

MULTIMEDIA GAMES INC  
Form 10-Q  
August 14, 2003  
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**SECURITIES AND EXCHANGE COMMISSION**

**Washington, D.C. 20549**

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**Form 10-Q**

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

**For the quarterly period ended: June 30, 2003**

**.. Transition Report Pursuant to Section 13 or 15 (d) of the Securities Exchange Act of 1934**

**For the transition period from \_\_\_\_\_ to \_\_\_\_\_**

**Commission File Number: 0-28318**

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**Multimedia Games, Inc.**

**(Exact Name of Registrant as Specified in its Charter)**

**Texas**  
**(State or Other Jurisdiction of Incorporation)**

**74-2611034**  
**(IRS Employer Identification Number)**

**206 Wild Basin, Building B, Fourth Floor**

**Austin, Texas 78746**

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(Address of Principal Executive Offices)

(512) 334-7500

(Registrant's Telephone Number, Including Area Code)

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

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

As of June 30, 2003, there were 13,125,467 shares of the Company's Common Stock, par value \$0.01, outstanding.

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## PART I

## FINANCIAL INFORMATION

## MULTIMEDIA GAMES, INC.

## CONSOLIDATED BALANCE SHEETS

As of June 30, 2003 and September 30, 2002

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

	June 30, 2003	September 30, 2002
	(Unaudited)	(Audited)
<b>ASSETS</b>		
<b>CURRENT ASSETS:</b>		
Cash and cash equivalents	\$ 19,021	\$ 15,247
Accounts receivable	6,519	5,697
Allowance for doubtful accounts receivable	(538)	(428)
Inventory, net	874	4,303
Prepaid expenses and other assets	1,366	1,418
Notes receivable, net	10,912	3,115
Federal and state income tax receivable	1,250	
Deferred income taxes	1,394	797
<b>Total current assets</b>	<b>40,798</b>	<b>30,149</b>
Restricted cash and long-term investments	1,287	1,493
Inventory non-current	12,175	10,328
Property and equipment, net	61,090	40,137
Notes receivable non-current	500	
Other assets	7,841	4,083
<b>Total assets</b>	<b>\$ 123,691</b>	<b>\$ 86,190</b>
<b>LIABILITIES AND STOCKHOLDERS EQUITY</b>		
<b>CURRENT LIABILITIES:</b>		
Current portion of long-term debt and capital leases	\$ 2,695	\$ 245
Accounts payable and accrued expenses	15,880	14,480
Federal and state income tax payable		1,181
Halls share of surplus		793
Prize fulfillment fees payable		44
Deferred revenue	24	1,929
<b>Total current liabilities</b>	<b>18,599</b>	<b>18,672</b>
Long-term debt and capital leases, less current portion	6,463	369
Other long-term liabilities	3,399	1,385
Deferred income taxes	2,041	252
<b>Total liabilities</b>	<b>30,502</b>	<b>20,678</b>

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Commitments and contingencies (Note 2)

Stockholders' equity:

Preferred stock, Series A, \$0.01 par value, 2,000,000 shares authorized, no shares issued and outstanding

Common stock, \$0.01 par value, 25,000,000 shares authorized, 14,230,670 and 13,963,489 shares issued, and 13,125,467 and 12,889,144 shares outstanding, respectively

Additional paid-in capital

Stockholders' notes receivable

Treasury stock, 1,105,203 and 1,074,345 shares at cost, respectively

Retained earnings

Total stockholders' equity

**Total liabilities and stockholders' equity**

	142	140
	44,092	40,996
	(1,451)	(2,417)
	(6,491)	(5,847)
	56,897	32,640
	<u>93,189</u>	<u>65,512</u>
	<b><u>\$ 123,691</u></b>	<b><u>\$ 86,190</u></b>

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 June 30, 2003 and 2002**

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

	<b>2003</b>	<b>2002</b>
	<b>(Unaudited)</b>	<b>(Unaudited)</b>
<b>REVENUES:</b>		
Gaming revenue Class II	\$ 82,055	\$ 74,048
Gaming revenue Class III	1,068	1,630
Player station and license sale and lease revenue	12,489	2,546
Other	384	396
<b>Total revenues</b>	<b>95,996</b>	<b>78,620</b>
Allotments to hall operators	58,004	52,366
Bingo prizes and related costs	68	395
<b>Net revenues</b>	<b>37,924</b>	<b>25,859</b>
<b>OPERATING COSTS AND EXPENSES:</b>		
Cost of player stations and licenses sold	7,335	1,334
Selling, general and administrative expenses	10,599	9,589
Amortization and depreciation	5,512	3,622
<b>Total operating costs and expenses</b>	<b>23,446</b>	<b>14,545</b>
<b>Operating income</b>	<b>14,478</b>	<b>11,314</b>
<b>OTHER INCOME (EXPENSE):</b>		
Interest income	71	76
Interest expense	(187)	(10)
<b>Income before income taxes</b>	<b>14,362</b>	<b>11,380</b>
Income tax expense	5,498	4,537
<b>Net income</b>	<b>\$ 8,864</b>	<b>\$ 6,843</b>
<b>Earnings per share:</b>		
Basic	\$ 0.68	\$ 0.54
Diluted	\$ 0.60	\$ 0.47
<b>Shares used in earnings per-share calculation:</b>		
Basic	12,999,419	12,669,643
Diluted	14,817,718	14,600,376

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

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**Table of Contents****MULTIMEDIA GAMES, INC.****CONSOLIDATED STATEMENTS OF INCOME****For the Nine Months Ended June 30, 2003 and 2002**

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

	<b>2003</b>	<b>2002</b>
	<b>(Unaudited)</b>	<b>(Unaudited)</b>
<b>REVENUES:</b>		
Gaming revenue Class II	\$ 249,709	\$ 201,672
Gaming revenue Class III	3,132	4,419
Player station and license sale and lease revenue	15,623	6,324
Other	1,110	1,049
<b>Total revenues</b>	<b>269,574</b>	<b>213,464</b>
Allotments to hall operators	175,645	142,792
Bingo prizes and related costs	1,171	1,127
<b>Net revenues</b>	<b>92,758</b>	<b>69,545</b>
<b>OPERATING COSTS AND EXPENSES:</b>		
Cost of player stations and licenses sold	8,730	4,149
Selling, general and administrative expenses	29,667	24,740
Amortization and depreciation	15,073	10,433
<b>Total operating costs and expenses</b>	<b>53,470</b>	<b>39,322</b>
<b>Operating income</b>	<b>39,288</b>	<b>30,223</b>
<b>OTHER INCOME (EXPENSE):</b>		
Interest income	263	189
Interest expense	(245)	(38)
<b>Income before income taxes</b>	<b>39,306</b>	<b>30,374</b>
Income tax expense	15,049	11,890
<b>Net income</b>	<b>\$ 24,257</b>	<b>\$ 18,484</b>
<b>Earnings per share:</b>		
Basic	\$ 1.87	\$ 1.50
Diluted	\$ 1.66	\$ 1.27
<b>Shares used in earnings per-share calculation:</b>		
Basic	12,941,280	12,348,204
Diluted	14,647,583	14,589,082



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

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## MULTIMEDIA GAMES, INC.

