-looking statement if we obtain new information or upon the occurrence of future events or otherwise.



PART I

ITEM 1. IDENTITY OF DIRECTORS, SENIOR MANAGEMENT AND ADVISERS

Not Applicable

ITEM 2. OFFER STATISTICS AND EXPECTED TIMETABLE

Not Applicable

ITEM 3. KEY INFORMATION

SELECTED FINANCIAL DATA

Set forth below is the selected income statement and balance sheet data for the year ended October 31, 1998, the two months in the period ended December 31, 1998 (the Company's year end having changed from October 31 to December 31 in that year) and each of the four years in the period ended December 31, 2002. This data is derived from the financial statements included herein and from those previously reported for earlier periods. This summary should be read in conjunction with "Operating and Financial Review and Prospects" and the consolidated financial statements and notes thereto included elsewhere in this document.

| (in thousands, except per share data and margins) | YEAR ENDED DECEMBER 31, | | | |
|---|---|---|---|---|
| | 2002 | 2001 | 2000 | 1999 |
| INCOME STATEMENT DATA: | | | | |
| Net sales | $124,646 | $98,554 | $106,696 | $136,71 |
| Cost of sales | 77,481 | 64,698 | 83,041 | 80,91 |
| Gross profit | 47,165 | 33,856 | 23,655 | 55,80 |
| Operating expenses: | | | | |
| Selling, general and administrative | 27,695 | 26,279 | 32,322 | 28,35 |
| Research and development | 4,094 | 5,775 | 5,210 | 6,03 |
| Acquired research and development | -- | -- | -- | - |
| Depreciation and amortization | 2,858 | 4,013 | 5,427 | 4,95 |
| Restructuring charge | -- | 1,551 | 1,190 | - |
| Total operating expenses | 34,647 | 37,618 | 44,149 | 39,34 |
| Operating income (loss) | 12,518 | (3,762) | (20,494) | 16,46 |
| Other income | 306 | 24 | 781 | 71 |
| Foreign currency gain (loss), net | 1,744 | (219) | 49 | 30 |
| Share of loss of affiliated company | -- | -- | -- | (1,74 |
| Net interest income | 35 | 136 | 664 | 1,46 |
| Income (loss) before income taxes | 14,603 | (3,821) | (19,000) | 17,20 |
| (Provision) credit for income taxes | (2,669) | (553) | 901 | (14 |
| Net income (loss) | $11,934 | $(4,374) | $(18,099) | $17,05 |
| Net income (loss) per share - basic | $0.67 | $(0.25) | $(1.03) | $0.9 |
| Weighted average number of common shares | 17,726 | 17,612 | 17,608 | 18,14 |
| Net income (loss) per share - diluted | $0.65 | $(0.25) | $(1.03) | $0.9 |
| Weighted average number of common shares and common equivalent shares | 18,336 | 17,612 | 17,608 | 18,97 |

(continued)

| (in thousands, except per share data and margins) | 2002 | 2001 | YEAR ENDED DECEMBER 31, 2000 | 1999 | TWO M END DECEM 19 |
| --- | --- | --- | --- | --- | --- |
| INCOME STATEMENT DATA: | | | | | |
| STATISTICAL DATA: | | | | | |
| Gross margin | 37.8% | 34.4% | 22.2% | 40.8% | 4 |
| Operating margin | 10.0% | (3.8%) | (19.2%) | 12.0% | 2 |
| BALANCE SHEET DATA (AT PERIOD END): | | | | | |
| Working capital | $50,155 | $36,709 | $42,619 | $65,123 | $65 |
| Total assets | 95,302 | 88,407 | 99,315 | 122,174 | 108 |
| Long-term debt | - | 1,825 | 5,473 | 10,946 | |
| Total debt | 2,671 | 6,319 | 12,901 | 13,809 | |
| Common stock | 178 | 176 | 176 | 176 | |
| Shareholders' equity | 74,636 | 63,052 | 67,388 | 86,062 | 85 |

RISK FACTORS

Investment in the shares of Common Stock of Radica Games Ltd ("the Company") involves a significant degree of risk. Prospective investors should carefully consider the following factors together with the other information contained or incorporated by reference herein prior to making any investment decision regarding the Company or its securities.

MANUFACTURING IN CHINA

The Company's factory (the "Factory") location is in Southern China and its headquarters are in Hong Kong, which is a Special Administrative Region of China. See "Item 4. Information on the Company - Description of Business - Manufacturing Facilities".

Risk of China Losing Normal Trade Relations ("NTR") Status or of Changes in Tariff or Trade Policies. The Company manufactures in China and exports from Hong Kong and China to the United States and worldwide. Its products sold in the United States are currently not subject to US import duties. On September 19, 2000, the US Senate voted to permanently normalize trade with China, which provides a favorable category of US import duties. In addition, on December 11, 2001 China was accepted into the World Trade Organization ("WTO"), a global international organization of 144 countries that regulates international trade.

As a result of opposition to certain policies of the Chinese government and China's growing trade surpluses with the United States, there has been, and in the future may be, opposition to the extension of NTR status for China. The loss of NTR status for China, changes in current tariff structures or adoption in the United States of other trade policies adverse to China could have an adverse effect on the Company's business.

Chinese Political, Economic and Legal Risks. The success of the Company's current and future operations in China and Hong Kong is highly dependent on the Chinese government's continued support of economic reform programs that encourage private investment, and particularly foreign private investment. Although the Chinese government has adopted an "open door" policy with respect to foreign investment, there can be no assurance that such policy will continue. A change in policies by the Chinese government could adversely affect the Company by, among other things, imposing confiscatory taxation, restricting currency conversion, imports and sources of supplies, or expropriating private enterprises. Although the Chinese government has been pursuing economic reform policies for nearly two decades, no assurance can be given that the Chinese government will continue to pursue such policies or that such policies may not be significantly altered, especially in the event of a change in leadership or other social or political disruption.

The Company's production and shipping capabilities could be adversely effected by ongoing tensions between the Chinese and Taiwanese governments. In the event that Taiwan does not adopt a plan for unifying with China, the Chinese government has threatened military action against Taiwan. As of yet, Taiwan has not indicated that they intend to propose and adopt a reunification plan. If an invasion were to occur, Radica's supply of components from Taiwanese suppliers, including computer processing units (CPUs), could be cut off, potentially limiting the Company's production capabilities. Invasion could also lead to sanctions or military action by the US and/or European countries, which could materially effect sales to those countries.



China does not have a comprehensive system of laws. Enforcement of existing laws may be sporadic and implementation and interpretation thereof inconsistent. The Chinese judiciary is relatively inexperienced in enforcing the laws that exist, leading to a higher than usual degree of uncertainty as to the outcome of any litigation. Even where adequate law exists in China, it may be impossible to obtain swift and equitable enforcement of such law, or to obtain enforcement of a judgment by a court of another jurisdiction. It is widely believed that China's entry into the WTO should expedite the uniform interpretation and enforcement of laws throughout China.

Dependence on Local Government. The Company operates its Factory in China under agreements with the local government. Many aspects of such agreements and operation of the Factory are dependent on the Company's relationship with the local government and existing trade practices. The relationship of the Company with the local government could be subject to adverse change in the future, especially in the event of a change in leadership or other social or political disruption.

Chinese Taxation. The Company paid $920,000 in foreign enterprise tax on its Joint Venture in China in 2002, the fourth year it has paid foreign enterprise tax in China. The Company was granted 50% relief from foreign enterprise tax through December 31, 2001 under the Foreign Enterprise Law of The People's Republic of China ("PRC"), and was therefore taxed at 12%. In 2002, the Company was taxed at the full rate of tax of 24%; however, the Company is applying to be designated as an "Export Oriented Enterprise", which will reduce its tax rate to 12% if the application is successful. In addition, under the existing processing arrangement and in accordance with the current tax regulations in the PRC, manufacturing income generated in the PRC is not subject to PRC foreign enterprise taxes (see "Item 4. Information on the Company - Description of Business - Manufacturing Facilities").

The PRC assesses tax on the Company based on two separate contracts: a Processing Agreement (PA) and a Joint Venture (JV) contract. The JV contract is a joint venture with the local township that lasts through August 12, 2024 and tax is payable quarterly based on tax rates determined upon entering the agreement. The tax on a PA is assessed on labor and raw material costs submitted periodically to the PRC customs offices throughout the year. During 2001, the Company made a decision to end its use of PA contracts. As of the date of this report, the Company had one outstanding PA contract for which a discharge has been applied. The Company does not expect to have any open PA contracts by June

30, 2003.

The Chinese tax system is subject to substantial uncertainties and has been subject to recently enacted changes, the interpretation and enforcement of which are also uncertain. There can be no assurance that changes in Chinese tax laws or their interpretation or their application will not subject the Company to substantial Chinese taxes in the future.

The Company's operations involve a significant amount of transactions which cross a number of international borders. In addition, the Company's manufacturing operations are in China, where the negotiation and settlement of tax obligations with the local tax authorities are a normal occurrence.

The Company establishes provisions for its known and estimated income tax obligations. However, whether through a challenge by one of the many tax authorities in international jurisdictions where the Company and its subsidiaries operate of the Company's transfer pricing, the Company's claim regarding lack of permanent establishment, or other matters that may exist, the Company is exposed to possible additional taxation that has not been accrued.

Limited Infrastructure. Electricity, water, sewage, telephone and other infrastructure are limited in the locality of the Factory. In the past, the Company has experienced temporary shortages of electricity and water supply. The Company has installed seven back-up electrical generators in the Factory which can support it in the event of a power shortage. There can be no assurance that the infrastructure on which the Factory is dependent will be adequate to operate the Factory successfully.

DEPENDENCE ON CURRENT PRODUCT APPEAL AND NEW PRODUCT INTRODUCTIONS

The Company's operating results depend largely upon the appeal of its products to consumers. Consumer preferences are highly subjective, and there can be no assurance that consumers will continue to find existing products appealing or will find new products appealing. Also, the Company continues to offer a relatively limited range of products that are all in the categories of games or video game accessories. This exposes the Company to the risks of any narrowly focused business. Changes in consumer preferences away from the kinds of products offered by the Company could have an adverse effect on the Company.

Some of the Company's products have been only recently introduced and although they may experience good initial sales growth, there is no assurance that such initial success is indicative of significant future sales. As a general matter, the

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Company expects that the sales of these products will eventually decline. The Company cannot predict how long the product cycle will last for any product. In order to control costs, and take advantage of the finite shelf space available to the Company, it will also need to delete products from its line periodically. The Company's long-term operating results will therefore depend largely upon its continued ability to conceive, develop and introduce new appealing products at competitive prices.

Once a new product is conceived, the principal steps to the introduction of the product include design, sourcing and testing of the electronic components, tooling, and purchase and design of graphics and packaging. At any stage in the process, there may be difficulties or delays in completing the necessary steps to meet the contemplated product introduction schedule. It is, for example, common in new product introductions or product revisions to encounter technical and other difficulties affecting manufacturing efficiency and, at times, the ability to manufacture at all, that will typically be corrected or improved over a period of time with continued manufacturing experience and engineering efforts. If one or more aspects necessary for introduction of products are not met in a timely fashion, or if technical difficulties take longer than anticipated to overcome, the anticipated product introductions will be delayed, or in some cases may be terminated. Therefore no assurances can be given that products will be introduced in a timely fashion.

For most of the Company's history, electronic games made up a significant portion of the Company's overall sales (see chart on page 16). In 1998 and 1999, electronic games made up 77.1% and 64.2%, respectively. In response to the heavy concentration of sales within this category, Radica has worked to diversify its product lines. Electronic games accounted for 54.2%, 53.0% and 50.3% of sales in 2000, 2001 and 2002, respectively.

Future products may utilize different technologies and require knowledge of markets in which the Company does not presently participate. Significant delays in the introduction of, or the failure to introduce, new products or improved products would have an adverse effect on the Company's operating results.

There is no assurance that retailers will react positively to new product introductions. There is also a risk that the demand for new or existing products could drop suddenly. As a result, the Company may build excess quantities of certain products and subsequently have to put inventory provisions in place to mark the value of excess inventory quantities down to their estimated market value.

There are often technical challenges in bringing a product into production. The Company may announce and sell a product but later find it must be delayed or abandoned due to difficulties in engineering and manufacturing. There can be no assurance that an announced product will ship on time or not be abandoned.

NO ASSURANCE OF GROWTH

There can be no assurance that the Company will achieve future growth in net sales or that it will be able to maintain its present levels of net sales or profitability. The Company's current business strategy emphasizes the sale of a controlled number of products, while representing a more diverse range of products, e.g., Handheld games, Barbie(TM) electronic games, the Girl Tech(R) line, Play TV(R) products, video game accessories ("VGA") sold under the Gamester(R) brand, Original Design Manufacturing ("ODM") and Original Equipment Manufacturing ("OEM") products.

DEPENDENCE ON MAJOR CUSTOMERS

Historically, a significant portion of the Company's sales have been concentrated with a few large retail customers. See Note 18 of Notes to the Consolidated Financial Statements included herein. Most of the Company's retail customers operate on a purchase order basis and the Company does not have long-term contracts with its retail customers. While management considers the Company's relationships with its major retail customers to be good, the loss of one or more of its major retail customers would have an adverse effect on the Company's results of operations.

On January 22, 2002 the Kmart Corporation filed for protection from its creditors under Chapter 11 of the United States Bankruptcy Code. The Company's receivable exposure was entirely provided for during 2001 and no additional write-downs or expenses related to the bankruptcy were incurred during 2002. The

Company continued to sell to Kmart under a debtor-in-possession agreement during 2002 and will closely monitor its account with Kmart in order to minimize future exposure.

During 2002, a significant portion of the Company's sales also came from Shinsedai Co., Ltd. ("SSD") in the form of OEM projects. Additionally, a significant portion of OEM sales came from Hasbro, which is also a competitor of the Company.



The Company does not have a specific contract with SSD or Hasbro regarding these projects and there is no assurance that the Company will continue to receive orders from SSD or Hasbro, which could have an adverse effect on the Company.

DEPENDENCE ON SUPPLIERS AND SUBCONTRACTORS

The Company is dependent on suppliers for the components and parts that it assembles to produce its products. The Company generally purchases the specific LCDs or semiconductor chips for any particular product model from a single supplier. An interruption of the supply of LCDs, semiconductor chips or other supplies from a supplier could result in significant production delays.

SSD supplies the chips used in Radica's Play TV and Connectv(R) lines of products. If SSD refused or were unable to provide these chips, the Company would be unable to manufacture and distribute these product lines.

The Company also relies on outside manufacturers for production of some of its video game accessories. While the Company has moved the majority of this production into its own Factory, manufacturer delays or shut downs could have a significant impact on future sales of VGA products.

CONCENTRATED MANUFACTURING FACILITIES

A disruption of operations at the Factory due to fire, labor dispute, dispute with the local government or otherwise, would have an adverse effect on the Company's results of operations. In such event, the Company believes that it could partially mitigate the effect of a disruption by increasing the use of subcontractors to assemble its products, but there can be no assurance that it would be able to do so. In addition, the Company's manufacturing facilities are dependent on the Company's relationship with the local government.

NO ASSURANCE OF SUCCESS IN NEW BUSINESS

From time to time, Radica expands into related or new businesses in order to diversify and grow. Examples include the development of its ODM and OEM partnerships and its expansion into the VGA market. There is no assurance that such businesses can be retained or that the Company will be successful in such ventures.

NO ASSURANCE OF CONTINUED ODM/OEM BUSINESS

The Company manufactures goods for third parties, often without a contract. The Company's contracts with ODM/OEM customers can generally be terminated by either party on short notice, therefore there can be no assurance that such business can be retained for an extended period of time. Loss of such business would materially affect the Company's revenues.

DEPENDENCE ON KEY PERSONNEL

The success of the Company is substantially dependent upon the expertise and services of its senior management personnel. The loss of the services of senior executives would have an adverse effect on the Company's business.

SEASONALITY

The Company experiences a significant seasonal pattern in its operating results and working capital requirements. The Company typically generates most of its sales in the third and fourth quarters of its fiscal year, prior to the traditional gift season. The high level of seasonality causes the Company to take large risks in the purchase of inventory and extending credit to customers for the holiday season. There can be no guarantee that the Company or its customers will sell all their inventories. Excess inventory at year-end may result in financial losses from obsolescence reserves, returns, markdowns and bad debts.

The Company's operating results may also fluctuate during the year due to other factors such as the timing of the introduction of new products. The market price of the Common Stock may be subject to significant fluctuations in response to variations in quarterly operating results and other factors. See Exhibit 12.1 Statement re Selected Quarterly Financial Data included herein.



INDUSTRY AND PRODUCT LINE VOLATILITY

The toy and game industry is known for a high level of volatility as a result of changing consumer tastes, competition and over saturation of popular products. Radica has experienced significant volatility in its results in its past history. While the Company has diversified its business in recent years to reduce volatility, there can be no guarantee that this history of volatility will not continue.

COMPETITION

The electronic games, youth electronics and VGA businesses are highly competitive. The Company currently faces direct competition from a number of other producers of handheld electronic games and video game accessories. The barriers for new producers to enter into the Company's markets are relatively low and the Company expects that it will face increased competition in the future. Some competitors offer products at lower prices, are better established in the industry and are larger than the Company. In addition, with respect to ODM/OEM manufacturing, the Company competes with a number of substantially larger and more experienced manufacturers. As the Company enters other markets and businesses, it expects to face new competition.

INTELLECTUAL PROPERTY RISKS

From time to time, other companies and individuals may assert exclusive patent, copyright, trademark and other intellectual property rights to technologies or marks that are important to the Company's industry generally or to the Company's business specifically. The Company will evaluate each claim relating to its products or other aspects of its business and, if appropriate, will seek a license to use the protected technology. There can be no assurance that the Company will be able to obtain licenses to intellectual property of third parties on commercially reasonable terms, if at all. In addition, the Company could be at a disadvantage if its competitors obtain licenses for protected technologies on more favorable terms than does the Company. If the Company or its suppliers are unable to license protected technology used in the Company's products, the Company could be prohibited from marketing those products or may have to market products without desirable features. The Company could also incur substantial costs to redesign its products or to defend any legal action taken against the Company. If the Company's products or manufacturing methods should be found to infringe protected technology, the Company could be enjoined from further infringement and required to pay damages to the infringed party. Any of the foregoing could have an adverse effect on the results of operations and financial position of the Company. See "Item 8. Financial Information - Legal Proceedings".

PRODUCT LIABILITY

Historically, the Company has had only a minor experience of complaints relating to injuries or other damages caused by its products. However, in recent years the Company has introduced products that involved more active play including its Play TV baseball, snowboard and boxing games. In fiscal 2000, the Company received a number of consumer complaints that bats used in the Play TV baseball game could be broken resulting in a projectile striking a game participant. The Company recalled the bats for replacement with a reengineered bat. The Company is in the process of handling all remaining claims resulting from damages from the recalled bat and all pending claims are covered by the Company's product liability insurance. The Company may be exposed to claims for damages in these or other circumstances, some or all of which may not be covered by insurance. There can be no guarantee that current or future products may not result in claims or that the Company's insurance will be adequate.

TAXATION

The Company cannot predict whether its tax rates will change as tax regulations and the application or interpretation thereof in the various jurisdictions within which the Company operates are always subject to change. See "Item 4. Information on the Company - Description of Business - Taxation of the Company and its Subsidiaries". Taxes are subject to audit. There can be no guarantee that additional taxes may be due as a result of audits or other factors. See also "Risk Factors - Manufacturing in China - Chinese Taxation".

COPY PRODUCT

On occasion in the electronic games and VGA industries, successful products are "knocked-off" or copied. While the Company strives to protect its intellectual property there can be no guarantee that knock-offs will not have a significant effect on

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its business. The costs incurred in protecting the Company's intellectual property rights could be significant and there is no assurance that the Company will be able to successfully protect its rights.

BAD DEBTS AND RETURNS

While the Company performs full credit checks on all of its customers it cannot be assured that any customer will not default on a payment of debt. Such a default could have a significant effect on the Company's results. It is industry practice for retailers to hold back payments on slow moving stock or to request markdowns or returns on such stock. It is the Company's policy in North America to only take back defective product and while the Company believes it will be able to enforce this policy under normal industry conditions, it may not be possible to enforce this policy in all cases. The VGA market generally experiences a higher rate of defective and overstock returns than the electronic and mechanical game market does. Generally, defective VGA that are manufactured by third party manufacturers are returned to the manufacturer or destroyed on site for credit. In such cases, there is no guarantee that the Company will be paid by the manufacturer.

In certain instances, where retailers are unable to sell the quantity of products which have been ordered from the Company, the Company may, in accordance with industry practice, assist retailers to enable them to sell such excess inventory by offering discounts or accepting returns. A portion of firm orders, by their terms, may be canceled if shipment is not made by a certain date. The Company minimizes the related costs of such discounts and returns by engaging personnel to visit selected customers and assist in the management of Radica product returns. The Company establishes provisions based on historical experience at the time of sale of the related products. The return of non-defective products occurs infrequently in the US. In the UK market, accepting non-defective product returns is regular industry practice and is required in certain vendor agreements.

CONTROL BY EXISTING SHAREHOLDERS

The Company's largest shareholders (see "Item 7. Major Shareholders and Related Party Transactions - Control of Registrant") including a group that consists of Dito Devcar Corporation and certain related persons, and a group that consists of RAD Partners 1999 LLC and certain related persons and/or Mary Hansen, own beneficially in the aggregate a majority of the outstanding Common Stock. Assuming that they were in agreement, such persons would have the power to elect the Company's directors and to approve or disapprove all other matters requiring shareholders' approval regardless of the vote of any other shareholders.

ENFORCEABILITY OF CIVIL LIABILITIES

The Company is a Bermuda holding company, and a substantial portion of its assets are located outside the United States. In addition, certain of the Company's directors and officers and certain of the experts named herein are resident outside the United States (principally in Hong Kong, the United Kingdom and the People's Republic of China), and all or a substantial portion of the assets of such persons are or may be located outside the United States. As a result, it may not be possible for investors to effect service of process within the United States upon such persons, or to enforce against them or the Company judgments obtained in the United States courts predicated upon the civil liability provisions of the United States securities laws. Among other things, the Company understands that there is doubt as to the enforceability in Bermuda and Hong Kong, respectively, in original actions or in actions for enforcement of judgments of United States courts, of civil liabilities predicated solely upon the United States securities laws.

SHARES ELIGIBLE FOR FUTURE SALE

At December 31, 2002, the Company had 17,796,131 shares of Common Stock outstanding. The Company estimates that most of such shares were sold in a registered offering or in a transaction under Rule 144, and therefore such shares (other than any shares purchased by "affiliates" of the Company) are tradable without restriction. The remaining shares owned by existing shareholders are restricted securities under the Securities Act of 1933, as amended (the "Securities Act") and may be sold only pursuant to a registration statement under the Securities Act or an applicable exemption from the registration requirements of the Securities Act, including Rule 144 thereunder. Most of these restricted shares are currently eligible for sale pursuant to Rule

144, subject to the limitations of such rule. In addition, the Company has granted to the Hansen Trust certain registration rights with respect to its shares. (See "Item 7. Major Shareholders and Related Party Transactions - Interest of Management in Certain Transactions") No predictions can be made as to the effect, if any, that market sales of shares by existing shareholders or the availability of such shares for future sale will have on the market price of Common Stock prevailing from time to time. The prevailing market price of Common Stock could be adversely affected by future sales of Common Stock by existing shareholders.



LICENCES AND ROYALTIES

The Company has entered into various license and royalty agreements in which it pays fees in exchange for rights to the use of product inventions or trademarked names, shapes and likenesses for use in development of the Company's product line. The agreements generally include minimum fee guarantees based on a reasonable expectation of the product sales to be generated throughout the life of the agreement. There can be no assurance that the Company will be able to meet these projected expections and may be obligated to pay unearned fees as a result. Licence and royalty agreements are for fixed terms and often contain performance-related covenants. There is no assurance that the Company will be able to maintain or extend the rights to its existing licences.

CONSIGNMENT INVENTORY

During 2001, the Company entered into distribution agreements in France and Germany in which inventory is sold to the distributors on a consignment basis. The Company has implemented controls to ensure that the physical inventory is regularly matched to the Company's internal records. There is no assurance that the consumer demand for the product in France and Germany will match the distributors' anticipated demand and there is a risk that the Company will be left with excess inventories in these markets, which would need to be closed out at prices below cost.

LABOR

Labor disputes initiated by unions and trade groups could negatively impact the business of the Company's vendors and customers. Such disputes could ultimately cause shipping delays, increased costs and lost revenues resulting from failure to deliver product to customers. The Company has no way of anticipating when such actions will occur.

SOURCING

The Company sources batteries, power sources and various electronic devices from various manufacturers for certain customers and receives most of its sourcing revenue from one customer. This revenue is subject to bid and there can be no assurance that this customer will not find another agent or method of sourcing.

DEPENDENCE ON VGA PLATFORM PROVIDERS

The Company's VGA Product Range (Gamester), is dependent on First Party Manufacturers of video game consoles such as Sony, Microsoft and Nintendo to continue to support and market existing games platforms like PlayStation(R) 2, Xbox(TM) and Game Boy(R) Advance, and to continue to develop gaming formats and accompanying software in the future. Radica cannot guarantee success in this category, without the ongoing support of these platform providers. If a platform is withdrawn from the market or fails to sell, the Company may be forced to liquidate its inventories or accept returns resulting in significant losses.

PROFITABILITY OF THE VGA BUSINESS

The Company's VGA product line, Gamester, has not been profitable since the acquisition of the line in 1999. Several factors have contributed to the losses including delays in third-party platform introductions, slower than expected realization of full US distribution and price wars on certain commodity VGA items. While the Company believes that it has taken measures during 2002 to ensure that the line will be successful in 2003, there is no guarantee that the VGA line will be profitable in the future or that the Company will continue to manufacture and distribute the line in future years. Continued future losses or withdrawal from the VGA business may result in significant write downs of certain Company assets.

ITEM 4. INFORMATION ON THE COMPANY

DESCRIPTION OF BUSINESS

Radica Games Limited (NASDAQ: RADA) manufactures and markets a diverse line of electronic entertainment products covering three product lines - electronic games carrying the Radica and Play TV brand names, Gamester branded video game controllers & accessories, and youth electronics carrying the Girl Tech and Barbie(TM) brand names. Radica also manufactures for other companies in the electronic game industry and provides sourcing services for retail customers. Manufacturing services are classified as a fourth product line while sourcing services are included within the results of other product lines as appropriate. The business is divided into two reportable segments: Games, which includes the electronic games



and youth electronics product lines as well as manufacturing services, and Video Game Accessories ("VGA") which relates to the Gamester product line. Sourcing services are provided within both reporting segments.

Founded in 1983 by Americans living in Hong Kong, the Company is headquartered in Hong Kong and manufactures its products in its Factory in southern China. The Company markets its products through subsidiaries in the United States, the United Kingdom, Canada and Hong Kong. Its largest market is in the United States where in 2002 it had the second largest market share in the electronic handheld and tabletop electronic games according to industry data source, The NPD Group, Inc. In the United Kingdom, the Company's subsidiary had the largest market share of the video game controller market among third-party manufacturers in 2001 according to industry data source, Chart Track. In 1994 the Company went public when its shares began trading on the NASDAQ exchange and are traded under the RADA symbol. A complete description of Radica's product line and company information can be found on its website (www.radicagames.com).

Radica employs about 4,000 people worldwide in its group of companies. The Company's largest retail customers include Wal-Mart, Target, Toys R Us, Kmart, Kohl's, Argos and Kay Bee. Its largest manufacturing customers are SSD Company (Japan) and Hasbro. Internationally the Company sells products in approximately 30 countries.

HISTORY OF PRODUCT LINES

ELECTRONIC GAMES

The Company has operated as a marketer and manufacturer of games since 1983, starting a small operation in Hong Kong providing souvenir casino games for the Las Vegas market including mechanical, toy, bank slot machines. Radica expanded into the electronic game business setting up a factory in China in 1991 and a distribution operation in the United States in 1992. The business grew substantially from that point and the Company became the leading supplier of casino type electronic handheld games in the US market with games such as Video Poker and Video Blackjack. The Company's electronic game products are sold under the Radica and Play TV brand names.

In 1995 Radica began to diversify its product line into other electronic handheld game areas beyond casino themed games. The Company began to offer classic games such as Solitaire, Hearts and Gin Rummy, and sports games such as its World Class Golf(TM) and Football. In addition to the casino and classic games that helped build the Company, in recent years Radica has expanded its electronic game offerings to a very broad line of electronic games including virtual fishing games such as Bass Fishin'(TM), virtual hunting games such as Buckmasters(R) Deer Huntin'(TM), a line of games based on EA SPORTS(TM) products, TETRIS(R) and Rush Hour(TM), Harley-Davidson(R) licensed games, and other games such as King Pin Bowling(TM), Talking Bingo(TM) and Ultimate Pinball(TM).

During its history Radica has become known as an industry leader in innovation and creative use of technology. For example, Radica's line of fishing games, one of the top-selling product lines in the history of electronic games, revolutionized the electronic handheld games category after its introduction in 1996. The games feature virtual motion-sensing technology that allows the player to use the physical game as a rod and reel. The player casts, feels the fish bite, sets the hook with a jerk, and reels in the fish with a real handle. This product started an industry trend in creating virtual reality games where the product provides the feel of the real sport. This is delivered by realistic game shapes, motion sensors and tactile feed back. For 2003 Radica is introducing Castmaster Bass Fishin'(R). Castmaster has a portable unit which detaches from the main rod to slip into a briefcase and allows the fisherman on the go to take practice fishing on the road. Place the unit back in the rod and you have a full-featured fishing game with all the realism and feedback for which Radica is known. Radica has expanded its line of virtual motion sensing games beyond the fishing category. An example of this is the Company's Buckmasters(R) Bow Huntin' II(TM) game. Motion sensors in the game mean you just tilt the game left and right and up and down to get the deer in you sight.

In 2000, Radica developed virtual reality further when it introduced NASCAR(R) I-Racer(TM). The full headset complete with headphones, produce 3D graphics and digital dimensional sound for a virtual reality experience. Vibration feedback in the steering wheel puts you in the race. Radica also introduced in 1999 a line of Tiger Woods licensed electronic golf games shaped like a real golf club that were able to sense direction and velocity of swing as an input to the game.

In 2000, Radica once again brought innovation to the electronic games category with the introduction of Radica Play TV games featuring XaviX(R) technology licensed from SSD Co., Ltd. The technology provides consumers with easy-to-use Play TV games, which are freestanding devices that plug directly into the TV and use the screen as the display. This single-chip, multi-processor integrated circuit is designed to generate high-quality graphics and sound on a television set without the use of a video game console. Most importantly the technology allows motion sensing control devices to interact with the TV images such as using a physical baseball bat controller to hit video pitches or a physical snowboard controller to control your race down a video ski slope. Play TV Baseball, Play TV Snowboarder, and Play TV Buckmasters(R) Huntin' were introduced in 2000 and 2001. In 2002 Radica expanded the Play TV line to include Play TV Baseball 2(TM), Play TV Boxing(TM), Play TV Soccer(TM) and Play TV Junior Construction(TM). In 2003 Radica will update its top selling Play TV Buckmasters(R) Huntin' by introducing Huntin' 2. Play TV will reach a whole new audience with Play TV Rescue Heroes(TM), an interactive vehicle playset based on Fisher-Price's(R) preschool vehicle, action figure and playset line.

In 2001 Radica introduced Skannerz(R). Targeting boys 7-12, Skannerz utilizes UPC scanner technology to create a fun, collectible-driven game. Use Skannerz to scan the UPC code of any consumer product to download monsters, magic potions and weapons to use in battle. Play alone or link two game units to battle against a friend. Each game unit includes a comic book. Building on this line for 2003 Radica will launch Skannerz Commander for Spring and Skannerz Battle Orbz in Fall. Skannerz Commander allows kids to create and control their own tribe of all new monsters. Train the strong, banish the weak and compete head-to-head against your friends. Skannerz Battle Orbz is a whole new way to battle. Players collect "monster disks," create their team, train and battle them against their opponents using"Rolling Battle Action." You can learn more about Skannerz and Radica's new Skannerz products on its website (www.skannerz.com).

In 2003 Radica will introduce its first multiplayer table top electronic game. Total Meltdown(TM) is a skill and action game which appeals to the whole family. Total Meltdown is a race against time that challenges players to test their mind and agility with four intense code-breaking games. With flashing lights, ticking clock and a taunting voice, players must complete the series of games: decipher the correct port for each of the "live wires;" complete a circuit with 12 perplexing pieces; crack the code to access the core and be agile enough to remove the core without touching the sides before it suffers a Total Meltdown.

VIDEO GAME ACCESSORIES

In June of 1999, Radica announced the acquisition of Leda Media Products, a UK company that, with its Gamester brand, is a leader in video game controllers in Europe (now known as Radica UK Ltd.). To date, Radica has established unique and successful video game controller and accessory products to enhance game play and performance on video game consoles for Nintendo, Sony and Microsoft including game control pads, steering wheels and memory cards. All Gamester products are designed to make the game more fun or make the user a better player, bringing the unfair advantage(TM) to the gamer.

Radica began shipping and selling the Gamester product line to the United States and Canada during the second half of 2001 and has moved most of the manufacturing of controllers into its Factory in China. The addition of Radica's wholly owned manufacturing plant in China served to boost the brand's credibility after the acquisition in 1999 with use of a thoroughly modern, high-tech, ISO 9001 certified facility. As a result, new product development is specially designed and built by Radica for the Gamester brand, except for certain items which are outsourced to third parties.

Radica introduced many new innovative peripherals in 2002 including the pressure-sensitive slim line Sportsboard(TM), an interactive skateboard/snowboard for top selling PS2 "boarding" games such as Tony Hawk, Shaun Palmer and SSX(TM). Radica licensed Lotus(R) in order to develop Official replica racing wheels to enhance play on some of the most popular racing game titles. Lotus and Radica share commitment to quality and innovation, and the licensing agreement has produced the popular Lotus Pro Racer and the Lotus Xbox(TM) Steering Wheel.

In 2001 Radica signed a worldwide licensing agreement with Microsoft to design, manufacture and market peripherals for the Xbox(TM) video game system. Xbox(TM) peripherals include the Vortex(TM) Controller, and the Pro Racer(TM) Hand-Held Wheel. Recognizing market demand, Radica recently introduced the Compact Pro game pad for all Xbox(TM) games.

The portable video game category expanded in 2001 with the introduction of Nintendo's Game Boy(R) Advance (GBA). Radica has introduced several products for the GBA including the new Flood Light(TM) that provides a superior illumination of the GVA screen using a fluorescent light. The UK has licensed NXT(R), creators of sound technology, to develop speakers to enhance surround sound of all GBA software titles. The licensing agreement has created the popular GBA Mini Woofer. The GBA line includes a broad selection of cases, bags, chargers, adaptors and accessory packs. A detailed description of the Gamester line can be found on the Internet at www.gamesterusa.com (US) or www.gamesteruk.com (UK).

YOUTH ELECTRONICS

In 1998 Radica acquired the start up Girl Tech Company. Girl Tech's mission is to enhance girls' lives and foster their use of technology by bringing to market personal, technology enhanced lifestyle electronics just for girls ages 8-12. These products are designed with girls' play preferences in mind addressing issues that are important to them such as privacy and

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communication. Girl Tech's products and services are tied by the common theme of encouraging girls to have fun with and benefit from the use of technology. The web site (www.girltech.com) contains over 600 pages of content to help address girls issues and acquaint girls with the uses of technology. It has been the recipient of website awards and is also a great place to see the Girl Tech product line.

In 1999, Girl Tech introduced of a line of breakthrough products for girls, including the Password Journal(R), which uses voice recognition technology to keep a girl's journal safe from intruders. In 2001 and 2002, Password Journal 2 was among the top ten products in the Youth Electronics market according to The NPD Group. Based on this success, Radica continues to expand its Password line for 2002 with the introduction of a new item: Password Room Control(TM), the first electronic device that allows a girl to turn on or off electric appliances in her bedroom with the sound of her voice. Also added to the Girl Tech line for 2002 was Eye-Lock(TM) Room Guard, the high-tech way for girls to "snoop-proof" their bedroom. The high tech "eye-code" allows girls to enter their private color combination and secure their doorknob. Blink the correct code and you can enter, blink the wrong code and an alarm sounds. In 2003 Radica will continue to update and improve the Password Journal with a new Password Journal product. While maintaining the voice recognition lock and other features that have made the two previous versions of this product so popular, the new Password Journal allows girls to customize their journal by designing their own cover. The new Password Journal includes a gel pen and custom fit paper for girls to use their creativity to personalize their journal.

Another introduction for Girl Tech in 2003 is Dare Ya!(TM), "The Ultimate Game of Truth or Dare." Girls can create their own double dares by recording them into the game. The game comes with traditional truth or dare cards in different categories such as gross, dreamy and performance. Truth or Dare has been a classic game for years and the new Dare Ya! from Girl Tech is taking it to a new level.

In February of 2002 Radica and Mattel announced that Radica received a license to bring to market electronic girls lifestyle products and electronic games under the Barbie(TM) brand name. The product line previewed at the 2002 Toy Fair and featured products intended for a younger age range than its Girl Tech line and targets girls 3 to 7 years old. Barbie(TM) is the dominant brand in girls' toys

The new Barbie(TM) electronics product line was led by the Barbie(TM) Dance Party(TM) game. This product allows girls to dance with Barbie(R) on TV through the use of the XaviX(R) technology that is used on the Company's Play TV line. The player is asked to follow Barbie(R)'s lead in fun dance moves and steps all demonstrated on the TV set. In 2003, Radica will introduce Scanimals(TM) Pet Rescue applying the same technology used in the Company's Skannerz product. Girls scan UPC codes in search of lost pets. There are 50 pets in all with different games such as Match and Obstacle Course. Based on the success of Password Journal, Radica will introduce My Secret Diary for the Barbie(TM) age girl. My Secret Diary opens electronically with a magnetic glitter pen. Additional games and accessories are planned for the future.

MANUFACTURING SERVICES

Since 1996 Radica has designed, engineered and manufactured products for other companies in the electronic games business. The Company's Factory in Tai Ping, Dongguan, Southern China has 524,000 square feet of factory space and 308,000 square feet of dormitory space. It has the capacity to house in excess of 5,000 people and employment typically varies from 3,000 to 6,000 depending upon seasonal demands. The Factory is capable of manufacturing up to 800,000 units per week. Radica manufactures for other companies on an ODM (original design and manufacture) basis. Radica currently designs and manufactures games for Hasbro, WiZ and their customer Bandai, as well as SSD and their customers Takara and Epoch. Radica also provides sourcing services for customers in the UK market, the largest customer of which is Argos.

BUSINESS STRATEGY

As a result of its efforts toward diversification, the Company now has a significant presence in four core product lines including electronic games, youth electronics, video game accessories and manufacturing services. The Company believes that these product lines are significantly related to each other in terms of their entertainment value and the expertise that is involved in delivering products in each of its categories of electronic entertainment. As a result there are synergistic skills that can be used to benefit each area of the Company's four core product lines. Within these product lines the Company is focused on building its five brands including the Radica brand of electronic games, the Play TV brand of electronic games, the Girl Tech and Barbie(TM) brands of youth electronics and game products, and the Gamester brand of video game accessories. It is the Company's strategy to focus on building each of these product lines and brands to their fullest potential through aggressive product development and marketing programs.



The Company's products are sold to retail customers and foreign distributors who sub distribute to retail customers in certain other worldwide markets. The Company sells direct to retail customers in North America and the United Kingdom. While the Company may occasionally sell directly to retailers in other worldwide markets it usually sells through sub distributors.

The Company also manufacturers most of its own products in its Factory in China in order to maintain quality and to minimize inventories of long lead-time electronic components. A small percentage of product sales come from products that are sourced from other factories by Radica's sourcing group. The Company utilizes the excess capacity of its Factory to manufacture products of a similar nature to its own products for other companies such as the Hasbro Games Group and SSD in Japan. The Company also provides sourcing services to certain retailers such as Argos in the United Kingdom. By providing such manufacturing and sourcing services to other companies Radica seeks to spread the overhead cost of its manufacturing and sourcing operations in order to improve profitability.

PRODUCT LINE SALES

The following table sets forth a breakdown of the Company's sales by major product category for the last four fiscal years.

| | YEAR ENDED DECEMBER 31, | | | | | |
|---|---|---|---|---|---|---|
| | 2002 | | | | | |
| PRODUCT LINES | % OF NET SALES VALUE | NET SALES VALUE | UNITS SOLD | NO. OF MODELS* | % OF NET SALES VALUE | SAL |
| (in thousands, except percentage and no. of models information) | | | | | | |
| Electronic Games | 50.3% | $ 62,684 | 6,277 | 101 | 53.0% | $ |
| Youth Electronics | 13.4% | 16,744 | 1,208 | 22 | 11.9% | |
| VGA | 12.7% | 15,844 | 2,118 | 150 | 10.5% | |
| Manufacturing Services | 23.6% | 29,374 | 6,666 | 30 | 24.6% | |
| | 100.0% | 124,646 | 16,269 | 303 | 100.0% | |

| | YEAR ENDED DECEMBER 31, | | | | | |
|---|---|---|---|---|---|---|
| | 2002 | | | | | |
| PRODUCT LINES | % OF NET SALES VALUE | NET SALES VALUE | UNITS SOLD | NO. OF MODELS* | % OF NET SALES VALUE | SAL |
| (in thousands, except percentage and no. of models information) | | | | | | |
| Electronic Games | 54.2% | $ 57,868 | 6,933 | 114 | 64.2% | $ |
| Youth Electronics | 13.0% | 13,897 | 1,211 | 12 | 5.4% | |
| VGA | 9.5% | 10,116 | 1,752 | 108 | 7.0% | |
| Manufacturing Services | 23.3% | 24,815 | 4,686 | 22 | 23.4% | |
| Total | 100.0% | 106,696 | 14,582 | 256 | 100.0% | $1 |

* Number of models includes new and continuing products as well as a significant number of discontinued items often sold in small quantities from existing closeout inventories.

Radica sells a broad range of electronic and mechanical handheld and tabletop games under the Radica brand name. These games simulate sports and recreational activities, such as fishing, hunting, golf, baseball and snowboarding; casino games, such as blackjack, poker and slots; and popular heritage games such as solitaire, checkers, Tetris(R) and crossword puzzles.

During 1999, Radica introduced its Girl Tech line of electronic products. The Girl Tech line provides unique and innovative gadgets for girls that utilize technologies such as the electronic voice recognition used in Password Journal and Password Room Control.

In June of 1999, the Company acquired Radica UK, which expanded its product portfolio to include VGA such as steering wheels, joypads, memory cards and other video game accessories for PlayStation(R), PlayStation(R) 2, Nintendo 64,



Nintendo Game Boy(R) and PC Platforms. The Company currently sells products for the following platforms: Sony PlayStation(R), Sony PlayStation(R) 2, Nintendo Game Boy(R) Advance, Nintendo GameCube(TM) and Microsoft Xbox(TM).

During 2000, Radica introduced its Play TV line, featuring the XaviX(R) technology which allows users to plug games directly into their television set for display of the game contact on the screen without requiring connection through a video game system.

During 2001, Radica entered into an agreement to become an approved licensed vendor of video game accessories for the Microsoft Xbox(TM). Xbox(TM) peripherals include the Xbox(TM) Pro Racer and the Xbox(TM) Vortex Assortment.

NEW PRODUCT INTRODUCTION

Each year Radica plans to introduce new products to refresh and extend its product line. The company is currently following a strategy in the VGA business segment to reduce the number of stock keeping units (SKUs), focusing on only the highest potential products. In fiscal 2003, the Company intends to update its product line by introducing approximately 60 new products. This would represent a reduction of 31 new introductions from 2002 in the VGA line. In 2002, VGA introductions were higher than would be expected in 2003 due to the fact that new video game platform introductions required a higher level of supporting new products than in subsequent years.

2003 vs. 2002 New Product Introductions (by category)

| | 2003 | 2002 |
|---|---|---|
| Electronic Games | 23 | 14 |
| Youth Electronics | 12 | 8 |
| VGA | 25 | 56 |
| TOTAL | 60 | 78 |

The Company believes that its strategy of offering various game models with differing features enables it to market its games to a wide age range of consumers with different tastes and financial means.

The Company anticipates that new product introductions in fiscal 2003 will be concentrated in the second and third quarters of that year. It is possible that the Company will determine not to proceed with any given product or that one or more aspects necessary for introduction of the products in fiscal 2003 will be delayed, which could delay or prevent certain anticipated product introductions.

LICENSING

During fiscal 2002, Radica engaged in several licensing agreements in which the Company was given permission to use the name, logo, game concept and/or license of a person, company or brand in exchange for a royalty fee.

Among the licensors were Electronic Arts, Group Lotus plc, UK, Buckmasters, Harley-Davidson, Elvis Presley Enterprises, Sony Pictures, makers of Men in Black II(TM), the Tetris(R) Company, New Transducers Limited, developers of NXT(R) manufacturing sound technology, SSD, developers of XaviX(R) technology, Microsoft, developers of Microsoft Xbox(TM) and Mattel, makers of Barbie(TM).

The Company intends to incorporate some of these licenses into its 2003 product line and will pursue new licenses in instances where management feels it will enhance the value and marketability of a particular product.

MANUFACTURING

Radica's manufacturing is generally limited to IC bonding, plastic injection, clamshell production, mold manufacture, surface mount technology ("SMT") and assembly operations. The Company orders customized components and parts from suppliers and uses subcontractors for more complicated operations such as masking of the Company's proprietary software onto the semiconductor chips used in its games, LCD tooling and a proportion of tooling of molds for its plastic parts.

In 2002 the Company assembled most of the Radica and Girl Tech lines of products in order to control its costs, quality, production and delivery schedules. VGA were assembled both in-house and by third party manufacturers.

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The Company's products are not required to obtain any quality approvals prior to sales in the United States. The Company, however, is required to have and has obtained CE approval, Europe's toy safety standard, for its products sold in Europe. The Company has been granted a Chinese toy quality license from the Chinese Import and Export Commodity Inspection Bureau, which is required of toy and game manufacturers in China to export toys or games. In addition, the Company voluntarily complies with ASTM 963, a US toy safety standard.

The Company received renewal of its ISO 9001 quality certification from Underwriters Laboratory on January 24, 2001. The scope of the registration covers the design, sales and distribution of electronic and electro-mechanical games and related gift products.

MANUFACTURING FACILITIES

Radica currently manufactures its products at its Tai Ping Factory in Dongguan, Southern China approximately 40 miles northwest of Hong Kong. The Factory was constructed with the cooperation of the local government according to the Company's design specifications on a 3.7 acre site and contains 524,000 sq. ft. of factory space and 308,000 sq. ft. of dormitory space, capable of housing over 5,000 workers. An extension of the Factory commenced in December

1999 to add 202,000 square feet of factory space and 178,000 square feet of dormitory space allowing for up to an additional 3,000 employees to be housed. The cost of construction of the extension would have been approximately $3.0 million, exclusive of manufacturing equipment. As a result of the drop in demand for Radica product in the US during 2000, work towards completion of this addition has been postponed and may continue when market demand warrants use of the additional space. The expansion has been sufficiently completed to the point that no impairment issues exist and it is currently being used for storage during peak production season. The unit capacity of the Factory depends on the product mix produced. In any event, there can be no assurance that the Company will be able to operate at full capacity or have sufficient sales to warrant doing so.

In June 1994 the Company entered into a joint venture agreement ("Joint Venture Agreement") with the local government to operate the Factory. The Company contributed the cost of the construction of the Factory to the joint venture while the local village contributed the land-use rights. The joint venture is for 30 years after which it may be renegotiated. The construction cost of the Factory is being treated as a prepaid 30-year leasehold on the Factory. Upon the commencement of production, the local government received a fixed annual fee as the joint venture partner. The annual fee is subject to increases every three years and had originally been set at a 20% increase every 3 years but has been successfully renegotiated to be 10% every 3 years. Aside from the fixed annual fee paid to the Company's joint venture partner, the Company is the sole beneficiary of the results of the joint venture, and the Company solely controls the joint venture's operations, including the operating and capital decisions of the joint venture in the ordinary course of business.

The Company also manufactures in the Factory under a processing agreement ("Processing Agreement") with the local government. The Processing Agreement provides by its terms that the local government will provide manufacturing facilities and supply workers to the Company and that the Company will pay a management fee and processing fee and certain other charges. The management fee is paid to the local government and is based on a negotiated sum per worker at the Factory. The processing fee is based on the value of raw materials shipped into the Factory and the value of products shipped from the Factory and is established in production agreements agreed upon with local government officials. The Company pays the processing fees through the Bank of China in Hong Kong and the funds are then placed in an operating account including other Company funds in China, all of which are used to pay the costs of the Factory including fees due to the local government as part of the processing agreement. Changes in PRC tax and customs law have made it increasingly difficult to use the Processing Agreement.

All of the Company's operations in the PRC, whether within the joint venture or the Processing Agreement are accounted for as wholly-owned operations and included in the Company's consolidated financial statements.

During 2001, the Company made a decision to end its use of the Processing Agreement. As of the date of this report, the Company has one outstanding Processing Agreement contract which requires PRC tax authority approval before it can be transferred to the joint venture. An application has been made for this approval. The Company does not expect to have any open Processing Agreement contracts by June 30, 2003.

In order to completely discontinue its use of Processing Agreement contracts, the Company must transfer all existing assets held under the Processing Agreement. This may require the Company to incur a one-time payment to increase the capital reserves of the Joint Venture Agreement. The amount of this payment has yet to be determined. The payment would not result in any outflow of funds in the Company's consolidated financial statements.

In practice, the Company operates all aspects of the Factory, including hiring, paying and terminating workers. Most of the Company's Factory workers are hourly employees and are provided room and board in addition to their wages. In addition, the Company bears all other costs of operating the Factory, including utilities and certain employee social welfare charges established by the local government. Many aspects of the Processing Agreement and operation of the Factory are dependent on the Company's relationship with the local government and existing trade practices in addition to the terms of the Processing Agreement. The Company believes that its relationship with the local government is good.

Should the Company decide to curtail its manufacturing activities in China, it may be required to pay back certain tax benefits it has received and may be held liable for certain fees. Such liabilities may be substantial.

MATERIALS

Major components used in the Company's products are liquid crystal displays ("LCDs"), semiconductor chips, printed circuit boards ("PCBs") and molded plastic parts. The Company purchases LCDs, PCBs, and semiconductor chips from several suppliers, although specific LCDs, PCBs or semiconductor chips for any particular model are generally purchased from a single supplier. The Company generally provides six to nine months order indications to its semiconductor chip suppliers and must place firm orders a minimum of eight weeks in advance of delivery. This lead time in some cases extends to twenty weeks when the market is in short supply. The Company generally tries to maintain only two months supply of semiconductor chips, which may constrain increased production of its products on short notice. The Company pays for most of its materials in US dollars.

The Company's major suppliers of electronic and mechanical handheld and tabletop game materials in fiscal 2002 included Arrow / Components Agent Limited (semi-conductor chips), Epson Hong Kong Limited (semi-conductor chips), Evergreen PCB Factory Limited (PCBs), GPI International Limited (batteries), Lead Jump Development Limited (PCBs), Meise Label Printing Fty (printing), Senmax, Limited (keypads), Sensory, Inc. (semiconductor chips), SSD Company, Ltd (semi-conductor chips), United Radiant Technology (HK) Limited (LCDs), Wintek Corporation (LCDs) and Yu Lee Printing Co. (printing).

The Company's major suppliers of VGA in fiscal 2002 included Minwa Electronics Co. Ltd. (power adaptors), Mascotte Industrial Associates (HK) Ltd. (game accessories) and Jesmay Electronics Co. Ltd. (cables).

SALES AND DISTRIBUTION

Radica's products are sold in approximately 30 countries, with the United States accounting for over 60% of net sales in fiscal 2002. The Company sells its products directly to over 350 active retailers in the US and UK and to approximately 30 distributors worldwide. The Company participates in the electronic data interchange ("EDI") program maintained by 15 customers in the USA including Wal-Mart, Target, Kmart, Kohl's, J.C. Penney's and Sears, and 7 customers in the UK, including Argos, Comet and Dixon's. In fiscal 2002, the largest customer of the Company, Wal-Mart, accounted for 24.7% of net sales; in addition ODM/OEM work for SSD accounted for 9.2% of net sales. All sales to third party distributors and retail customers are final upon transfer of title. In the case of the consignment distributors in France and Germany, sales are recognized only upon verification of sell-through to the customers of distributors. The top five customers were as follows:

| CUSTOMER NAME | % OF SALES FOR THE FISCAL YEAR 2002 | 2001 |
| --- | --- | --- |
| 1. Wal-Mart (USA) | 24.7% | 22.8% |
| 2. SSD (Japan) | 9.2% | 11.1% |
| 3. TRU (USA) | 8.5% | 5.0% |
| 4. Argos (UK) | 8.3% | 7.3% |
| 5. Target (USA) | 7.4% | 6.1% |

The following table sets forth certain of the Company's major customers in 2002, including distributors (alphabetical order).



CATALOG SHOWROOMS

Brookstone
Sharper Image

DEPARTMENT STORES

J.C. Penney's
Kohl's
Woolworth's

MAIL ORDER/SPECIALTY GIFT SHOP OPERATORS

Avon
Buckmaster
Custom Souvenir and Novelty
DFS North America
Dufferen Game Room Stores
Figis
Hammacher Schlemmer
Home Shopping Network
Host Marriott Corp
Spiegel
Spillsbury
Spencer Gifts
Starboard Cruise Services
Wish Book

DRUG/MASS MERCHANDISERS

Ames
Army Airforce Exchange
BJ Stores
Cokem
Dollar General
Fred Meyer
Kmart
Meijer
Milton D Myer Co.
Pamida
QVC
Ross Stores
Shopko
Snyder Drugs
Target
Wal-Mart
Zellers

SPORTING GOODS STORES

Sports Authority
Bass Pro Shops

TOY RETAILERS

Kay Bee
Toys'R'Us

DISTRIBUTORS (VGA)

Giochi Preziosi (Italy)
Koch (Germany)

ELECTRONIC

About Time
Best Buy
Biggs Hype
Circuit Ci
Comet
Corner Dis
Dixon's
Electronic
Fry's
Gamestop
Ingram Ent
Musicland
Transworld
W.H. Smith

DISTRIBUTO

Amoy oy (F
Estona Inc
Forte Co.
Galeria 76
Gemini Ind
Imbi Mario
Importador
Irwin Paci
John Hanse
Lansay (Fr
Masudaya C
Playthings
Replay Int
Souvenirwo

| | | |
|---|---|---|
| Zany Brainy | Nobilis (France) | The Orient |
| | Pifa S.A. (Belgium) | Universal |
| | Top Toy (Denmark) | |
| | Unsaco AS (Norway) | |

The acquisition of Radica UK gave the Company the resources to move UK sales of Radica product in-house. Subsequently, Radica terminated its distribution agreement with its UK distributor in 1999.

Radica USA uses regional sales managers working for the Company to manage its customers as well as the manufacturers representatives and brokers that sell its products to certain retailers. These manufacturers representatives are not employees of the Company and work on a commission basis.

The Company's customers normally provide indications of interest, which may be canceled at any time, from three to six months prior to scheduled delivery, but only confirm orders eight weeks in advance of delivery. Accordingly the Company generally operates without a significant backlog of regular orders.

During 2002, the Company sold on consignment to two of its distributors: Nobilis in France and Koch in Germany (see "Item 3. Key Information - Risk Factors - Risk of Consignment Inventory"). At the end of 2002, the Company terminated its current agreement with Nobilis and is in the process of negotiating a distributor agreement with them. The impact of this decision has been accrued for as at 31 December 2002.

In certain instances, where retailers are unable to sell the quantity of products which have been ordered from the Company, the Company may, in accordance with industry practice, assist retailers to enable them to sell such excess inventory

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by offering discounts or accepting returns. A portion of firm orders, by their terms, may be canceled if shipment is not made by a certain date. The Company minimizes the related costs of such discounts and returns by engaging personnel to visit selected customers and assist in the management of Radica product returns. The Company establishes provisions based on historical experience at the time of sale of the related products. The return of non-defective products occurs infrequently in the US. In the UK market, accepting non-defective product is regular industry practice and the Company establishes its return provisions on such sales based on experience.

In February 2003, the Company gave notice of termination to both Nobilis and Koch of their distributor agreements. The Company took a provision against the consignment inventories held by these distributors that was accrued for as of 31 December 2002. While the Company believes the accrual is adequate to cover potential losses, there can be no guarantee it will be adequate.

The Company's Radica, Girl Tech, Play TV and Connectv products carry a 90 days consumer warranty from the date of sale. The Company's VGA products carry a one year warranty from the date of sale. In each of the last three years, warranty costs incurred have been less than 3% of net sales and substantially all warranty claims are received within 90 days of invoice.

PRODUCT DEVELOPMENT

At the end of 2002, Radica's engineering and development department had approximately 97 staff worldwide. The Company's product development starts with design teams in Dallas, Texas; and Hertfordshire, England and continues through to the engineering teams in Shenzhen and in the Dongguan Factory. The Company has a formalized product development process that includes quarterly meetings of its worldwide product development and sales departments. In fiscal 2000, 2001 and 2002, the Company spent approximately $5,210,000, $5,775,000 and $4,094,000 respectively, on research and development. The Company's research and development is heavily oriented toward market demand. Based on its ongoing contact with consumers, retailers and distributors worldwide, the Company's sales and marketing departments seek to understand and assist the product development teams in responding to consumer and retailer preferences. The sales department also targets certain retail price points for new products which drive the Company's product development, with designs, features, materials, manufacturing and distribution all developed within the parameters of the target retail price. The Company also reviews product submission from a network of third party inventors that have been approved by management. These submissions are subjected to the same product development process and market demand considerations as internal submissions.

In January of 2002, the Company executed its December 2001 reorganization plan that included the closure of the San Francisco research and development office and the relocating of the Hong Kong engineering positions to offices in China. This reorganization significantly reduced costs without decreasing efficiency. By trimming the breadth of its product lines going forward, the Company expects to continue developing the majority of products internally during 2003. However, changes in business philosophy or unforeseen circumstances may arise that could force the Company to outsource a larger than expected amount of its development work.

SEGMENT INFORMATION

See Note 19 of the Notes to the Consolidated Financial Statements included herein.

ORIGINAL DESIGN MANUFACTURING AND ORIGINAL EQUIPMENT MANUFACTURING

In 1995, the Company was successful in establishing a relationship with the Hasbro Games Group to design and manufacture products for them. The Company continues to manufacture for Hasbro, which is also Radica's largest competitor, and also has OEM and ODM business with SSD of Japan. In 2002 the Company used the technology developed for its Skannerz product line to build D-Scanner for WiZ of Japan. The Company intends to pursue other ODM and OEM business in the future. However it is uncertain whether the Company can retain its current business on a long-term basis or successfully attract additional ODM business or that it will be profitable.

INTELLECTUAL PROPERTY

The Company owns many patents, trademarks and copyrights and is in the process of registering other intellectual properties. It will continue to apply for intellectual property registrations on new products as management deems necessary.

The Company anticipates that patents, trademarks, copyrights and other intellectual property rights will become increasingly important in the electronic entertainment industry in which the Company operates, particularly since the Company is introducing a wider range of products. As the industry focuses on intellectual property matters, there will be opportunities for the Company to protect its products through patents, trademarks and other formalized filings, although the efficacy of these protections is uncertain. By the same token, the Company will be exposed to risks that its products or other aspects of its business will be found to infringe the intellectual property rights of others. See "Item 3. Key Information - Risk Factors - Intellectual Property Risks".

COMPETITION

The games business is highly competitive. Radica believes that it is one of the leading sellers of electronic games and youth electronics. The Company's primary competitor is the Hasbro Games Group ("Hasbro"), which is also an OEM customer of the Company. Hasbro procures its products from manufacturers in China including Radica. The barriers for new producers to enter the Company's markets are relatively low and the Company expects that it will face strong competition. The Company competes for consumer purchases on the basis of price, quality and game features and for retail shelf space also on the basis of service, including reliability of delivery, and breadth of product line. Some competitors offer products at lower prices than the Company, are better established in the toy and games industry and are larger than the Company. The Company's products also compete with other gifts and games for consumer purchases. In addition, with respect to ODM/OEM activities, the Company competes with a number of substantially larger and more experienced manufacturers. As the Company enters other markets and businesses, it expects to face strong competition.

The VGA market is also highly competitive. The market share in the UK is spread primarily amongst ten companies that have 63.5% of the overall market. The Company began significant distribution of VGA in the US market in 2001. Like the handheld electronic games market, the Company competes for customer purchases on the basis of price, quality, and features and for retail shelf space on the basis of service. Major competitors are MadCatz, Pelican, Guillemot and Big Ben.

In January 2003 the Company established Radica (Macao Commercial Offshore) Limited in Macao, China to handle all sales administration on behalf of the Factory in Dongguan.

TAXATION OF THE COMPANY AND ITS SUBSIDIARIES

There is currently no Bermuda income, corporation or profits tax payable by the Company. As an exempted company, the Company is liable to pay to the Bermuda government an annual registration fee calculated on a sliding scale basis by reference to its assessable capital, that is, its authorized share capital plus any share premium on its issued shares of Common Stock currently at a rate not exceeding $25,000 per annum.

The Hong Kong profits tax rate currently applying to corporations is 16%. The Hong Kong government has recently announced that this rate will increase to 17.5% in 2003. Currently, Radica HK and one other Hong Kong-based subsidiary pay Hong Kong profits tax on service and sales income.

On July 1, 1994, the Company's manufacturing operations were transferred to a Sino-Foreign Joint Venture. As Radica Games itself does not carry on any business in China, it is not subject to tax. The Joint Venture enjoyed a two year tax holiday which expired in 1999. From January 1, 1999 to December 31, 2001 its profits were taxed at a reduced rate of 12%, half the regular tax rate of 24%. In 2002, the Company was taxed at the regular tax rate plus a local tax rate of 3%, but has applied to be designated as an "Export Oriented Enterprise", which will reduce its tax rate to 12% if the application is successful. The excess tax paid in 2002 will offset the profit tax of 2003 if the application for a reduced rate is approved in May 2003.

Radica USA and Disc Inc. are fully subject to US and Canada federal taxation, as well as any applicable state or local taxation, on their taxable income. Currently, the highest marginal rate of US federal corporate income tax is 35%; the highest marginal rate of Canada federal corporate income tax is 25%. In addition, dividends paid by Radica USA and Disc Inc. to the Company will be subject to a 30% US federal withholding tax, resulting in an effective rate of US federal taxation on distributed profits of up to 54.5%.

Radica UK is fully subject to UK corporate taxation. The UK profits tax rate currently applying to corporations is 30%.

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EMPLOYEES

As of December 31, 2002 the Company's workforce was comprised of the following:

| | Production | Sales and Marketing | R&D | Finance | Operations & Admin | Total by location |
|---|---|---|---|---|---|---|
| Asia | 4,015 | 6 | 79 | 24 | 124 | 4,248 |
| USA | - | 21 | 13 | 9 | 14 | 57 |
| Europe | - | 10 | 5 | 5 | 7 | 27 |
| Total | 4,015 | 37 | 97 | 38 | 145 | 4,332 |

At December 31, 2001 and 2000 the Company's workforce comprised 4,185 persons and 4,378 persons, respectively.

None of the Company's employees are subject to a collective bargaining agreement and the Company has never experienced a work stoppage. Management believes that its employee relations are good.

DESCRIPTION OF PROPERTIES

See "Manufacturing Facilities" above. The Company completed the first phase of construction of its Factory (241,000 sq. ft.) on a 3.7 acre parcel of land in May 1995 and the second phase (223,000 sq. ft.) in August 1998. The Factory currently contains 524,000 sq. ft. of factory space and 308,000 sq. ft. of dormitory space, capable of housing over 5,000 workers. An extension of the Factory commenced in December of 1999 to add 202,000 square feet of factory space and 178,000 square feet of dormitory space. As a result of the drop in demand for Radica product in the US during 2000, work towards completion of this addition has been postponed and will continue when market demand warrants use of the additional space. The Company owns a long-term leasehold on its executive offices (13,561 sq. ft. inclusive of 2 leased units of 4,482 sq. ft.) and warehouse space (7,900 sq. ft.) in Fo Tan, Hong Kong as well as two houses for employees in Hong Kong (2,100 sq. ft. each) which have been made available to Mr. Howell and Mr. Scott, officers of the Company. Radica operates its Factory under the terms of the Joint Venture Agreement and Processing Agreement. The Company leases additional office space in Hertfordshire, UK and Macau, Dallas, Texas and Pasadena, California. The Company leases showrooms in Tsim Sha Tsui, Hong Kong and New York, New York and provides individual offices for sales personnel employed in Massachusetts and Illinois. During 2002, the Company sold one of its executive units in Fo Tan, Hong Kong totaling 1,843 sq. ft., leased one of its Fo Tan units totaling 2,589 sq. ft. and plans to lease additional space in another Fo Tan unit totaling 2,500 sq. ft in 2003. In addition, during 2002 the Company leased out the house that had been made available to Mr. Howell and is currently paying rent on a different house for Mr. Howell in Hong Kong.

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ITEM 5. OPERATING AND FINANCIAL REVIEW AND PROSPECTS

RESULTS OF OPERATIONS

FISCAL 2002 COMPARED TO FISCAL 2001

The following table sets forth items from the Company's Consolidated Statements of Operations as a percentage of net revenues:

| | Year ended December 31, | |
|---|---|---|
| | 2002 | 2001 |
| Net sales | 100.0% | 100.0% |
| Cost of sales | 62.2% | 65.6% |
| Gross margin | 37.8% | 34.4% |
| Selling, general and administrative expenses | 22.2% | 26.7% |
| Research and development | 3.3% | 5.8% |
| Depreciation and amortization | 2.3% | 4.1% |
| Restructuring charge | 0.0% | 1.6% |
| Operating income (loss) | 10.0% | (3.8%) |
| Other income | 0.3% | 0.0% |
| Foreign currency gain (loss), net | 1.4% | (0.2%) |
| Interest income, net | 0.0% | 0.1% |
| Income (loss) before income taxes | 11.7% | (3.9%) |
| Provision for income taxes | (2.1%) | (0.5%) |
| Net income (loss) | 9.6% | (4.4%) |

The Company reported net income of $11.9 million for fiscal year 2002 or $0.65 per diluted share versus a net loss of $4.4 million or $0.25 per diluted share for fiscal year 2001.

Summary of sales achieved from each category of products:

| | YEAR ENDED DECEMBER 31, | | | |
|---|---|---|---|---|
| | 2002 | | 2001 | |
| Product Lines | % of Net Sales Value | Net Sales Value | % of Net Sales Value | Net Sales Value |
| (US$ in thousands) | | | | |
| Electronic Games | 50.3% | $ 62,684 | 53.0% | $ 52,268 |

| | | | | |
|---|---|---|---|---|
| Youth Electronics | 13.4% | 16,744 | 11.9% | 11,720 |
| VGA | 12.7% | 15,844 | 10.5% | 10,335 |
| Manufacturing Services | 23.6% | 29,374 | 24.6% | 24,231 |
| Total | 100.0% | $ 124,646 | 100.0% | $ 98,554 |

Gross margin for the year was 37.8% compared to 34.4% for the year ended December 31, 2001 as a result of improved cost control, factory efficiencies and product mix.

Operating expenses for the year were $34.6 million compared to $37.6 million for the year ended December 31, 2001. The decrease in expenditure was as a result of cost reductions, including R&D due to the restructuring announced in Q4 2001, offset by increased variable costs due to the 26.5% increase in sales. In addition depreciation and amortization charges dropped by $1.2 million of which $0.8 million was due to the adoption of SFAS 142 and the resulting cessation of amortization of goodwill.

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The following table shows the major operating expenses and income taxes:

| | Year ended December 31, | |
|---|---|---|
| (US dollars in millions) | 2002 | 2001 |
| Commissions | $ 0.6 | $ 0.7 |
| Indirect salaries and wages | 8.1 | 8.2 |
| Advertising and promotion expenses | 8.5 | 8.1 |
| Research and development expenses | 4.1 | 5.8 |
| Provision for income taxes | 2.7 | 0.6 |

Research and development costs decreased from 2001 as a result of the 2001 reorganization (see "Item 4. Information on the Company - Description of Business - Product Development"). The increase in the provision for income taxes from 2001 was primarily the result of a valuation allowance put in place to offset the UK deferred tax asset.

CAPITAL RESOURCES AND LIQUIDITY

At December 31, 2002 the Company had $32.7 million of cash and net assets of $74.6 million compared to $25.8 million and $63.1 million, respectively at December 31, 2001. The Company generates a significant majority of its cash from its normal operations but seasonal cash requirements have been met with the use of short-term borrowings, which included borrowings under secured lines of credit.

At December 31, 2002, cash and cash equivalents, net of short-term borrowings, were $31.8 million of which $9.0 million of cash deposits have been pledged as security for undrawn or substantially repaid facilities. Management does not consider that there are any significant restrictions on its ability to gain access to these deposits given the significant excess of pledged assets over outstanding borrowings. This compares with cash and cash equivalents, net of short-term borrowings of $25.0 million at December 31, 2001. The Company generated approximately $12.0 million, $10.3 million and $(4.7 million) of net cash from its operating activities in 2002, 2001 and 2000, respectively. The increase in 2002 from 2001 was primarily a result of higher sales revenue and higher gross margins in 2002 compared to 2001, combined with decreased expenditure as a result of cost reductions in operations. Receivables increased to $15.1 million from the December 31, 2001 level of $13.9 million. This was the result of higher sales during the second half of 2002 compared to the same period in 2001. Inventories increased to $20.4 million from $17.2 million at December 31, 2001 primarily as a result of inventory buildup in preparation for the first quarter of 2003. The reserves for doubtful accounts, customer returns, warranty expenses and accrued sales allowance were as follows:

| (US dollars in thousands) | Balance at beginning of year | Charged to expense | Utilization write-offs |
|---|---|---|---|
| 2002 | | | |
| Allowance for doubtful accounts | $ 2,207 | $ 60 | $ (1,9 |
| Allowance for estimated product returns | 1,555 | 390 | (6 |
| Accrued warranty expenses | 900 | 1,771 | (1,6 |
| Accrued sales allowance | 3,912 | 1,864 | (2,1 |
| | $ 8,574 | $ 4,085 | $ (6,4 |
| 2001 | | | |
| Allowance for doubtful accounts | $ 2,073 | $ 1,056 | $ (9 |
| Allowance for estimated product returns | 1,494 | 1,528 | (1,4 |
| Accrued warranty expenses | 950 | 1,911 | (1,9 |
| Accrued sales allowance | 3,717 | 2,914 | (2,7 |
| | $ 8,234 | $ 7,409 | $ (7,0 |

Current liabilities were $20.7 million at December 31, 2002 compared to $23.5 million at December 31, 2001. The decrease was the result of reduction in accounts payable, current portion of long-term debt and accrued expenses from 2001.



Prepaid assets decreased to $1.7 million from $2.3 million at December 31, 2001. This was the result of a decrease in prepaid license and royalty fees. Accrued payroll and employee benefits increased to $2.8 million at December 31, 2002 from $0.9 million at December 31, 2001 primarily as a result of accrued bonuses relating to the 2002 fiscal year. Total debt stood at $2.7 million at December 31, 2002, down $3.6 million from $6.3 million at December 31, 2001.

Cash flows from investing activities were a net utilization of $1.1 million, $1.0 million and $4.3 million in 2002, 2001, and 2000, respectively. During 2002 and 2001, the Company invested in the purchase of property, plant and equipment.

Cash used in financing activities was $3.3 million in 2002 compared with $6.4 million in 2001. This change was primarily due to repayment of short-term debt during 2001.

The Company commits to inventory production, advertising and marketing expenditures prior to the peak third and fourth quarter retail-selling season. Accounts receivable increase during the third and fourth quarter as customers increase their purchases to meet customer demand during the holiday season. Due to the concentrated time frame of this selling period, payments for these accounts receivable are generally not due until the fourth quarter or early in the first quarter of the subsequent year. This timing difference between expenses paid and revenues collected sometimes makes it necessary for the Company to borrow amounts during the year. As of December 31, 2002, the Company had more than $5.0 million of various lines of credit available. A breakdown of the Company's short-term and long-term financing during 2002 is as follows:

| Bank | Loan Amount as at 1/1/2002 | Debt Repayment | Loan Amount as at 12/31/2002 | Date of Maturity |
|---|---|---|---|---|
| (US$ in thousands) | | | | |
| China Construction Bank (Humen, China) | $ 846 | $ -- | $ 846 | August 7, 2003 |
| HSBC | $ 5,473 | $ (3,648) | $ 1,825 | June 22, 2003 |

Both loans are payable in installments. Loan installments due within twelve months of year-end are included in short-term liabilities; installment payments scheduled beyond twelve months from year-end are included in long-term debt (See Note 9 of the Consolidated Financial Statements). The term loan is secured by certain properties and deposits of the Company (see Note 16 of the Consolidated Financial Statements). The agreements contain covenants that, among other things, require the Company to maintain a minimum of tangible net worth, gearing ratio and other financial ratios. The Company is in compliance with these covenants as at December 31, 2002.

In the normal course of business, the Company enters into debt arrangements, licensing agreements and commitments with various third parties for the use of their inventor concepts and intellectual property. Certain of these agreements and commitments contain provisions for guaranteed or minimum royalty amounts during the term of the contracts.

| | Total | 2003 | 2004 | 2005 | 2006 | 2007 | Thereafter |
|---|---|---|---|---|---|---|---|
| (US$ in thousands) | | | | | | | |
| Long-term debt | $1,825 | $1,825 | $ -- | $ -- | $ -- | $ -- | $ -- |
| Licensing minimums | 80 | 63 | 1 | 16 | -- | -- | -- |
| Operating leases | 2,744 | 475 | 350 | 252 | 245 | 242 | 1,180 |
| Joint venture fee | 3,808 | 126 | 130 | 130 | 138 | 143 | 3,141 |
| Total | $8,457 | $2,489 | $ 481 | $ 398 | $ 383 | $ 385 | $4,321 |

Management believes that the Company's existing credit lines are sufficient to meet future short-term cash demands. The Company funds its operations and liquidity needs primarily through cash flow from operations, as well as utilizing borrowings under the Company's secured and unsecured credit facilities when needed. During 2003, the Company expects to continue to fund its working capital needs through operations and its revolving credit facility and believes that the funds available to it are adequate to meet its needs. The Company expects to be in compliance with its covenants in 2003. However, unforeseen circumstances, such as severe softness in or a collapse of the retail environment may result in a significant decline in revenues and operating results of the Company, thereby causing the Company to exhaust its cash resources. If this were to occur, the Company may be required to seek alternative financing of its working capital. In addition, this may cause the Company to be in non-compliance with its debt covenants and to be unable to utilize its revolving credit facility.



The Company had no derivative instruments or off balance sheet financing activities during fiscal years 2001 and 2002. The Company believes that its existing cash and cash equivalents and cash generated from operations are sufficient to satisfy the current anticipated working capital needs of its core business.

FISCAL 2001 COMPARED TO FISCAL 2000

The Company experienced a net loss of $4.4 million for fiscal year 2001 or $0.25 per diluted share versus a net loss of $18.1 million or $1.03 per diluted share for fiscal year 2000.

Net sales for 2001 were $98.6 million, compared to $106.7 million in 2000. The decline in net sales during 2001 resulted from worldwide economic recession; and the effect of the September 11 terrorist attacks in New York, which eroded US consumer confidence and as a result caused retailers to exercise caution in their buying. Several top US retailers cancelled holiday reorders in the wake of the attacks.

| | YEAR ENDED DECEMBER 31, | | | |
|---|---|---|---|---|
| | 2001 | | 2000 | |
| PRODUCT LINES | % OF NET SALES VALUE | NET SALES VALUE | % OF NET SALES VALUE | NET SALES VALUE |
| (US$ in thousands) | | | | |
| Electronic Games | 53.0% | $ 52,268 | 54.2% | $ 57,868 |
| Youth Electronics | 11.9% | 11,720 | 13.0% | 13,897 |
| VGA | 10.5% | 10,335 | 9.5% | 10,116 |
| Manufacturing Services | 24.6% | 24,231 | 23.3% | 24,815 |
| Total | 100.0% | $ 98,554 | 100.0% | $ 106,696 |

Gross margin for the year was 34.4% compared to 22.2% in fiscal year 2000 as a result of a combination of improvements to inventory control allowing for less closeout product and continued cost reduction on products.

Operating expenses for 2001, excluding $1.6 million of restructuring costs, were $36.1 million compared to operating expenses of $43.0 million, excluding $1.2 million of restructuring costs in fiscal year 2000. The 2001 restructuring plan was approved by the Board of Directors in December 2001 for implementation in February of 2002 and included the elimination of the San Francisco R&D office, the elimination of several R&D and operational provisions in Hong Kong with the intent of replacing many of these positions with new staff at the factory in China, the elimination of certain other positions worldwide and the transfer of two employees to other offices. The estimated costs related to the reorganization were accrued in the fourth quarter of 2001 and include $1.4 million in severance-related costs and $0.2 million in office shutdown and other reorganization related costs.

The 2000 restructuring plan occurred in the second quarter of 2000 and included the elimination of several positions worldwide. The costs included $1.1 million in severance-related costs and $0.1 million in office shutdown and other reorganization related costs.

The following table shows the major operating expenses, other income and income taxes:

| | Year ended December 31, | |
|---|---|---|
| (US dollars in millions) | 2001 | 2000 |
| Commissions | $ 0.7 | $ 2.3 |
| Indirect salaries and wages | 8.2 | 7.5 |
| Advertising and promotion expenses | 8.1 | 11.1 |
| Research and development expenses | 5.8 | 5.2 |
| Other income | - | 0.8 |
| Provision (credit) for income taxes | 0.6 | (0.9) |

The decrease in commissions in 2001 was the result of both the decrease in sales from 2000 and Radica USA's decision to increase efficiency by changing its sales force from third party sales representatives to an in-house sales team. Because the

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Play TV line of products was in its second year and required less promotion, advertising and promotional costs decreased in 2001 from 2000.

CRITICAL ACCOUNTING POLICIES AND ESTIMATES

The Company prepares its consolidated financial statements in accordance with accounting principles generally accepted in the United States of America. Management is required to make certain estimates and assumptions that affect the reported amounts of assets and liabilities and the reported amounts of revenue and expenses. Below is a listing of accounting policies that the Company considers critical in preparing its consolidated financial statements. These policies include estimates made by management using the information available to them at the time the estimates are made, but these estimates could change considerably if different information or assumptions were used.

BAD DEBT ALLOWANCE

The bad debt allowance is an adjustment to customer trade receivables for amounts that are determined to be uncollectible or partially uncollectible. The bad debt allowance offsets gross trade receivables and is computed based on management's best assessment of the impact on trade receivables of the business environment, customers' financial condition, historical trends and customer disputes. Deterioration in the retail environment or the economy could adversely impact the trade receivables valuation.

ALLOWANCE FOR SALES RETURNS, MARKETING AND ADVERTISING

A sales return allowance is recorded for estimated sales returns from customers. The allowance is based on historical trends and management's best assessment of sales returns as a percentage of overall sales. The Company also records an allowance for marketing and advertising costs agreed with certain customers. These allowances are based on other specific dollar-value programs or percentages of sales, depending on how the program is negotiated with the individual customer.

WARRANTY

The Company records a warranty allowance for costs related to defective product sold to customers. The warranty allowance is based on historical trends and management's best assessment of what the defective return percentage will be for a given product. Due to the introduction of new product, actual warranty costs could deviate significantly from the recorded allowance. This deviation could have a material impact on the financial results of the Company.

INVENTORIES

The Company states its inventory values at the lower of cost or market. Inventory reserves are accrued for slow-moving and obsolete inventory. Radica's management uses estimates to record these reserves. Slow-moving and obsolete inventories may be partially or fully reserved depending on the length of time the product has been in inventory and the forecast sales for the product over the course of the following year. Changes in public and consumer preferences and demand for product or changes in the buying patterns and inventory management of customers could adversely impact the inventory valuation.

IMPAIRMENT OF LONG-LIVED ASSETS AND GOODWILL

Long-lived assets, identifiable intangibles and goodwill have been reviewed for impairment based on Statement of Financial Accounting Standards ("SFAS") No. 144.

In accordance with SFAS No. 144, long-lived assets, such as property, plant, and equipment, and purchased intangibles subject to amortization, are reviewed for impairment whenever events or changes in circumstances indicate that the carrying amount of an asset may not be recoverable. Recoverability of assets to be held and used is measured by a comparison of the carrying amount of an asset to estimated undiscounted future cash flows expected to be generated by the asset. If the carrying amount of an asset exceeds its estimated future cash flows, an impairment charge is recognized by the amount by which the carrying amount of the asset exceeds the fair value of the asset.

Goodwill and intangible assets not subject to amortization are tested annually for impairment, and are tested for impairment more frequently if events and circumstances indicate that the asset might be impaired. An impairment loss is recognized to the extent that the carrying amount exceeds the asset's fair value.



Prior to the adoption of SFAS No. 144, the Company accounted for long-lived assets in accordance with SFAS No. 121, Accounting for Impairment of Long-lived Assets and for Long-lived Assets to be Disposed Of.

DEFERRED TAX ASSETS

The Company records valuation allowances against its deferred tax assets. In determining the allowance, management considers all available evidence for certain tax credit, net operating loss and capital loss carryforwards. The evidence used in assessing the need for valuation allowances includes the use of business planning, projections of future taxable income and corporate-wide tax planning. Differences in actual results from projections used in determining the valuation allowances could result in future adjustments to the allowance.

RECENTLY ISSUED ACCOUNTING STANDARDS

A discussion of certain recently issued accounting standards and the estimated impact on the Company is set out in note 2 to the consolidated financial statements.

ITEM 6. DIRECTORS, SENIOR MANAGEMENT AND EMPLOYEES

The following table sets forth the directors and executive officers of the Company in fiscal 2002.

| Name | Term Expires | Residency | Pos |
|---|---|---|---|