

MULTIMEDIA GAMES INC
Form 10-Q
May 10, 2006
Table of Contents

UNITED STATES
SECURITIES AND EXCHANGE COMMISSION

Washington, D.C. 20549

Form 10-Q

(Mark One)

QUARTERLY REPORT PURSUANT TO SECTION 13 OR 15 (d) OF THE SECURITIES EXCHANGE ACT OF 1934

For the quarterly period ended March 31, 2006

OR

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

For the transition period from _____ to _____

Commission File Number: 001-14551

Multimedia Games, Inc.

(Exact name of registrant as specified in its charter)

Texas
(State or other jurisdiction of

incorporation or organization)

206 Wild Basin Road, Building B, Fourth Floor

74-2611034
(IRS Employer

Identification No.)

78746

Edgar Filing: MULTIMEDIA GAMES INC - Form 10-Q

Austin, Texas
(Address of principal executive offices)

(Zip Code)

(512) 334-7500

(Registrant's telephone number, including area code)

Registrant's website: www.multimedialogames.com

None

(Former name, former address and former fiscal year, if changed since last report)

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 a large accelerated filer, an accelerated filer, or a non-accelerated filer. See definition of accelerated filer and large accelerated filer in Rule 12b-2 of the Exchange Act. (Check one):

Large accelerated filer

Accelerated filer

Non-accelerated filer

Indicate by check mark whether the Registrant is a shell company (as defined in Rule 12b-2 of the Exchange Act). Yes No

APPLICABLE ONLY TO CORPORATE ISSUERS:

As of May 2, 2006, there were 27,143,211 shares of the registrant's common stock, par value \$0.01 per share, outstanding.

Table of Contents

FORM 10-Q

INDEX

PART I. FINANCIAL INFORMATION

| | | |
|---------|--|----|
| Item 1. | <u>Financial Statements (Unaudited)</u> | |
| | <u>Consolidated Balance Sheets</u> | |
| | (As of March 31, 2006 and September 30, 2005) | 3 |
| | <u>Consolidated Statements of Income</u> | |
| | (For the three months ended March 31, 2006 and 2005) | 4 |
| | <u>Consolidated Statements of Income</u> | |
| | (For the six months ended March 31, 2006 and 2005) | 5 |
| | <u>Consolidated Statements of Cash Flows</u> | |
| | (For the six months ended March 31, 2006 and 2005) | 6 |
| | <u>Notes to Consolidated Financial Statements</u> | 7 |
| Item 2. | <u>Management's Discussion and Analysis of Financial Condition and Results of Operations</u> | 17 |
| Item 3. | <u>Quantitative and Qualitative Disclosures About Market Risk</u> | 30 |
| Item 4. | <u>Controls and Procedures</u> | 30 |

PART II. OTHER INFORMATION

| | | |
|----------|--|----|
| Item 1. | <u>Legal Proceedings</u> | 31 |
| Item 1A. | <u>Risk Factors</u> | 31 |
| Item 2. | <u>Unregistered Sales of Equity Securities and Use of Proceeds</u> | 41 |
| Item 6. | <u>Exhibits</u> | 41 |
| | <u>Signatures</u> | 42 |
| EX | 31.1 | |
| EX | 31.2 | |
| EX | 32.2 | |

Table of Contents**PART I****FINANCIAL INFORMATION****Item 1. Financial Statements****MULTIMEDIA GAMES, INC.****CONSOLIDATED BALANCE SHEETS****As of March 31, 2006 and September 30, 2005**

(In thousands, except shares and per share amounts)

(Unaudited)

| | March 31, 2006 | September 30, 2005 |
|--|-------------------|-----------------------|
| ASSETS | | |
| CURRENT ASSETS: | | |
| Cash and cash equivalents | \$ 1,996 | \$ 118 |
| Accounts receivable, net of allowance for doubtful accounts of \$341 and \$229, respectively | 16,832 | 18,807 |
| Inventory | | 414 |
| Contract costs in excess of billing | | 789 |
| Prepaid expenses and other | 1,820 | 3,177 |
| Notes receivable, net | 8,931 | 9,362 |
| Federal and state income tax receivable | 1,388 | |
| Deferred income taxes | 1,673 | 2,075 |
| Total current assets | 32,640 | 34,742 |
| Restricted cash and long-term investments | 995 | 1,068 |
| Leased gaming equipment, net | 29,208 | 37,391 |
| Property and equipment, net | 93,087 | 93,894 |
| Notes receivable noncurrent | 30,310 | 31,964 |
| Intangible assets, net | 58,133 | 53,674 |
| Other assets | 1,077 | 1,959 |
| Deferred tax asset noncurrent | 898 | |
| Total assets | \$ 246,348 | \$ 254,692 |
| LIABILITIES AND STOCKHOLDERS EQUITY | | |
| CURRENT LIABILITIES: | | |
| Current portion of revolving lines of credit | \$ 18,441 | \$ |
| Current portion of long-term debts and capital leases | 9,523 | 13,401 |
| Accounts payable and accrued expenses | 22,053 | 35,349 |
| Federal and state income tax payable | 34 | 3,312 |
| Deferred revenue | 1,705 | 2,081 |
| Total current liabilities | 51,756 | 54,143 |
| Revolving lines of credit | 24,643 | 27,770 |
| Long-term debts and capital leases, less current portion | 2,924 | 6,498 |
| Other long-term liabilities | 2,768 | 3,049 |
| Deferred revenue noncurrent | 423 | 1,057 |

Edgar Filing: MULTIMEDIA GAMES INC - Form 10-Q

| | | |
|---|-------------------|-------------------|
| Deferred income taxes | | 3,258 |
| Total liabilities | 82,514 | 95,775 |
| Commitments and contingencies | | |
| 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, 30,960,222 and 30,802,524 shares issued, and 27,048,837 and 27,050,285 shares outstanding, respectively | 310 | 308 |
| Additional paid-in capital | 69,550 | 67,184 |
| Treasury stock, 3,911,385 and 3,752,239 shares at cost, respectively | (24,741) | (23,285) |
| Retained earnings | 118,715 | 114,710 |
| Total stockholders' equity | 163,834 | 158,917 |
| Total liabilities and stockholders' equity | \$ 246,348 | \$ 254,692 |

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

Table of Contents

MULTIMEDIA GAMES, INC.

CONSOLIDATED STATEMENTS OF INCOME

For the Three Months Ended March 31, 2006 and 2005

(In thousands, except per-share amounts)

(Unaudited)

| | Three Months Ended March 31, | |
|---|---------------------------------|-----------------|
| | 2006 | 2005 |
| REVENUES: | | |
| Gaming revenue: | | |
| Class II | \$ 24,748 | \$ 31,222 |
| Charity | 5,144 | 5,454 |
| All other | 4,381 | 2,121 |
| Gaming equipment, system sale and lease revenue | 11,069 | 811 |
| Other | 1,114 | 439 |
| Total revenues | 46,456 | 40,047 |
| OPERATING COSTS AND EXPENSES: | | |
| Cost of gaming equipment and systems sold and royalty fees paid | 10,125 | 960 |
| Selling, general and administrative expenses | 17,582 | 15,606 |
| Amortization and depreciation | 14,129 | 14,763 |
| Total operating costs and expenses | 41,836 | 31,329 |
| Operating income | 4,620 | 8,718 |
| OTHER INCOME (EXPENSE): | | |
| Interest income | 611 | 350 |
| Interest expense | (1,054) | (663) |
| Income before income taxes | 4,177 | 8,405 |
| Income tax expense | 1,701 | 3,193 |
| Net income | \$ 2,476 | \$ 5,212 |
| Basic earnings per share | \$ 0.09 | \$ 0.19 |
| Diluted earnings per share | \$ 0.09 | \$ 0.18 |

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

Table of Contents

MULTIMEDIA GAMES, INC.

CONSOLIDATED STATEMENTS OF INCOME

For the Six Months Ended March 31, 2006 and 2005

(In thousands, except per-share amounts)

(Unaudited)

| | Six Months Ended March 31, | |
|---|-------------------------------|------------------|
| | 2006 | 2005 |
| REVENUES: | | |
| Gaming revenue: | | |
| Class II | \$ 49,152 | \$ 58,891 |
| Charity | 9,812 | 10,054 |
| All other | 8,014 | 7,421 |
| Gaming equipment, system sale and lease revenue | 11,694 | 1,805 |
| Other | 1,822 | 1,042 |
| Total revenues | 80,494 | 79,213 |
| OPERATING COSTS AND EXPENSES: | | |
| Cost of gaming equipment and systems sold and royalty fees paid | 10,722 | 1,801 |
| Selling, general and administrative expenses | 33,540 | 32,431 |
| Amortization and depreciation | 28,472 | 28,044 |
| Total operating costs and expenses | 72,734 | 62,276 |
| Operating income | 7,760 | 16,937 |
| OTHER INCOME (EXPENSE): | | |
| Interest income | 1,092 | 782 |
| Interest expense | (2,020) | (1,217) |
| Income before income taxes | 6,832 | 16,502 |
| Income tax expense | 2,827 | 6,267 |
| Net income | \$ 4,005 | \$ 10,235 |
| Basic earnings per share | \$ 0.15 | \$ 0.37 |
| Diluted earnings per share | \$ 0.14 | \$ 0.34 |

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 Six Months Ended March 31, 2006 and 2005**

(In thousands)

(Unaudited)

| | Six Months Ended March 31, | |
|--|---------------------------------------|-----------------|
| | 2006 | 2005 |
| CASH FLOWS FROM OPERATING ACTIVITIES: | | |
| Net income | \$ 4,005 | \$ 10,235 |
| Adjustments to reconcile net income to cash and cash equivalents provided by operating activities: | | |
| Amortization | 3,287 | 1,930 |
| Depreciation | 25,185 | 26,114 |
| Accretion of contract rights | 2,049 | 801 |
| Write-off of and loss on disposal of long-lived assets | 255 | 117 |
| Provisions for inventory and long-lived assets | 90 | 35 |
| Deferred income taxes | (3,754) | (2,377) |
| Share-based compensation | 1,354 | |
| Options issued to consultants | 8 | 81 |
| Provision for doubtful accounts | 118 | 142 |
| (Increase) decrease in: | | |
| Accounts receivable | 4,595 | (2,374) |
| Inventory | 414 | 199 |
| Contract costs in excess of billing | 789 | |
| Prepaid expenses and other | 2,239 | (1,736) |
| Federal and state income tax payable/receivable | (4,666) | 8,666 |
| Notes receivable | 93 | 3,732 |
| Increase (decrease) in: | | |
| Accounts payable and accrued expenses | (13,584) | 858 |
| Other long-term liabilities | (208) | (548) |
| Deferred revenue | (1,010) | (422) |
| NET CASH PROVIDED BY OPERATING ACTIVITIES | 21,259 | 45,453 |
| CASH FLOWS FROM INVESTING ACTIVITIES: | | |
| Acquisition of property and equipment and leased gaming equipment | (16,513) | (30,243) |
| Acquisition of intangible assets | (2,771) | (6,859) |
| Advances under development agreements | (15,175) | (21,088) |
| Repayments under development agreements | 7,666 | 9,448 |
| NET CASH USED IN INVESTING ACTIVITIES | (26,793) | (48,742) |
| CASH FLOWS FROM FINANCING ACTIVITIES: | | |
| Proceeds from exercise of stock options, warrants, and related tax benefit | 1,006 | 988 |
| Proceeds from long-term debt | | 10,000 |
| Principal payments of long-term debt and capital leases | (7,452) | (4,928) |
| Proceeds from revolving lines of credit | 29,000 | 13,636 |
| Payments on revolving lines of credit | (13,686) | (6,036) |
| Purchase of treasury stock | (1,456) | (3,880) |

Edgar Filing: MULTIMEDIA GAMES INC - Form 10-Q

| | | |
|---|--------------|--------------|
| NET CASH PROVIDED BY FINANCING ACTIVITIES | 7,412 | 9,780 |
| Net increase in cash and cash equivalents | 1,878 | 6,491 |
| Cash and cash equivalents, beginning of period | 118 | 4,768 |
| Cash and cash equivalents, end of period | \$ 1,996 | \$ 11,259 |
| SUPPLEMENTAL CASH FLOW DATA: | | |
| Interest paid | \$ 1,624 | \$ 1,116 |
| Income tax paid | \$ 10,903 | \$ 105 |
| NON-CASH TRANSACTIONS: | | |
| Property and equipment and other assets acquired through: | | |
| Capital Lease | | 575 |
| Long-term debt | | 410 |

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

Table of Contents

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 for the year ended September 30, 2005, as amended by the Amendment No. 1 on Form 10-K/A thereto.

The financial statements included herein as of March 31, 2006, and for each of the three and six months ended March 31, 2006 and 2005, 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 six months ended March 31, 2006 are not necessarily indicative of the results which will be realized for the year ending September 30, 2006.

Operations. The Company is a supplier of interactive systems, electronic games, and gaming terminals for the Native American gaming market, as well as the growing racetrack casino, charity and commercial bingo/sweepstakes and video lottery markets. The Company designs and develops networks, software and content that provide its customers with, among other things, comprehensive gaming systems delivered through a telecommunications network linking the Company's gaming terminals with one another, both within and among gaming facilities, thereby enabling players to simultaneously participate in the same game and to compete against one another to win common pooled prizes. The Company's ongoing development and marketing efforts focus on Class II and Class III gaming systems and products for use by Native American tribes throughout the United States, video lottery systems, sweepstakes and amusement with prize games, other products for domestic and international lotteries, and products for domestic and international charity and commercial bingo facilities. 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 offers content for its gaming systems that has been designed and developed by the Company, as well as game themes the Company 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., Innovative Sweepstakes Systems, Inc., MGAM Services, LLC, MGAM Systems International, Inc., Megabingo International, LLC, Multimedia Games De Mexico S de R L de CV and Servicios De Wild Basin S de R L de CV. 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, the 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 share-based compensation, provisions for bad debts and contract losses, useful lives of property and equipment and intangible assets, impairment of property and equipment and intangible assets, deferred taxes, and the provision for and disclosure of litigation and loss contingencies. Actual results may differ materially from these estimates in the future.

Reclassifications. Certain reclassifications were made to the prior-period financial statements to conform to the current-period financial statement presentation. These reclassifications did not have an impact on the Company's previously reported financial position or results of operations.

Revenue Recognition. The majority of the Company's gaming revenue is of a recurring nature, and is generated under participation arrangements by providing its customers with gaming terminals, gaming terminal content licenses and back-office equipment, collectively referred to as gaming equipment. Under these arrangements, the Company retains ownership of the gaming equipment installed at customer facilities, and receives revenue based on a percentage of the hold per day generated by the gaming equipment. Certain of the Company's arrangements require a portion of the facilities' hold per day to be set aside 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. Participation revenue generated from the Company's Native American Class II product is reported in its results of operations as Gaming revenue - Class II, revenue from its charity bingo product is included in

Table of Contents

MULTIMEDIA GAMES, INC.

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)

(Unaudited)

Gaming revenue Charity, and participation revenue from the Company's Tribal Instant Lottery Game, or TILG, and its Native American Class III products, including games played under the Oklahoma Compact and the Iowa Lottery, are included in Gaming revenue All other.

The Company also generates revenues from the sale or lease of Class III gaming equipment in Washington State and from related back-office fees based on a share of the hold per day of the installed equipment. Back-office fees cover the service and maintenance costs for back-office servers installed in each gaming facility to run its gaming equipment, 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 gaming terminals sold to its 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 arrangements. Revenue from participation arrangements and back-office fees is generally considered both realizable and earned at the end of each gaming day.