## CONSOLIDATED STATEMENTS OF CASH FLOWS

For the Nine Months Ended June 30, 2003 and 2002

(In thousands)

	<u>2003</u>	<u>2002</u>
	<u>(Unaudited)</u>	<u>(Unaudited)</u>
CASH FLOWS FROM OPERATING ACTIVITIES:		
Net income	\$ 24,257	\$ 18,484
Adjustments to reconcile net income to cash and cash equivalents provided by operating activities:		
Amortization and depreciation	15,073	10,433
Write off of property and equipment	51	
Options issued to consultants	184	54
Provision for doubtful accounts		616
Provision for obsolete inventory	672	325
Deferred income taxes	1,192	1,720
Tax benefit of stock options exercised	1,519	4,692
(Increase) decrease in:		
Accounts receivable	(509)	(1,387)
Inventory	(9,472)	(4,390)
Prepaid expenses and other assets	(46)	(951)
Federal and state income tax payable (receivable)	(3,950)	(5,194)
Prize fulfillment fees payable	(44)	(79)
Notes receivable current	(4,614)	(263)
Accounts payable and accrued expenses	1,400	4,352
Halls share of surplus	(996)	846
Deferred revenue	(1,905)	
<b>NET CASH PROVIDED BY OPERATING ACTIVITIES</b>	<b>22,812</b>	<b>29,258</b>
CASH FLOWS FROM INVESTING ACTIVITIES:		
Acquisition of property and equipment and patents	(20,992)	(22,939)
Development of tribal gaming facilities	(4,765)	
Restricted cash and long-term investments and other long-term liabilities	173	269
Notes receivable non-current	(500)	
Stockholders notes receivable, net	322	(294)
<b>NET CASH USED IN INVESTING ACTIVITIES</b>	<b>(25,762)</b>	<b>(22,964)</b>
CASH FLOWS FROM FINANCING ACTIVITIES:		
Proceeds from exercise of stock options, warrants, and related tax benefit	2,914	7,803
Principal payments of long-term debt and capital leases	(561)	
Proceeds from long-term debt	4,371	649
Purchase of treasury stock		(17)
Preferred stock dividends		(4)
<b>NET CASH PROVIDED BY FINANCING ACTIVITIES</b>	<b>6,724</b>	<b>8,431</b>
Net increase in cash and cash equivalents	3,774	14,725
Cash and cash equivalents, beginning of period	15,247	4,868

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Cash and cash equivalents, end of period	<u>\$ 19,021</u>	<u>\$ 19,593</u>
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The accompanying notes are an integral part of the consolidated financial statements

**Table of Contents****MULTIMEDIA GAMES, INC.****CONSOLIDATED STATEMENTS OF CASH FLOWS (Continued)****For the Nine Months Ended June 30, 2003 and 2002**

(In thousands)

	<u>2003</u>	<u>2002</u>
	<u>(Unaudited)</u>	<u>(Unaudited)</u>
<b>SUPPLEMENTAL CASH FLOW DATA:</b>		
Interest paid	\$ 245	\$ 38
Income taxes paid	\$ 14,785	\$ 5,359
<b>NON-CASH TRANSACTIONS:</b>		
Transfer of inventory to property and equipment	\$ 10,382	\$ 3,750
<b>Property and equipment acquired through:</b>		
Capital lease	\$ 3,074	\$
Long-term debt	\$ 1,660	\$
Non-compete agreement included in other assets and other long-term liabilities	\$ 2,047	\$
Collection of stockholders' note receivable with the Company's common stock	\$ 644	\$

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

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**MULTIMEDIA GAMES, INC.**

**NOTES TO UNAUDITED CONSOLIDATED FINANCIAL STATEMENTS**

**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, 2002.

The consolidated financial statements included herein as of June 30, 2003, and for each of the three and nine months ended June 30, 2003 and 2002 have been prepared by the Company without an audit, pursuant to accounting principles generally accepted in the United States of America 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 United States of America 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 each of the periods. Operating results for the three and nine months ended June 30, 2003 are not necessarily indicative of the results which will be realized for the year ending September 30, 2003.

The Company's consolidated financial statements include the activities of Multimedia Games, Inc. and its wholly-owned subsidiaries: MegaBingo, Inc., MGAM Systems, Inc., MGAM Services, LLC, TV Games, Inc. (dissolved April 10, 2003) and Multimedia Creative Services, Inc. (dissolved October 4, 2002). All significant intercompany transactions and balances have been eliminated.

**Revenue Recognition.** The Company derives its Class II gaming revenues primarily from participation arrangements with its customers. Under participation arrangements, the Company retains ownership of the electronic player stations installed at customers' tribal gaming facilities, and receives revenue based on a percentage of the hold per day generated by each player station. The network-wide hold is reported by the Company as gaming revenue, and represents the total amount end users wager, less the total amount paid to end users for prizes. The amounts retained by the halls for their share of the hold are reported by the Company in its results of operations as allotments to hall operators, and are deducted from the Company's total revenues to arrive at its net revenues.

The majority of the Company's Class III video lottery terminals, or VLTs, have been sold to customers outright for a one-time purchase price, and are reported by the Company under player station and license sale and lease revenue. Certain game themes used by the Company in the Class III market have been licensed from third parties and are resold to customers along with its Class III VLTs. Revenues from the sale of Class III VLTs and the sale of player station licenses are recognized when the units are delivered to the customer and the licensed games installed. For the remainder of its Class III VLTs, the Company enters into either participation arrangements similar to those for its Class II systems, or lease-purchase arrangements. Under lease-purchase arrangements, the Company receives a series of lease payments based on a percentage of the customer's hold per day generated by the VLT. At the end of the lease period, the Company transfers ownership of the VLT to the customer.

The Company also receives back-office fees based on a share of the hold per day from both leased and sold Class III VLTs. Back-office fees cover the service and maintenance costs for back-office servers installed in each hall to run its Class III games, as well as the cost of related software updates. For those VLTs sold to customers, the back-office fees are considerably smaller than the revenue share received from Class II player stations being rented under participation arrangements. Accordingly, the Company derives its Class III revenues to a greater extent from VLT sales, when compared to participation arrangements in the Class II market. Sales of Class III VLTs are usually clustered around the expansion of existing casinos or the opening of new casinos.

***Inventory Current.*** The Company's current inventory consists primarily of completed Class III VLTs, and components for Class III VLTs expected to be sold to customers within the Company's next fiscal year.

***Inventory Non-Current.*** The Company's non-current inventory consists of completed Class II player station units expected to be placed with customers under participation arrangements under which the Company retains title to the units. Units are transferred from non-current inventory to the Company's property and equipment upon consummation of participation agreements, and as such units are placed with Class II customers. Non-current inventory also consists of both new and used components, stated at their net carrying value.

***Property and Equipment.*** Property and equipment is stated at cost. The cost of property and equipment is depreciated over their estimated useful lives, generally using the straight-line method for financial reporting, and accelerated methods

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

for tax reporting purposes. A substantial portion of the Company's property and equipment is depreciated over two to seven years. Player stations placed with customers under lease arrangements where player station ownership is conveyed to the customer at the end of the lease term are depreciated over the shorter of the lease term or three years. Property and equipment includes a pool of rental player stations, i.e., the rental pool. Rental pool units are those units which have previously been in the field, but are currently back at the Company being refurbished and/or awaiting redeployment. Routine maintenance of property and 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 and equipment are recorded by removing the related cost and accumulated depreciation from the accounts. Gains or losses on sales and retirements of property and equipment are reflected in the Company's results of operations.

Internally developed gaming software is stated at cost, which is amortized over the estimated useful life of the software, generally using the straight-line method. The Company amortizes internally developed games and gaming engines over an eighteen-month period, gaming platforms over a three-year period, and its central management systems over a five-year period. Software development costs are capitalized once technological feasibility has been established, and are amortized when the software is placed into service. Any subsequent software maintenance costs, such as bug fixes and subsequent testing, are expensed as incurred. Discontinued software development projects are expensed when the determination to discontinue is made.

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 future cash flows expected to be generated by the asset. If such assets are considered to be impaired, the impairment to be recognized is measured by the amount by which the carrying amount of the assets exceeds the fair value of the assets, which considers the discounted future net cash flows. Assets to be disposed of are reported at the lower of the carrying amount or the fair value less costs of disposal. The analysis of long-lived assets at June 30, 2003 indicated there was no impairment of these assets' carrying values.

**Long-term debt and capital leases.** At June 30, 2003 and September 30, 2002, the Company's long-term debt and capital leases consisted of the following:

	June 30, 2003	September 30, 2002
	(In thousands)	
Term loan facility	\$ 2,500	\$
Capital leases	2,891	
Long-term debt	3,767	614
Long-term debt and capital leases	9,158	614
Less current portion	2,695	245
Long-term debt and capital leases, less current portion	\$ 6,463	\$ 369

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The Company's debt structure consists of a Credit Facility which provides the Company with a \$10.0 million term loan facility and a \$5.0 million revolving credit facility used primarily for working capital needs, and capital leases and long-term debt used to finance property and equipment for the Company's operations.

The term loan, which can be drawn under three tranches closing six months apart, all maturing in June 2006, and a revolving credit facility, which expires in June 2005, bear interest at a rate of Prime plus 1.25% (or 5.5% as of June 30, 2003) with a floor of 5.5%. The Credit Facility contains certain customary financial and operational covenants, and is collateralized by substantially all the Company's assets. As of June 30, 2003, there were no borrowings outstanding under the revolving credit facility.

***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 potentially be uncollectible. Management analyzes historical collection trends and changes in its customer payment patterns, customer concentration and credit worthiness when evaluating the adequacy of its allowance for doubtful accounts. The Company includes any receivable balances that are determined to be uncollectible, along with a general reserve, in its overall allowance for doubtful accounts.



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**MULTIMEDIA GAMES, INC.**

**NOTES TO UNAUDITED CONSOLIDATED FINANCIAL STATEMENTS (Continued)**

**Inventory Reserves.** Inventories are stated at the lower of cost (first in, first out) or market. Management regularly reviews its inventory quantities on hand and records reserves for excess and obsolete inventory based primarily on its estimated forecast of product demand and production and service requirements.

**MegaBingo® Activities.** During the quarter ended December 31, 2002, the Company approved a plan to exit its MegaBingo gaming activities. As part of the exit plan, the final championship game was accelerated to April 2003, requiring the Company to fund the present value of the \$1.0 million award prize. Under Emerging Issues Task Force, or EITF, Issue No. 94-3, Liability Recognition for Certain Employee Termination Benefits and Other Costs to Exit an Activity (Including Certain Costs Incurred in a Restructuring), approximately \$420,000 related to the prize was determined to be an exit cost, and was accrued during the nine months ended June 30, 2003, and reported under bingo prizes and related costs.

**Reclassifications.** Certain reclassifications were made to the prior period financial statements to conform to the current period financial statement presentation. Specifically, stockholders' notes receivable, net was reclassified from a financing activity to an investing activity in the consolidated statement of cash flows for the nine months ended June 30, 2002, and write off of offering costs was reclassified to selling, general and administrative expenses for the three and nine months ended June 30, 2002. These reclassifications did not have an impact on the Company's previously reported financial position or results of operations.

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

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

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

**Three Months Ended June 30,**

2003	2002
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**(In thousands, except shares**

**and per-share amounts)**

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Income available to common stockholders	basic	\$ 8,864	\$ 6,843
		<u>          </u>	<u>          </u>
Income available to common stockholders	diluted	\$ 8,864	\$ 6,843
		<u>          </u>	<u>          </u>
Weighted average common shares outstanding		12,999,419	12,669,643
Effect of dilutive securities:			
Options		1,770,896	1,787,471
Warrants		47,403	143,262
Convertible preferred stock			
		<u>          </u>	<u>          </u>
Weighted average common and potential shares outstanding		14,817,718	14,600,376
		<u>          </u>	<u>          </u>
Basic earnings per share		\$ 0.68	\$ 0.54
		<u>          </u>	<u>          </u>
Diluted earnings per share		\$ 0.60	\$ 0.47
		<u>          </u>	<u>          </u>

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## MULTIMEDIA GAMES, INC.

## NOTES TO UNAUDITED CONSOLIDATED FINANCIAL STATEMENTS (Continued)

	Nine months Ended June 30,	
	2003	2002
	(In thousands, except shares and per-share amounts)	
Income available to common stockholders basic	\$ 24,257	\$ 18,480
Income available to common stockholders diluted	\$ 24,257	\$ 18,484
Weighted average common shares outstanding	12,941,280	12,348,204
Effect of dilutive securities:		
Options	1,646,317	2,010,097
Warrants	59,986	215,354
Convertible preferred stock		15,427
Weighted average common and potential shares outstanding	14,647,583	14,589,082
Basic earnings per share	\$ 1.87	\$ 1.50
Diluted earnings per share	\$ 1.66	\$ 1.27

For the three and nine months ended June 30, 2003, options to purchase 112,500 shares of Common Stock at exercise prices ranging from \$23.58 to \$30.95 per share were outstanding, but were not included in the computation of diluted earnings per share because the options' exercise prices were greater than the average market price of the common shares.

**Stock-Based Compensation.** The Company applies Accounting Principles Board Opinion, or APB, No. 25, Accounting for Stock Issued to Employees, in accounting for its stock option plans, rather than the alternative fair value accounting provided under SFAS No. 123, Accounting for Stock-Based Compensation. Under APB No. 25, no compensation expense is recognized for grants of options to common-law employees and directors at an exercise price equal to or greater than the market price of the stock on the date of grant. Accordingly, based on the Company's grants in the three and nine months ended June 30, 2003 and 2002, no compensation expense has been recognized.

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

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	Three Months Ended June 30,		Nine months Ended June 30,	
	2003	2002	2003	2002
(In thousands, except per-share amounts)				
Net income:				
As reported	\$ 8,864	\$ 6,843	\$ 24,257	\$ 18,484
Deduct: Total estimated stock-based employee compensation determined under fair value method for all awards, net of related tax benefit	(824)	(612)	(3,473)	(1,601)
Pro forma	\$ 8,040	\$ 6,231	\$ 20,784	\$ 16,883
Basic earnings per share:				
As reported	\$ 0.68	\$ 0.54	\$ 1.87	\$ 1.50
Pro forma	\$ 0.62	\$ 0.49	\$ 1.61	\$ 1.37
Diluted earnings per share:				
As reported	\$ 0.60	\$ 0.47	\$ 1.66	\$ 1.27
Pro forma	\$ 0.54	\$ 0.43	\$ 1.42	\$ 1.16

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**MULTIMEDIA GAMES, INC.**

**NOTES TO UNAUDITED CONSOLIDATED FINANCIAL STATEMENTS (Continued)**

**2. COMMITMENTS AND CONTINGENCIES**

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

**Indian Gaming Regulatory Act.** Virtually all of the Company's business relates to gaming activities on Native American lands. The operation of gaming on Native American lands is subject to the Indian Gaming Regulatory Act of 1988, or IGRA, which created the National Indian Gaming Commission, or NIGC, to promulgate regulations to enforce certain aspects of IGRA.

IGRA classifies games that may be played on Native American land into three categories: Class I gaming includes traditional Native American social and ceremonial games and is regulated only by the tribes. Class II gaming includes bingo and, if played at the same location where bingo is played, pull-tabs, lotto, punch boards, tip jars, instant bingo, certain card games played under limited circumstances, and other games similar to bingo. And Class III gaming consists of all forms of gaming that are not Class I or Class II, such as video lottery games, slot machines, most table games and keno.

IGRA allows Native American tribes to legally engage in Class II gaming on Native American lands in any state where the state permits such gaming by any person for any purpose. For example, if a state permits churches to hold charity bingo nights, then IGRA would allow Native American tribes to engage in bingo on Native American lands located in that state as a Class II gaming activity, free of any interference, regulation, or taxation by that state. During the three months ended June 30, 2003, approximately 63% of the Company's net revenues were derived from Class II gaming, and most of the balance was derived from the sale of VLTs and related licenses in the Class III gaming market.

IGRA also regulates the terms of gaming management contracts with Native Americans, which must be approved by the NIGC before taking effect. The NIGC has determined that the agreements pursuant to which the Company provides its Class II games, equipment and services are service agreements and not management contracts, thereby allowing the Company to obtain terms that might otherwise not be permitted. Under existing regulations, management contracts can have a maximum term of seven years, and limit the amount payable to the manager to 30% of the net revenue from the related gaming activity. On occasion, however, as a condition of its approval of a management contract, the NIGC has required that both a shorter term and a reduced percentage of the net revenue be accepted by a manager. There is no assurance that further review of the Company's agreements by the NIGC, or alternative interpretations of applicable laws and regulations will not require substantial modifications to those agreements in a manner that could materially and adversely affect the Company's business. See Certain Risk Factors Changes in regulation or regulatory interpretations could require us to modify the terms of our contracts with customers.

**Johnson Act.** The Johnson Act defines an illegal gambling device as any machine or mechanical device designed primarily for gambling and that, when operated, delivers money to a player as the result of the application of an element of chance. Courts that have considered the scope of the Johnson Act in relation to IGRA have generally determined that the Johnson Act does not prohibit the use of electronic and technological aids to bingo that operate to broaden the participation of players to play against one another rather than against a machine.

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Class II gaming is defined by IGRA as including the game of chance commonly known as bingo (whether or not electronic, computer or other technological aids are used in connection therewith). However, IGRA's definition of Class II gaming expressly excludes electronic or electromechanical facsimiles of any game of chance or slot machines of any kind. Prior to June 17, 2002, regulations adopted by the NIGC defined electronic or electromechanical facsimiles of any game of chance or slot machines of any kind as being equivalent to gambling devices, as defined and prohibited by the Johnson Act.

On June 17, 2002, the NIGC published new regulations, effective July 16, 2002, defining the terms electronic, computer or other technological aids that can legally be used in Class II gaming, and electronic or electromechanical facsimiles of a game of chance that may not be legally used in Class II gaming. The NIGC essentially did away with using the Johnson Act definition of gambling device as the method of determining what constituted an illegal electronic or electromechanical facsimile of a game of chance, and relied instead upon existing court cases which have identified legal technological aids as those that broaden the participation levels of players in the same game, facilitate

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**MULTIMEDIA GAMES, INC.**

**NOTES TO UNAUDITED CONSOLIDATED FINANCIAL STATEMENTS (Continued)**

communication between and among gaming facilities, and allow players to play a game with or against other players rather than with or against a machine.

These new NIGC regulations are not binding upon the Department of Justice, or DOJ, which is the agency charged with enforcing the Johnson Act. The DOJ has asserted in the past and may continue to assert their position, either in future appeals of existing district and circuit court decisions or other case filings, that any electronic or mechanical device used in gaming, such as the electronic player stations used to play the Company's Class II games, are illegal gambling devices, and thus in violation of the Johnson Act.

However, in a recent decision of the United States Court of Appeals for the Tenth Circuit (Seneca-Cayuga Tribe of Oklahoma, et al. vs. National Indian Gaming Commission, et al., decided April 17, 2003), a federal court for the first time considered the applicability of the Johnson Act to Class II gaming in light of the June 17, 2002, NIGC regulations, and held that the Johnson Act did not prohibit the use of devices that constituted technological aids within the meaning of IGRA. In reaching its decision, the Tenth Circuit gave significant deference to the NIGC and its rule-making process that defined technological aids. Similar deference to the NIGC in adopting these new regulations was afforded by the United States Court of Appeals for the Eighth Circuit in a case decided in favor of the Santee Sioux Tribe of Nebraska in March, 2003. The Company cannot predict whether the decisions of the Eighth and Tenth Circuits will be followed as law by other courts, absent an appeal to the Supreme Court that upholds the decision. However, should the case be followed by other courts, the threat of DOJ enforcement actions should be significantly reduced.

Two federal district courts and two circuit courts have specifically addressed the question of the electronic player stations used by the Company in the play of its games. Both district courts found that the Company's player stations are legal technological aids to the game of bingo, and therefore not in violation of the Johnson Act. The DOJ appealed both district court cases, but the decisions of the lower courts were affirmed by the Courts of Appeals for the Ninth and Tenth Circuits.

***Tribal-State Compacts.*** Video lottery terminals operated in conjunction with local central determinant systems are offered by the Company in the state of Washington pursuant to a compact between the state and certain Native American tribes in that state. These compacts are recognized by IGRA to permit Class III gaming, which would otherwise be illegal.

***Native American Regulation of Gaming.*** IGRA requires that Native American tribes adopt and submit for NIGC approval gaming ordinances that regulate the conduct of gaming by the tribe. While these ordinances vary from tribe to tribe, they commonly provide for the following:

- Native American ownership of the gaming operation;
- Establishment of an independent tribal gaming commission;
- Use of gaming net revenues for Native American government, economic development, health, education, housing or related purposes;
- Independent audits, including specific audits of all contracts for amounts greater than \$25,000;
- Native American background investigations and licenses;
- Adequate safeguards for the environment and the public health and safety; and

Dispute resolution procedures.

***MegaNanza Litigation and Related NIGC Settlement Proceedings.*** On April 15, 2002, the Company received an Advisory Opinion from the Deputy General Counsel of the NIGC, stating that MegaNanza and its related family of games were Class III games as defined by IGRA. On April 18, 2002, the Company filed a lawsuit against the NIGC in the United States District Court for the Northern District of Oklahoma, seeking a judicial declaration that the Company's MegaNanza family of games are Class II games. MegaNanza operates in what is called "nonstandard sequence," or in a "bonanza-bingo" style, meaning that the ball draw occurs before bingo cards are sold to players. On June 14, 2002, the NIGC, represented by and acting through the DOJ, filed a motion to dismiss the case, claiming the Court lacked jurisdiction on various procedural grounds. After the NIGC Commissioner issued a Notice of Violation, or NOV, to the Company's largest customer on June 17, 2002, the court granted the Company's motion seeking the issuance of a temporary restraining order against the NIGC from taking any enforcement actions against any of the Company's customers for playing MegaNanza. Notwithstanding the existence of the temporary restraining order against the NIGC, as a result of the issuance of the NOV, the Company's largest MegaNanza customer and certain other customers discontinued playing MegaNanza, and requested that the Company install Reel Time Bingo, a "standard sequence" bingo game, meaning that the ball draw occurs after the bingo cards are sold.



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**MULTIMEDIA GAMES, INC.**

**NOTES TO UNAUDITED CONSOLIDATED FINANCIAL STATEMENTS (Continued)**

On September 10, 2002, the Court granted the motion by the DOJ to dismiss the Company's action for lack of jurisdiction by the Court, but did not address the Company's substantive claim that MegaNanza was a legal Class II game. As a consequence of the dismissal, the temporary restraining order was dissolved, and the NIGC was no longer prohibited from issuing additional NOV's or from taking further enforcement actions. The Company appealed the granting of the motion to dismiss to the United States Court of Appeals for the Tenth Circuit. Prior to the Tenth Circuit's taking any action on the Company's appeal, the Company and the NIGC entered into a Settlement Agreement that established a fast-track process for the NIGC to consider and issue its opinion on the classification of a version of Reel Time Bingo. The Company has already introduced one of these versions, and intends to introduce others in the future to completely replace MegaNanza. In return for the fast-track process, the Company immediately dismissed with prejudice its pending appeal before the Tenth Circuit.

The Company and the NIGC, along with several of the Company's tribal customers remain in discussions regarding the attributes of a version of Reel Time Bingo Version 2.0, or RTB 2, that the NIGC would require before it will issue its opinion on a version of RTB 2. The Company believes that several of the attributes of RTB 2 recently requested by the NIGC are not required by applicable law, NIGC regulations or case law, but rather represent preferences and, therefore, should not be germane to the classification of RTB. Indeed, several of the recently requested changes have been found by every federal district and appeals court to have considered the issue to be permissible attributes of Class II gaming. Despite these differences, the Company remains optimistic that it will ultimately receive a satisfactory opinion from the NIGC that a version of RTB 2 is a legal Class II game; however, no assurance to that effect can be given, due to the uncertainties inherent in dealing with any federal agency.

Once the NIGC opinion is issued, the Settlement Agreement stipulates that the NIGC is required to notify all Class II tribes of its position on electronic bonanza-bingo style games. The Company believes that once the competitive landscape is leveled, its technology and gaming development teams will continue to develop new and exciting games that are superior to those of the competition, enabling the Company to capture a meaningful portion of the entertainment dollars in the Class II market that are currently played on competitors' bonanza-bingo style games.

**Other Litigation.** The Company is a defendant in a lawsuit filed in the Federal Court for the Western District of Oklahoma, alleging that the Company tortiously interfered with a contract between the plaintiff and a Native American tribe that granted the plaintiff the exclusive right to provide gaming machines to the tribe. In July 2003, the plaintiff stated its claim for damages in an amount ranging between \$5.6 million and \$13.2 million. The case was originally scheduled for a jury trial in August 2003, but at the plaintiff's request, has been rescheduled for trial in September 2003. The Company believes the plaintiff's cause of action is without merit and that the Company will prevail in the litigation. Accordingly, as of June 30, 2003, the Company had not recorded a provision for any losses that may result from the outcome of the trial; however, the Company can make no assurance as to the outcome, due to the uncertainties inherent in any jury trial.

**New York Lottery.** In May 2002, the New York Lottery notified the Company that it had been selected as the winning vendor to provide the central system for video lottery games to be operated at New York State racetracks. On December 17, 2002, the Company executed a definitive agreement to provide the central system, and submitted it to the New York Lottery for its final approval. On April 10, 2003, a final approved and signed contract was obtained from the New York State Comptroller and Attorney General.

During January 2003, in conjunction with purchasing equipment for build-out of the Company's central system related to the New York Lottery project, the Company secured \$12.0 million in vendor-based financing, of which \$3.7 million was drawn during the nine months ended June 30, 2003. The Company, at its option, may use the financing to fund equipment through direct financing, under capital or operating leases, or a

combination thereof.

As of June 30, 2003, the Company had acquired \$3.3 million of the anticipated \$15.8 million in equipment and third-party software required to develop, produce, and implement the central system. During the nine months ended June 30, 2003, the Company also capitalized \$1.6 million related to the internal development of the central system, and expects to capitalize additional internal development costs in the future.

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**MULTIMEDIA GAMES, INC.**

**NOTES TO UNAUDITED CONSOLIDATED FINANCIAL STATEMENTS (Continued)**

**Development Agreements.** In its efforts to place additional Class II player stations with both new and existing customers, the Company enters into development agreements to provide financing for new tribal gaming facilities or for the expansion of existing facilities. In return, the Company receives a percentage of the floor space in the facility dedicated to exclusive placement of its player stations, and a fixed percentage of the hold per day from the player stations over the term of the agreement. The agreements typically provide for repayment by the customer of some or all of the construction advances. Amounts that are advanced in excess of those reimbursed by the customer for real property and land improvements are allocated to an intangible asset. Generally, the remaining amounts advanced relate to personal property owned by the Company and located at the tribal gaming facility. These assets are carried in the Company's property and equipment.

As of June 30, 2003, the Company had entered into development agreements to provide up to a total of \$15.7 million towards the construction and/or expansion of three tribal gaming facilities, and had advanced \$9.3 million under these agreements. The Company is in various stages of discussion with new and existing customers to provide funding for similar development opportunities, and subsequent to June 30, 2003, entered into two additional agreements to provide up to \$19.5 million towards the construction and/or expansion of two tribal gaming facilities.

**Employment Agreement.** On March 26, 2003, as part of the CEO succession process, the Company entered into an employment agreement with Gordon Graves whereby Mr. Graves resigned as the Company's CEO on February 18, 2003 (the effective date of the agreement). Under the terms of the agreement, Mr. Graves will serve as the Chairman of the Board of Directors and as a member of the Company's Executive Committee through September 2003, and for 30-day successive periods thereafter, at the option of the Board. Mr. Graves receives a salary of \$12,500 per month for his services rendered on the Company's Executive Committee. If Mr. Graves discontinues his services on the Executive Committee but remains as Chairman of the Board, Mr. Graves shall be entitled to receive the same compensation paid to any other non-employee serving on the Board, but shall no longer be compensated as a member of the Executive Committee. So long as Mr. Graves is compensated for his membership on the Executive Committee, he is not separately compensated as a member of the Board.

Among other things, the employment agreement also contains a covenant not to compete by Mr. Graves, that begins on the effective date of the agreement, and extends for a period of three years from the time Mr. Graves no longer serves as the Chairman of the Board nor on the Company's Executive Committee. At the end of the three-year period, Mr. Graves, at his option, may continue not to compete against the Company. In consideration for his promise not to compete, Mr. Graves will receive \$250,000 per annum, payable monthly, commencing in February 2003, and ending upon Mr. Graves' death or his decision to compete against the Company. The Company recorded a liability for approximately \$2.0 million based on the present value of the estimated payments due Mr. Graves under the covenant not to compete during the actuarial life expectancy of Mr. Graves of 16 years. A corresponding intangible asset of approximately \$2.0 million was recorded for the covenant not to compete, and is being amortized on a straight-line basis over 5 years.

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

#### **OVERVIEW**

We are the leading supplier of online systems and linked, interactive Class II electronic gaming systems and player stations to the rapidly growing Native American gaming market. We design and develop hardware, software, networks and content that provide our customers with comprehensive gaming systems. Historically, we have focused our efforts on Class II central determinant gaming systems and Class III central determinant video lottery systems used primarily by Native American tribes.

We derive the majority of our gaming revenues from the placement of Class II player stations under participation arrangements, and to a lesser degree from the placement of Class III video lottery terminals, or VLTs, under lease-purchase or participation arrangements, and the back-office fees generated by Class III video lottery systems. A significantly smaller portion of our revenues are generated from the sale of VLTs and game licenses in the Class III market, except for a relatively few periods during which market conditions (e.g., the opening of a new casino, or a change in the law that allows existing casinos to increase the number of VLTs permitted under prior law) result in a one-time spike in the numbers of VLTs sold during the period.

#### *Class II Market*

We derive our Class II gaming revenues primarily from participation arrangements with our customers. Under participation arrangements, we retain ownership of the player stations installed at our customers' tribal gaming facilities, and receive revenue based on a percentage of the hold per day generated by each player station. The network-wide hold is reported by us as gaming revenue, and represents the total amount end users wager, less the total amount paid to end users for prizes. The amounts retained by the halls for their share of the hold are reported in our results of operations as allotments to hall operators, and are deducted from our total revenues to arrive at our net revenues. We believe that net revenue and our net revenue per player station per day are the most important factors for evaluating our performance in the Class II market. Net revenue per player station per day represents total revenues less allotments to hall operators, divided by the average number of player stations and the number of days in the period.

Our revenue growth has been driven primarily by our technological innovations, which have increased the net revenue per player station per day, and the increase in our installed Class II player station base. Our gaming platforms enable us to rapidly launch new games with moderate cost, which we believe also provide end users with greater levels of entertainment. We believe that this leads to a greater number of end users and to end users receiving more perceived value from their entertainment dollar.

Our New Generation gaming platform operates at a speed considerably faster than our Legacy gaming platform, generally resulting in end users playing a greater number of games on our New Generation platform than they otherwise could have on our Legacy gaming platform 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 games for longer periods of time than they would have played on our Legacy platform, resulting in a higher net revenue per player station on our New Generation platform.

As the market grows, and if the rules and regulations governing Class II gaming are clarified by court decisions and by improved rule-making procedures, we believe new competitors with significant gaming experience and financial resources will enter the Class II market. We believe

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the increased competition will intensify pressure on our pricing model, with the result that 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 more entertaining games with technological enhancements that we believe will appeal to end users, we believe that the level of net revenue retained by our customers from their installed base of player stations will become a more significant competitive factor, one that may require us to change the terms of our participation arrangements with customers. Consequently, we believe that a simple business model based upon the average hold per player station per day 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.

Since our inception, we produced MegaBingo, a live paper bingo game that originally featured a live bingo ball draw that was televised and transmitted to multiple bingo halls throughout the U.S. MegaBingo enabled players in participating halls to compete with players in other halls in a single live bingo game to win a large jackpot prize. Since introducing our Legacy and New Generation gaming platforms, we experienced a decline in the revenue generated by MegaBingo, as hall operators migrated to our Class II player stations, which many players found more entertaining. As a result of the

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continued decline both in the number of participating halls and in the resulting revenue during the quarter ended December 31, 2002, we initiated a plan to discontinue the play of MegaBingo in mid-February 2003, and held a championship game during April 2003 to conclude MegaBingo play. For the nine months ended June 30, 2003, MegaBingo revenues were \$392,000.

In May 1996, we introduced our Class II MegaMania game, the first in a series of high-speed, interactive bingo games based on our Legacy gaming platform, that are played on player stations linked with one another via a nationwide, broadband telecommunications network. In January 2001, we introduced our MegaNanza game, a New-Generation bonanza-style bingo game, where the balls are drawn before the bingo cards are purchased. MegaNanza plays faster than our Legacy games, and has generated increased revenues for us and our customers. In June 2002, we introduced Reel Time Bingo, a New-Generation-based high-speed standard sequence bingo game, in which the cards are purchased before the balls are drawn. We intend to convert substantially all of our remaining MegaNanza games to some version of Reel Time Bingo or another standard sequence bingo game, both in response to the settlement agreement reached between us and the NIGC, and to take advantage of improved technologies. We believe the conversion can be accomplished relatively easily, as MegaNanza and Reel Time Bingo are game engines that operate on our New Generation gaming platform, which, among other benefits, allows the conversion to be achieved by loading new software, either from our network operations center or at the customer's gaming facility. We expect to effect most conversions by having our field technicians or customer service personnel visit the customer's gaming facilities, as some game conversions require changing game-specific glass and other player station graphics. For the quarter ended June 30, 2003, MegaNanza and Reel Time Bingo accounted for 18% and 70%, respectively, of our Class II gaming revenues, compared to 45% and 43%, respectively, of our Class II gaming revenues during the quarter ended March 31, 2003. We believe this trend will continue as we convert the remaining MegaNanza games to Reel Time Bingo.

During our initial conversion from MegaNanza to Reel Time Bingo in June 2002, and the subsequent period of system optimization, we realized a lower net revenue per player station per day on our Reel Time Bingo player stations than we had historically realized with MegaNanza. We believe this is a normal consequence of converting a highly popular game to a new one, since end users require time to familiarize themselves with the new game. Consequently, during the fiscal year ended September 30, 2002, our average net revenue per player station per day for Reel Time Bingo was less than that of MegaNanza.

For the quarter ended June 30, 2003, the net revenue per player station per day for Reel Time Bingo was approximately \$32, compared to approximately \$44 for MegaNanza. We converted 396 MegaNanza units to Reel Time Bingo during the quarter, and as of June 30, 2003, 883 MegaNanza player stations, representing 9.6% of our total installed base of Class II player stations, remained in five facilities with higher holds than the historical network average for MegaNanza. We believe the net revenue per player station per day for Reel Time Bingo was affected by converting larger numbers of lower-performing MegaNanza player stations to Reel Time Bingo, while retaining the higher-performing MegaNanza units in operation. On a casino-to-casino comparison, where MegaNanza player stations have been wholly converted to Reel Time Bingo, and prior to recent changes in the competitive environment, those units have generally performed equal to or better than the MegaNanza units replaced, following a player familiarization period.

### ***Class III Market***

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

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We also receive back-office fees based on a share of the hold per day from both leased and sold VLTs. Back-office fees cover the service and maintenance costs for back-office servers installed in each hall to run our Class III games, as well as the cost of related software updates. For those VLTs sold to our customers, the back-office fees are considerably smaller than the revenue share we receive from Class II player stations being rented under participation agreements. Accordingly, we derive our Class III revenues to a greater extent from VLT sales, compared to the level of gaming revenues derived from participation arrangements in the Class II market.

In June 1999, we first installed Class III VLTs in the state of Washington, which was the first state where Class III video lottery systems were permitted by Native American-state compact. During 2000, we had significant sales of Class III VLTs, as initial sales were made pursuant to newly adopted Native American compacts with the state of Washington

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which, by their terms, limited the number of installed Class III VLTs permitted on Native American land. As new casinos are introduced into the Washington market or existing casinos are expanded, and as the compact limitations on the number of installed VLTs are eased, we have experienced brief periods during which the number of VLTs sold has spiked, thereby resulting in anomalies when comparing one period to another. We expect these same conditions will result in additional sales of Class III VLTs in the future. During the quarter ended June 30, 2003, we sold a record 1,062 VLTs, primarily resulting from two customers opening new casinos, and a lease-purchase customer converting to purchase. For the nine months ending June 30, 2003, we had an average of 2,156 Class III VLTs in service, compared to 1,803 units during the same period of 2002.

### ***License Agreements***

We have license agreements with WMS® Gaming, Inc., or WMS, and Bally Gaming Inc., or Bally, to use certain trademarks, logos and graphics in connection with our Class III games. We, in turn, resell these licenses to our customers in connection with the installation of our Class III VLTs that use these licenses. Revenues from these license fees are reported in our results of operations under player station and license sale and lease revenue. We also have a similar license agreement for the Class II market with Bally, WMS, and Mikohn Gaming Corporation. Because we generally install our Class II player stations and games with our customers under participation arrangements, thereby retaining ownership of the player stations, we do not resell licenses for use in the Class II market.

### ***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, player station platforms and game 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 66% to \$2.5 million for the three months ended June 30, 2003, from \$1.5 million for the same period of 2002. For the nine months ended June 30, 2003, research and development expenses increased by 62% to \$7.5 million, from \$4.6 million in the same period of 2002. The increase in research and development expense in both the three and nine months was primarily driven by an increased headcount in our development group, and the resulting increase in corporate facilities allocation as we have focused our internal efforts on the development of new gaming products and systems for the Class II and Class III markets, as well as potential markets.

### ***Capitalized Software***

We capitalize certain costs related to the design and development of our gaming products and systems. We generally amortize internally developed games over an eighteen-month period, gaming platforms and engines over a three-year period, and our central management systems over a five-year period. During the quarter ending June 30, 2003, we capitalized \$1.0 million of costs related to the development of our gaming products and systems.

### ***Trademarks***



Other registered trademarks and tradenames used by us include: Betnet, MegaBingo®, MegaMania®, MegaNanza, and Reel Time Bingo. All references herein to those trademarks and tradenames are deemed to include the applicable tradename or trademark designation.

**Table of Contents****RESULTS OF OPERATIONS**

The following tables outline our end-of-period and average installed base of player stations for the three months ended June 30, 2003 and 2002:

	<b>Three Months Ended June 30,</b>	
	<b>2003</b>	<b>2002</b>
<b>End-of-period installed player station base:</b>		
Class II		
Reel Time Bingo	6,686	1,024
MegaNanza	883	3,579
New Generation Platform		
Legacy Platform	1,675	2,472
Class III	2,455	2,093
<b>Three Months Ended June 30,</b>		
<b>2003 2002</b>		
<b>Average installed player station base:</b>		
Class II		
Reel Time Bingo	5,840	337
MegaNanza	1,112	3,860
New Generation Platform		
Legacy Platform	1,731	2,531
Class III	2,244	2,084

**Three Months Ended June 30, 2003 Compared to the Three Months Ended June 30, 2002**

Total revenues increased 22% to \$96.0 million during the three months ended June 30, 2003, from \$78.6 million in the same period in 2002, primarily as the result of an \$8.0 million, or 11%, increase in Class II gaming revenue, and a \$9.9 million, or 391% increase in player station and license sale and lease revenue. Partially offsetting these increases were a decrease in Class III gaming revenue of \$562,000, and a decrease in MegaBingo revenue of \$294,000. Specifically, for the three months ended June 30, 2003:

***Gaming Revenue Class II***

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New Generation games generated revenues of \$72.3 million, compared to \$60.4 million in the same period in 2002, or a 20% increase, based on an average of 6,952 and 4,197 player stations in daily operation during each of the respective periods.

There was an average of 1,731 Class II Legacy player stations in daily operation, a 32% decrease from 2,531 in the same period of 2002, as certain tribal gaming facilities replaced Legacy player stations with higher-performing units.

MegaBingo revenues decreased to zero from \$294,000 in the same period of 2002. The decrease in MegaBingo revenues was the result of discontinuing game play during mid-February 2003 and holding the final MegaBingo championship game in April 2003.

### ***Gaming Revenue Class III***

Total gaming revenues from Class III video lottery systems, which primarily consist of rental and back-office fees, decreased 35% to \$1.1 million, from \$1.6 million for the same period in 2002. The decrease in Class III gaming revenue was primarily due to a customer converting from equipment rental to purchase in the last quarter of fiscal 2002, and the resulting decrease in our Class III rental fees. The decrease in Class III rental fees was partially offset by a 25% increase in Class III back-office fees to \$928,000 in the three months ended June 30, 2003, from \$745,000 during the same period of 2002, resulting from a 8% increase in the average number of Class III VLTs in service to 2,244 units, from 2,084 units in the prior period.

### ***Player Station and License Sale and Lease Revenue***

Player station and license sale and lease revenue increased by 391% to \$12.5 million, from \$2.5 million in the same period of 2002. Two customers opened new facilities, and a lease-purchase customer converted to a purchase during the quarter, resulting in the sale of 1,062 Class III player stations.

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Allotments to hall operators increased 11% to \$58.0 million for the three months ended June 30, 2003, from \$52.4 million in the same period of 2002. The increase in allotments to hall operators was attributable to the increase in hall commissions related to our Class II gaming, and is commensurate with the overall increase in our Class II gaming revenue. MegaBingo hall commissions decreased to zero, which relates to the decline in related MegaBingo revenues discussed above.

Bingo prizes and related costs decreased 83% to \$68,000 for the three months ended June 30, 2003, from \$395,000 in the same period of 2002. The costs during the current quarter relate to the final MegaBingo championship game held in April 2003.

Cost of player stations and licenses sold increased \$6.0 million, or 450%, to \$7.3 million for the three months ended June 30, 2003, from \$1.3 million in the same period of 2002. The increase is due to the increase in related revenue discussed above.

Selling, general and administrative expenses increased 11% to \$10.6 million for the three months ended June 30, 2003, from \$9.6 million in the same period of 2002. Salaries and wages and employee benefits increased primarily as a result of additional personnel hired to address our gaming network and development needs. The need for additional office space, due to a greater number of employees, increased rent expense. Travel costs increased due to the greater number of employees and the pursuit of new business. Legal and professional fees increased primarily as a result of increased legal and professional services for research into new products and markets. Repairs and maintenance and insurance increased due to the greater number of player stations in the field during the quarter ended June 30, 2003, compared to the same quarter in 2002. During the quarter ending June 30, 2002, offering costs of \$780,000 related to an abandoned public offering were written off.

Amortization and depreciation expense increased 52% to \$5.5 million for the three months ended June 30, 2003, from \$3.6 million for the same period of 2002, primarily as a result of a 66% increase in the average installed base of New Generation player stations. The increase in player station depreciation on participation games during the June 2003 quarter was partially offset by accelerated depreciation on player stations under lease-purchase arrangements with customers having payment terms under one year during the same period in 2002.

Interest income decreased 6% to \$71,000 for the three months ended June 30, 2003, from \$76,000 in the same period of 2002.

Interest expense amounted to \$187,000 for the three months ended June 30, 2003, and \$10,000 in the same period of 2002, as the result of an increase in long-term debt and capital leases compared to the same quarter in fiscal 2002.

Income tax expense increased 21% to \$5.5 million for the three months ended June 30, 2003, from \$4.5 million in the same period of 2002, due to higher taxable income. The effective tax rate decreased to 38.3% for the three months ended June 30, 2003, from 39.9% in the same period of 2002, as a result of lower-than-expected blended state income tax rates.

## **Nine Months Ended June 30, 2003 Compared to the Nine Months Ended June 30, 2002**

Total revenues increased 26% to \$269.6 million during the nine months ended June 30, 2003, from \$213.5 million in the same period in 2002, primarily as the result of a \$48.0 million, or 24% increase in Class II gaming revenue, and a \$9.2 million, or 147% increase in player station and

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license sale and lease revenue. Partially offsetting these increases were a decrease in Class III gaming revenue of \$1.3 million, and a decrease in MegaBingo revenue of \$571,000. Specifically, for the nine months ended June 30, 2003:

### *Gaming Revenue Class II*

New Generation games generated revenues of \$218.1 million, compared to \$158.8 million in the same period in 2002, a 37% increase, based on an average of 6,341 and 3,426 player stations in daily operation during each of the respective periods.

There was an average of 2,068 Class II Legacy player stations in daily operation, a 25% decrease from 2,758 in the same period of 2002, since we experienced a higher-than-historical removal rate during the current period as certain tribal gaming facilities replaced Legacy player stations with higher-performing units.

MegaBingo revenues decreased 59% to \$392,000, from \$963,000 in the same period of 2002. This decrease in MegaBingo revenues was the result of discontinuing game play during mid-February 2003 and holding the final MegaBingo championship game in April 2003.

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***Gaming Revenue Class III***

Total gaming revenues from Class III video lottery systems, which consist of rental and back-office fees, decreased 29% to \$3.1 million, from \$4.4 million for the same period in 2002. The decrease in Class III gaming revenue was primarily due to a customer converting from equipment rental to purchase in the last quarter of fiscal 2002, and the resulting decrease in our Class III rental fees. The decrease in Class III rental fees was partially offset by a 23% increase in Class III back-office fees to \$2.6 million in the nine months ended June 30, 2003, from \$2.1 million during the same period of 2002, resulting from a 20% increase in the average number of Class III VLTs in service to 2,156 units, from 1,803 units in the prior period.

***Player Station and License Sale and Lease Revenue***

Player station and license sale and lease revenue increased by 147% to \$15.6 million, from \$6.3 million in the same period of 2002. Two customers opened new facilities, and a lease-purchase customer converted to a purchase during the quarter, resulting in the sale of 1,062 player stations.

Allotments to hall operators increased 23% to \$175.6 million for the nine months ended June 30, 2003, from \$142.8 million in the same period of 2002. The increase in allotments to hall operators was attributable to the increase in hall commissions related to our Class II gaming, and is commensurate with the overall increase in our Class II gaming revenue. Hall commissions related to MegaBingo decreased 80%, which relates to the decline in related MegaBingo revenues discussed above.

Bingo prizes and related costs increased 4% to \$1.2 million for the nine months ended June 30, 2003, from \$1.1 million in the same period of 2002, resulting from the costs associated with the final MegaBingo championship game.

Cost of player stations and licenses sold increased \$4.6 million, or 110%, to \$8.7 million for the nine months ended June 30, 2003, from \$4.1 million in the same period of 2002. The increase is due to the increase in related revenue discussed above.

Selling, general and administrative expenses increased 20% to \$29.7 million for the nine months ended June 30, 2003, from \$24.7 million in the same period of 2002. Salaries and wages and employee benefits increased primarily as a result of additional personnel hired to address our gaming network and development needs and the pursuit of new business. The need for additional office space, due to a greater number of employees, increased rent expense. Travel costs increased due to the greater number of employees and the pursuit of new business. Legal and professional fees increased primarily as a result of increased legal and professional services for research into new products and markets. Repairs and maintenance and insurance increased due to the greater number of player stations in the field during the nine months ended June 30, 2003, compared to the same period in 2002. During fiscal 2002, offering costs of \$780,000 related to an abandoned public offering were written off.

Amortization and depreciation expense increased 45% to \$15.1 million for the nine months ended June 30, 2003, from \$10.4 million for the same period of 2002, primarily as a result of an 85% increase in the average installed base of New Generation player stations. The increase in player station depreciation on participation games during the nine months ended June 30, 2003 was partially offset by accelerated depreciation on player stations under lease-purchase arrangements with customers having payment terms under one year during the same period in 2002.

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Interest income increased 39% to \$263,000 for the nine months ended June 30, 2003, from \$189,000 in the same period of 2002, primarily resulting from higher interest-bearing cash balances during 2003.

Interest expense amounted to \$245,000 for the nine months ended June 30, 2003, and \$38,000 for the same period in 2002, increasing as the result of an increase in long-term debt and capital leases, compared to the same period in fiscal 2002.

Income tax expense increased 27% to \$15.0 million for the nine months ended June 30, 2003, from \$11.9 million in the same period of 2002, due to higher taxable income. The effective tax rate decreased to 38.3% for the nine months ended June 30, 2003, from 39.2% in the same period of 2002, as a result of lower-than-expected blended state income tax rates.

### **CRITICAL ACCOUNTING POLICIES**

We prepare our consolidated financial statements in conformity with accounting principles generally accepted in the United States of America. As such, we are required to make certain estimates, judgments and assumptions that we believe are reasonable based on the information available. These estimates and assumptions affect the reported amounts of assets

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and liabilities at the date of the financial statements, and the reported amounts of revenues and expenses during the periods presented. There can be no assurance that actual results will not differ from those estimates. We believe the following represent our most critical accounting policies:

**Revenue Recognition.** We derive our Class II gaming revenues primarily from participation arrangements with our customers. Under participation arrangements, we retain ownership of player stations installed at our customers' tribal gaming facilities, and receive revenue based on a percentage of the hold per day generated by each player station. We report the network-wide hold as gaming revenue. The hold represents the total amount end users wager, less the total amount paid to end users for prizes. Amounts retained by the halls for their share of the hold are reported in our results of operations as allotments to hall operators, and are deducted from our total revenues to arrive at our net revenues.

The majority of our Class III VLTs have been sold to customers outright, for a one-time purchase price, and are reported in our results of operations as player station and license sale and lease revenue. Certain game themes used by us in the Class III market have been licensed from third parties and are resold to customers along with our Class III VLTs. Revenues from sales of Class III VLTs and the sale of player station licenses are recognized when the units are delivered to the customer and the licensed games installed. For the remainder of our Class III VLTs, we enter into either participation arrangements similar to those for our Class II player stations, or lease-purchase arrangements. Under lease-purchase arrangements, we receive a series of lease payments based on a percentage of the customer's hold per day generated from the leased VLTs. At the end of the lease period, we transfer ownership of the VLTs to the customer.

In our Class III market, we also receive back-office fees based on a share of the hold per day. Back-office fees cover the service and maintenance costs for our back-office servers installed in each hall to run our Class III games, as well as the related cost of software updates. For those Class III VLTs sold to our customers, the back-office fees are considerably smaller than the revenue share we receive from Class II player stations being rented under participation arrangements. Accordingly, we derive our Class III revenues to a greater extent from VLT sales when compared to participation arrangements in the Class II market.

**Inventory.** Our current inventory consists primarily of completed Class III VLTs, and components for Class III VLTs we expect to sell to customers within the next year. Our non-current inventory comprises both completed Class II player stations, and new and refurbished components for Class II player stations we expect to place under participation arrangements under which we retain title to the unit. Class II units are transferred from non-current inventory to property and equipment upon consummation of participation arrangements, and as such units are placed with customers.

**Property and Equipment.** We state property and equipment at cost. The cost of property and equipment is depreciated over their estimated useful lives generally using the straight-line method for financial reporting, and accelerated methods for tax reporting purposes. A substantial portion of our property and equipment is depreciated over two to seven years. Player stations placed with customers under lease arrangements where player station ownership is conveyed to the customer at the end of the lease term is depreciated over the shorter of the lease term or three years. Property and equipment includes a pool of rental player stations, i.e., the rental pool. Rental pool units are those which have previously been in the field, but are currently back at our facility being refurbished and/or awaiting redeployment. Routine maintenance of property and 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 and equipment 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 operations.

We state internally developed gaming software at cost, which we amortize over the estimated useful life of the software, generally using the straight-line method. We amortize internally developed games over an eighteen-month period, gaming platforms and engines over a three-year period, and our central management systems over a five-year period. We capitalize software development costs once technological feasibility has been established, and begin amortizing the software once in service. We expense any subsequent software maintenance costs, such as bug fixes and subsequent testing, as incurred. Software development projects that are discontinued are expensed at the time the determination to



discontinue is made.

We review our property and equipment for impairment whenever events or changes in circumstances indicate we may not recover the carrying amount of an asset. We measure recoverability of assets to be held and used by comparing the carrying amount of an asset to future cash flows expected to be generated by the asset. If we determine an asset to be impaired, we measure the impairment as the amount by which the carrying amount of the assets exceeds their fair value, considering the discounted future net cash flows. We report assets to be disposed of at the lower of the carrying amount or the fair value less costs of disposal.

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**Allowance for Doubtful Accounts.** We maintain an allowance for doubtful accounts related to our accounts receivable and notes receivable that have been deemed to have a high risk of collectibility. We review our accounts receivable and notes receivable on a monthly basis to determine if any receivables will potentially be uncollectible. We analyze historical collection trends and changes in our customer payment patterns, customer concentration and credit worthiness when evaluating the adequacy of our allowance for doubtful accounts. We include any receivable balances that are determined to be uncollectible, along with a general reserve, in our overall allowance for doubtful accounts.

**Inventory Reserves.** Inventories are stated at the lower of cost (first in, first out) or market. We regularly review our inventory quantities on hand and record reserves for excess and obsolete inventory based primarily on our estimated forecast of product demand and production and service requirements.

**Stock-Based Compensation.** We apply Accounting Principles Board Opinion, or APB, No. 25 in accounting for our stock option plans, rather than the alternative fair value accounting provided under SFAS No. 123, Accounting for Stock-Based Compensation, as amended by SFAS No. 148, Accounting for Stock-Based Compensation Transition and Disclosure. Under APB No. 25, no compensation expense is recognized for grants of options to common-law employees and directors at an exercise price equal to or greater than the market price of the stock on the date of grant. Accordingly, based on our grants during the three and nine months ended June 30, 2003 and 2002, no compensation expense has been recognized.

## **RECENT ACCOUNTING PRONOUNCEMENTS**

In June 2002, the FASB issued SFAS No. 146, Accounting for Costs Associated with Exit or Disposal Activities, which addresses accounting for restructuring and similar costs. SFAS No. 146 supersedes previous accounting guidance, principally Emerging Issues Task Force, or EITF, Issue No. 94-3. This Statement is effective for restructuring activities initiated after December 31, 2002. SFAS No. 146 requires that the liability for costs associated with an exit or disposal activity be recognized when the liability is incurred. Under EITF No. 94-3, a liability for an exit cost was recognized at the date of a company's commitment to an exit plan. SFAS No. 146 also establishes that the liability should initially be measured and recorded at fair value. The adoption of this Statement did not have a material impact on our financial position and results of operations.

In December 2002, the FASB issued SFAS No. 148, