

MULTIMEDIA GAMES INC
Form 10-Q
August 09, 2005
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UNITED STATES
SECURITIES AND EXCHANGE COMMISSION

Washington, D.C. 20549

Form 10-Q

x Quarterly Report Pursuant to Section 13 or 15 (d) of the Securities Exchange Act of 1934

For the quarterly period ended: **June 30, 2005**

.. 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: 001-14551

Multimedia Games, Inc.

(Exact Name of Registrant as Specified in its Charter)

Texas
(State or Other Jurisdiction)

of Incorporation)

74-2611034
(IRS Employer

Identification Number)

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206 Wild Basin Road, Building B, Fourth Floor

Austin, Texas
(Address of Principal Executive Offices)

78746
(Zip Code)

Registrant's telephone number, including area code: (512) 334-7500

Registrant's website: www.multimedialogames.com

Indicate by check mark whether the Registrant (1) has filed all reports required to be filed by Section 13 or 15 (d) of the Securities Exchange Act of 1934 during the preceding 12 months (or for such shorter period that the Registrant was required to file such reports), and (2) has been subject to such filing requirements for the past 90 days: Yes No

Indicate by check mark whether the Registrant is an accelerated filer (as defined in Rule 12b-2 of the Exchange

Act): Yes No

As of August 3, 2005, there were 27,133,740 shares of the Registrant's common stock, par value \$0.01 per share, outstanding.

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Table of Contents**MULTIMEDIA GAMES, INC.****CONSOLIDATED BALANCE SHEETS****As of June 30, 2005 and September 30, 2004**

(In thousands, except shares and per-share amounts)

(Unaudited)

	June 30, 2005	September 30, 2004
	<u> </u>	<u> </u>
ASSETS		
CURRENT ASSETS:		
Cash and cash equivalents	\$ 5,894	\$ 4,768
Accounts receivable, net of allowance for doubtful accounts of \$204 and \$533, respectively	10,652	10,397
Inventory	812	930
Deferred contract costs	6,029	
Prepaid expenses and other	1,944	2,242
Notes receivable, net	5,506	12,299
Federal and state income tax receivable	35	5,044
Deferred income taxes	1,899	1,909
	<u> </u>	<u> </u>
Total current assets	32,771	37,589
Restricted cash and long-term investments	1,068	1,216
Leased gaming equipment, net	41,954	40,652
Property and equipment, net	90,706	93,090
Notes receivable noncurrent	29,287	20,588
Intangible assets, net	45,348	21,941
Other assets	3,317	2,331
	<u> </u>	<u> </u>
Total assets	\$ 244,451	\$ 217,407
	<u> </u>	<u> </u>
LIABILITIES AND STOCKHOLDERS EQUITY		
CURRENT LIABILITIES:		
Current portion of long-term debt and capital leases	\$ 14,335	\$ 9,713
Accounts payable and accrued expenses	26,929	25,780
Federal income tax payable	1,439	
Deferred revenue	2,276	1,847
	<u> </u>	<u> </u>
Total current liabilities	44,979	37,340
Revolving line of credit	20,970	
Long-term debt and capital leases, less current portion	9,253	10,753
Other long-term liabilities	3,030	3,932
Deferred revenue noncurrent	1,128	2,050
Deferred income taxes	7,816	13,185
	<u> </u>	<u> </u>
Total liabilities	87,176	67,260
	<u> </u>	<u> </u>
Commitments and contingencies		

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Stockholders' equity:

Preferred stock:

Series A, \$0.01 par value, 1,800,000 shares authorized, no shares issued and outstanding

Series B, \$0.01 par value, 200,000 shares authorized, no shares issued and outstanding

Common stock, \$0.01 par value, 75,000,000 shares authorized, 30,780,329 and 30,453,245 shares issued, and 27,154,690 and 27,917,597 shares outstanding, respectively

	308	305
Additional paid-in capital	67,143	65,157
Treasury stock, 3,625,639 and 2,535,648 shares at cost	(22,028)	(12,382)
Retained earnings	111,852	97,067

Total stockholders' equity	157,275	150,147
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Total liabilities and stockholders' equity	\$ 244,451	\$ 217,407
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The accompanying notes are an integral part of the consolidated financial statements.

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MULTIMEDIA GAMES, INC.

CONSOLIDATED STATEMENTS OF INCOME

For the Three Months Ended June 30, 2005 and 2004

(In thousands, except per-share amounts)

(Unaudited)

	<u>2005</u>	<u>2004</u>
Revenues:		
Gaming revenue:		
Class II	\$ 28,191	\$ 29,043
Charity	4,622	3,009
All other	2,814	3,323
Player terminal and license sale and lease revenue	957	805
Other	565	740
	<u>37,149</u>	<u>36,920</u>
OPERATING COSTS AND EXPENSES:		
Cost of player terminals and licenses sold	787	666
Selling, general and administrative expenses	14,104	12,951
Amortization and depreciation	14,576	9,765
	<u>29,467</u>	<u>23,382</u>
Operating income	7,682	13,538
OTHER INCOME (EXPENSE):		
Interest income	608	178
Interest expense	(675)	(429)
	<u>7,615</u>	<u>13,287</u>
Income before income taxes	7,615	13,287
Income tax expense	3,065	3,451
	<u>\$ 4,550</u>	<u>\$ 9,836</u>
Net income	\$ 4,550	\$ 9,836
	<u>\$ 0.17</u>	<u>\$ 0.35</u>
Basic earnings per share	\$ 0.17	\$ 0.35
	<u>\$ 0.16</u>	<u>\$ 0.32</u>
Diluted earnings per share	\$ 0.16	\$ 0.32

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

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MULTIMEDIA GAMES, INC.

CONSOLIDATED STATEMENTS OF INCOME

For the Nine Months Ended June 30, 2005 and 2004

(In thousands, except per-share amounts)

(Unaudited)

	<u>2005</u>	<u>2004</u>
Revenues:		
Gaming revenue:		
Class II	\$ 87,082	\$ 89,477
Charity	14,676	5,453
All other	10,235	7,269
Player terminal and license sale and lease revenue	2,762	7,193
Other	1,607	1,583
	<u>116,362</u>	<u>110,975</u>
OPERATING COSTS AND EXPENSES:		
Cost of player terminals and licenses sold	2,588	4,240
Selling, general and administrative expenses	46,535	41,795
Amortization and depreciation	42,620	26,170
	<u>91,743</u>	<u>72,205</u>
Operating income	24,619	38,770
OTHER INCOME (EXPENSE):		
Interest income	1,390	906
Interest expense	(1,892)	(1,067)
	<u>24,117</u>	<u>38,609</u>
Income before income taxes	24,117	38,609
Income tax expense	9,332	13,003
	<u>14,785</u>	<u>25,606</u>
Net income	\$ 14,785	\$ 25,606
	<u>0.53</u>	<u>0.94</u>
Basic earnings per share	\$	\$
	<u>0.50</u>	<u>0.83</u>
Diluted earnings per share	\$	\$

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

Table of Contents**MULTIMEDIA GAMES, INC.****CONSOLIDATED STATEMENTS OF CASH FLOWS****For the Nine Months Ended June 30, 2005 and 2004****Increase (Decrease) in Cash and Cash Equivalents**

(In thousands)

(Unaudited)

	<u>2005</u>	<u>2004</u>
CASH FLOWS FROM OPERATING ACTIVITIES:		
Net income	\$ 14,785	\$ 25,606
Adjustments to reconcile net income to cash and cash equivalents provided by operating activities:		
Amortization	3,139	1,700
Depreciation	39,481	24,470
Accretion of contract rights	1,541	36
Write off of long-lived assets	217	
Provision for inventory and long-lived assets	35	
Deferred income taxes	(5,359)	2,968
Options issued to consultants	144	383
Recovery of doubtful accounts	(225)	(17)
(Increase) decrease in:		
Accounts receivable	(269)	(3,583)
Inventory	118	(1,793)
Deferred contract costs	(6,029)	
Prepaid expenses and other	(1,690)	(1,289)
Federal and state income tax payable/receivable	6,448	(1,179)
Notes receivable	5,798	728
Increase (decrease) in:		
Accounts payable and accrued expenses	1,138	5,632
Deferred revenue	(493)	220
Other long-term liabilities	(504)	977
NET CASH PROVIDED BY OPERATING ACTIVITIES	<u>58,275</u>	<u>54,859</u>
CASH FLOWS FROM INVESTING ACTIVITIES:		
Acquisition of property and equipment and leased gaming equipment	(36,509)	(59,288)
Acquisition of intangible assets	(7,990)	(3,600)
Advances under development agreements	(38,906)	(10,182)
Repayments under development agreements	10,985	760
Advances on notes receivable		(20,574)
Stockholders' notes receivable, net		(37)
Repayments of notes receivable		21,107
NET CASH USED IN INVESTING ACTIVITIES	<u>(72,420)</u>	<u>(71,814)</u>
CASH FLOWS FROM FINANCING ACTIVITIES:		

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Proceeds from exercise of stock options, warrants, and related tax benefit	1,845	18,080
Proceeds from long-term debt	10,000	7,708
Principal payments of long-term debt and capital leases	(7,898)	(5,504)
Proceeds from revolving line of credit	36,606	
Payments on revolving line of credit	(15,636)	
Purchase of treasury stock	(9,646)	
NET CASH PROVIDED BY FINANCING ACTIVITIES	15,271	20,284
Net increase in cash and cash equivalents	1,126	3,329
Cash and cash equivalents, beginning of period	4,768	26,319
Cash and cash equivalents, end of period	\$ 5,894	\$ 29,648

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Table of Contents**MULTIMEDIA GAMES, INC.****CONSOLIDATED STATEMENTS OF CASH FLOWS (Continued)****For the Nine Months Ended June 30, 2005 and 2004**

(In thousands)

(Unaudited)

	<u>2005</u>	<u>2004</u>
SUPPLEMENTAL CASH FLOW DATA:		
Interest paid	\$ 1,782	\$ 1,066
Income tax paid	\$ 8,183	\$ 418
NON-CASH TRANSACTIONS:		
Property and equipment and other assets acquired through:		
Capital lease	575	5,280
Long-term debt	445	1,303
Receipt of Company's common stock for repayment of stockholders' note receivable		1,599
Receipt of Company's common stock as consideration for employee stock option exercise		472

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

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MULTIMEDIA GAMES, INC.

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

(Unaudited)

1. SIGNIFICANT ACCOUNTING POLICIES

The accompanying consolidated financial statements should be read in conjunction with the Company's consolidated financial statements and footnotes contained within the Company's Annual Report on Form 10-K/A for the year ended September 30, 2004.

The financial statements included herein as of June 30, 2005, and for each of the three and nine months ended June 30, 2005 and 2004 have been prepared by the Company without an audit, pursuant to accounting principles generally accepted in the United States of America, or U.S., and the rules and regulations of the Securities and Exchange Commission. They do not include all of the information and footnotes required by accounting principles generally accepted in the U.S. for complete financial statements. The information presented reflects all adjustments consisting solely of normal adjustments which are, in the opinion of management, considered necessary to present fairly the financial position, results of operations, and cash flows for the periods. Operating results for the three and nine months ended June 30, 2005 are not necessarily indicative of the results which will be realized for the year ending September 30, 2005.

Operations. The Company is a technology supplier to the gaming industry; it designs and develops interactive electronic gaming systems that are marketed primarily to Native American, charity and commercial bingo gaming facilities, and to state lottery commissions located throughout the U.S. The Company's gaming systems are typically provided to customers under revenue sharing arrangements, except for video lottery terminals in the Class III market in Washington State, which are typically sold for an up-front purchase price. The Company provides Class II gaming to its tribal customers through a nationwide, broadband telecommunications network. Player terminals in the Class II gaming market are typically interconnected within a gaming facility and across multiple facilities, thereby enabling players to simultaneously participate in the same game and to compete against one another to win common pooled prizes. In the charity bingo market, player terminals are typically only interconnected within the gaming facility where the player terminals are located. The Company provides a central determinant system for use by state lottery commissions. The Company offers Point-of-Sale Terminals, or POSTs, in conjunction with its Tribal Instant Lottery Game, or TILG, in the Class III market; these are supported by central determinant system technology similar to that used in the state lottery market. The Company offers content for its gaming systems that has been designed and developed by the Company, as well as game themes it has licensed from others.

Consolidation Principles. The Company's financial statements include the activities of Multimedia Games, Inc. and its wholly-owned subsidiaries: MegaBingo, Inc., MGAM Systems, Inc. and MGAM Services, LLC. Intercompany balances and transactions have been eliminated.

Accounting Estimates. The preparation of financial statements in conformity with accounting principles generally accepted in the U.S. requires management to make estimates and assumptions that affect the reported amounts of assets and liabilities, disclosure of contingent assets and liabilities at the date of the financial statements, and the reported amounts of revenues and expenses during the reporting period. Examples include provisions for bad debts and inventory obsolescence, asset lives of equipment, deferred taxes, and the provision for and disclosure of litigation and loss contingencies. Actual results may differ significantly from these estimates in the future.

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Reclassifications. Certain reclassifications were made to the prior period's financial statements to conform to the current period financial statement presentation. These reclassifications did not have an impact on the Company's previously reported net income.

Historically, the Company entered into certain agreements with its tribal customers that, among other things, guaranteed certain prize payouts. These were based upon attaining an assumed level of gross game receipts and upon statistical assumptions as to the frequency of winners; the agreements required customers to deposit a fixed percentage of gross gaming receipts in a depository account controlled by us. The depository account was used by the Company to reimburse prizes, prize fulfillment fees, insurance payments and bank fees. In these instances, the Company was essentially acting as a "bank" by managing prizes across multiple facilities on its network of electronic player terminals. Based on the its role as a "bank," the Company historically considered its role more as a principal than an agent, and reported the hold per day from its player terminals as revenue and deducted amounts paid to or retained by facilities as "Allotments to facility operators."

The vast majority of these arrangements have gone away over the past few years, prompting the Company to evaluate its revenue presentation.

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MULTIMEDIA GAMES, INC.

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)

(Unaudited)

The Company's current gaming arrangements typically do not guarantee prize payout levels and require that only its share of the hold per day be remitted to the Company. Management has determined that the net amounts remitted by customers should be reported as revenue and not presented on a gross basis, as previously reported. As a result, the Company has presented its current period revenues in accordance with this policy and reclassified Allotments to facility operators for the three and nine months ended June 30, 2004 to conform to the current period presentation.

Revenue Recognition. The Company derives its gaming revenues primarily from participation arrangements with its Native American and charity bingo customers. Participation revenue generated from the Company's Class II gaming systems is reported in its results of operations as Gaming revenue Class II, while revenue generated from charity customers is included in Gaming revenue Charity, and revenue from the Company's TILG product and games played under the Oklahoma and Washington compacts is included in Gaming revenue All other. Under these arrangements, the Company retains ownership of the player terminals, POSTs and back-office equipment (which are collectively referred to as gaming systems) installed at customer gaming facilities, and receives revenue based on a percentage of the hold per day generated by each gaming system. The hold is generally considered both realizable and earned at the end of each gaming day. Certain of the Company's arrangements require it to set aside a portion of a facility's hold per day to be used to fund facility-specific marketing, advertising, promotions and service. These amounts are offset against revenue, and deferred in a liability account until expended.

The Company generates gaming revenues from the state video lottery market by providing the central determinant system for video lottery terminal networks. In return for providing the system, the Company receives a small portion of the network-wide hold, which is reported in its financial results of operations as a part of Gaming revenue All other.

The Company also generates gaming revenues from back-office fees based on a share of the hold per day from both leased and sold Class III POSTs in Washington State. Back-office fees cover the service and maintenance costs for back-office servers installed in each gaming facility to run its Class III games, as well as the cost of related software updates. These back-office fees are reported in the Company's results of operations as a part of Gaming revenue All other. For those POSTs sold to customers, the back-office fees are based on a considerably smaller percentage of the hold per day than the revenue share received from terminals being rented under participation agreements. Accordingly, the Company derives its Class III revenues to a greater extent from POST sales than from participation-based back-office fees. Sales of Class III POSTs are usually clustered around the expansion of existing casinos, the opening of new casinos, or changes in applicable law that permit customers to operate a greater number of POSTs than previously allowed.

The majority of the Company's Class III POSTs in Washington State have been sold to customers outright for a one-time purchase price, and are reported by the Company under Player terminal and license sale and lease revenue. Certain game themes used by the Company in the Class III market have been licensed from third parties and are generally licensed to customers along with the Class III POSTs. For the remainder of its Class III POSTs, the Company enters into participation arrangements similar to those in the Class II market.

Revenues from the sale of player terminals, player terminal licenses and license of our gaming systems are accounted for under Staff Accounting Bulletin 104, Revenue Recognition, or SAB 104, Statement of Position 97-2 Software Revenue Recognition, or SOP 97-2, and Emerging Issues Task Force, or EITF, Issue 00-21, Revenue Arrangements with Multiple Deliverables, or EITF 00-21. In accordance with the provisions of SAB 104, SOP 97-2 and EITF 00-21, sales that are considered to contain multiple deliverables are bifurcated into accounting units based on their

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relative fair market value, provided each component is not essential to the function of the other. Revenue from these separate accounting units is then recognized when: a) persuasive evidence of an arrangement exists and the sales price is fixed and determinable; b) delivery has occurred and services have been rendered; and c) collectibility is reasonably assured. If vendor-specific objective evidence of fair value does not exist, the revenue is deferred until such time that all elements have been delivered or services have been performed. If any element is determined to be essential to the function of the other, revenues are generally recognized utilizing the subscription method of accounting over the term of the services rendered.

Cash and Cash Equivalents. The Company considers all highly liquid investments (i.e., investments which, when purchased, have original maturities of three months or less) to be cash equivalents.

Allowance for Doubtful Accounts. The Company maintains an allowance for doubtful accounts related to its accounts receivable and notes receivable that have been deemed to have a high risk of collectibility. Management reviews its accounts receivable and notes receivable on a monthly basis to determine if any receivables will

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MULTIMEDIA GAMES, INC.

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)

(Unaudited)

potentially be uncollectible. Management analyzes historical collection trends and changes in its customer payment patterns, customer concentration, and creditworthiness when evaluating the adequacy of its allowance for doubtful accounts. In its overall allowance for doubtful accounts, the Company includes any receivable balances that are determined to be uncollectible. Based on the information available, management believes the allowance for doubtful accounts is adequate; however, actual write-offs might exceed the recorded allowance.

Deferred Contract Costs. During Fiscal 2005, the Company entered into a contract with a customer, pursuant to which it will deliver a video lottery system and player terminals at a number of retail sites. Costs directly attributable to this contract, consisting principally of engineering, development, installation and hardware costs, are being deferred until the revenue is recognized.

Billings under the contract are tied to certain defined objectives. As of June 30, 2005, the Company had not billed any amounts under this contract.

Inventory. The Company's inventory consists primarily of completed player terminals, related component parts and back-office computer equipment expected to be sold within the Company's next fiscal year. Inventories are stated at the lower of cost (first in, first out) or market.

Development Agreements. The Company enters into development agreements to provide financing for new tribal gaming facilities, or for the expansion of existing facilities. In return, the customer commits to a fixed number of player terminal placements in the facility, and the Company receives a fixed percentage of those player terminals' hold per day over the term of the agreement. Certain of the agreements contain performance standards for its player terminals that could allow the facility to reduce a portion of the Company's player terminals. The agreements typically provide for a portion of the amounts retained by the gaming facility for their share of the hold to be used for repayment of some or all of the advances. Amounts advanced in excess of those reimbursed by the customer for real property and land improvements are allocated to an other asset and amortized over the life of the contract. Amounts related to personal property owned by the Company and located at the tribal gaming facility are carried in the Company's property and equipment, and depreciated over the estimated useful life of the related asset.

At June 30, 2005 and September 30, 2004, the following net amounts related to advances made under development agreements were recorded in the following balance sheet captions:

	June 30,	September 30,
	2005	2004
	<u> </u>	<u> </u>
	(In thousands)	
Included in:		
Notes receivable	\$ 31,369	\$ 22,836
Property and equipment, net of accumulated depreciation	12,761	10,343

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Intangible assets – contract rights, net of accumulated amortization	30,936	11,812
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Notes Receivable. At June 30, 2005 and September 30, 2004, the Company's notes receivable consisted of the following:

	June 30,	September 30,
	2005	2004
	(In thousands)	
Notes receivable from development agreements	\$ 31,369	\$ 22,836
Notes receivable from equipment sales	2,502	9,040
Other notes receivable	922	1,086
Allowance for notes receivable		(75)
	<u>34,793</u>	<u>32,887</u>
Notes receivable, net		
Less current portion	5,506	12,299
	<u>29,287</u>	<u>20,588</u>
Notes receivable – non-current		

Notes receivable from development agreements are generated from reimbursable amounts advanced under development agreements, and generally bear interest at prevailing interest rates. These notes are typically collateralized by all the personal property not owned by the Company and contained within the respective tribal gaming facility, although the value of such property, if repossessed, may be less than the note receivable

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(Unaudited)

outstanding. As of June 30, 2005, the average interest rate on notes receivable from development agreements was 5.33%, and the expected term of such notes ranged from one to three years; however, the timing of required payments may vary, as certain of the note repayment terms are based on the hold per day per player terminal retained by the facilities.

Notes receivable from equipment sales consist of financial instruments issued by customers for the purchase of player terminals and licenses, and generally bear interest at prevailing interest rates. All of the Company's notes receivable from equipment sales are collateralized by the related equipment sold, although the value of such equipment, if repossessed, may be less than the note receivable outstanding. As of June 30, 2005, the average interest rate on notes receivable from equipment sales was 7.03%, and the term of such notes ranged from one to two years.

Property and Equipment and Leased Gaming Equipment. Property and equipment and leased gaming equipment is stated at cost. The cost of property and equipment and leased gaming equipment is depreciated over their estimated useful lives, generally using the straight-line method for financial reporting, and accelerated methods for tax reporting purposes. Player terminals placed with customers under participation arrangements are included in leased gaming equipment. Leased gaming equipment includes a pool of rental terminals, i.e., the rental pool. Rental pool units are those units that have previously been placed in the field under participation arrangements, but are currently back at the Company being refurbished and/or awaiting redeployment. Routine maintenance of property and equipment and leased gaming equipment is expensed in the period incurred, while major component upgrades are capitalized and depreciated over the estimated useful life of the component. Sales and retirements of depreciable property are recorded by removing the related cost and accumulated depreciation from the accounts. Gains or losses on sales and retirements of property are reflected in the Company's results of operations.

Management reviews long-lived assets 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 its fair value, which considers the future undiscounted cash flows expected to be generated by the asset. If such assets are considered to be impaired, the impairment recognized is measured by the amount by which the carrying amount of the assets exceeds their fair value. Assets to be disposed are reported at the lower of the carrying amount or the fair value less costs of disposal. An analysis of the long-lived assets at June 30, 2005 indicated there was no impairment to these assets' carrying values.

Equipment under Capital Lease. Equipment under capital leases is recorded at the lower of the present value of the minimum lease payments or the fair value of the assets. The cost of leased property and equipment is amortized using the Company's normal depreciation policy, described under Property and Equipment and Leased Gaming Equipment.

Credit Facility, Long-Term Debt and Capital Leases. At June 30, 2005 and September 30, 2004, the Company's Credit Facility, long-term debt and capital leases consisted of the following:

June 30,	September 30,
2005	2004

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	(In thousands)	
Revolving line of credit	\$ 20,970	\$
Term Loan facility	\$ 14,243	\$ 7,181
Other long-term debt	3,805	4,998
Capital lease obligations	5,540	8,287
Long-term debt and capital leases	23,588	20,466
Less current portion	14,335	9,713
Long-term debt and capital leases, less current portion	\$ 9,253	\$ 10,753

The Company's debt structure consists of a Credit Facility, which provides the Company with a \$20.0 million term loan facility, or the Term Loan, a \$15.0 million revolving line of credit, or the Revolver, and a \$35.0 million reducing line of credit, or the Reducing Revolver. Two of the three tranches of the Term Loan mature in June 2006 and bear interest at a rate of Prime plus 1.25% (or 7.50% as of June 30, 2005). The third tranche of the Term Loan matures in June 2007 and bears interest at a rate of Prime plus 1.25%. As of June 30, 2005, the Company had drawn \$20.2 million under the available tranches of the Term Loan. Equal installments of principal and interest are payable over the term of the first two tranches, which are 36 and 30 months, respectively. On the third tranche, installments based on a 24-month term are due beginning in July 2005, with a balloon payment due in June 2007.

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MULTIMEDIA GAMES, INC.

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)

(Unaudited)

The Revolver provides the Company with up to \$15.0 million for working capital needs. The Revolver bears interest at a rate of Prime plus 1.25%, and has a commitment fee based on the daily average unborrowed commitment. The Revolver matures in November 2006. As of June 30, 2005, \$12.0 million was outstanding under the Revolver, leaving \$3.0 million available, which was reduced by \$1.0 million, reflecting outstanding letters of credit.

The Reducing Revolver provides the company with up to \$35.0 million, which is advanceable based on the Company's unfinanced capital expenditures. After the first 12 months, the availability under the Reducing Revolver is reduced quarterly, based on a 36-month straight-line amortization. The Reducing Revolver bears interest at a rate of Prime plus 1.25% and has a commitment fee based on the daily average unborrowed commitment. Interest payments are due monthly, and principal plus unpaid interest is due when the Reducing Revolver matures in June 2009. As of June 30, 2005, \$9.0 million was outstanding under the Reducing Revolver, leaving \$26.0 million available.

The Credit Facility contains certain customary financial and operational covenants, and is collateralized by substantially all the Company's assets. The Company is in compliance with these covenants as of June 30, 2005.

Other long-term debt at June 30, 2005 consists of a five-year loan related to financing the Company's corporate aircraft, and various three-to five-year loans for the purchase of automobiles and property and equipment.

Capital lease obligations consist of various three-year noncancelable capital leases for certain equipment used in the Company's operations.

Fair Value of Financial Instruments. The fair value of a financial instrument is the amount at which the instrument could be exchanged in a current transaction between willing parties, other than in a forced sale or liquidation. At June 30, 2005 and September 30, 2004, the carrying amounts for the Company's financial instruments, which include accounts and notes receivable, accounts payable, and long-term debt and capital leases, approximate fair value.

Income Taxes. The Company applies the provisions of SFAS No. 109 Accounting for Income Taxes. Under SFAS No. 109, deferred tax liabilities or assets arise from differences between the tax basis of liabilities or assets and their basis for financial reporting, and are subject to tests of recoverability in the case of deferred tax assets. Deferred tax assets and liabilities are measured using enacted tax rates expected to apply to taxable income in the years in which those temporary differences are expected to be recovered or settled. A valuation allowance is provided for deferred tax assets to the extent realization is not judged to be more likely than not.

Treasury Stock. The Company utilizes the cost method for accounting for its treasury stock acquisitions and dispositions.

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Earnings per Common Share. Earnings per common share is computed in accordance with SFAS No. 128, Earnings per Share. Presented below is a reconciliation of net income available to common stockholders and the differences between weighted average common shares outstanding, which are used in computing basic earnings per share, and weighted average common and potential shares outstanding, which are used in computing diluted earnings per share.

	Three Months Ended June 30,	
	2005	2004
	(In thousands, except shares	
	and per-share amounts)	
Income available to common stockholders basic and diluted	\$ 4,550	\$ 9,836
Weighted average common shares outstanding	27,331,945	27,872,523
Effect of dilutive securities:		
Options	1,811,533	3,063,153
Weighted average common and potential shares outstanding	29,143,478	30,935,676
Basic earnings per share	\$ 0.17	\$ 0.35
Diluted earnings per share	\$ 0.16	\$ 0.32

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MULTIMEDIA GAMES, INC.

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)

(Unaudited)

	<u>Nine Months Ended June 30,</u>	
	<u>2005</u>	<u>2004</u>
	(In thousands, except shares	
	and per-share amounts)	
Income available to common stockholders basic and diluted	\$ 14,785	\$ 25,606
Weighted average common shares outstanding	27,734,915	27,286,216
Effect of dilutive securities:		
Options	1,988,042	3,465,999
Weighted average common and potential shares outstanding	29,722,957	30,752,215
Basic earnings per share	\$ 0.53	\$ 0.94
Diluted earnings per share	\$ 0.50	\$ 0.83

At June 30, 2005 and 2004, options to purchase 1,152,500 and 225,000 shares, respectively, of Common Stock at exercise prices ranging from \$10.11 to \$21.53 per share, and \$11.79 to \$15.47 per share, respectively, were outstanding, but were not included in the computation of diluted earnings per share due to their antidilutive effect.

Stock-Based Compensation. The Company applies Accounting Principles Board Opinion No. 25 Accounting for Stock Issued to Employees, or APB 25, in accounting for its stock option plans, rather than the alternative fair value accounting provided under SFAS No. 123, Accounting for Stock-Based Compensation. Under APB 25, no compensation expense is recognized for grants of options to common-law employees and directors at an exercise price equal to or greater than the market price of the stock on the date of grant. Accordingly, based on the Company's grants in the three and nine months ended June 30, 2005 and 2004, no compensation expense has been recognized.

Pro forma information regarding net income and earnings per share under the alternative fair value accounting is required by SFAS No. 123, as amended by SFAS No. 148, Accounting for Stock-Based Compensation Transition and Disclosure. For purposes of pro forma disclosures, the estimated fair value of the options granted is amortized to expense over the options' vesting period. Had the Company determined compensation expense for stock option grants based on their estimated fair value on their grant date, the Company's net income and earnings per share would have been as follows:

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	Three Months Ended June 30,		Nine Months Ended June 30,	
	2005	2004	2005	2004
(In thousands, except per-share amounts)				
Net income:				
As reported	\$ 4,550	\$ 9,836	\$ 14,785	\$ 25,606
Deduct: Estimated stock-based employee compensation determined under fair value method for all awards, net of related tax benefit	(718)	(815)	(2,337)	(3,993)
Pro forma	\$ 3,832	\$ 9,021	\$ 12,448	\$ 21,613
Basic earnings per common share:				
As reported	\$ 0.17	\$ 0.35	\$ 0.53	\$ 0.94
Pro forma	\$ 0.14	\$ 0.32	\$ 0.45	\$ 0.79
Diluted earnings per common share:				
As reported	\$ 0.16	\$ 0.32	\$ 0.50	\$ 0.83
Pro forma	\$ 0.13	\$ 0.29	\$ 0.42	\$ 0.70

2. COMMITMENTS AND CONTINGENCIES

Litigation

General. The Company is subject to federal, state and Native American laws and regulations that affect both its general commercial relationships with its Native American tribal customers as well as the products and services provided to them. The following is only a summary of the more material aspects of these laws and regulations, and is not a complete recitation of all applicable law.

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MULTIMEDIA GAMES, INC.

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)

(Unaudited)

Development Agreements. On April 23, 2004, the Company reported that the Acting General Counsel of the National Indian Gaming Commission, or NIGC, had issued a letter to the Company and one of its tribal customers opining that its development agreement regarding the WinStar Casino in Thackerville, Oklahoma constitutes a management contract. The authority of the NIGC to review and approve gaming related contracts is limited to management contracts and related collateral agreements. According to the Acting General Counsel, the performance of any planning, organizing, directing, coordinating or controlling with respect to any part of a gaming operation constitutes management for purposes of determining whether an agreement for any of these activities is a management contract. The Company has expressed its disagreement with the Acting General Counsel's interpretation, and its belief that her view of management is broader than was intended by Congress. The Company also believes that the Acting General Counsel's opinion may be based in part on collateral agreements that were provided to the NIGC in error and that are not presently in effect.

On December 1, 2004 the Company received a series of letters from the NIGC expressing the Commission's concern that certain of its agreements violate the requirements of the Indian Gaming Regulatory Act of 1988, or IGRA, and tribal gaming regulations which state that the Native American tribes hold the sole proprietary interest in the tribes' gaming operations. In particular, the NIGC is concerned that the Company's development agreements, whereby it advances development funds to its tribal customers in exchange for allocated floor space and a share of gaming revenue, create a proprietary interest of the Company's in the tribes' gaming operations. As a result of its concern, the NIGC has requested that the Company and its tribal customers provide a written justification for the percentage of shared revenue specified in the subject agreements, which, in the view of the NIGC, exceeds the level permissible under a management agreement. The NIGC has also asked that the Company and its tribal customers provide an explanation why these arrangements do not result in the Company holding a proprietary interest in its tribal customers' gaming operations. In addition, on December 1, 2004, the Company received a letter from the NIGC expressing the Commission's concern that an Integrated Electronic Gaming Services Agreement with one of the Company's customers, dated January 2000 and covering one of its Legacy games, constituted a management agreement. According to the Acting General Counsel, the performance of any planning, organizing, directing, coordinating or controlling, with respect to any part of a gaming operation, constitutes management for purposes of determining whether an agreement is a management contract, which requires NIGC approval.

If certain of the Company's development agreements are finally determined to be management contracts or to create a proprietary interest of the Company's in tribal gaming operations, there could be material adverse consequences to us. In that event, the Company may be required, among other things, to modify the terms of such agreements. Such modification may adversely affect the terms on which the Company conducts business, and significantly impact its financial condition and results of operations from such agreements and from other development agreements that may be similarly interpreted by the NIGC.

The Company's contracts could be subject to further review at any time. Any further review of these agreements by the NIGC, or alternative interpretations of applicable laws and regulations could require substantial modifications to those agreements, or result in their designation as management contracts, which could materially and adversely affect the terms on which it conducts business.

Other Litigation. In addition to the threat of litigation relating to the Class II or Class III status of the Company's games and equipment, the Company is the subject of various pending and threatened claims arising out of the ordinary course of business. The Company believes that any liability resulting from these claims will not have a material adverse effect on its results of operations or financial condition.

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Diamond Games. The Company is a defendant in a lawsuit filed on November 16, 2004, in the State Court in Oklahoma City, Oklahoma alleging four causes of action: 1) Deceptive Trade Practices, 2) Unfair Competition; 3) Wrongful Interference with Diamond Games, Inc.'s Business; and 4) Restraint of Trade. All of the theories of recovery arise out of Oklahoma State law. The Company removed the case from the state court to the United States District Court for the Western District of Oklahoma. Diamond Games filed a motion and the case was remanded back to state court. The Company filed a motion to dismiss the case. The motion is still pending. The essence of the case alleges that the Company offered MegaNanza[®] and Reel Time Bingo[®] to tribes in Oklahoma, even though they were both allegedly illegal Class III games which had a severe negative impact on Diamond Games' market for their legal pull-tab game, Lucky Tab II. Also, the case alleges that the Company's development agreements unfairly interfere with their ability to successfully conduct their business. Diamond Games is seeking unspecified damages and injunctive relief; however, the Company believes the claims of Diamond Games are without merit and intends to defend the case vigorously.

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MULTIMEDIA GAMES, INC.

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)

(Unaudited)

International Gamco, Inc. International Gamco, Inc., or Gamco, claiming certain rights in United States Patent No. 5,324,035, or the '035 Patent, brought suit on May 25, 2004 against the Company in the United States District Court for the Southern District of California, claiming that the Company's central determinant system, as operated in the New York State Lottery, infringes the '035 Patent. The Company currently sublicenses the right to practice the technology stated in the '035 Patent in Native American gaming jurisdictions in the United States, pursuant to an agreement between it and Bally Gaming, Inc. Bally obtained the right to sublicense those rights to the Company from Oasis Technologies, Inc., or Oasis, a previous owner of the '035 Patent.

In the event that the Company desires to expand its rights beyond Native American gaming, the agreement provides the Company the option: 1) to pursue legal remedies to establish its rights independent of the '035 Patent; or 2) to negotiate directly and enter into a separate agreement with Oasis for such rights, paying either a one-time license fee per jurisdiction or a unit fee per gaming machine. Gamco claims to have acquired ownership of Oasis' rights to the '035 Patent.

Prior to deployment of its central determinant system in New York, the Company undertook an analysis of the patent issues to determine whether or not its central determinant system infringed the claims of the '035 Patent. The Company determined that it did not infringe. Although continuing to assert that it did not infringe, the Company offered to enter into a license agreement with Gamco, who refused the offer and filed its complaint seeking injunctive relief, unspecified damages, and attorneys' fees. The Company intends to vigorously defend this matter. The Court has announced that it will issue a show cause order requiring Gamco to show cause why the suit should not be dismissed due to Gamco's lack of standing. Given the inherent uncertainties in any litigation, the Company is unable to make any prediction as to the outcome.

Aristocrat Technologies, Inc. Aristocrat Technologies, Inc has sued the Company in Cause No. CV05-0679 FMC, in the United States District Court, Central District of California, alleging that the Company's deployment of its networked central-determinant instant lottery game infringes U.S. Letters Patent No. 4,817,951, entitled "Player Operable Lottery Machine Having Display Means Displaying Combination of Game Result Indicia" (the '951 Patent). Aristocrat seeks an injunction, damages for infringement, and a trebling of damages for willful infringement. Preliminary research indicates that the Company does not infringe the '951 Patent. Aristocrat filed this suit on January 27, 2005, and served the Company on May 27, 2005. The Company has answered and intends to vigorously defend this matter. Given the inherent uncertainties in any litigation, the Company is unable to make any prediction as to the outcome.

HomeBingo Network, Inc. HomeBingo Network, Inc. has sued the Company and the gaming entity of the Miami Tribe of Oklahoma in Cause No. 05-CV-0608, in the United States District Court, Northern District of New York, alleging that the Company's deployment of Reel Time Bingo and other bingo games infringes U.S. Letters Patent No. 6,186,892, entitled "Bingo Game for use on the Interactive Communication Network which Relies upon Probabilities for Winning". HomeBingo seeks an injunction, damages in the amount of a reasonable royalty, and a trebling of damages for willful infringement. The Company received no demand or prior indication that this suit was going to be filed. The Company intends to vigorously defend this matter. Given the inherent uncertainties in any litigation, the Company is unable to make any prediction as to the outcome.

Other. Existing federal and state regulations may also impose civil and criminal sanctions for various activities prohibited in connection with gaming operations, including false statements on applications, and failure or refusal to obtain necessary licenses described in the regulations.

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MULTIMEDIA GAMES, INC.

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)

(Unaudited)

Development Agreements

As of June 30, 2005, the Company had entered into development agreements to provide up to \$138.2 million towards the construction and/or remodeling of tribal gaming facilities, and had advanced \$92.0 million under these agreements. In exchange for a certain amount of the funds advanced under the development agreement, the Company receives a fixed number of player terminal placements in the facility. A portion of the hold per day generated by these player terminals is used to repay the construction advance. Consequently, the payback period is dependent on the hold per day generated by the Company's player terminals. The Company is in various stages of discussion with new and existing customers to provide funding for similar opportunities under joint development agreements.

Off Balance Sheet Arrangements

As of June 30, 2005, the Company had \$1.0 million in outstanding letters of credit issued under the Revolver to guarantee its performance under certain contracts.

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ITEM 2. MANAGEMENT'S DISCUSSION AND ANALYSIS OF FINANCIAL CONDITION AND RESULTS OF OPERATIONS

Overview

We are a supplier of complex, mission-critical systems to the gaming segment of the entertainment industry. We design and develop linked, interactive, electronic gaming systems and related products that provide our customers with a comprehensive gaming system. Our products are marketed primarily to operators of Native American, charity and commercial gaming facilities, and to operators and/or regulators of domestic and international lotteries. Historically, we have focused our development and marketing efforts on Class II gaming systems and Class III video lottery systems used primarily by Native American tribes. We have recently focused our marketing efforts on the emerging charity markets in the U.S., and on domestic and international lottery jurisdictions.

We derive the majority of our gaming revenues from the placement of Point-of-Sale Terminals, or POSTs, and back-office equipment, which we collectively refer to as gaming systems, under participation arrangements. To a lesser degree, we derive revenue from the placement of POSTs in the Washington State Class III market under lease-purchase or participation arrangements, and from the back-office fees generated by those video lottery systems. We also generate gaming revenues in return for providing the central determinant system for a network of POSTs operated by the New York State Division of the Lottery. A significantly smaller portion of our revenues is generated from the sale of POSTs and game licenses in the Class III market in Washington State, except for a relatively few periods during which market conditions result in a temporary increase in the number of POSTs sold during the period (e.g., the opening of a new casino, or a change in the law that allows existing casinos to increase the number of POSTs permitted under prior law).

Class II Market

We derive our Class II gaming revenues primarily from participation arrangements with our Native American customers. Under participation arrangements, we retain ownership of the player terminals and gaming equipment installed at our customers' tribal gaming facilities, and receive revenue based on a percentage of the hold per day generated by each gaming system. Our portion of the hold per day is reported by us as Gaming revenue - Class II, and represents the total amount that end users wager, less the total amount paid to end users for prizes, and the amounts retained by the facilities for their share of the hold. Our historical revenue growth is a reflection of the increase in our installed base of player terminals in the Class II market, and the technological advances we have developed and implemented.

Our New Generation gaming system operates at a speed considerably faster than our Legacy system, generally resulting in end users playing a greater number of games on our New Generation system in the same amount of time. As a result of the faster speed of play and higher payout ratios, we believe that end users derive a higher level of satisfaction from playing our New Generation games. We believe that this enhanced satisfaction results in end users playing more games and for longer periods of time than on our Legacy system, resulting in higher play on our New Generation system. In November 2003, we introduced and began deploying our Gen4 back-office system, which enables us to produce games with bonus rounds and wide-area progressives, provides more end-user enjoyment and also provides better networking capabilities among gaming systems. Furthermore, our Gen4 gaming system allows us to operate multiple gaming engines within a single facility. This will be especially beneficial in certain Oklahoma facilities where the operators have decided to continue offering Class II games after they begin offering the new Class III games that are permitted under the tribal-state compact.

As the market grows, and the rules and regulations governing Class II gaming are clarified by court decisions and by improved rule-making procedures, we believe new competitors with significant gaming experience and financial resources will enter the Class II market. New tribal-state compacts, such as the Oklahoma gaming legislation, may also lead to increased competition from such competitors. In addition, we

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are experiencing an extended period of uncertainty relative to enforcement of existing restrictions on non-Class II devices, which is forcing us to continue competing against games that do not appear to comply with the published regulatory restrictions on Class II games. As a result of this increased competition in Oklahoma, we have and may continue to experience pressure on our pricing model, with the result that gaming providers are competing on the basis of price as well as the entertainment value and technological superiority of their products. While we will continue to compete by regularly introducing new and more entertaining games with technological enhancements that we believe will appeal to end users, we believe that the level of revenue retained by our customers from their installed base of player terminals will become a more significant competitive factor, one that may require us to change the terms of our participation arrangements with customers. Consequently, we believe that a simple business model based upon the average hold per player terminal per day will become less relevant in predicting our performance, as our participation arrangements with customers become less standardized and more complex.

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Class III Market

The majority of our Class III POSTs in Washington State have been sold to customers outright, for a one-time purchase price, and are reported in our results of operations as Player terminal and license sale and lease revenue. Certain game themes we use in the Class III market have been licensed from third parties and are resold to customers along with our Class III POSTs. Revenues from the sale of Class III POSTs and the sale of terminal licenses are recognized when the units are delivered to the customer, and the licensed games installed. To a considerably lesser extent, we also enter into either participation arrangements or lease-purchase arrangements for our Class III POSTs, on terms similar to those used for our gaming systems in the Class II market.

We also receive back-office fees based on a share of the hold per day from both leased and sold POSTs in Washington State. Back-office fees cover the service and maintenance costs for back-office servers installed in each facility to run our Class III games, as well as the cost of related software updates.

In December 2003, we installed POSTs for our new Tribal Instant Lottery Game, or TILG, in California. TILG is a one-touch game based on a simulated scratch-off lottery ticket, and employs our central determinant system technology. In January 2005, we removed all of the deployed TILG POSTs and redeployed a significant number of these original placements as Reel Time Bingo.

In May 2004, the Oklahoma Legislature passed legislation authorizing certain forms of gaming at racetracks, and additional types of games at tribal gaming facilities, pursuant to a tribal-state compact. This legislation was subject to approval in a statewide referendum, which was subsequently obtained in the November 2004 elections. The Oklahoma gaming legislation allows the tribes to sign a compact with the State of Oklahoma to operate an unlimited number of electronic instant bingo games, electronic bonanza-style bingo games, electronic amusement games and non-house-banked tournament card games. In addition, certain horse tracks in Oklahoma will be allowed to operate a limited number of instant and bonanza-style bingo games and electronic amusement games. On March 30, 2005, our bonanza-style bingo games became the first such games played in the state. As of June 30, we had placed more than 900 player terminals, to be operated under the compact, at ten facilities; approximately 750 were bonanza-style games, and the remainder were amusement games, including re-spin and poker titles.

Charity and Commercial Bingo Market

In December 2003, we began installing our first electronic bingo player terminals for the charity market in Alabama. In addition, during July 2004, we began installing player terminals in the Louisiana charity market.

State Video Lottery Market

In January 2004, we began the first operation of our central determinant system for the video lottery terminal network that the New York Lottery operates at licensed New York State racino racetracks. As payment for providing and maintaining the central determinant system, we receive a small portion of the network-wide hold per day.

Development Agreements

As we seek to continue the growth in our customer base and to expand our installed base of linked player terminals, a key element of our strategy has become entering into joint development agreements with various Native American tribes to help fund new or expand existing tribal gaming facilities. Pursuant to these agreements, we advance funds to the tribes for the construction of new tribal gaming facilities or for the expansion of existing facilities. The agreements typically provide for a portion of the amounts retained by the gaming facility for their share of the hold to be used to repay some or all of the advances.

Amounts advanced that are in excess of those to be reimbursed by such tribes for real property and land improvements are allocated to an other asset and amortized over the life of the contract. Amounts advanced that relate to personal property owned by us and located at the tribal gaming facility are carried in our property and equipment, and depreciated over the estimated useful life of the asset.

In return for the amounts advanced by us, we received a commitment for a fixed number of player terminal placements in the facility, and a fixed percentage of the hold per day from those units over the term of the agreement. Certain of the agreements contain performance standards for our player terminals that could allow the facility to reduce a portion of our player terminals. To date, we have entered into development agreements for an

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aggregate commitment to advance approximately \$138.2 million. As of June 30, 2005, we had advanced a total of \$92.0 million under such agreements and expect to advance the remaining \$46.2 million over the next twelve months.

We are in various stages of discussion with new and existing tribal customers to provide funding for similar opportunities under additional development agreements.

Research and Development

Research and development activities primarily relate to the development of new gaming systems, gaming engines, player tracking systems, casino data management systems, central video lottery systems, gaming platforms and content, and enhancements to our existing product lines. Research and development costs consist primarily of salaries and benefits, consulting fees, and an allocation of corporate facilities costs related to these activities. Once the technological feasibility of a project has been established, the project is transferred from research to development, and capitalization begins.

Research and development expenses increased by 38.1% to \$4.4 million for the three months ended June 30, 2005, from \$3.2 million for the comparable period in the prior fiscal year. For the nine months ended June 30, 2005, research and development expenses increased by 42.8% to \$12.7 million from \$8.9 million for the same period of 2004. This increase primarily resulted from an increased headcount in our development group as we have focused our internal efforts on developing new gaming systems and game themes. We expect our research and development expenses to grow over the upcoming periods as we continue focusing on product development and adding development staff.

Recent Developments

Oklahoma Tribal-State Compact. In May 2004, the Oklahoma Legislature passed legislation authorizing certain forms of gaming at racetracks, and additional types of games at tribal gaming facilities, pursuant to a tribal-state compact. This legislation was subject to approval in a statewide referendum, which was subsequently obtained in the November 2004 elections. The Oklahoma gaming legislation allows the tribes to sign a compact with the State of Oklahoma to operate an unlimited number of electronic instant bingo games, electronic bonanza-style bingo games, electronic amusement games and non-house-banked tournament card games. In addition, certain horse tracks in Oklahoma will be allowed to operate a limited number of instant and bonanza-style bingo games and electronic amusement games. All vendors placing games at any of the racetracks under the compact will ultimately be required to be licensed by the State of Oklahoma. Pursuant to the compacts, vendors placing games at tribal facilities will have to be licensed by each tribe. All electronic games placed under the compact will have to be certified by independent testing laboratories to meet technical specifications. These were published by the Oklahoma Horse Racing Commission and the individual tribal gaming authorities in the first calendar quarter of 2005.

We believe the recently adopted Oklahoma legislation significantly clarifies and expands the types of gaming permitted by Native America tribes in that state. We expect continued intensified competition from vendors currently operating in Oklahoma, as well as new market entrants. As a result, we anticipate further pressure on our market and revenue share percentages in Oklahoma. In addition, in the immediate future, we expect continued regulatory uncertainty in Oklahoma. In particular, although we and other vendors have begun to offer games enabled by the new legislation, the compacted tribes regulatory processes and specifications timetable varies from tribe to tribe. Certain other vendors and tribes may begin to offer new games prior to the time that the state or individual tribes have the regulatory and licensing in place. It is unclear what, if any, regulatory enforcement action could or would be taken against tribes and vendors offering games not authorized by existing law but permitted under the newly adopted, but not yet effective, legislation.

The new legislation requires Oklahoma tribes to develop their own licensing procedures for their vendors. Some of our Oklahoma tribal customers have developed these procedures, and others are in the process of defining the procedures. For that reason, deployment of games to be operated under the compact in Oklahoma is proceeding at an erratic pace and will continue to do so for many months. Moreover, tribal policies and procedures, as well as tribal selection of gaming vendors, are subject to the political and governance environment within the tribe. Changes in tribal leadership or tribal political pressure can affect our relationships with our customers. As a result of these and other considerations, it remains difficult to forecast the short-term impact on our business from the recent Oklahoma gaming legislation.

NIGC. On April 23, 2004, we reported that the Acting General Counsel of the National Indian Gaming Commission, or NIGC, had issued a letter to us and one of our tribal customers opining that our development agreement regarding the WinStar Casino in Thackerville, Oklahoma constitutes a management contract. The authority of the NIGC to review and approve gaming-related contracts is limited to management contracts and related collateral agreements.

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According to the Acting General Counsel, the performance of any planning, organizing, directing, coordinating or controlling with respect to any part of a gaming operation constitutes management for purposes of determining whether an agreement for any of these activities is a management contract. We have expressed our disagreement with the Acting General Counsel's interpretation, and our belief that her view of management is broader than was intended by Congress. We also believe that the Acting General Counsel's opinion may be based, in part, on collateral agreements that we provided to the NIGC in error and that are not presently in effect. We, along with certain tribal customers, have submitted additional information and documents related to our development agreements for review by the NIGC. If certain of our development agreements are finally determined to be management contracts, there could be material adverse consequences for us. In that event, we may be required to modify the terms of such agreements. Such modification may adversely affect the terms on which we conduct business, and significantly impact our financial condition and results of operations from such agreements and from other development agreements that may be similarly interpreted by the NIGC.

On December 1, 2004, we received a series of letters from the NIGC expressing the Commission's concern that certain of our agreements violate the requirements of the Indian Gaming Regulatory Act of 1988, or IGRA, and tribal gaming regulations that the Native American tribe hold the sole proprietary interest in the tribe's gaming operations. In particular, the NIGC is concerned that our development agreements, whereby we advance development funds to our tribal customers in exchange for allocated floor space and a share of gaming revenue, give us a proprietary interest in the tribe's gaming operations. As a result of its concern, the NIGC has requested that we and our tribal customers provide a written justification for the percentage of shared revenue specified in the subject agreements, which in the view of the NIGC exceeds the level permissible under a management agreement, and is evidence of our proprietary interest. The NIGC has also asked that we and our tribal customers provide an explanation why our arrangements do not result in our holding a proprietary interest in our tribal customers' gaming operations.

Also, on December 1, 2004, we received a letter from the NIGC expressing the Commission's concern that our January 2000 Integrated Electronic Gaming Services Agreement with one of our customers, covering one of our Legacy games, constituted a management agreement. According to the Acting General Counsel, the performance of any planning, organizing, directing, coordinating or controlling, with respect to any part of a gaming operation, constitutes management for purposes of determining whether an agreement is a management contract, which requires NIGC approval.

If certain of our development agreements are finally determined to be management contracts or to create a proprietary interest of ours in tribal gaming operations, there could be material adverse consequences to us. In that event, we may be required, among other things, to modify the terms of such agreements. Such modification may adversely affect the terms on which we conduct business, and significantly impact our financial condition and results of operations from such agreements and from other development agreements that may be similarly interpreted by the NIGC.

Our contracts could be subject to further review at any time. Any further review of these agreements by the NIGC, or alternative interpretations of applicable laws and regulations could require substantial modifications to those agreements or result in their redesignation as management contracts, which could materially and adversely affect the terms on which we conduct business.

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The following tables outline our end-of-period and average installed base of gaming terminals for the three and nine months ended June 30, 2005 and 2004:

	As of			
	June 30,			
	2005	2004		
End-of-period installed gaming terminal base:				
Class II player terminals				
Reel Time Bingo	9,157	8,686		
MegaNanza				
	9,157	8,686		
New Generation system	9,157	8,686		
Legacy system	558	1,009		
Oklahoma compacted games	938			
Other player terminals and POSTs	2,628	1,996		
			Three Months Ended	Nine Months Ended
			June 30,	June 30,
			2005	2004
			2005	2004
Average installed gaming terminal base:				
Class II player terminals				
Reel Time Bingo	9,905	8,793	9,730	8,752
MegaNanza				27
	9,905	8,793	9,730	8,779
New Generation system	9,905	8,793	9,730	8,779
Legacy system	587	1,124	691	1,255
Oklahoma compacted games	531		222	
Other player terminals and POSTs	2,518	1,639	3,760	923

Reclassifications

Certain reclassifications were made to the prior period's financial statements to conform to the current period financial statement presentation. These reclassifications did not have an impact on our previously reported net income.

Historically, we entered into certain agreements with our tribal customers that, among other things, guaranteed certain prize payouts. These were based upon attaining an assumed level of gross game receipts and upon statistical assumptions as to the frequency of winners; the agreements required customers to deposit a fixed percentage of gross gaming receipts in a depository account we controlled. We used the depository account to reimburse prizes, prize fulfillment fees, insurance payments and bank fees. In these instances, we were essentially acting as a bank by

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managing prizes across multiple facilities on our network of electronic player terminals. Based on our role as a bank, we historically considered our role more as a principal than an agent, and reported the hold per day generated from our player terminals as revenue, and deducted amounts paid to or retained by facilities as Allotments to facility operators. The vast majority of these arrangements have gone away over the past few years, prompting us to evaluate our revenue presentation.

Our current gaming arrangements typically do not guarantee prize payout levels, and require that only our share of the hold per day be remitted to us. Management has determined the net amounts remitted by customers should be reported as revenue, and not presented on a gross basis. As a result, we have presented our current period revenues in accordance with this policy, and reclassified Allotments to facility operators for the three and nine months ended June 30, 2004 to conform to the current period presentation.

Three Months Ended June 30, 2005, Compared to Three Months Ended June 30, 2004

Total revenues for the three months ended June 30, 2005 were \$37.1 million compared to \$36.9 million for the same period of 2004. The increase in revenues was primarily driven by an increase in the installed base of player terminals in the charity market, offset by a decrease in Class II and other gaming revenues.

Gaming Revenue Class II

Class II gaming revenues decreased by \$852,000, or 3%, from \$29.0 million in the three months ended June 30, 2004, to \$28.2 million in the three months ended June 30, 2005, due primarily to a decrease in the installed base of Legacy player terminals.

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Reel Time Bingo revenues were \$27.3 million for the quarter ended June 30, 2005, compared to \$27.2 million in the quarter ended June 30, 2004. This slight increase in revenues resulted from a greater average installed base of player terminals, a portion of which were attributable to conversions from TILG, and was partially offset by the lower average hold per day experienced on the Reel Time Bingo network.

Gaming Revenue Charity

Charity gaming revenues increased 54%, to \$4.6 million for the June 2005 quarter, compared to \$3.0 million for the same quarter of 2004. The increase relates to the greater number of player terminals installed in the three months ended June 30, 2005, compared to the same period in 2004.

As of June 30, 2005, we had an installed player terminal base of 2,628 units in the charity market, compared to 1,479 units in the prior year. The increase primarily relates to placements in Alabama.

Gaming Revenue All Other

Class III rental and back-office fees increased 27%, to \$1.5 million in the three months ended June 30, 2005, from \$1.2 million during the same period of 2004.

Other recurring gaming revenue generated from TILG, and to a lesser degree, from the central determinant system for the New York Lottery, decreased to \$565,000 for the quarter ended June 30, 2005, compared to \$2.2 million in same quarter of 2004. The decrease relates to the fiscal 2005 second-quarter conversion of TILG POSTs to Reel Time Bingo.

We began generating revenues from the central determinant system for the New York Lottery in January 2004. Currently, five of the eight planned racinos are operating, with approximately 5,600 total POSTs. To date, we have realized substantially less revenue than anticipated from our New York Lottery operations, in significant part due to delays in the opening of planned racino operations at several racetracks. We are nevertheless required to incur ongoing expenses associated with development and maintenance of the New York video lottery system, and we do not currently expect to have profitable operations there at least through 2005. Delays in the anticipated development of the New York video lottery system and other emerging market opportunities may continue to adversely impact our revenue and operating results.

Player Terminal and License Sale and Lease Revenue

Player terminal and license sale and lease revenue increased to \$957,000, from \$805,000 in the same period of 2004. During the quarter ended June 30, 2005, eight video lottery terminals were sold, compared to 30 sold in the same quarter of fiscal 2004, resulting in \$124,000 in player terminal revenue. In the third quarter of fiscal 2005, player terminal revenue of \$281,000 was recognized ratably, based on the contract term. The release of a new type of game theme in the current quarter resulted in an increase in license sales, from \$488,000 in the quarter ended June 30, 2004, to \$552,000 in the quarter ended June 30, 2005.

Other revenue, which consisted primarily of service and maintenance fees, decreased 23%, to \$565,000 for the three months ended June 30, 2005, from \$740,000 in the same period of 2004. The decrease is due to the rental of temporary facilities during fiscal 2004, which have since been discontinued.

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Cost of player terminal and licenses sold increased to \$787,000 for the three months ended June 30, 2005, from \$666,000 in the same period of 2004. The increase relates to increased sales of player terminals and ancillary equipment and licenses during the third quarter of 2005, compared to the same period in 2004.

Selling, general and administrative expenses increased to \$14.1 million for the three months ended June 30, 2005, from \$13.0 million in the same period of 2004. The increase continues to reflect higher salaries and wages and the related employee benefits and taxes, which increased approximately \$2.3 million, due to the additional personnel hired to develop our gaming systems and content, and to monitor and develop proposals to address opportunities in both domestic and international markets. At June 30, 2005, we employed 451 full-time and part-time employees, compared to 414 at June 30, 2004. Consulting and contract labor decreased \$368,000, due to decreased commissions in the California TILG market. Legal, professional and lobbying fees increased approximately \$563,000, primarily as a result of increased legal and professional services related to our research of new products, entry into new markets and Sarbanes-Oxley consulting costs. Advertising and promotion expense decreased \$408,000, due to the entrance into new markets early in fiscal 2004. Repairs and maintenance, transportation, and related cost decreased by \$619,000, because installation costs related to large charity installations were included in the three months ended June 30, 2004. Bad debt expense decreased \$394,000, as certain accounts receivable, previously reserved for, were recovered.

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Depreciation expense increased 48%, to \$13.4 million for the three months ended June 30, 2005, from \$9.1 million in 2004, primarily as a result of a 10.7% increase in the installed base of terminals under participation arrangements. Amortization expense increased to \$1.2 million for the quarter ended June 2005, compared to \$706,000 for the same quarter of 2004. The majority of the increase was related to amortization of license agreements for gaming content and internally developed software.

Interest income increased to \$608,000 for the three months ended June 30, 2005, from \$178,000 in the same period of 2004, due to the higher balance of notes receivable bearing variable interest rates.

Interest expense increased 57%, to \$675,000 for the third fiscal quarter of 2005, from \$429,000 for the same quarter of fiscal 2004, due primarily to an increase in amounts outstanding under our Credit Facility. As we continue to fund our capital commitments pursuant to our development agreements and otherwise, we will likely be required to borrow more money under our Credit Facility. As a result, our interest expense will likely continue to increase in the future.

Income tax expense decreased to \$3.0 million for the three months ended June 30, 2005, from \$3.5 million in the same period of 2004. These figures represent effective tax rates of 40.2% and 26.0% for the three months ended June 30, 2005 and 2004, respectively. Income tax expense for the June 30, 2004 quarter includes a benefit of approximately \$1.7 million, relating to an over-accrual from prior years' state and federal income tax provision, which resulted in a lower-than-expected effective rate. The higher-than-expected effective rate in the June 30, 2005 quarter was the result of higher-than-normal non-deductible lobbying expenses.

Nine Months Ended June 30, 2005, Compared to Nine Months Ended June 30, 2004

Total revenues for the nine months ended June 30, 2005 were \$116.4 million, compared to \$111.0 million for the same period in fiscal 2004, a 5% increase. The increase in revenues primarily resulted from an increase in the installed base of player terminals in the charity market. This increase was offset by a decrease in player terminal and license sale and lease revenue, as the nine months ended June 30, 2004 results benefited from the sale of 487 player terminals, compared to the sale of 51 player terminals in the same period of 2005.

Gaming Revenue Class II

Class II gaming revenues decreased by \$2.4 million, or 3%, from \$89.5 million in the nine months ended June 30, 2004, to \$87.1 million in the nine months ended June 30, 2005, due primarily to a decrease in the average installed base of Legacy player terminals.

New Generation system revenues, which include Reel Time Bingo and MegaNanza games, were \$83.7 million for the nine months ended June 30, 2005, compared to \$83.3 million in the same period of fiscal 2004. This increase was related to the greater average installed base of player terminals and was partially offset by the lower average hold per day.

Gaming Revenue Charity

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Charity gaming revenues increased \$9.2 million to \$14.7 million for the nine months ended June 30, 2005, compared to \$5.5 million for the same period of 2004. The increase relates to the greater number of player terminals installed in the nine months ended June 30, 2005 when compared to the same period of 2004.

Gaming Revenue All Other

Class III rental and back-office fees increased 11% to \$4.2 million, in the nine months ended June 30, 2005, from \$3.8 million during the same period of 2004.

Other recurring gaming revenue generated from TILG, and to a lesser degree, from the central determinant system for the New York Lottery, increased to \$5.2 million for the nine months ended June 30, 2005, compared to \$3.5 million in same period of 2004. The increase relates to our launch of TILG and the New York lottery system late in the first quarter of fiscal 2004. During the second quarter of 2005, TILG POSTs were converted to Reel Time Bingo.

We began generating revenues from the central determinant system for the New York Lottery in January 2004. Currently, five of the eight planned racinos are operating, with approximately 5,600 total

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POSTs. To date, we have realized substantially less revenue than anticipated from our New York Lottery operations, in significant part due to delays in the opening of planned racino operations at several racetracks. We are nevertheless required to incur ongoing expenses associated with development and maintenance of the New York video lottery system, and we do not currently expect to have profitable operations there at least through 2005. Delays in the anticipated development of the New York video lottery system and other emerging market opportunities may continue to adversely impact our revenue and operating results.

Player Terminal and License Sale and Lease Revenue

Player terminal and license sale and lease revenue decreased to \$2.8 million, from \$7.2 million in the same period of 2004. During the nine months ended June 30, 2005, 51 video lottery terminals were sold, compared to 487 in the same period of fiscal 2004, resulting in \$494,000 and \$4.8 million, respectively, in player terminal revenue. Player terminal revenue of \$844,000 was recognized ratably in the nine months ended June 30, 2005, based on the contract term. The fewer number of video lottery terminals sold in the current period resulted in a decrease in license sales from \$1.9 million to \$1.4 million in the nine months ended June 30, 2005.

Other revenue, which consisted primarily of service and maintenance fees, remained relatively constant at \$1.6 million. The slight increase was due to the greater number of player terminals in service, and service contract income related to video lottery terminals in the State of Washington.

Cost of player terminal and licenses sold decreased to \$2.6 million for the nine months ended June 30, 2005, from \$4.2 million in the same period of 2004. The decrease relates to reduced sales of player terminals and ancillary equipment and licenses during the third quarter of 2005, compared to the same period in 2004.

Selling, general and administrative expenses increased 11%, to \$46.5 million for the nine months ended June 30, 2005, from \$41.8 million in the same period of 2004. The increase continues to reflect higher salaries and wages and the related employee benefits and taxes, which increased approximately \$3.1 million, due to the additional personnel hired to develop our gaming systems and content, and to monitor and develop proposals to address opportunities in both domestic and international markets. At June 30, 2005, we employed 451 full-time and part-time employees, compared to 414 at June 30, 2004. The decreased number of player terminal installations decreased repairs and maintenance, and transportation and related costs by \$372,000. Consulting and contract labor increased \$1.1 million, due to commissions and the large first-quarter deployment of player terminals in the California TILG market. Legal, professional and lobbying fees increased approximately \$1.7 million, primarily as a result of increased legal and professional services related to our research of new products, entry into new markets and Sarbanes-Oxley consulting costs. Advertising and promotion decreased \$1.5 million, due to the entrance into new markets in early fiscal 2004. Bad debt expense decreased \$209,000, as certain accounts receivable, previously reserved for, were recovered.

Depreciation expense increased 61%, to \$39.5 million for the nine months ended June 30, 2005, from \$24.5 million in 2004, primarily as a result of a 10.7% increase in the installed base of terminals under participation arrangements. Amortization expense increased to \$3.1 million for the quarter ended June 2005, compared to \$1.7 million for the same quarter of 2004. The majority of the increase was related to amortization of license agreements for gaming content and internally developed software.

Interest income increased 54%, to \$1.4 million for the nine months ended June 30, 2005, from \$906,000 in the same period of 2004, due to the higher balance of notes receivable bearing variable interest rates.

Interest expense increased 77%, to \$1.9 million for the nine months ended June 30, 2005, from \$1.1 million for the same quarter of fiscal 2004, due primarily to an increase in amounts outstanding under our Credit Facility. As we continue to fund our capital commitments pursuant to our

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development agreements and otherwise, we will likely be required to borrow more money under our Credit Facility. As a result, our interest expense will likely continue to increase in the future.

Income tax expense decreased to \$9.3 million for the nine months ended June 30, 2005, from \$13.0 million in the same period of 2004. These figures represent effective tax rates of 38.7% and 33.7% for the nine months ended June 30, 2005 and 2004, respectively. Income tax expense for the nine months ended June 30, 2004, includes a benefit of approximately \$1.7 million relating to an over-accrual from prior years' state and federal income tax provision.

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RECENT ACCOUNTING PRONOUNCEMENTS ISSUE

In December 2004, the Financial Accounting Standards Board, or FASB, issued Statement of Financial Accounting Standards, or SFAS, No. 123 (revised 2004), Share-Based Payment. Statement 123(R) will provide investors and other users of financial statements with more complete and neutral financial information by requiring that the compensation cost relating to share-based payment transactions be recognized in financial statements. That cost will be measured based on the fair value of the equity or liability instruments issued. Statement 123(R) covers a wide range of share-based compensation arrangements, including share options, restricted share plans, performance-based awards, share appreciation rights, and employee share purchase plans. Statement 123(R) replaces FASB Statement No. 123, Accounting for Stock-Based Compensation, and supersedes APB Opinion No. 25, Accounting for Stock Issued to Employees.

Statement 123, as originally issued in 1995, established as preferable a fair-value-based method of accounting for share-based payment transactions with employees. However, that Statement permitted entities the option of continuing to apply the guidance in Opinion 25, as long as the footnotes to financial statements disclosed what net income would have been had the preferable fair-value-based method been used. Public entities (other than those filing as small business issuers) will be required to apply Statement 123(R) as of the first interim or annual reporting period that begins after June 15, 2005. In April 2005, the Securities and Exchange Commission adopted a rule that amended the required application date of 123(R) from interim or annual reporting periods beginning after June 15, 2005, to the beginning of the entities next fiscal year. We are currently evaluating the effect adoption of SFAS 123 (R) will have on our overall results of operations and financial position.

In March 2005, the FASB issued FASB Interpretation, or FIN, No. 47, Accounting for Conditional Asset Retirement Obligations. FIN No. 47 clarifies that the term conditional asset retirement obligation as used in SFAS No. 143, Accounting for Asset Retirement Obligations, refers to a legal obligation of an entity to perform an asset retirement activity in which the timing and/or method of settlement are conditional on a future event that may or may not be within the control of the entity. Such an obligation to perform the asset retirement activity is unconditional, even though uncertainty exists about the timing and/or method of settlement. Accordingly, an entity is required to recognize a liability for the fair value of a conditional asset retirement obligation if the fair value of the liability can be reasonably estimated. FIN No. 47 is effective no later than the end of fiscal years ending after December 15, 2005. Retrospective application for interim financial information is permitted but is not required. We are currently assessing the effect adoption of FIN No. 47 will have on our overall results of operations and financial position.

In May 2005, the FASB issued SFAS No. 154, Accounting Changes and Error Corrections, a replacement of APB Opinion No. 20 and FASB Statement No. 3, which changes the requirements for the accounting for and reporting of a change in accounting principle. SFAS No. 154 applies to all voluntary changes in accounting principles and also to changes required by an accounting pronouncement that does not contain specific transition provisions. SFAS NO. 154 carries forward without change the guidance contained in APB Opinion No. 20, Accounting Changes, for reporting the correction of an error in previously issued financial statements and a change in accounting estimate. SFAS No. 154 is effective for accounting changes and corrections of errors made in fiscal years beginning after December 15, 2005. We will be adopting SFAS No. 154, effective January 1, 2006. SFAS No. 154 does not change the transition provisions of any existing accounting pronouncements.

CRITICAL ACCOUNTING POLICIES

We prepare our consolidated financial statements in conformity with accounting principles generally accepted in the United States of America. As such, we are required to make certain estimates, judgments and assumptions that we believe are reasonable based on the information available. These estimates and assumptions affect the reported amounts of assets and liabilities at the date of the financial statements, and the reported amounts of revenues and expenses during the periods presented. There can be no assurance that actual results will not differ from those estimates. We believe the following represent our most critical accounting policies:

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Revenue Recognition. Revenues from the sale of player terminals, player terminal licenses and license of gaming systems are generally accounted for under Staff Accounting Bulletin 104, Revenue Recognition, or SAB 104, Statement of Position 97-2 Software Revenue Recognition, or SOP 97-2, or Emerging Issues Task Force, or EITF, Issue 00-21, Revenue Arrangements with Multiple Deliverables, or EITF 00-21. In accordance with the provisions of SAB 104, SOP 97-2 and EITF 00-21, sales that are considered to contain multiple deliverables are bifurcated into accounting units based on their relative fair market value, provided each component is not essential to the function of the other. Revenue from these separate accounting units is then recognized when: a) persuasive evidence of an arrangement exists and the sales price is fixed and determinable; b) delivery has occurred and services have been rendered; and

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c) collectibility is reasonably assured. If vendor-specific objective evidence of fair value does not exist, the revenue is deferred until such time that all elements have been delivered or services have been performed. If any element is determined to be essential to the function of the other, revenues are generally recognized utilizing the subscription method of accounting over the term of the services that are rendered.

Revenue recognition for our gaming systems is complex and involves judgment in: a) identifying multiple deliverables, since each system contract is generally unique; b) determining the interoperability of certain elements of our hardware and software; and c) assessing the creditworthiness of our customers. While we believe our assumptions are reasonable, these factors significantly influence our decision to recognize or defer revenue from each gaming system, and if different, could materially affect the timing of our revenues.

Property and Equipment and Leased Gaming Equipment. The cost of property and equipment and leased gaming equipment is depreciated over their estimated useful lives, generally using the straight-line method for financial reporting, and accelerated methods for tax reporting purposes. A majority of our assets are susceptible to changes in technology and changes in the competitive marketplace influencing customer preferences, such as cabinet style or game titles. These factors could cause us to evaluate and change the estimated lives used to depreciate assets.

Furthermore, we review our property and equipment and leased gaming equipment for impairment whenever events or changes in circumstances, such as technological obsolescence or customer preferences, indicate we may not recover the carrying amount of an asset. We measure recoverability of assets to be held and used by comparing the carrying amount of an asset to future cash flows expected to be generated by the asset. While we believe that our estimates and assumptions used in evaluating the carrying amount of these assets are reasonable, different assumptions could materially affect either the carrying amount or the estimated useful lives of the assets.

Development Agreements. We enter into development agreements to provide financing for new tribal gaming facilities, or for the expansion of existing facilities. In return, the customer commits to a fixed number of player terminal placements in the facility, and we receive a fixed percentage of those player terminals hold per day over the term of the agreement. Certain of the agreements contain performance standards for our player terminals that could allow the facility to reduce a portion of our player terminals. The agreements typically provide for a portion of the amounts retained by the gaming facility for their share of the hold to be used for repayment of some or all of the advances. Amounts advanced in excess of those reimbursed by the customer for real property and land improvements are allocated to intangible assets and amortized over the life of the contract. Amounts related to personal property owned by us and located at the tribal gaming facility are carried in our property and equipment, and depreciated over the estimated useful life of the related asset or the contract life, whichever is shorter.

We utilize the life of a contract to amortize the intangible assets associated with development agreements. We review the carrying value of these contract rights at least annually or whenever changes in circumstances indicate the carrying value of these assets may not be recoverable. While we believe that our estimates and assumptions used in evaluating the carrying value of these assets are reasonable, different assumptions could materially affect either the carrying value or the estimated useful lives of the contract rights.

Allowance for Doubtful Accounts. We maintain an allowance for doubtful accounts related to our accounts receivable and notes receivable that have been deemed to have a high risk of collectibility. We review our accounts receivable and notes receivable on a monthly basis to determine if any receivables will potentially be uncollectible. We analyze historical collection trends and changes in our customers payment patterns, customer concentration and creditworthiness when evaluating the adequacy of our allowance for doubtful accounts. A large percentage of receivables are with Native American tribes that have their reservations and gaming operations in the state of Oklahoma, and we have concentrations of credit risk with several tribes. Despite the industry, geographic and customer concentrations related to our receivables, due to our historical experience on receivable collections, management considers credit risk is minimal with respect to accounts receivable. We include any receivable balances that are determined to be uncollectible in our overall allowance for doubtful accounts. Changes in our assumptions or estimates reflecting the collectibility of certain accounts could materially affect our allowance for both trade and notes receivable.

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At June 30, 2005 and September 30, 2004, our allowance for doubtful trade accounts and notes receivable was \$204,000 and \$608,000 respectively.

Income taxes. We apply the provisions of SFAS No. 109, Accounting for Income Taxes. Under SFAS No. 109, deferred tax liabilities or assets arise from differences between the tax basis of liabilities or assets and their basis for financial reporting, and are subject to tests of recoverability in the case of deferred tax assets. Deferred tax assets and liabilities are recognized for the future tax consequences attributable to differences between the financial statements carrying amounts of assets and liabilities, and their respective tax basis. Deferred tax assets and

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liabilities are measured using enacted tax rates expected to apply to taxable income in the years in which those temporary differences are expected to be recovered or settled. The effect on deferred tax assets and liabilities of a change in tax rates is recognized in the period that includes the enactment date.

The accounting for income taxes involves significant judgments and estimates, and deals with complex tax regulations. The recoverability of certain deferred tax assets is based in part on estimates of future income and the timing of temporary differences, so the failure to fully realize such deferred tax assets could result in a higher tax provision in future periods.

At June 30, 2005 and September 30, 2004, our net deferred tax liability totaled \$5.9 million and \$11.3 million, respectively.

LIQUIDITY AND CAPITAL RESOURCES

At June 30, 2005, we had unrestricted cash and cash equivalents of \$5.9 million, compared to \$4.8 million at September 30, 2004. At June 30, 2005, we had a working capital deficit of \$12.2 million, compared to working capital of \$249,000 at September 30, 2004. The working deficit as of June 30, 2005, was the result of our repurchases of treasury stock and our continued investment in development agreements. During the nine months ended June 30, 2005, we used \$9.7 million to purchase treasury stock and advanced \$27.9 million, net of amounts reimbursed, under development agreements.

As of June 30, 2005, our total contractual cash obligations were as follows (in thousands):

	Less than		More than		Total
	1 year	1-3 years	3-5 years	5 years	
Revolving line of credit	\$	\$ 20,970	\$	\$	\$ 20,970
Long-term debt, excluding interest ⁽¹⁾	10,619	6,360	1,069		18,048
Capital leases ⁽²⁾	4,364	1,908			6,272
Operating leases ⁽³⁾	1,527	2,787	2,914	123	7,351
Purchase commitments ⁽⁴⁾	7,292				7,292
Payments due under employment agreement ⁽⁵⁾	250	500	500	2,146	3,396
Gaming facility joint development agreements ⁽⁶⁾	46,172				46,172
Total	\$ 70,224	\$ 32,525	\$ 4,483	\$ 2,269	\$ 109,501

(1) Consists of various three-to five-year loans for the purchase of automobiles and property and equipment at an overall average annual interest rate of 6.60%, a five-year loan related to financing our corporate aircraft at an annual interest rate of LIBOR plus 2.75%, and amounts borrowed under our Credit Facility at an annual interest rate of Prime plus 1.25%.

(2) Consists of various three-year capital leases for property and equipment at an overall average annual interest rate of 7.52%.

(3) Consists of operating leases for our facilities and office equipment that expire at various times through 2010.

(4) Consists of commitments to purchase third-party licenses and player terminals.

(5) Represents the expected future payments due, based on life expectancy tables, to Gordon Graves for his noncompete agreement entered into under his Employment Agreement.

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- (6) Represents commitments for payments toward development and construction and/or expansion of tribal gaming facilities. For purposes of this table, cash obligations under development agreements are considered payable over the next twelve months, although the actual timing of the payments may extend beyond twelve months, depending on the number and schedule of development projects ongoing at any given time.

During the nine months ended June 30, 2005, we generated \$58.3 million in cash from our operations, compared to \$54.9 million during the same period of 2004. This \$3.4 million increase in cash generated from operations over the prior period was primarily the result of the payment timing related to accounts payable, as well as the timing of accounts and notes receivable collections. Additionally, during the nine months ended June 30, 2005, we invested \$6.0 million of cash generated from operations on the implementation of the video lottery system in Israel.

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Cash used in investing activities increased to \$72.4 million in the nine months ended June 30, 2005, from \$71.8 million in the same period of 2004. The increase was primarily the result of a \$28.7 million increase in net amounts advanced under development agreements, and was partially offset by a \$22.8 million decrease in acquisitions of property and equipment. During the nine months ended June 30, 2005, additions to property and equipment consisted of:

	Cash Capital Expenses	Financed Capital Expenses	Total Additions to P&E
Player terminal and gaming equipment	\$ 21,431	\$ 575	\$ 22,006
Licenses	9,148		9,148
Tribal gaming facilities and portable buildings	5,103		5,103
Vehicles	7	445	452
Other	820		820
	<u> </u>	<u> </u>	