The Company provides gaming solutions to domestic and international lottery organizations through a combination of gaming equipment and gaming systems utilizing central determinant system technology. The equipment and systems are either sold outright for a one-time fee, or are provided on a participation basis, whereby 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 markets a modular suite of software gaming support products, such as player tracking, which enables operators to monitor, manage and track player activity, and slot accounting systems, slot management systems, and slot monitoring systems, collectively referred to as the MGAME® System. The MGAME system is either sold to customers as a complete system or on a module-by-module basis for a one-time license fee and a recurring fee for post-customer support, or is provided under a participation arrangement.

Sales of the Company's gaming equipment and gaming systems are reported under Gaming Equipment, system sale and lease revenue.

Revenue from the sale of software is accounted for under Statement of Position 97-2, Software Revenue Recognition, or SOP 97-2. 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.

In accordance with the provisions of Emerging Issues Task Force, or EITF, Issue 00-21, Revenue Arrangements with Multiple Deliverables, or 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. The majority of its multiple element contracts are for some combination of gaming terminals, content, system software, license fees and maintenance.

Revenues from the stand-alone product sales or separate accounting units are recorded 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.

Costs and Billings on Uncompleted Contract. During fiscal 2005, the Company entered into a fixed-price contract with a customer and delivered an electronic instant lottery system to the Israel Lottery. Revenues from this fixed-price contract were recognized using the completed-contract method. During the March 2006 quarter, we recorded \$8.0 million related to the Company's system sale to the Israel Lottery upon completion of the contractual terms for acceptance of this system, while total estimated cost was recorded at \$8.2 million. Revenue recognition is pursuant to contract accounting treatment under ARB 45, Long-Term Construction-Type Contracts, and SOP 81-1, Accounting for Performance of Construction-Type and Certain Production-Type Contracts, since the agreement represents a system to be designed based on specifications that are unique to the customer.

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.

Edgar Filing: MULTIMEDIA GAMES INC - Form 10-Q

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

-8-

Table of Contents**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.

Inventory. The Company's inventory consists primarily of completed gaming 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 gaming facilities or for the expansion of existing facilities. In return, the facility dedicates a percentage of its floor space to exclusive placement of the Company's gaming terminals, and the Company receives a fixed percentage of those gaming terminals' hold per day over the term of the agreement. Certain of the agreements contain performance standards for its gaming terminals that could allow the facility to reduce a portion of the Company's guaranteed floor space. 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 recorded as notes receivable. Amounts advanced in excess of those to be reimbursed by the customer for real property and land improvements are allocated to intangible assets and are generally amortized over the life of the contract, which is recorded as a reduction of revenue generated from the gaming facility. 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. In the past and in the future, we may by mutual agreement and for additional consideration, amend these contracts to reduce our floor space at the facilities.

Management reviews intangible assets for impairment whenever events or changes in circumstances indicate that the carrying amount of an asset may not be recoverable. For the period ended March 31, 2006, there was no impairment to the assets' carrying values.

At March 31, 2006 and September 30, 2005, the following net amounts related to advances made under development agreements were recorded in the following balance sheet captions:

| | March 31, | September 30, |
|--|----------------|---------------|
| | 2006 | 2005 |
| | (In thousands) | |
| Included in: | | |
| Notes receivable | \$ 37,618 | \$ 38,421 |
| Property and equipment, net of accumulated depreciation | 8,472 | 9,381 |
| Intangible assets - contract rights, net of accumulated amortization | 44,709 | 39,705 |

Notes Receivable. At March 31, 2006 and September 30, 2005, the Company's notes receivable consisted of the following:

| | March 31, | September 30, |
|--|----------------|---------------|
| | 2006 | 2005 |
| | (In thousands) | |
| Notes receivable from development agreements | \$ 37,618 | \$ 38,421 |
| Notes receivable from equipment sales | 940 | 2,042 |
| Other notes receivable | 683 | 863 |

Edgar Filing: MULTIMEDIA GAMES INC - Form 10-Q

| | | |
|------------------------------|-----------|-----------|
| Notes receivable, net | 39,241 | 41,326 |
| Less current portion | (8,931) | (9,362) |
| Notes receivable non-current | \$ 30,310 | \$ 31,964 |

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 outstanding. As of March 31, 2006, the average interest rate on notes receivable from development agreements was

Table of Contents**MULTIMEDIA GAMES, INC.****NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)**

(Unaudited)

5.49%, 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 gaming terminal retained by the facilities.

Notes receivable from equipment sales consist of financial instruments issued by customers for the purchase of gaming 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 March 31, 2006, the average interest rate on notes receivable from equipment sales was 5.25%, 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. Gaming 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 of are reported at the lower of the carrying amount or the fair value less costs of disposal. For the period ended March 31, 2006, there was no impairment to the 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 March 31, 2006 and September 30, 2005, the Company's Credit Facility, long-term debt and capital leases consisted of the following:

| | March 31, | September 30, |
|-------------------------------------|----------------|---------------|
| | 2006 | 2005 |
| | (In thousands) | |
| Revolving lines of credit | \$ 43,084 | \$ 27,770 |
| Less current portion | (18,441) | |
| Long-term revolving lines of credit | \$ 24,643 | \$ 27,770 |
| Term Loan facility | \$ 7,555 | \$ 12,014 |
| Other long-term debt | 2,386 | 3,320 |
| Capital lease obligations | 2,506 | 4,565 |

Edgar Filing: MULTIMEDIA GAMES INC - Form 10-Q

| | | |
|---|----------|----------|
| Long-term debt and capital leases | 12,447 | 19,899 |
| Less current portion | (9,523) | (13,401) |
| Long-term debt and capital leases, less current portion | \$ 2,924 | \$ 6,498 |

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 (or 7.75% as of March 31, 2006). The third tranche of the Term Loan matures in June 2007, and also bears interest at a rate of Prime. As of March 31, 2006, 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 began in July 2005, with a balloon payment due in June 2007.

Table of Contents

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, payable monthly, at a rate of Prime, and has a commitment fee based on the daily average unborrowed commitment. The Revolver matures in November 2006. As of March 31, 2006, \$9.4 million was outstanding under the Revolver, leaving \$5.6 million available, which was further reduced by \$1.1 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, payable monthly, at a rate of Prime 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 March 31, 2006, \$33.7 million was outstanding under the Reducing Revolver, leaving no availability.

The Company also maintains a lock-box arrangement with the bank providing the Credit Facility. Neither arrangement provides the bank with dominion of funds, so the revolving lines of credit are classified according to their terms.

The Credit Facility is collateralized by substantially all of the Company's assets, and contains financial covenants as defined in the agreement, that include a maximum indebtedness to EBITDA ratio of 1.50:1.00, a maximum total liabilities to tangible net worth ratio of 1.25:1.00, a minimum trailing twelve-month EBITDA of \$60.0 million, and a maximum rolling four-quarter capital expenditures rate, including amounts advanced under development agreements, of \$175.0 million. The Company was in compliance with these covenants as of March 31, 2006.

Other long-term debt at March 31, 2006 represents 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.

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 March 31, 2006 and September 30, 2005, the carrying amounts for the Company's financial instruments, which include accounts and notes receivable, accounts payable, the Credit Facility, and long-term debt and capital leases, approximate fair value.

Income Taxes. The Company applies the provisions of Statement of Financial Accounting Standards, or 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 bases 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.

Table of Contents**MULTIMEDIA GAMES, INC.****NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)**

(Unaudited)

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 March 31, | |
|---|--|-------------|
| | 2006 | 2005 |
| | (In thousands, except shares and per share amounts) | |
| Income available to common stockholders basic and diluted | \$ 2,476 | \$ 5,212 |
| Weighted average common shares outstanding | 26,984,119 | 27,917,833 |
| Effect of dilutive securities: | | |
| Options | 2,025,838 | 1,845,264 |
| Weighted average common and potential shares outstanding | 29,009,957 | 29,763,097 |
| Basic earnings per share | \$ 0.09 | \$ 0.19 |
| Diluted earnings per share | \$ 0.09 | \$ 0.18 |

| | Six Months Ended March 31, | |
|---|--|-------------|
| | 2006 | 2005 |
| | (In thousands, except shares and per share amounts) | |
| Income available to common stockholders basic and diluted | \$ 4,005 | \$ 10,235 |
| Weighted average common shares outstanding | 26,999,281 | 27,936,400 |
| Effect of dilutive securities: | | |
| Options | 1,932,864 | 2,076,297 |
| Weighted average common and potential shares outstanding | 28,932,145 | 30,012,697 |
| Basic earnings per share | \$ 0.15 | \$ 0.37 |
| Diluted earnings per share | \$ 0.14 | \$ 0.34 |

At March 31, 2006 and 2005, options to purchase 1.6 and 1.2 million shares, respectively, of Common Stock at exercise prices ranging from \$7.61 to \$21.53 per share, and \$10.11 to \$21.53 per share, respectively, were outstanding, but were not included in the computation of diluted earnings per share due to their antidilutive effect.

Edgar Filing: MULTIMEDIA GAMES INC - Form 10-Q

Share-Based Compensation. Prior to October 1, 2005, the Company elected to follow the intrinsic-value-based method prescribed by Accounting Principles Board Opinion No. 25, Accounting for Stock Issued to Employees, to account for its stock option plans, as allowed by SFAS No. 123, Accounting for Stock Based Compensation. Under APB No. 25, the Company did not recognize compensation expense for grants of stock options to common-law employees and directors with an exercise price equal to or greater than the market price of the stock on the date of grant.

On October 1, 2005, the Company adopted the provisions of SFAS No. 123(R), Share-Based Payment. SFAS No. 123(R) is a revision of SFAS No. 123, Accounting for Stock Based Compensation, and supersedes APB 25. Among other items, SFAS No. 123(R) eliminated the use of APB 25 and the intrinsic value method of accounting, and requires the Company to recognize, in the financial statements, the cost of employee services received in exchange for awards of equity instruments, based on the grant date fair value of those awards. The Company currently utilizes the Black-Scholes-Merton option-pricing model to measure the fair value of stock options granted to employees consistent with the method used for pro forma disclosures under SFAS No. 123.

The Black-Scholes-Merton model incorporates various assumptions, including expected volatility, expected life, and risk-free interest rates. The expected volatility is based on the historical volatility of the Company's common stock over the most recent period commensurate with the estimated expected life of the Company's stock options, adjusted for the impact of unusual fluctuations not reasonably expected to recur. The expected life of an award is based on historical experience and on the terms and conditions of the stock awards granted to employees.

Table of Contents**MULTIMEDIA GAMES, INC.****NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)**

(Unaudited)

The assumptions used for the three-month periods ended March 31, 2006 and 2005 and the resulting estimates of weighted-average fair value per share of options granted during those periods are as follows:

| | 2006 | 2005 |
|--|------------|------------|
| Weighted average expected life | 5.00 years | 5.00 years |
| Risk free interest rate | 4.10% | 4.12% |
| Expected volatility | 62.0% | 62.0% |
| Expected dividend yields | | |
| Weighted average fair value of options granted during the period | \$ 5.93 | \$ 4.38 |

SFAS No. 123(R) permits companies to adopt its requirements using either a modified prospective method, or a modified retrospective method. The Company applied the modified prospective method, under which compensation cost is recognized in the financial statements beginning with the adoption date for all share-based payments granted after that date, and for all unvested awards granted prior to the adoption date of SFAS No. 123(R).

The following table presents a comparison of the actual three and six months ended March 31, 2006, reported net income, net income per share and compensation cost of stock options granted to employees, to the pro forma amounts that would have been reported if compensation expense had been determined using the fair value method required by SFAS No. 123 for the three months ended March 31, 2006:

| | Three Months Ended March 31, | | Six Months Ended March 31, | |
|--|---------------------------------|----------|-------------------------------|-----------|
| | 2006 | 2005 | 2006 | 2005 |
| Net income: | | | | |
| As reported | \$ 2,476 | \$ 5,212 | \$ 4,005 | \$ 10,235 |
| Reported share-based compensation, net of tax | 534 | | 1,067 | |
| Pro forma share-based compensation, net of tax | | (761) | | (1,619) |
| Pro forma | \$ 3,010 | \$ 4,451 | \$ 5,072 | \$ 8,616 |
| Basic earnings per common share: | | | | |
| As reported | \$ 0.09 | \$ 0.19 | \$ 0.15 | \$ 0.37 |
| Pro forma | \$ 0.11 | \$ 0.16 | \$ 0.19 | \$ 0.31 |
| Diluted earnings per common share: | | | | |
| As reported | \$ 0.09 | \$ 0.18 | \$ 0.14 | \$ 0.34 |
| Pro forma | \$ 0.10 | \$ 0.15 | \$ 0.18 | \$ 0.29 |

2. COMMITMENTS AND CONTINGENCIES*Litigation*

Edgar Filing: MULTIMEDIA GAMES INC - Form 10-Q

Development Agreements. In April 2004, the Company received a letter from the National Indian Gaming Commission, or NIGC, advising the Company that its agreements with a certain customer may constitute a management contract requiring the approval of the NIGC Chairman. The Company has maintained that the agreement, relied on by the NIGC, was an outdated agreement that was not applicable to the customer's gaming facility. To date, the NIGC has taken no further action in this matter.

On November 30, 2004, the Company received letters from the Acting General Counsel of the NIGC advising the Company that, based on the fee it receives under its agreements with other tribes, collectively, the tribes, those agreements may evince a proprietary interest by the Company in the tribes' gaming activities in violation of IGRA and the tribes' gaming ordinances. The NIGC invited the Company and the tribes to submit any explanation or information that would establish that the agreement terms do not violate the requirement that the tribes maintain the sole proprietary interest in the gaming operation. The NIGC letters also advised that some of the agreements may also constitute management contracts, thereby requiring the approval of the NIGC Chairman.

Table of Contents

MULTIMEDIA GAMES, INC.

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)

(Unaudited)

The Company has responded to the NIGC, and has explained why the agreements do not violate the sole proprietary interest prohibition of the IGRA or constitute management agreements. Furthermore, the Company will vigorously contest any action by the NIGC that would adversely affect its agreements with the tribes. To date, the NIGC has taken no further action in this matter.

If certain of the Company's development agreements are finally determined to be management contracts or to create a proprietary interest of the Company in tribal gaming operations, there could be material adverse consequences to the Company. 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 have a significant impact on 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.

On March 29, 2006, the Senate Committee on Indian Affairs reported to the Senate floor the Indian Gaming Regulatory Act Amendments of 2006, or S. 2078. If enacted, S. 2078 would, among other things, expand the NIGC's authority to review and approve consulting agreements, development agreements, financing agreements and agreements whereby compensation to the non-tribal party is based on a percentage of gaming revenues. Under the current law, the Company's equipment lease agreements and development and financing agreements with Native American tribes do not require the approval of the NIGC. If S. 2078 is enacted, however, many of the Company's Native American gaming contracts would require NIGC approval. As part of the review and approval process, the NIGC could materially and adversely affect the terms of the contracts and the Company, its board of directors and significant shareholders would have to undergo a background investigation prior to the approval of the contracts.

Diamond Games. The Company is a defendant, along with others, including Clifton Lind, Robert Lannert and Gordon Graves, in a lawsuit filed on November 16, 2004, in the State Court in Oklahoma City, Oklahoma, alleging five causes of action: 1) Deceptive Trade Practices, 2) Unfair Competition, 3) Wrongful Interference with Diamond Games, Inc.'s, or Diamond Games', Business; 4) Malicious Wrong / Prima Facie Tort; and 5) Restraint of Trade. The Company filed a motion to dismiss the case, challenging subject matter jurisdiction of the Oklahoma state courts. The motion was denied. A motion to reconsider was likewise denied. Relief was sought from the Supreme Court of Oklahoma by an Application for a Writ of Prohibition. The application for a writ was denied on October 10, 2005. The case asserts that the Company offered allegedly illegal Class III games on the MegaNanza[®] and Reel Time Bingo[®] gaming systems to Native American tribes in Oklahoma. Diamond Games claims that the offer of these games negatively affected the market for its pull-tab game, Lucky Tab II. Diamond Games also alleges that the Company's development agreements with Native American tribes unfairly interfere with the ability of Diamond Games to successfully conduct its 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. The Company's defense will include a continued challenge to the jurisdiction of the Oklahoma state courts over matters directly involving the self-governance of Native American tribes involved in Indian gaming, which has been recognized as a governmental enterprise. At the present time, the case is in the preliminary stages of discovery which entails responding to the adverse party's requests for production of documents and the review and analysis of documents produced by Diamond Games in response to discovery requests.

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. The suit claims that the Company's central determinant system, as operated in the New York State Lottery, infringes the '035 Patent. Gamco claimed to have acquired ownership of the '035 Patent from Oasis Technologies, Inc., or Oasis, a previous owner of the '035 Patent. In February 2003, Oasis assigned the '035 Patent to International Game Technology, or IGT. Gamco claimed to have received a license back from IGT for the New York State Lottery. The lawsuit claimed that the Company infringed the '035 Patent after the date on which Gamco assigned the '035 Patent to IGT.

Edgar Filing: MULTIMEDIA GAMES INC - Form 10-Q

Pursuant to an agreement between the Company and Bally Technologies, Inc. (formerly Alliance Gaming, Inc.), or Bally, the Company currently sublicenses the right to practice the technology stated in the 035 Patent in Native American gaming jurisdictions in the United States. Bally obtained from Oasis the right to sublicense those rights to

-14-

Table of Contents

MULTIMEDIA GAMES, INC.

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)

(Unaudited)

the Company. That sublicense remains in effect today. Under the sublicense from Bally, in the event that the Company desires to expand its rights beyond Native American gaming jurisdictions, the agreement provides the Company the following options: 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 specified one-time license fee per jurisdiction or a unit fee per gaming machine.

Prior to deployment of the Company's central determinant system in New York, MGAM 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 noninfringement, 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.

At the request of the Company, the court issued Gamco an order to show cause that it has standing to sue the Company. On September 27, 2005, the court dismissed Gamco's lawsuit for lack of standing. The court granted Gamco leave to file an amended complaint for infringement, if any, that might have occurred during the time Gamco owned the patent. Gamco amended its complaint on November 14, 2005, alleging that the Company sold or offered to sell master processing units as part of the service to be provided to the New York State Lottery. On December 7, 2005, the Company filed a motion to dismiss the amended complaint, asserting that no equipment, including any master processing units, were sold or offered for sale to the New York State Lottery, and that no alleged infringing equipment was used in the New York State Lottery during the time that Gamco owned the '035 Patent.

Prior to the hearing on the Company's motion to dismiss, Gamco entered into a Modification Agreement with IGT which purports to grant Gamco additional rights to pursue the Company for infringement for operating the central determinant system in New York. On January 27, 2006, Gamco filed a motion to dismiss its amended complaint, without prejudice, with the express intent of filing another patent infringement complaint based on the recently executed Modification Agreement.

On February 28, 2006, the court denied both the Company's and Gamco's motions to dismiss. The court granted Gamco leave to file a second amended complaint. The court expressed no opinion on whether the Modification Agreement entered into by Gamco and IGT conveyed sufficient rights to confer standing on Gamco. The Company intends to file another motion challenging Gamco's standing to sue the Company for any acts that it claims the Company committed following the transfer of the patent to IGT. 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.

Aristocrat Technologies, Inc. On January 27, 2005, Aristocrat Technologies, Inc. filed suit in the United States District Court for the Central District of California, alleging that deployment of the Company's networked central-determinant instant lottery system infringes U.S. Letters Patent No. 4,817,951, entitled "Player Operable Lottery Machine Having Display Means Displaying Combination of Game Result Indicia," or the '951 Patent. Aristocrat is seeking an injunction, damages, and a trebling of damages for willful infringement. The Company's analysis indicates that its instant lottery system does not infringe the '951 Patent. Trial is set for December 5, 2006. 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.

HomeBingo Network, Inc. On May 16, 2005, HomeBingo Network filed suit in the United States District Court for the Northern District of New York, against the Company and the gaming entity of the Miami Tribe of Oklahoma, alleging that 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 Miami Tribe of Oklahoma has been dismissed from the lawsuit on the basis of tribal immunity, and as such, a lack of jurisdiction. The litigation is in the discovery phase. 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.

Mifal Hapayis. In April 2006, Mifal Hapayis, or Mifal, operator of the Israeli Lottery System, filed a third party claim against the Company seeking indemnity from damage that Mifal may incur due to an infringement suit filed against it by Ecotech Financial Systems Ltd., or Ecotech. The Company does not believe that it owes an indemnity

Table of Contents

MULTIMEDIA GAMES, INC.

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)

(Unaudited)

obligation to Mifal with respect to the claims of Ecotech and does not believe that the Ecotech patent is valid. The Company intends to vigorously defend the third party claim. Given the inherent uncertainties in any litigation, the Company is unable to make any prediction as to the outcome.

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.

Development Agreements. As of March 31, 2006, the Company had entered into development agreements to provide up to \$150.7 million towards the construction and/or remodeling of tribal gaming facilities, and had advanced \$121.6 million under these agreements. In exchange for a certain amount of the funds advanced under the development agreement, the Company receives a guarantee of floor space for its gaming terminals. Certain of the agreements contain gaming terminal performance standards that could allow the facility to reduce a portion of the Company's guaranteed floor space. A portion of the hold per day generated by these gaming terminals is used to repay the construction advance. Consequently, the payback period is dependent on the hold per day generated by the Company's gaming terminals located on the floor space.

Off Balance Sheet Arrangements. As of March 31, 2006, the Company had \$1.2 million in outstanding letters of credit. \$1.1 million is issued under the Revolver to guarantee its performance under certain contracts, while another \$60,000 is secured by cash.

Johnson Act. In October 2005, the DOJ made available to the public proposed legislation the agency has drafted amending the Johnson Act. The proposed legislation, if enacted, could materially and adversely affect the Company's Class II gaming market. The proposed legislation would classify electronic technological aids used by Native American tribes in Class II games, such as bingo, as gambling devices, and would authorize the use of such Class II devices by Native American tribes only if such devices are certified by the NIGC as Class II technological aids. The proposed legislation establishes criteria that must be met in order for the NIGC to certify a gambling device as a Class II technological aid. The criteria would restrict the speed of the Class II games, as well as the depictions and graphics used in the games, thereby rendering the game potentially less appealing to the customers. Recently, the DOJ announced that, based on tribal comments, the proposed legislation would be revised. The revised draft legislation has not been released to the public.

Table of Contents**ITEM 2. Management's Discussion and Analysis of Financial Condition and Results of Operations****Overview**

We are a supplier of interactive systems, electronic games, and gaming terminals for the Native American gaming market, as well as to the racetrack casino, charity and commercial bingo, sweepstakes and video lottery markets. We design and develop networks, software and content that provide our customers, among other things, comprehensive gaming systems delivered through a telecommunications network that links our gaming terminals with one another, both within and among gaming facilities. Our ongoing development and marketing efforts focus on Class II and Class III gaming systems and products for use by Native American tribes throughout the United States, video lottery systems and other products for domestic and international lotteries, products for charity and commercial bingo opportunities, and promotional sweepstakes and amusement with prize systems.

We derive the majority of our gaming revenues from the placement of gaming terminals, gaming terminal content licenses, and back-office equipment, which we collectively refer to as gaming equipment, under participation arrangements. To a lesser degree, we derive revenue from the placement of gaming equipment 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 gaming terminals operated by the New York State Division of the Lottery. A significantly smaller portion of our revenues is generated from the sale of gaming equipment 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 gaming terminals 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 gaming terminals permitted under prior law).

Class II Market

We derive our Class II gaming revenues from participation arrangements with our Native American customers. Under participation arrangements, we retain ownership of the 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 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 July 2005, we introduced and began deploying our Gen5 gaming system to our Class II markets. The product is gradually replacing the Gen IV back-office system that we introduced in late 2003, and which enabled enhancements to prior systems to allow us to add bonus-round games and wide-area progressive jackpots to our extensive library of game titles. The new Gen5 product features a more robust database for accounting, player tracking and database marketing, enhanced hardware and software redundancy, the ability to provide customers with currency accounting and player tracking support for third-party vendor games, and the ability to offer Class II and Class III compacted games on a single integrated system.

As the market has grown, we have seen new competitors with significant gaming experience and financial resources enter the Class II market. As the rules and regulations governing Class II gaming are clarified by court decisions and by new rule-making procedures, we expect there to be even more competition. New tribal-state compacts, such as the Oklahoma gaming legislation passed by referendum in 2004, have also led to increased competition from such competitors. In addition, we continue to experience 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, and continued conversion to games played under the compact, we have and may continue to experience pressure on our pricing model and hold per day, 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. We have also experienced and may continue to experience a decline in the number of our Class II games deployed in Oklahoma. 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 gaming 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 gaming terminal per day will become less relevant in predicting our performance, as our participation arrangements with customers become less standardized and more complex.

Table of Contents

Class III Market

The majority of our Class III gaming equipment in Washington State have been sold to customers outright, for a one-time purchase price, and are reported in our results of operations as Gaming equipment, system 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 gaming terminals. Revenues from the sale of Class III gaming equipment 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 gaming terminals, on terms similar to those used for our gaming terminals 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 gaming equipment 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 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 March 31, 2006, we had placed 1,173 gaming terminals at sixteen facilities that are operating under the Oklahoma compact.

Charity and Commercial Bingo Market

In December 2003, we began installing a high speed, standard bingo game for the charity market in Alabama, and as of March 31, 2006, we had 2,296 gaming terminals installed in three facilities. Charity bingo and other forms of charity gaming are operated by or for the benefit of nonprofit organizations for charitable, educational and other lawful purposes. These games are typically only interconnected within the gaming facility where the terminals are located. Regulation of charity gaming is vested with each individual state, and in some states, regulatory authority is delegated to county or municipal governmental units. We typically place gaming terminals under participation arrangements in the charity market and receive a percentage of the hold per day generated by each of the gaming terminals. In addition, during July 2004, we began installing a limited number of charity gaming units in the state of Louisiana. As of March 31, 2006, we had 170 units installed in Louisiana.

State Video Lottery Market

Beginning 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 racetrack casinos. As payment for providing and maintaining the central determinant system, we receive a small portion of the network-wide hold per day. In January 2006, we began installing video lottery terminals in Iowa, and as of March 31, 2006, had installed 383 terminals. We received payments based on the hold per day for providing the player terminals, and an additional percentage of the hold per day for the system. This system was subsequently banned by the state of Iowa, and all terminals were disconnected from our central determinant system on or before May 3, 2006.

Promotional Sweepstakes System

On December 15, 2005, we leased a promotional sweepstakes system to the Birmingham Race Course, a greyhound race course in Birmingham, Alabama. A promotional sweepstakes game allows a patron to obtain sweepstakes entries either by purchasing a product or service or by other means whereby no purchase is necessary. There are a number of methods that allow a patron to redeem their sweepstakes entries, including having the predetermined outcome displayed by video card readers. On December 22, 2005, the local sheriff served a search warrant, issued by an Alabama state judge, on the Birmingham Race Course. Pursuant to a search warrant, the local sheriff shut down the promotional sweepstakes system that was operating at the facility. On January 31, 2006, the Alabama Circuit Court issued a Declaratory Judgment and Injunction that declared that the Promotional Sweepstakes game is legal under Alabama law (see Recent Developments). On March 22, 2006, the Jefferson County District Attorney appealed the entire final judgment to the Alabama Supreme Court. We do not know when the Alabama Supreme Court will rule on this matter. We currently have placed 1,318 video readers in the Birmingham Race Course facility, and we believe these units will be in operation at least until and unless the Alabama Supreme Court reaches an adverse decision in the case.

Table of Contents

Development Agreements

As we seek to continue the growth in our customer base and to expand our installed base of linked gaming 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 that a portion of the amounts retained by the gaming facility for their share of the hold per day 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 are generally 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 receive a commitment for a fixed number of gaming 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 gaming terminals that could allow the facility to reduce a portion of our gaming terminals. To date, we have entered into development agreements for an aggregate commitment to advance approximately \$150.7 million. As of March 31, 2006, we had advanced a total of \$121.6 million under such agreements and expect to advance the remaining \$29.1 million over the next twelve to twenty-four months. In addition, the agreements contain performance clauses, which could reduce our floor space allocation rights. In the past and in the future, we may by mutual agreement and for additional consideration, amend these contracts to reduce our floor space at the facilities.

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 22% to \$5.2 million, for the three months ended March 31, 2006, from \$4.3 million for the comparable period in the prior fiscal year. For the six months ended March 31, 2006, research and development expenses increased by 18%, to \$10.0 million, from \$8.4 million for the same period of 2005. 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.

Recent Developments

Promotional Sweepstakes System

We, through our wholly-owned subsidiary, Innovative Sweepstakes Systems, Inc., or Innovative, leased our new promotional sweepstakes system to the Birmingham Race Course, which became operational on December 15, 2005. Prior to deploying our system, as is our general practice, we obtained and relied upon independent legal opinions analyzing Alabama law as applied to sweepstakes systems. We believed our system was in compliance with applicable law. However, the gaming markets that we address are heavily regulated, and we consistently disclosed the risks of regulatory enforcement action against our customers and equipment.

On December 22, 2005, the Jefferson County Sheriff served a search warrant, issued by an Alabama state judge, on the Birmingham Race Course in Birmingham, Alabama. Pursuant to such warrant, the sheriff's officers removed certain computer servers and sweepstakes video readers from the race course facility.

That same day, the Circuit Court in Jefferson County, Alabama, or the Alabama Circuit Court, issued a temporary restraining order preventing the Jefferson County Sheriff from removing additional units, and essentially freezing matters until the January 3, 2006 hearing.

Table of Contents

On January 4, 2006, the Alabama Circuit Court issued an order in the case of Jefferson County Racing Association v. Hale, Civil Action No. CV 2005-07684, granting plaintiffs' motions that, (a) commencing on January 5, 2006, the law enforcement officials return all equipment, information and information media seized from the Birmingham Race Course on December 22, 2005, and (b) plaintiffs may begin immediate repairs and reinstallation of the equipment at the Birmingham Race Course. The court order prohibited operation of the games at the Birmingham Race Course without further order of the court. Innovative filed a motion to intervene in the case. The Alabama Circuit Court allowed the intervention and aligned Innovative with the plaintiff. On January 17, 2006, the District Attorney of Jefferson County intervened as a defendant and filed counterclaims against the plaintiffs seeking declaratory and injunctive relief.

After a bench trial on the merits, the Alabama Circuit Court, on January 31, 2006, issued a Declaratory Judgment and Injunction in the case of Jefferson County Racing Association v. Hale, Civil Action No. CV 2005-07684, wherein the court set forth its findings of fact and made the following rulings:

This Court declared that the Quincy's Sweepstakes, as represented to this Court during trial, is a lawful sweepstakes promotion and is not illegal under Alabama law;

The Sheriff is, therefore, permanently enjoined from further actions against such operations at the Race Course facility, provided plaintiffs operate the Sweepstakes as represented to the Court; and

The Sheriff was instructed to return to the Race Course all money seized during the raid, as well as any remaining papers, records, equipment or property seized but not heretofore returned.

On February 6, 2006, the Sheriff filed a Compliance Report with the Alabama Circuit Court representing that he would not appeal the court's ruling. On February 14, 2006, the Jefferson County District Attorney filed a post-judgment motion and a notice of appeal of the injunction portion of the trial court's January 31, 2006 order. On March 21, 2006, the Alabama Circuit Court denied the District Attorney's post-judgment motion. On March 22, 2006, the Jefferson County District Attorney appealed the final judgment to the Alabama Supreme Court. It is expected that briefs will be filed for consideration by the Alabama Supreme Court. At this time, we do not know when the Alabama Supreme Court will issue an opinion in this case. We currently have placed 1,318 video readers in the Birmingham Race Course facility, and we believe these units will be in operation at least until and unless the Alabama Supreme Court reaches an adverse decision in this case.

Johnson Act

In October 2005, the DOJ made available to the public proposed legislation the agency has drafted amending the Johnson Act. The proposed legislation, if enacted, could materially and adversely affect our Class II gaming market. The proposed legislation would classify electronic technological aids used by Native American tribes in Class II games, such as bingo, as gambling devices, and would authorize the use of such Class II devices by Native American tribes only if such devices are certified by the National Indian Gaming Commission, or NIGC, as Class II technological aids. The proposed legislation establishes criteria that must be met in order for the NIGC to certify the gambling devices as a Class II technological aid. The criteria would restrict the speed of the Class II games, as well as the depictions and graphics used in the games, thereby rendering the game potentially less appealing to the customers. Recently, the DOJ announced that, based on tribal comments, the proposed legislation would be revised. The revised draft legislation has not been released to the public.

Table of Contents**RESULTS OF OPERATIONS**

The following tables outline our end-of-period and average installed base of gaming terminals for the three and six months ended March 31, 2006 and 2005:

| | At March 31, | |
|---|--------------|--------|
| | 2006 | 2005 |
| End-of-period installed gaming terminal base | | |
| Class II gaming terminals | | |
| Reel Time Bingo® | 8,439 | 10,704 |
| Legacy system | 392 | 609 |
| Oklahoma compacted games | 1,173 | 68 |
| Other gaming terminals ⁽¹⁾ | 2,849 | 2,437 |

| | Three Months Ended | | Six Months Ended | |
|--|--------------------|--------|------------------|--------|
| | March 31, | | March 31, | |
| | 2006 | 2005 | 2006 | 2005 |
| Average installed gaming terminal base: | | | | |
| Class II gaming terminals | | | | |
| Reel Time Bingo | 8,718 | 11,016 | 9,004 | 10,533 |
| Legacy system | 390 | 658 | 413 | 729 |
| Oklahoma compacted games | 1,189 | 2 | 1,147 | 1 |
| Other gaming terminals ⁽¹⁾ | 2,700 | 2,420 | 2,635 | 3,336 |

(1) Other gaming terminals include charity, Tribal Instant Lottery Game, or TILG, and Iowa Lottery

At March 31, 2006, there were 1,318 sweepstakes video readers installed, and the average installed base for the three and six months ended March 31, 2006, was 644 and 355, respectively. There were no sweepstakes video readers installed during 2005.

Three Months Ended March 31, 2006, Compared to Three Months Ended March 31, 2005

Total revenues for the three months ended March 31, 2006 were \$46.5 million, compared to \$40.0 million for the same period of 2005. The revenue increase was driven by the increased gaming equipment, system sale and lease revenue, and partially offset by the decline of Class II gaming and TILG revenues discussed below.

Gaming Revenue Class II

Class II gaming revenues decreased by \$6.5 million, or 21%, from \$31.2 million in the three months ended March 31, 2005, to \$24.8 million in the three months ended March 31, 2006.

Legacy revenue decreased \$263,000, or 25%, to \$778,000 in the three months ended March 31, 2006, from \$1.0 million in the three months ended March 31, 2005. The average installed base of Legacy gaming terminals decreased 41%, which was partially offset by a 36% increase in hold per day.

Reel Time Bingo revenue was \$24.0 million for the quarter ended March 31, 2006, compared to \$30.2 million in the quarter ended March 31, 2005, a \$6.2 million, or 21% decrease. The average installed base of gaming terminals decreased 21%, but was partially offset by a 4% higher average hold per day. Accretion of contract rights related to development agreements, which is recorded as a reduction of revenue, increased \$592,000, to \$1.1 million in the three months ended March 31, 2006, compared to \$475,000 in the three months ended March 31, 2005. During fiscal 2005 and the first two quarters of fiscal 2006, 1,388 Reel Time Bingo gaming terminals were converted to

Edgar Filing: MULTIMEDIA GAMES INC - Form 10-Q

games played under the compact, and \$2.2 million was generated in second quarter 2006 revenues, which are included in All other gaming revenues.

Table of Contents**Gaming Revenue Charity**

Charity gaming revenues decreased 6%, to \$5.1 million for the March 2006 quarter, compared to \$5.5 million for the same quarter of 2005. The average installed gaming terminal base increased 7% in the three months ended March 31, 2006, compared to the same period in 2005, but was offset by a 16% decrease in the average hold per day, resulting from facilities increasing their install base.

Gaming Revenue All Other

Class III rental and back-office fees decreased 13%, to \$1.2 million in the three months ended March 31, 2006, from \$1.4 million during the same period of 2005. In January 2006, the only rental customer converted to a purchase. Gaming equipment, system sale, and lease revenue reflect revenues of \$167,000 for both gaming equipment and license sales related to this conversion.

In March 2005, we began converting Reel Time Bingo gaming terminals to games that could be played under the Oklahoma compact. These games generated revenue of \$2.2 million in the three months ended March 31, 2006, compared to \$2,000 during the same period of 2005.

Other recurring gaming revenue generated from TILG decreased to no revenue for the quarter ended March 31, 2006, compared to \$252,000 in same quarter of 2005. The decrease relates to the fiscal 2005 second-quarter conversion of the remaining TILG Point-of-Sale Terminals, or POSTs, to Reel Time Bingo.

Revenues from the New York Lottery system increased 34% to \$613,000 in the three months ended March 31, 2006, from \$458,000 in the three months ended March 31, 2005. Currently, five of the eight planned racetrack casinos are operating, with approximately 5,500 total terminals. 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 racetrack casino 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 until one or more of the larger racetrack casinos open.

The Iowa Lottery system began operations in January 2006, and revenues for the quarter ended March 31, 2006, were \$373,000. As of March 31, 2006, there were 383 player terminals installed. Pursuant to legislative actions, these units were disconnected from our central determinant system on or before May 3, 2006.

Other Revenue

Other revenues increased to \$1.1 million for the quarter ended March 31, 2006, from \$439,000 during the same period of 2005. The increase was primarily the result of the installation of the sweepstakes system in Alabama.

Gaming Equipment and System Sale and Lease Revenue and Cost of Sales

| | Three Months ended | | | |
|---|--------------------|--------|-----|------|
| | March 31, | | | |
| | 2006 | 2005 | | |
| Gaming equipment and system revenue | \$ 10,432 | \$ 288 | | |
| Cost of gaming equipment and systems sold | (9,650) | (297) | | |
| Gross Margin | 782 | 7% | (9) | (3)% |

Edgar Filing: MULTIMEDIA GAMES INC - Form 10-Q

| | | | | | |
|-----------------------|----|-------|-----|-----|-------|
| License revenue | \$ | 364 | | \$ | 523 |
| Cost of licenses sold | | (175) | | | (307) |
| Gross Margin | | 189 | 52% | 216 | 41% |
| Lease revenue | | 273 | | | |
| Cost of royalty fees | | 300 | | | 356 |

Gaming terminal and system revenue reflected the recognition of the sale of 338 gaming terminals and a system sale in the three months ended March 31, 2006, compared to no gaming terminal or system sales in the three months ended March 31, 2005. System revenues from a fixed-price contract of \$8.0 million and cost of sales of \$8.2 million were recognized on the completed-contract method. Gaming terminal revenue of \$2.0 million and cost of sales of \$1.3 million were recognized in the quarter ended March 31, 2006 on the sale of 257 units. During the current quarter of 2006, a customer converted from rental to purchase, generating gaming terminal revenues of \$103,000. In the periods ended March 31, 2006 and 2005, gaming equipment sale revenue included revenues of \$281,000 and cost of

Table of Contents

sales of \$70,000 for both quarters related to a certain equipment sale being recognized ratably over the term of the agreement. Margins on licenses sold increased as some partially depreciated licenses were sold. In January 2006, operations of the Iowa Lottery system began and generated lease revenues of \$273,000. Royalty fees decreased due to lower revenue on some licensed game themes in play.

Selling, general and administrative expenses increased approximately \$2.0 million, or 13%, to \$17.6 million for the three months ended March 31, 2006, from \$15.6 million in the same period of 2005. This increase was primarily a result of a) an increase in share-based compensation of \$676,000 for the three months ended March 31, 2006, compared to no employee share-based compensation expense in the same period during 2005; b) an increase in legal professional and lobbying services of approximately \$1.0 million due to our involvement in litigation, research of new products and the entry into new markets; c) an increase in salaries and wages and the related employee benefits of approximately \$200,000 relating to additional staff to design and develop gaming systems and content and monitor and develop new markets. At March 31, 2006, we employed 478 full-time and part-time employees, compared to 447 at March 31, 2005; and d) an increase in communication costs of approximately \$170,000 relating to the increased number of facilities in Iowa and for the sweepstakes games in Birmingham.

These increases were offset, in part, by a reduction in our consulting and contract labor services of approximately \$500,000, as we reduced the level of consulting and contract labor, including converting certain consultants to employees.

Depreciation expense decreased 8%, to \$12.5 million for the three months ended March 31, 2006, from \$13.6 million in 2005, primarily as a result of player terminals continuing in service beyond their estimated useful life. Amortization expense increased 42% to \$1.6 million for the quarter ended March 31, 2006, compared to \$1.1 million for the same quarter of 2005. The majority of the increase was related to amortization of license agreements for gaming content and internally developed software.

Interest income increased 75% to \$611,000 for the three months ended March 31, 2006, from \$350,000 in the same period of 2005, due to the higher balance of notes receivable bearing variable interest rates.

Interest expense increased 59%, to \$1.0 million for the second fiscal quarter of 2006, from \$663,000 for the same quarter of fiscal 2005, due primarily to an increase in amounts outstanding under our Credit Facility. The Credit Facility provides us with a \$20.0 million term loan facility, or the Term Loan, a \$15.0 million revolving line of credit, and a \$35.0 million reducing revolving line of credit. 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 by \$1.5 million, to \$1.7 million for the three months ended March 31, 2006, from \$3.2 million in the same period of 2005. These figures represent effective tax rates of 40.7% and 38.0% for the three months ended March 31, 2006 and 2005, respectively. Statement of Financial Accounting Standards, or SFAS, No. 123(R), Share-Based Payment, is a revision of SFAS No. 123, Accounting for Stock Based Compensation. It supersedes Accounting Principles Board Opinion No. 25, Accounting for Stock Issued to Employees, or APB 25. It includes several modifications to the way that income taxes are recorded in the financial statements. The expense for certain types of option grants is only deductible for tax purposes at the time that the taxable event takes place, which could cause variability in our effective tax rates recorded throughout our fiscal year. The higher effective tax rate for the three months ended March 31, 2006, was primarily a result of the timing of such deductibility of stock options.

Our tax years ended 2002, 2003 and 2004 are currently under examination from the Internal Revenue Service, or IRS. We have received a proposed adjustment of approximately \$835,000 relating to the deductibility of certain lobbying expenses the IRS has determined should be disallowed. The IRS has not made an assessment, but if it does, we may appeal the determination. If the assessment is upheld, our effective tax rate would be higher for the year ended September 30, 2006.

Six Months Ended March 31, 2006, Compared to Six Months Ended March 31, 2005

Total revenues for the six months ended March 31, 2006 were \$80.5 million, compared to \$79.2 million for the same period of 2005.

Table of Contents***Gaming Revenue Class II***

Class II gaming revenues decreased by \$9.7 million, or 17%, from \$58.9 million in the six months ended March 31, 2005, to \$49.2 million in the six months ended March 31, 2006.

Legacy revenue decreased \$964,000, or 39%, to \$1.5 million in the six months ended March 31, 2006, from \$2.5 million in the six months ended March 31, 2005. The average installed base of Legacy gaming terminals decreased 43%, which was partially offset by a 20% increase in hold per day.

Reel Time Bingo revenue was \$47.6 million for the six months ended March 31, 2006, compared to \$56.4 million in the six months ended March 31, 2005, an \$8.8 million, or 16% decrease. The average installed base of gaming terminals decreased 15%, but was partially offset by a 5% higher average hold per day. Accretion of contract rights related to development agreements, which is recorded as a reduction of revenue, increased \$1.2 million, to \$2.0 million in the six months ended March 31, 2006, compared to \$801,000 in the six months ended March 31, 2005. During fiscal 2005 and the first two quarters of fiscal 2006, 1,388 Reel Time Bingo gaming terminals were converted to games played under the compact, and generated \$3.9 million in first and second quarter 2006 revenues, which are included in All other gaming revenues.

Gaming Revenue Charity

Charity gaming revenues decreased 2%, to \$9.8 million for the March 31, 2006 quarter, compared to \$10.1 million for the same quarter of 2005. The average installed gaming terminal base increased 11% in the six months ended March 31, 2006, compared to the same period in 2005, but was offset by a 15% decrease in the average hold per day, resulting from facilities increasing their installed base.

Gaming Revenue All Other

Class III rental and back-office fees decreased 7%, to \$2.5 million in the six months ended March 31, 2006, from \$2.7 million during the same period of 2005. In January 2006, the only rental customer converted to a purchase. Gaming equipment, system sale, and lease revenue reflect revenues of \$167,000 for both gaming equipment and license sales related to this conversion.

In March 2005, we began converting Reel Time Bingo gaming terminals to games that could be played under the Oklahoma compact. These games generated revenue of \$3.9 million in the six months ended March 31, 2006, compared to \$2,000 during the same period of 2005.

Other recurring gaming revenue generated from TILG decreased to no revenue for the six months ended March 31, 2006, compared to \$3.8 million in same quarter of 2005. The decrease relates to the fiscal 2005 second-quarter conversion of the remaining TILG POSTs to Reel Time Bingo.

Revenues from the New York Lottery system increased 32% to \$1.2 million in the six months ended March 31, 2006, from \$888,000 in the six months ended March 31, 2005. Currently, five of the eight planned racetrack casinos are operating, with approximately 5,500 total terminals. 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 racetrack casino 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 until one or more of the larger racetrack casinos open.

Edgar Filing: MULTIMEDIA GAMES INC - Form 10-Q

The Iowa Lottery system began operations in January 2006, and revenues for the six months ended March 31, 2006 were \$373,000. As of March 31, 2006, there were 383 player terminals installed. Pursuant to legislative actions, these units were disconnected from our central determinant system on or before May 3, 2006.

Other Revenue

Other revenues increased 75% to \$1.8 million, for the six months ended March 31, 2006, from \$1.0 million during the same period of 2005. The increase was primarily the result of the installation of the sweepstakes system in Alabama.

Table of Contents**Gaming Equipment and System Sale and Lease Revenue and Cost of Sales**

| | Six Months ended | | | |
|---|------------------|------------|----------------|------------|
| | 2006 | | March 31, 2005 | |
| Gaming equipment and system revenue | \$ 10,768 | | \$ 932 | |
| Cost of gaming equipment and systems sold | (9,755) | | (712) | |
| Gross margin | 1,013 | 9% | 220 | 24% |
| License revenue | \$ 653 | | \$ 873 | |
| Cost of licenses sold | (354) | | (395) | |
| Gross margin | 299 | 46% | 478 | 55% |
| Lease revenue | 273 | | | |
| Cost of royalty fees | 613 | | 694 | |

Gaming terminal and system revenue reflected sales of 338 gaming terminals and one system sale in the six months ended March 31, 2006, compared to 43 gaming terminals and no system sales in the six months ended March 31, 2005. System revenues from a fixed-price contract of \$8.0 million and cost of sales of \$8.2 million were recognized on the completed-contract method. Gaming terminal revenue of \$2.0 million and cost of sales of \$1.3 million were recognized in fiscal 2006 on the sale of 257 units. During fiscal 2006, a customer converted from rental to purchase, generating gaming terminal revenue of \$103,000. In the periods ended March 31, 2006 and 2005, gaming equipment sale revenue included revenues of \$562,000 for both quarters and cost of sales of \$140,000 and \$229,000, respectively related to a certain equipment sale being recognized ratably over the term of the agreement. Margins on licenses sold decreased, as a licensed third-party participation game introduced in the second quarter of fiscal 2005 has a lower margin than the outright sale of the license. In January 2006, operations of the Iowa Lottery system began and generated lease revenues of \$273,000. Royalty fees decreased due to lower revenue on some licensed game themes in play.

Selling, general and administrative expenses increased approximately \$1.1 million, or 3%, to \$33.5 million for the six months ended March 31, 2006, from \$32.4 million in the same period of 2005. This increase was primarily a result of a) an increase in share-based compensation of \$1.4 million for the six months ended March 31, 2006, compared to no employee share-based compensation expense in the same period during 2005; b) an increase in legal professional and lobbying services of approximately \$1.2 million, due to our involvement in litigation, research of new products and the entry into new markets; and c) an increase in salaries and wages and the related employee benefits of approximately \$250,000 relating to additional staff to design and develop gaming systems and content and monitor and develop new markets. At March 31, 2006, we employed 478 full-time and part-time employees, compared to 447 at March 31, 2005.

These increases were offset, in part, by a reduction in our consulting and contract labor services of approximately \$1.7 million, as we reduced the level of consulting and contract labor, including converting certain consultants to employees.

Depreciation expense decreased 4%, to \$25.2 million for the six months ended March 31, 2006, from \$26.1 million in 2005, primarily as a result of player terminals continuing in service beyond their estimated useful life. Amortization expense increased 70% to \$3.3 million for the six months ended March 31 2006, compared to \$1.9 million for the same quarter of 2005. The majority of the increase was related to amortization of license agreements for gaming content and internally developed software.

Interest income increased 40% to \$1.1 million for the six months ended March 31, 2006, from \$782,000 in the same period of 2005, due to the higher balance of notes receivable bearing variable interest rates.

Interest expense increased 66%, to \$2.0 million for the second fiscal quarter of 2006, from \$1.2 million for the same quarter of fiscal 2005, 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.

Table of Contents

Income tax expense decreased by \$3.4 million, to \$2.8 million for the six months ended March 31, 2006, from \$6.3 million in the same period of 2005. These figures represent effective tax rates of 41.4% and 38.0% for the six months ended March 31, 2006 and 2005, respectively. SFAS No. 123(R) includes several modifications to the way that income taxes are recorded in the financial statements. The expense for certain types of option grants is only deductible for tax purposes at the time that the taxable event takes place, which could cause variability in our effective tax rates recorded throughout our fiscal year. The higher effective tax rate for the six months ended March 31, 2006, was primarily a result of the timing of such deductibility of stock options.

Our tax years ended 2002, 2003 and 2004 are currently under examination from the IRS. We have received a proposed adjustment of approximately \$835,000 relating to the deductibility of certain lobbying expenses the IRS has determined should be disallowed. The IRS has not made an assessment, but if it does, we may appeal the determination. If the assessment is upheld, our effective tax rate would be higher for the year ended September 30, 2006.

RECENT ACCOUNTING PRONOUNCEMENTS ISSUE

In December 2004, the Financial Accounting Standards Board, or FASB, issued Statement of Financial Accounting Standards, or SFAS No. 123(R), Share-Based Payment. SFAS 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. SFAS 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. SFAS 123(R) replaces FASB SFAS 123, Accounting for Stock-Based Compensation, and supersedes APB Opinion No. 25, Accounting for Stock Issued to Employees.

SFAS 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) are required to apply SFAS 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 entity's next fiscal year. We adopted SFAS 123(R) on October 1, 2005, the effects of which are discussed under Results of Operations.

In March 2005, the FASB issued Financial Interpretation No. 47, or FIN 47, Accounting for Conditional Asset Retirement Obligations an interpretation of FASB SFAS 143. FIN 47 requires asset retirement obligations to be recorded when a legal obligation exists, even though the timing and/or method of the settlement of such obligations is conditional on a future event. FIN 47 is effective for fiscal years beginning after December 15, 2005. We do not expect the adoption of FIN 47 will have a material impact on our financial position and results of operations.

In May 2005, the FASB issued SFAS No. 154, Accounting Changes and Error Corrections, a replacement of APB Opinion No. 20 and FASB SFAS 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 October 1, 2006, and do not expect the adoption to have a material impact on our financial position and results of operations. SFAS No. 154 does not change the transition provisions of any existing accounting pronouncements.

CRITICAL ACCOUNTING POLICIES

Management's Discussion and Analysis of Financial Condition and Results of Operations is based upon our Consolidated Condensed Financial Statements, which we have prepared in accordance with U.S. generally accepted accounting principles. The preparation of these financial statements requires us to make estimates and assumptions that affect the reported amounts of assets, liabilities, revenue and expenses, and related disclosure of contingent assets and liabilities. We base our estimates on historical experience and on various other assumptions that we believe to be reasonable under the circumstances, the results of which form the basis for making judgments about

Table of Contents

the carrying values of assets and liabilities that are not readily apparent from other sources. We have discussed the development, selection and disclosure of these estimates with the Audit Committee of our Board of Directors. Actual results may differ from these estimates under different assumptions or conditions.

An accounting policy is deemed to be critical if it requires an accounting estimate to be made based on assumptions about matters that are highly uncertain at the time the estimate is made, if different estimates reasonably could have been used, or if changes in the estimate that are reasonably likely to occur could materially impact the financial statements. We believe that other than the adoption of Statement of Financial Accounting Standards, or SFAS No. 123, (revised 2004), Share-Based Payment (SFAS 123(R)), there have been no significant changes during the six months ended March 31, 2006 to the items that we disclosed as our critical accounting policies and estimates in Management's Discussion and Analysis of Financial Condition and Results of Operations in our Annual Report on Form 10-K for the fiscal year ended September 30, 2005, as amended by the Amendment No.1 on Form 10-K/A thereto.

Share-Based Compensation Expense. Effective October 1, 2005, we adopted the fair value recognition provisions of SFAS 123(R), using the modified prospective transition method, and therefore have not restated prior periods' results. Under this method, we recognize compensation expense for all share-based payments granted after November 1, 2005 and prior to but not yet vested as of October 1, 2005, in accordance with SFAS 123(R). Under the fair value recognition provisions of SFAS 123(R), we recognize share-based compensation net of an estimated forfeiture rate and only recognize compensation cost for those shares expected to vest on a straight-line basis over the service period of the award. Prior to SFAS 123(R) adoption, we accounted for share-based payments under Accounting Principles Board Opinion No. 25, or APB 25, Accounting for Stock Issued to Employees, and accordingly, generally recognized compensation expense only if options were granted with a discounted exercise price.

Determining the appropriate fair value model and calculating the fair value of share-based payment awards requires the input of highly subjective assumptions, including the expected life of the share-based payment awards, and stock price volatility. Management determined that volatility is based on historical volatility trends. The assumptions used in calculating the fair value of share-based payment awards represent management's best estimates, but these estimates involve inherent uncertainties and the application of management's judgment. As a result, if factors change and we use different assumptions, our stock-based compensation expense could be materially different in the future. In addition, we are required to estimate the expected forfeiture rate, and only recognize expense for those shares expected to vest. If our actual forfeiture rate is materially different from our estimate, the share-based compensation expense could be significantly different from what we have recorded in the current period. See Note 2 to the Consolidated Condensed Financial Statements for a further discussion on stock-based compensation.

LIQUIDITY AND CAPITAL RESOURCES

At March 31, 2006, we had \$2.0 million unrestricted cash and cash equivalents, compared to \$118,000 at September 30, 2005. Our working capital deficit at March 31, 2006 decreased to a working capital deficit of \$19.1 million, compared to \$19.4 million at September 30, 2005. The working capital deficit as of March 31, 2006 was the result of acquisition of property and equipment and leased gaming equipment, the payment of accounts payable and accrued expenses, and our continued investment in development agreements. During fiscal 2006, we used \$16.5 million for capital expenditures of property and equipment, \$13.6 million for payments of accounts payable and accrued expenses, and advanced \$7.5 million, net of amounts reimbursed, under development agreements. At September 30, 2005, none of the lines of credit were current, and at March 31, 2006, \$18.4 million was due within twelve months.

Table of Contents

As of March 31, 2006, 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 lines of credit ⁽¹⁾ | \$ 21,939 | \$ 25,107 | \$ 2,214 | \$ | \$ 49,260 |
| Long-term debt ⁽²⁾ | 8,079 | 3,218 | 52 | | 11,349 |
| Capital leases ⁽³⁾ | 2,413 | 183 | | | 2,596 |
| Operating leases ⁽⁴⁾ | 1,455 | 2,860 | 1,894 | | 6,209 |
| Purchase commitments ⁽⁵⁾ | 1,894 | 2,038 | 288 | 1,488 | 5,708 |
| Payments due under employment agreement ⁽⁶⁾ | 250 | 500 | 500 | 1,958 | 3,208 |
| Gaming facility joint development agreements ⁽⁷⁾ | 29,046 | | | | 29,046 |
| Total | \$ 65,076 | \$ 33,906 | \$ 4,948 | \$ 3,446 | \$ 107,376 |

- (1) The revolving credit lines bear interest at a rate of Prime (7.75% as of March 31, 2006).
- (2) 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 7.37%, a five-year loan related to financing our corporate aircraft at an annual interest rate of LIBOR plus 2.75% (7.57% as of March 31, 2006), and amounts borrowed under our Credit Facility at annual interest rate of Prime (7.75% as of March 31, 2006).
- (3) Consists of various three-year capital leases for property and equipment at an overall average annual interest rate of 7.27%.
- (4) Consists of operating leases for our facilities and office equipment that expire at various times through 2010.
- (5) Consists of commitments to order third-party license agreements and for the purchase of gaming terminals.
- (6) Represents the expected future payments due, based on life expectancy tables, to Gordon Graves for his noncompete agreement entered into under his Employment Agreement.
- (7) 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 to twenty-four months, although the actual timing of payments may extend beyond twenty-four months, depending on the number and schedule of development projects ongoing at any given time.

During the six months ended March 31, 2006, we generated \$21.3 million in cash from our operations, compared to \$45.5 million during the same period of 2005. This \$24.2 million decrease in cash generated from operations over the prior period was primarily due to the timing of payments related to accounts payable and accrued expenses and federal and state tax payments.

Cash used in investing activities decreased to \$26.8 million in the six months ended March 31, 2006, from \$48.7 million in the same period of 2005. The decrease was primarily the result of a \$13.7 million decrease in acquisitions of property and equipment. During the six months ended March 31, 2006, additions to property and equipment consisted of:

| | Capital Expenditures |
|-------------------------------------|----------------------|
| Gaming equipment | \$ 15,198 |
| Third-party gaming content licenses | 1,246 |
| Other | 69 |
| Total | \$ 16,513 |

Cash provided by financing activities for the six months ended March 31, 2006 was \$7.4 million, compared to \$9.8 million in the same period of 2005. During the six months ended March 31, 2006, we drew a net of \$15.3 million under our revolving lines of credit compared to \$7.6 million in the same period of fiscal 2005. During the six months ended March 31, 2006, we repurchased 159,146 shares of treasury stock for a total cash consideration of \$1.5 million, compared to 440,786 shares of treasury stock purchased for \$3.9 million in the same period of 2005. We expect to continue repurchasing shares during the remainder of fiscal 2006, as discussed under Stock Repurchase Authorizations.

Our projected capital expenditures for the next year will consist of gaming terminals and related gaming equipment that are placed with our customers under participation arrangements, to which we have committed \$1.9 million under purchase arrangements with certain vendors,

Edgar Filing: MULTIMEDIA GAMES INC - Form 10-Q

substantial capital outlays of approximately \$29.1 million in connection with the joint development of new and expanded tribal gaming facilities, increased costs of maintaining and/or upgrading our rental pool of gaming terminals, and may include substantial capital expenditures in connection with potential acquisitions. In our strategy to partner with current and prospective customers to jointly

Table of Contents

develop tribal gaming facilities that will house our gaming terminals, and in pursuing any potential acquisitions, we may make expenditures that could significantly affect our cash flow and liquidity, and use a significant portion of both our cash flow from operations and any proceeds we receive from debt or equity financing we might undertake. Our total capital expenditures will depend upon the number of gaming terminals that we are able to place in service during the year, as well as the number and size of tribal gaming facilities we develop under existing or future agreements. Additional capital expenditures will be required for gaming terminals if we are successful in introducing our games into new markets, such as additional charity bingo markets. In addition to manufacturing our own, we also purchase gaming terminals from Bally Technologies, Inc. (formerly Alliance Gaming, Inc.), or Bally, and WMS Gaming Inc., or WMS, and licenses from Bally, WMS, and Progressive Gaming International Corporation, or Progressive (formerly Mikohn Gaming Corporation).

To date, we have entered into development agreements with our customers to provide up to \$150.7 million towards the construction of tribal gaming facilities. The development agreements typically require that some or all of the construction advances be repaid to us. As of March 31, 2006, we had advanced a total of \$121.6 million under such agreements, and expect to advance the remaining \$29.1 million over the next twelve to twenty-four months.

At March 31, 2006, our debt structure consisted of a Credit Facility, which provided us with a \$20.0 million term loan facility, or the Term Loan, a \$15.0 million revolving line of credit, and a \$35.0 million reducing revolving line of credit. As of March 31, 2006, we had drawn \$20.2 million under the Term Loan and had \$43.1 million outstanding under the revolving lines of credit. At March 31, 2006, we had availability of \$5.6 million, which was further reduced by \$1.1 million, reflecting outstanding letters of credit.

The Credit Facility contains financial covenants, as defined in the agreement, that include a maximum indebtedness to EBITDA ratio of 1.50:1.00, a maximum total liabilities to tangible net worth ratio of 1.25:1.00, a minimum trailing twelve month EBITDA of \$60.0 million, and a maximum rolling four-quarter capital expenditures rate, including advances made under development agreements, of \$175.0 million. We were in compliance with these covenants as of March 31, 2006.

We believe that our existing cash and cash equivalents, cash provided from our operations, and amounts available under our Credit Facility can sustain our current operations, which will include a portion of the financing required from us in connection with our development agreements, depending upon the timing and mix of those projects. However, our performance and financial results are, to a certain extent, subject to general conditions in or affecting the Native American gaming industry, and to general economic, political, financial, competitive and regulatory factors beyond our control. If our business does not continue to generate cash flow at current levels, or if the level of funding required in connection with our joint development agreements is greater or proceeds at a pace faster than anticipated, we may need to raise additional financing. Sources of additional financing might include additional bank debt or the public or private sale of equity or debt securities. However, sufficient funds may not be available, on terms acceptable to us or at all, from these sources or any others to enable us to make necessary capital expenditures and to make discretionary investments in the future.

Stock Repurchase Authorizations

Our Board of Directors authorized us to repurchase 900,000 shares of our common stock, effective April 2000, an additional 3,000,000 shares of our common stock, effective September 2001, and an additional 748,690 shares of our common stock, effective July 2004. The timing and total number of shares repurchased will depend upon prevailing market conditions and other investment opportunities. At March 31, 2006, there were 886,763 shares authorized for repurchase.

During the fiscal year ended September 2005, we repurchased 1,216,591 shares of our common stock with cash, at an average cost of \$8.96. We repurchased an additional 38,300 shares of our common stock with cash, at an average cost of \$9.10, during the quarter ended March 31, 2006, and 159,146 shares during the six months ended March 31, 2006, at an average cost of \$9.15.

At March 31, 2006, we had approximately 5.5 million options outstanding, with exercise prices ranging from \$1.00 to \$21.53 per share. At March 31, 2006, approximately 4.5 million of the outstanding options were exercisable.

SEASONALITY

We believe our operations are not materially affected by seasonal factors, although we have experienced fluctuations in our revenues from period to period. After the holiday season, (November through December) our revenues generally build steadily, with our last fiscal quarter (July through September) traditionally being our strongest quarter.

Table of Contents

CONTINGENCIES

For information regarding contingencies, see PART I Item 1. Financial Statements Commitments and Contingencies and PART II Item 1. Legal Proceedings.

INFLATION AND OTHER COST FACTORS

Our operations have not been, nor are they expected to be, materially affected by inflation. However, our operational expansion is affected by the cost of hardware components, which are not considered to be inflation sensitive, but rather, sensitive to changes in technology and competition in the hardware markets. In addition, we expect to continue to incur increased legal and other similar costs associated with regulatory compliance requirements and the uncertainties present in the operating environment in which we conduct our business.

FUTURE EXPECTATIONS AND FORWARD-LOOKING STATEMENTS

This Quarterly Report and the information incorporated herein by reference contains various forward-looking statements within the meaning of federal and state securities laws, including those identified or predicated by the words believes, anticipates, expects, plans, or similar expression with forward-looking connotation. Such statements are subject to a number of risks and uncertainties that could cause the actual results to differ materially from those projected. Such factors include, but are not limited to, the uncertainties inherent in the outcome of any litigation of the type described in this Quarterly Report under PART II Item 1. Legal Proceedings, trends and other expectations described in PART I Item 2. Management's Discussion and Analysis of Financial Condition and Results of Operations, risk factors disclosed in our earnings and other press releases issued to the public from time to time, as well as those other factors as described under Certain Risk Factors set forth below. Given these uncertainties, readers of this Quarterly Report are cautioned not to place undue reliance upon such statements.

ITEM 3. QUANTITATIVE AND QUALITATIVE DISCLOSURES ABOUT MARKET RISK

We are subject to market risks in the ordinary course of business, primarily associated with interest rate fluctuations.

In June 2003, we entered into a Credit Facility to provide us with additional liquidity to meet our short-term financing needs, as further described under PART I Item 1. Financial Statements Significant Accounting Policies Credit Facility, Long-Term Debt and Capital Leases. Pursuant to the Credit Facility, we may currently borrow up to a total of \$48.7 million under a \$15.0 million revolving line of credit and a \$35.0 million reducing revolving line of credit. The entire Credit Facility bears an adjustable interest rate of Prime.

In connection with the joint development agreements we enter into with many of our Native American tribal customers, we are required to advance funds to the tribes for the construction and development of tribal gaming facilities, some of which are required to be repaid. It is anticipated that some of these receivables will have fixed interest rates.

We also receive notes receivable for the sale of gaming terminals and licenses at fixed and variable interest rates.

As a result of our adjustable interest rate notes payable and fixed interest rate notes receivable described above, we are subject to market risk with respect to interest rate fluctuations. Any material increase in prevailing interest rates could cause us to incur significantly higher interest expense.

We estimate that a hypothetical increase of 100 basis points in interest rates would increase our interest expense by approximately \$522,000, based on our variable debt outstanding of \$52.0 million as of March 31, 2006. We do not currently manage this exposure with derivative financial instruments.

ITEM 4. CONTROLS AND PROCEDURES

Evaluation of Disclosure Controls and Procedures. As of the end of the period covered by this report, an evaluation was carried out under the supervision and with the participation of our management, including its Chief Executive Officer and Chief Financial Officer, of the effectiveness of the design and operation of its disclosure controls and procedures (as defined in rules 13a-15(e) and 15d-15(e) under the Securities Exchange Act of 1934) to ensure information required to be disclosed in our filings under the Securities Exchange Act of 1934, is (i) recorded, processed, summarized and reported within the time periods specified in the Commission rules and forms and (ii) accumulated and communicated to our management, including our Chief Executive Officer and Chief Financial Officer, as appropriate, to allow timely decisions regarding required disclosure. Management recognizes that any controls and procedures, no matter how well designed and operated, can only provide reasonable

Edgar Filing: MULTIMEDIA GAMES INC - Form 10-Q

assurance of achieving desired control objectives, and management is necessarily required to apply its judgment when evaluating the cost-benefit relationship of potential controls and procedures. Based upon the evaluation, the Chief Executive Officer and Chief Financial Officer concluded that the design and operation of these disclosure controls and procedures were effective as of March 31, 2006.

Changes in Internal Control over Financial Reporting. There were no significant changes in our internal control over financial reporting identified in management's evaluation during the second quarter of 2006 that have materially affected, or are reasonably likely to materially affect, our internal control over financial reporting.

-30-

Table of Contents

PART II

OTHER INFORMATION

ITEM 1. LEGAL PROCEEDINGS

We are subject to litigation from time to time in the ordinary course of our business, as well as litigation to which we are not a party that may establish laws that affect our business. See PART I Item 1. Financial Statements Commitments and Contingencies.

ITEM 1A. RISK FACTORS

We face legal and regulatory uncertainties that threaten our ability to conduct our business and to effectively compete in our Native American gaming markets, that increase our cost of doing business and that divert substantial management time away from our operations.

Historically, we have derived most of our revenue from the placement of Class II gaming terminals and systems for gaming activities conducted on Native American lands. These activities are subject to federal regulation under the Johnson Act, IGRA, and under the rules and regulations adopted by both the NIGC and the gaming commissions that each Native American tribe establishes to regulate gaming. The Johnson Act broadly defines gambling devices to include any machine or mechanical device designed and manufactured primarily for use in connection with gambling, and that, when operated, delivers money or other property to a player as the result of the application of an element of chance. A government agency or court that literally applied this definition, and did not give effect to subsequent congressional legislation or to certain regulatory interpretations or judicial decisions, could determine that the manufacture and use of our electronic gaming terminals, and perhaps other key components of our Class II gaming systems that rely to some extent upon electronic equipment to run a game, constitute Class III gaming and, in the absence of a tribal-state compact, are illegal. Our tribal customers could be subject to significant fines and penalties if it is ultimately determined they are offering an illegal game, and an adverse regulatory or judicial determination regarding the legal status of our products could have material adverse consequences for our business, operating results and prospects.

Significantly, in October 2005, the Department of Justice (DOJ) made available to the public proposed legislation the agency has drafted amending the Gambling Devices Act, 15 U.S.C. § 1171, *et seq.* (commonly referred to as the Johnson Act). The proposed legislation, if enacted, could materially and adversely affect our Class II gaming market. The proposed legislation would classify electronic technologic aids used by Native American tribes in Class II games, such as bingo, as gambling devices, and would authorize the use of such Class II devices by Native American tribes only if such devices are certified by the NIGC as Class II technologic aids. The proposed legislation establishes criteria that must be met in order for the NIGC to certify the gambling devices as Class II technologic aids. The criteria would restrict the speed of the Class II game, as well as the depictions and graphics used in the game, thereby rendering the game potentially less appealing to customers. The proposed legislation has yet to be introduced in Congress; however, the DOJ has indicated that it will seek to have its proposed legislation introduced in 2006.

In November, 2005 Senator John McCain introduced legislation designed in part to expand the authority of the NIGC to review contracts between Native American tribes and their suppliers. Senator McCain's proposal is in the early legislative phase, and we have not yet assessed the full impact on our business if legislation of this nature is ultimately adopted. However, it is likely that expanding the authority of the NIGC to include review of contracts such as those we typically enter into with our tribal customers, would significantly encumber our contracting process and may have the effect of delaying, modifying or preventing otherwise profitable contractual relationships.

The market for electronic Class II gaming terminals and systems is subject to continuing ambiguity, due to the difficulty of reconciling the Johnson Act's broad definition of gambling devices with the provisions of IGRA that expressly make legal the play of bingo and tribes' use of electronic, computer, or other technological aids in the play of bingo. Issues surrounding the classification of our games as Class II games that may generally be offered by our tribal customers without a tribal-state compact, or as Class III games that can only be offered by the tribes pursuant to such a compact, have affected our business in the past, and continue to do so. Government enforcement, regulatory action, judicial decisions, or the prospects or rumors thereof have in the past and will continue to affect our business, operating results and prospects. Although some of our games have been reviewed and approved as legal Class II games by the NIGC, we have placed and continue to derive revenue from a significant number of gaming terminals running games that have not been so approved. Our business and operating results would likely be adversely affected, at least in the short term, by any significant regulatory enforcement action involving our games.

Table of Contents

The trading price of our common stock has in the past and may in the future be subject to significant fluctuations based upon market perceptions of the legal status of our products.

Native American gaming activities involving our games and systems are also subject to regulation by state and local authorities, to the extent such gaming activities constitute, or are perceived to constitute, Class III gaming. Class III gaming is illegal in most states unless conducted by a tribe pursuant to a compact between a tribe and the state in which the tribe is located. The Class III video lottery systems we offer, such as the systems and terminals operating in Washington State, are subject to regulation by authorities in that state and to the terms of the compacts between the tribes offering such games and the State of Washington. Gaming activities under the new tribal-state compact in Oklahoma will be subject to the terms of the compact between such tribes and the State of Oklahoma. Regulatory interpretations and enforcement actions by state regulators could have significant and immediate adverse impacts on our business and operating results.

In addition to federal, state and local regulation, all Native American tribes are required by IGRA to adopt ordinances regulating gaming as a condition of their right to conduct gaming on Native American lands. These ordinances often include the establishment of tribal gaming commissions that make their own judgment about whether an activity is Class II or Class III gaming. Normally, we will not introduce a new Class II game in a customer's gaming facility unless the tribe's gaming commission has made its own independent determination that the game is Class II gaming. Adverse regulatory decisions by tribal gaming commissions could adversely affect our business.

We also face risks from a lack of regulatory or judicial enforcement action. In particular, we believe we have lost market share to competitors who offer games that do not appear to comply with published regulatory restrictions on Class II games, and thereby offer features not available in our products. As a consequence of recently adopted gaming legislation in Oklahoma, we believe vendors with whom we compete, as well as some tribes operating gaming facilities in Oklahoma, may increase deployment of these games in advance of final regulations required under the new legislation. To the extent tribes offer these games rather than ours, our market share, revenue and operating results have suffered, and may continue to suffer.

It is possible that new laws and regulations relating to Native American gaming may be enacted, and that existing laws and regulations could be amended or reinterpreted in a manner adverse to our business. Any regulatory change could materially and adversely affect the installation and use of existing and additional gaming terminals, games and systems, and our ability to generate revenues from some or all of our Class II games.

In addition to the risks described above, regulatory uncertainty increases our cost of doing business. We dedicate significant time to and incur significant expense for new game development, without any assurance that the NIGC, the DOJ, or other federal, state or local agencies or Native American gaming commissions will agree that our games meet applicable regulatory requirements. We also regularly invest in the development of new games, which may become irrelevant or noncompetitive before they are deployed. We devote significant time and expense to dealing with federal, state and Native American agencies having jurisdiction over Native American gaming, and in complying with the various regulatory regimes that govern our business. In addition, we are constantly monitoring new and proposed laws and regulations, or changes to such laws and regulations, and assessing the possible impact upon us, our customers and our markets.

The manner in which certain of our Native American customers acquired land in trust after 1988, and have used such land for gaming purposes, may affect the legality of those gaming facilities. The Inspector General for the Department of the Interior recently testified before a United States Senate committee that his office was in the process of completing an inquiry into techniques used by certain tribes of acquiring land in trust for non-gaming purposes but subsequently opening a gaming facility on such trust land. Recently, the Acting General Counsel for the NIGC testified before the Senate Indian Affairs Committee that, as a result of the Inspector General's inquiry, the NIGC was conducting its own investigation into the practice of certain tribes conducting gaming on land originally acquired in trust for non-gaming purposes. Unless the land qualifies under one of the exceptions contained in the IGRA, thereby authorizing gaming to be conducted on such land, it could lose its Indian lands status under IGRA.

We currently face risks related to regulation of our magnetic stripe gaming card system.

The NIGC has recently determined that the magnetic stripe card system, employed by Native American gaming operations using the gaming system developed by us, is an account access card system as defined in the NIGC's Minimum Internal Control Standards regulation, thereby triggering certain recordkeeping requirements. An account access card is defined as an instrument to access customer accounts for wagering at a gaming machine. Account access cards are used in connection with a computerized database. Account access cards are not smart cards.

Table of Contents

On July 8, 2005, the NIGC issued a Warning Notice to certain tribes for, among other things, noncompliance with the recordkeeping requirements applicable to account access cards. According to the Warning Notice, the cashiers were not obtaining signatures from the customers on our receipts when cashing out. The NIGC is also of the opinion that the Bank Secrecy Act recordkeeping requirements apply to account access cards. The Minimum Internal Control Standards (25 C.F.R. § 542.3(c)(2)) require compliance with the Bank Secrecy Act. Because the IRS is conducting a Bank Secrecy Act audit at one of the tribal casinos, the NIGC has deferred a determination of whether the tribal gaming operations are in compliance with 25 C.F.R. § 542.3(c)(2) until the IRS audit is completed.

In addition to the issues raised by the NIGC, we may face regulatory risks as a result of interpretations of other federal regulations, such as banking regulations, as applied to our gaming systems. We may be required to make changes to our games to comply with such regulations, with attendant costs and delays that could adversely affect our business.

We continue to work with our legal counsel and tribal customers, exploring ways to modify the magnetic stripe card system to eliminate the account aspect of the system so that it operates like script or a bearer instrument.

We believe diversification from Native American gaming activities is critical to our growth strategy. Our expansion into non-Native American gaming activities will present new challenges and risks that could adversely affect our business or results of operations. Our new markets are also subject to extensive legal and regulatory uncertainties.

We face intensified competition in the Class II market that has historically provided the substantial majority of our revenue and earnings. Moreover, the apparent trend in regulatory developments suggests that Class II gaming may diminish as a percentage of overall gaming activity in the United States. We believe it is imperative that we successfully diversify our operations to include gaming opportunities in markets other than our historical Class II jurisdictions. If we are unable to effectively develop and operate within these new markets, then our business, operating results and financial condition would be impaired.

Our growth strategy includes selling and/or licensing our systems, games and technology into segments of the gaming industry other than Native American gaming, principally the charity and commercial bingo markets, and new jurisdictions authorizing video lottery systems. These and other non-Native-American gaming opportunities are not currently subject to a nationwide regulatory system such as the one created by IGRA to regulate Native American gaming, so regulation is on a state-by-state, and sometimes a county-by-county basis. In addition, federal laws relating to gaming, such as the Johnson Act, which regulates slot machines and similar gambling devices, apply to new video lottery jurisdictions, absent authorized state law exemptions.

As we expand into new markets, we expect to encounter business, legal and regulatory uncertainties similar to those we face in our Native American gaming business. Our strategy is to attempt to be an early entrant into new and evolving markets where the legal and regulatory environment may not be well settled or well understood. As a result, we may encounter legal and regulatory challenges that are difficult or impossible to foresee and which could result in an unforeseen adverse impact on planned revenues or costs associated with the new market opportunity. For example, we face business and legal risks in connection with a charity gaming project, in part due to uncertainty related to the state authorization of charity gaming in that jurisdiction. In addition, On December 22, 2005, a local sheriff served a search warrant, issued by an Alabama state judge, on the Birmingham Race Course related to our promotional sweepstakes gaming system. Pursuant to a search warrant, the local sheriff shut down the promotional sweepstakes system that was operating at the facility. On January 31, 2006, the Alabama Circuit Court issued a Declaratory Judgment and Injunction that declared that the Promotional Sweepstakes game is legal under Alabama law (see Recent Developments). Regulatory action against our customers or equipment in these or in other markets could result in machine seizures and significant revenue disruptions, among other adverse consequences.

Successful growth in accordance with our strategy may require us to make changes to our gaming systems to ensure that they comply with applicable regulatory regimes, and may require us to obtain additional licenses. In certain jurisdictions and for certain venues, our ability to enter these markets will depend on effecting changes to existing laws and regulatory regimes. The ability to effect these changes is subject to a great degree of uncertainty and may never be achieved. We may not be successful in entering into other segments of the gaming industry.

Table of Contents

Generally, our placement of systems, games and technology into new market segments involves a number of business uncertainties, including:

Whether our resources and expertise will enable us to effectively operate and grow in such new markets;

Whether our internal processes and controls will continue to function effectively within these new segments;

Whether we have enough experience to accurately predict revenues and expenses in these new segments;

Whether the diversion of management attention and resources from our traditional business, caused by entering into new market segments, will have harmful effects on our traditional business;

Whether we will be able to successfully compete against larger companies who dominate the markets that we are trying to enter; and

Whether we can timely perform under our agreements in these new markets.

We have only recently begun to develop international business, and we currently expect to realize revenue from the sale of an Electronic Instant Lottery System to the Israel National Lottery during fiscal 2006. This transaction was not profitable, and may not lead to future profitable business. International transactions are subject to various risks, including:

Currency fluctuations;

Higher operating costs due to local laws or regulations;

Unexpected changes in regulatory requirements;

Costs and risks of localizing products for foreign countries;

Difficulties in staffing and managing geographically disparate operations;

Greater difficulty in safeguarding intellectual property, licensing and other trade restrictions;

Challenges negotiating and enforcing contractual provisions;

Repatriation of earnings; and

Edgar Filing: MULTIMEDIA GAMES INC - Form 10-Q

Anti-American sentiment due to the war in Iraq and other American policies that may be unpopular in certain regions, particularly in the Middle East.

Beginning 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 racetrack casinos. As payment for providing and maintaining the central determinant system, we receive a small portion of the network-wide hold per day. 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 operations at several racetrack casinos. We are nevertheless required to incur ongoing expenses associated with the development and maintenance of the New York video lottery system, and we do not currently expect to have profitable operations there until one or more of the larger racetrack casinos are opened. Delays in the anticipated development of the New York video lottery system and other emerging market opportunities may continue to adversely affect our revenue and operating results.

We believe future transactions with existing and future customers may be more complex than transactions entered into currently. As a result, we may enter into more complicated business and contractual relationships with customers which, in turn, can engender increased complexity in the related financial accounting. Legal and regulatory uncertainty may also affect our ability to recognize revenue associated with a particular project, and therefore the timing and possibility of actual revenue recognition may differ from our forecast.

We provide linked interactive electronic bingo systems and gaming terminals to charitable bingo operations in Alabama. During January 2004, we began placing gaming terminals in Alabama, and as of March 31, 2006, we had 2,296 gaming terminals at three facilities. The Attorney General of Alabama has recently completed a review of the gaming within the state. He concluded that the games that we were operating in Alabama were a legal form of bingo. He also concluded that two of the facilities are operating under a valid constitutional amendment authorizing the facilities the ability to play electronic bingo. The third facility is operating under a constitutional amendment that was flawed in its ratification. The Attorney General and his staff have indicated that they will file a declaratory judgment action asking the courts to invalidate this amendment as improperly ratified.

Table of Contents

Our future performance will depend on our ability to develop and introduce new gaming systems and to enhance existing games that are widely accepted and played.

Our future performance will depend primarily on our ability to successfully and cost-effectively enter new gaming markets, and develop and introduce new and enhanced gaming systems and content that will be widely accepted both by our customers and their end users. We believe our business requires us to continually offer games and technology that play quickly and provide more entertainment value than those our competitors offer. However, consumer preferences can be difficult to predict, and we may offer new games or technologies that do not achieve market acceptance. In addition, we may experience future delays in game development, or we may not be successful in developing, introducing, and marketing new games or game enhancements on a timely and cost-effective basis. We believe, for example, our recent operating results in the Alabama market have been due in part to the competitive position of our games and our need to continually offer new and compelling games in all our markets. Furthermore, our new games may be subject to challenge by the NIGC, the DOJ, or some other regulatory or law enforcement agencies applicable to that particular game.

If we are unable, for technological, regulatory, political, financial, marketing or other reasons, to develop and introduce new gaming systems and to enhance existing products in a timely manner in response to changing regulatory, legal or market conditions or customer requirements, or if new products or new versions of existing products do not achieve market acceptance, or if uneven enforcement policies cause us to continue facing competition from noncompliant games offered by some competitors, our business could be materially and adversely affected.

We are dependent upon a few customers who are based in Oklahoma.

For the six months ended March 31, 2006 and 2005, approximately 50% and 57%, respectively, of our gaming revenues were from Native American tribes located in Oklahoma, and approximately 34% and 35%, respectively, of our gaming revenues were from one tribe in that state. The significant concentration of our customers in Oklahoma means that local economic changes may adversely affect our customers, and therefore our business, disproportionately to changes in national economic conditions, including more sudden adverse economic declines or slower economic recovery from prior declines. The loss of any of our Oklahoma tribes as customers would have a material and adverse effect upon our financial condition and results of operations. In addition, the recent legislation allowing tribal-state compacts in Oklahoma could result in increased competition from other vendors, who we believe have avoided entry into the Class II market due to its uncertain and ambiguous legal environment. The new legislation allows for other types of gaming, both at tribal gaming facilities and at Oklahoma racetracks. The loss of significant market share to these new gaming opportunities or our competitors' products in Oklahoma could also have a material adverse effect upon our financial condition and results of operations.

As states enter into compacts with our existing Native American customers to allow Class III gaming, our results of operations could be materially harmed.

As our Class II tribal customers enter into such compacts with the states in which they operate, allowing the tribes to offer Class III games, we believe the number of our game machine placements in those customers' facilities could decline significantly, and our operating results could be materially adversely affected. As our tribal customers make the transition to gaming under compacts with the state, we believe there will be significant uncertainty in the market for our games that will make our business more difficult to manage or predict.

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 March 31, 2006, we had placed 1,173 gaming terminals at sixteen facilities that are operating under the Oklahoma compact. 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.

Table of Contents

We believe the recently adopted Oklahoma legislation significantly clarifies and expands the types of gaming permitted by Native America tribes in that state. We currently expect continued intensified competition from vendors currently operating in Oklahoma as well as from new market entrants. As a result, we anticipate further pressure on our market and revenue share percentages in Oklahoma. We believe the recent introduction of traditional slot machines into the Oklahoma market could adversely affect our operating results and market position in that state.

We expect continued regulatory uncertainty in Oklahoma. In particular, although we and other vendors may not begin to offer games enabled by the new legislation until state and tribal regulations, and rules and specifications adopted pursuant to that legislation become final, certain other vendors and tribes may begin to offer new games prior to that time. 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. New opportunities in the Oklahoma market resulting from the recent legislation may not develop as we anticipate, or may take longer to develop than we expected. Further, we may offer games similar to those games that do not appear to comply with published regulatory restrictions on Class II games, in an effort to compete on an equal footing. These games may be the subject of enforcement actions against us.

The new legislation requires Oklahoma tribes to develop their own vendor licensing procedures. 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 a 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.

We believe the establishment of state compacts depends on a number of political, social, and economic factors which are inherently difficult to ascertain. Accordingly, although we attempt to closely monitor state legislative developments that could affect our business, we may not be able to timely predict when or if a compact could be entered into by one or more of our tribal customers.

We are seeking to expand our business by lending money to new and existing customers to develop or expand gaming facilities, primarily in the state of Oklahoma, and we are jointly developing or expanding gaming and related facilities with some of these customers. We may not realize a satisfactory return, if any, on our investment, and we could lose some or all of our investment.

We enter into development agreements to jointly develop and provide financing to construct and/or remodel gaming facilities, primarily in the state of Oklahoma. Under our development agreements, we secure a long-term revenue share percentage and a fixed number of gaming terminal placements in the facility, in exchange for development and construction funding. Certain of the agreements contain performance standards for our gaming terminals that could allow the facility to reduce a portion of our gaming terminals. In connection with these advances, we could face liquidity pressure or a complete loss of our investment if a tribe does not timely pay any amounts owed to us from such funding. In addition, future NIGC decisions could affect our ability to place our games with these tribes. See **Certain Risk Factors** Enforcement of remedies or contracts against Native American tribes could be difficult. In addition, the NIGC has expressed its view that our development agreements violate the requirements of IGRA and tribal gaming regulations, which state that the Native American tribes must hold the sole proprietary interest in the tribes gaming operations, which presents additional risks for our business. See **Certain Risk Factors** Changes in regulation or regulatory interpretations could require us to modify the terms of our contracts with customers.

We may continue to seek to enter into strategic relationships and provide financing and development services for new or expanded gaming and related facilities for our customers. However, we may not realize the anticipated benefits of any strategic relationship or financing. In connection with one or more of these transactions, and to obtain the necessary development funds, we may: issue additional equity securities which would dilute existing stockholders; extend secured and unsecured credit to potential or existing tribal customers which may not be repaid; incur debt on terms unfavorable to us or that we are unable to repay; and incur contingent liabilities.

Our development efforts or financing activities may result in unforeseen operating difficulties, financial risks, or required expenditures that could adversely affect our liquidity. It may also divert the time and attention of our management that would otherwise be available for ongoing development of our business. As a result of providing financing or development services to our customers, we may incur liquidity pressure and we may not realize a satisfactory return, if any, on our investment, and we could lose some or all of our investment.

Table of Contents

We compete for customers and end users with other vendors of gaming systems and gaming terminals. We also compete for end users with other forms of entertainment.

We compete with other vendors for customers, primarily on the basis of the amount of profit our gaming products generate for our customers in relation to other vendors' gaming products. We believe that the most important factor influencing our customers' product selection is the appeal of those products to end users. This appeal has a direct effect on the volume of play by end users, and drives the amount of revenues generated for and by our customers. Our ability to remain competitive depends primarily on our ability to continuously develop new game themes and systems that appeal to end users, and to introduce those game themes and systems in a timely manner. See **Certain Risk Factors**. Our future performance will depend on our ability to develop and introduce new gaming systems and to enhance existing games that are widely accepted and played. We may not be able to continue to develop and introduce appealing new game themes and systems that meet the emerging requirements in a timely manner, or at all. In addition, others may independently develop games similar to our games, and competitors may introduce noncompliant games that unfairly compete in certain markets due to uneven regulatory enforcement policies. In addition, we have lost certain end users based upon our decision not to place pre-drawn games in the field that would be covered under the Oklahoma compact, but in advance of the effective date of the compact. After we are able to place the compacted games, it may take some time, if ever, to regain the players that we previously lost.

We believe continued developments in the Class II market that alleviate or clarify the legal and regulatory uncertainties of that market will result in increased competition in the interactive electronic Class II gaming market, including the entrance of new competitors with significant gaming experience and financial resources. We also expect to face increased competition as we attempt to enter new markets and new geographical locations. Specifically, three of the largest manufacturers of gaming equipment have entered or expressed an interest in the Class II market, and we are also increasingly competing against these vendors in our charity and lottery markets. In at least one instance, we have competed with a joint proposal of two of these significant vendors. We believe the increased competition will intensify pressure on our pricing model. In the future, gaming providers will compete 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 faster games with technological enhancements that we believe will appeal to end users, we believe that the net revenue our customers retain from their installed base of gaming terminals will become a more significant factor, one that may require us to change the terms of our participation arrangements with customers to remain competitive. Consequently, we believe that a simple business model based upon a relationship between the average hold per gaming terminal per day and the installed base of gaming terminals will become less relevant in predicting our performance, as the totality and the mix of our participation arrangements with customers become less standardized and more complex.

Given the limitations placed on Class II gaming, we may not be able to successfully compete in gaming jurisdictions and facilities where slot machines, table games and other forms of Class III gaming are permitted. Furthermore, increases in the popularity of and competition from an expansion of Class III gaming, or Internet and other account wagering gaming services, which allow end users to wager on a wide variety of sporting events and to play traditional casino games from home, could have a material adverse effect on our business, financial condition and operating results.

Our business requires us to obtain and maintain various licenses, permits and approvals from state governments and other entities that regulate our business.

We have obtained all state licenses, lottery board licenses, Native American gaming commission licenses, findings of suitability, registrations, permits and approvals necessary for the operation of our gaming activities. These include a license from Washington State to sell Class III video lottery systems, and licenses from the lottery boards of Texas, Iowa and New York. The Louisiana Department of Revenue as well as the Mississippi Gaming Commission have also issued licenses to us, and we have received licenses from all applicable Native American gaming commissions. We may require new licenses, permits and approvals in the future, and such licenses, permits or approvals may not be granted to us. The suspension, revocation, nonrenewal or limitation of any of our licenses would have a material adverse effect on our business, financial condition and results of operations.

Our Oklahoma tribal customers are in the early stages of developing their own licensing procedures under the new legislation, and we currently have limited, if any, information regarding the ultimate process or expenses involved with securing licensure by the tribes. Moreover, tribal policies and procedures, as well as tribal selection of gaming vendors, are subject to the political and governance environment within the tribe.

Table of Contents

We may not be successful in protecting our intellectual property rights, or avoiding claims that we are infringing upon the intellectual property rights of others.

We rely upon patent, copyright, trademark and trade secret laws, license agreements and employee nondisclosure agreements to protect our proprietary rights and technology, but these laws and contractual provisions provide only limited protection. We rely to a greater extent upon proprietary know-how and continuing technological innovation to maintain our competitive position. Insofar as we rely on trade secrets, unpatented know-how and innovation, others may be able to independently develop similar technology, or our secrecy could be breached. The issuance of a patent to us does not necessarily mean that our technology does not infringe upon the intellectual property rights of others. As the Class II market grows and we enter into new markets by leveraging our existing technology, it becomes more and more likely that we will become subject to infringement claims from other parties. Problems with patents or other rights could increase the cost of our products, or delay or preclude new product development and commercialization. If infringement claims against us are valid, we may seek licenses that might not be available to us on acceptable terms or at all. Litigation would be costly and time consuming, but may become necessary to protect our proprietary rights or to defend against infringement claims. We could incur substantial costs and diversion of management resources in the defense of any claims relating to the proprietary rights of others or in asserting claims against others.

We rely on software licensed from third parties, and technology provided by third-party vendors, the loss of which could increase our costs and delay deployment of our gaming systems and gaming terminals. We also rely on technology provided by third-party vendors which, if disrupted, could suspend play on some of our gaming terminals.

We integrate various third-party software products as components of our software. Our business would be disrupted if this software, or functional equivalents of this software, were either no longer available to us or no longer offered to us on commercially reasonable terms. In either case, we would be required to either redesign our software to function with alternate third-party software, or develop these components ourselves, which would result in increased costs and could result in delays in our deployment of our gaming systems and gaming terminals. Furthermore, we might be forced to limit the features available in our current or future software offerings.

We rely on the content of certain software that we license from third-party vendors. The software could contain bugs that could have an impact on our business.

We also rely on the technology of third-party vendors, such as telecommunication providers, to operate our nationwide broadband telecommunications network. A serious or sustained disruption of the provision of these services could result in some of our gaming terminals being non-operational for the duration of the disruption, which would adversely affect our ability to generate revenue from those gaming terminals.

We do not rely upon the term of our customer contracts to retain the business of our customers.

Our contracts with our customers are on a year-to-year or multi-year basis. Except for customers with whom we have entered into development agreements, we do not rely upon the stated term of our customer contracts to retain the business of our customers, as often noncontractual considerations unique to doing business in the Native American market override strict adherence to contractual provisions. We rely instead upon providing competitively superior gaming terminals, games and systems to give our customers the incentive to continue doing business with us. At any point in time, a significant portion of our business is subject to nonrenewal, and, if not renewed, would materially and adversely affect our earnings and financial condition.

Changes in regulation or regulatory interpretations could require us to modify the terms of our contracts with customers.

The NIGC has recently determined that the magnetic stripe card system, employed by Native American gaming operations using the gaming system developed by us, is an account access card system as defined in the NIGC's Minimum Internal Control Standards regulation, thereby triggering certain recordkeeping requirements. An account access card is defined as an instrument to access customer accounts for wagering at a gaming machine. Account access cards are used in connection with a computerized database. Account access cards are not smart cards.

On July 8, 2005, the NIGC issued a Warning Notice to certain tribes for, among other things, noncompliance with the recordkeeping requirements applicable to account access cards. According to the Warning Notice, the cashiers were not obtaining signatures from the customers on our receipts when cashing out. The NIGC is also of the opinion that the Bank Secrecy Act recordkeeping requirements apply to account access cards. The Minimum Internal

Table of Contents

Control Standards (25 C.F.R. § 542.3(c)(2)) require compliance with the Bank Secrecy Act. Because the IRS is conducting a Bank Secrecy Act audit at one of the tribal casinos, the NIGC has deferred a determination of whether the tribal gaming operations are in compliance with 25 C.F.R. § 542.3(c)(2) until the IRS audit is completed.

We continue to work with our legal counsel and tribal customers, exploring ways to modify the magnetic stripe card system to eliminate the account aspect of the system so that the card system operates like script or a bearer instrument.

Except as described below, the NIGC has considered the provisions of the agreements under which we provide our Class II games, equipment and services to our Native American customers, and has determined that these agreements are service agreements and are not management contracts. Management contracts are subject to additional regulatory requirements and oversight, including preapproval by the NIGC that could result in delays in providing our products and services to customers, as well as divert customers to our competitors.

In April 2004, we received a letter from the NIGC advising us that our agreements with a certain customer may constitute a management contract requiring the approval of the Chairman of the NIGC. We have maintained that the agreement, relied on by the NIGC, was an old, outdated agreement that was not applicable to the customer's gaming facility. The NIGC has taken no further action in this matter.

On November 30, 2004, we received letters from the Acting General Counsel of the NIGC advising us that our development agreements with certain other tribes may evince a proprietary interest by us in the tribes' gaming activities, in violation of IGRA and the tribes' gaming ordinances, based on the fee we receive under the agreement. The NIGC invited us and the tribes to submit any explanation or information that would establish that the agreement terms do not violate the requirement that the tribes maintain the sole proprietary interest in the gaming operation. The NIGC letters also advised that some of the agreements may also constitute management contracts, thereby requiring the approval of the Chairman of the NIGC.

We have responded to the NIGC, explaining why the agreements do not violate the sole proprietary interest prohibition of IGRA or constitute management agreements. Furthermore, we will vigorously contest any action by the NIGC that would adversely affect our agreements with the tribes. To date, the NIGC has taken no further action in this matter.

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 have a significant impact on our financial condition and results of operations from such agreements and from other development agreements that may be similarly interpreted by the NIGC.

If our key personnel leave us, our business could be materially adversely affected.

We depend on the continued performance of the members of our senior management team and our technology team. If we were to lose the services of any of our senior officers, directors, or any key member of our technology team, and could not find suitable replacements for such persons in a timely manner, it could have a material adverse effect on our business.

Enforcement of remedies or contracts against Native American tribes could be difficult.

Governing and Native American Law. Federally recognized Native American tribes are independent governments, subordinate to the United States, with sovereign powers, except as those powers may have been limited by treaty or by the United States Congress. Native Americans power to enact their own laws to regulate gaming is an exercise of Native American sovereignty, as recognized by IGRA. Native American tribes maintain their own governmental systems and often their own judicial systems. Native American tribes have the right to tax persons and enterprises conducting business on Native American lands, and also have the right to require licenses and to impose other forms of regulation and regulatory fees on persons and businesses operating on their lands.

Native American tribes, as sovereign nations, are generally subject only to federal regulation. Although Congress may regulate Native American tribes, states do not have the authority to regulate Native American tribes unless such authority has been specifically granted by Congress. In the absence of a specific grant of authority by Congress, states may regulate activities taking place on Native American lands only if the tribe has a specific agreement or compact with the state. In the absence of a conflicting federal or properly authorized state law, Native American law governs.

Table of Contents

Our contracts with Native American customers normally provide that only certain provisions will be subject to the governing law of the state in which a tribe is located. However, these choice-of-law clauses may not be enforceable.

Sovereign Immunity; Applicable Courts. Native American tribes generally enjoy sovereign immunity from suits similar to that of the individual states and the United States. In order to sue a Native American tribe (or an agency or instrumentality of a Native American tribe), the tribe must have effectively waived its sovereign immunity with respect to the matter in dispute.

Our contracts with Native American customers include a limited waiver of each tribe's sovereign immunity, and generally provide that any dispute regarding interpretation, performance or enforcement shall be submitted to, and resolved by, arbitration in accordance with the Commercial Arbitration Rules of the American Arbitration Association, and that any award, determination, order or relief resulting from such arbitration is binding and may be entered in any court having jurisdiction. In the event that such waiver of sovereign immunity is held to be ineffective, we could be precluded from judicially enforcing any rights or remedies against a tribe. These rights and remedies include, but are not limited to, our right to enter Native American lands to retrieve our property in the event of a breach of contract by the tribe party to that contract.

If a Native American tribe has effectively waived its sovereign immunity, there exists an issue as to the forum in which a lawsuit can be brought against the tribe. Federal courts are courts of limited jurisdiction and generally do not have jurisdiction to hear civil cases relating to Native Americans. In addition, contractual provisions that purport to grant jurisdiction to a federal court are not effective. Federal courts may have jurisdiction if a federal question is raised by the suit, which is unlikely in a typical contract dispute. Diversity of citizenship, another common basis for federal court jurisdiction, is not generally present in a suit against a tribe, because a Native American tribe is not considered a citizen of any state. Accordingly, in most commercial disputes with tribes, the jurisdiction of the federal courts may be difficult or impossible to obtain. We may be unable to enforce any arbitration decision effectively.

We may incur prize payouts in excess of game revenues.

Certain of our contracts with our Native American customers relating to our Legacy system games provide that our customers receive, on a daily basis, an agreed percentage of gross gaming revenues based upon an assumed level of prize payouts, rather than the actual level of prize payouts. This can result in our paying our customers amounts greater than our customers' percentage share of the actual hold per day. In addition, because the prizes awarded in our games are based upon assumptions as to the number of players in each game and statistical assumptions as to the frequency of winners, we may experience on any day, or over short periods of time, a game deficit, where the aggregate amount of prizes paid exceeds aggregate game revenues. If we have to make any excess payments to customers, or experience a game deficit over any statistically relevant period of time, we are contractually entitled to adjust the rates of prize payout to end users in order to recover any deficit. In the future, we may miscalculate our statistical assumptions, or for other reasons, we may experience abnormally high rates of jackpot prize wins, which could materially and adversely affect our cash flow on a temporary or long-term basis, and which could materially and adversely affect our earnings and financial condition.

Our business prospects and future success rely heavily upon the integrity of our employees and executives and the security of our gaming systems.

The integrity and security of our gaming systems is critical to its ability to attract customers and players. We strive to set exacting standards of personal integrity for our employees and for system security involving the gaming systems that we provide to our customers. Our reputation in this regard is an important factor in our business dealings with our current and potential customers. For this reason, an allegation or a finding of improper conduct on our part or on the part of one or more of our employees that is attributable to us, or an actual or alleged system security defect or failure attributable to us could have a material adverse effect upon our business, financial condition, results and prospects, including our ability to retain existing contracts or obtain new or renewed contracts.

Table of Contents**Any disruption in our network or telecommunications services, or adverse weather conditions in the areas in which we operate could affect our ability to operate our games, which would result in reduced revenues and customer down time.**

Our network is susceptible to outages due to fire, floods, power loss, break-ins, cyberattacks and similar events. We have multiple site back-up for our services in the event of any such occurrence. Despite our implementation of network security measures, our servers are vulnerable to computer viruses and break-ins; similar disruptions from unauthorized tampering with our computer systems in any such event could have a material adverse effect on our business, operating results and financial condition.

Adverse weather conditions, particularly flooding, tornadoes, heavy snowfall and other extreme weather conditions often deter our end users from traveling or make it difficult for them to frequent the sites where our games are installed. If any of those sites were to experience prolonged adverse weather conditions, or if the sites in Oklahoma, where a significant number of our games are installed, were to simultaneously experience adverse weather conditions, our results of operations and financial condition would be materially adversely affected.

In addition, our agreement with the New York State Division of the Lottery permits termination of the contract at any time for failure by us or our system to perform properly. We were also required to post a performance bond to secure our performance under such contract. Failure to perform under this or similar contracts could result in substantial monetary damages, as well as contract termination.

In addition, we enter into certain agreements that could require us to pay damages resulting from loss of revenues if our systems are not properly functioning, or as a result of a system malfunction or an inaccurate pay table.

Worsening economic conditions may adversely affect our business.

The demand for entertainment and leisure activities tends to be highly sensitive to consumers' disposable incomes, and thus a decline in general economic conditions or an increase in gasoline prices may lead to our end users' having less discretionary income with which to wager. This could cause a reduction in our revenues and have a material adverse effect on our operating results.

ITEM 2. UNREGISTERED SALES OF EQUITY SECURITIES AND USE OF PROCEEDS

The following table provides information relating to the Company's repurchase of shares of its common stock during the most recently completed quarter.

Summary of Stock Repurchases

(Unaudited)

| | Total Number of Shares Purchased | Average Price Paid per Share | Total Number of Shares Purchased as Part of Publicly Announced Plans or Programs | Maximum Number of Shares that May yet be Purchased Under the Plans or Programs |
|---------------------------------------|---|---|---|---|
| January 1, 2006 to January 31, 2006 | 22,300 | \$ 9.10 | 22,300 | 925,063 |
| February 1, 2006 to February 28, 2006 | 16,000 | 9.09 | 16,000 | 902,763 |
| March 1, 2006 to March 31, 2006 | | \$ | | 886,763 |
| Total | 38,300 | \$ 9.10 | 38,300 | |

All shares detailed above were repurchased as part of publicly announced repurchase plans. For a description of our authorized stock repurchase plans, see PART I Item 2. Management's Discussion and Analysis of Financial Condition and Results of Operations.

ITEM 6. EXHIBITS

(a) Exhibits
See Exhibit Index.

Table of Contents

SIGNATURES

Pursuant to the requirements of the Securities Exchange Act of 1934, the registrant has duly caused this report to be signed on its behalf by the undersigned, thereunto duly authorized.

Date: May 10, 2006

Multimedia Games, Inc.

By: /s/ Craig S. Nous
Craig S. Nous
Chief Financial Officer

Mr. Nous is signing as an authorized officer and as our Principal Financial Officer and Chief Accounting Officer.

-42-

Table of Contents**EXHIBIT INDEX**

| EXHIBIT NO. | TITLE | LOCATION |
|--------------------|---|-----------------|
| 3.1 | Amended and Restated Articles of Incorporation | (1) |
| 3.2 | Amendment to Articles of Incorporation | (10) |
| 3.3 | Amended and Restated Bylaws | (2) |
| 10.1 | Form of Integrated Gaming Services Agreement | (3) |
| 10.2 | 1994 Employee Stock Option Plan | (3) |
| 10.3 | 1994 Director Stock Option Plan | (3) |
| 10.4 | 1996 Stock Incentive Plan, as amended | (5) |
| 10.5 | President's Plan | (4) |
| 10.6 | 1998 Senior Executive Stock Option Plan | (5) |
| 10.7 | 2000 Stock Option Plan | (5) |
| 10.8 | 2001 Stock Option Plan | (6) |
| 10.9 | Stockholder Rights Plan | (7) |
| 10.10 | 2002 Stock Option Plan | (8) |
| 10.11 | Employment Agreement executed March 26, 2003 between the Company and Gordon Graves | (8) |
| 10.12 | 2003 Outside Directors' Stock Option Plan | (9) |
| 10.13 | Amended and Restated Loan and Security Agreement between the Company and Comerica Bank | (13) |
| 10.16 | Employment Agreement executed September 9, 2004 between the Company and Clifton Lind | (11) |
| 10.17 | Form of Indemnity Agreement entered between the Company and each of the members of the Company's Board of Directors | (11) |
| 10.18 | Ad Hoc Option Plan | (12) |
| 31.1 | Certification of Chief Executive Officer, pursuant to Section 302 of the Sarbanes Oxley Act of 2002 | (*) |
| 31.2 | Certification of Chief Financial Officer, pursuant to Section 302 of the Sarbanes Oxley Act of 2002 | (*) |
| 32.1 | Certification of the Chief Executive Officer and Chief Financial Officer Pursuant to U.S.C. Section 1350, as adopted, pursuant to Section 906 of the Sarbanes Oxley Act of 2002 | (*) |

- (1) Incorporated by reference to our Form 10-QSB filed with the Securities and Exchange Commission for the quarter ended March 31, 1997.
- (2) Incorporated by reference to our Form 10-K filed with the Securities and Exchange Commission for the fiscal year ended September 30, 2003.
- (3) Incorporated by reference to our Form 10-KSB filed with the Securities and Exchange Commission for the fiscal year ended September 30, 1994.
- (4) Incorporated by reference to our Form 10-KSB filed with the Securities and Exchange Commission for the fiscal year ended September 30, 1998.
- (5) Incorporated by reference to our Registration Statement on Form S-8 filed with the Securities and Exchange Commission on December 1, 2000.
- (6) Incorporated by reference to our Registration Statement on Form S-8 filed with the Securities and Exchange Commission on October 18, 2001 (File No. 333-100611).
- (7) Incorporated by reference to our Registration Statement on Form 8-A, filed with the Securities and Exchange Commission on October 23, 1998.
- (8) Incorporated by reference to our Form 10-Q filed with the Securities and Exchange Commission for the quarter ended March 31, 2003.
- (9)

Edgar Filing: MULTIMEDIA GAMES INC - Form 10-Q

Incorporated by reference to Appendix B of our Definitive Proxy Statement on Schedule 14A filed with the Securities and Exchange Commission on January 6, 2004.

- (10) Incorporated by reference to our Form 10-Q filed with the Securities and Exchange Commission for the quarter ended December 31, 2003.
- (11) Incorporated by reference to our Form 10-K filed with the Securities and Exchange Commission for the fiscal year ended September 30, 2004.
- (12) Incorporated by reference to our Registration Statement on Form S-8 filed with the Securities and Exchange Commission on October 18, 2002 (File No. 333-100612).
- (13) Incorporated by reference to our Form 10-K filed with the Securities and Exchange Commission for the fiscal year ended September 30, 2005.
- (*) Filed herewith.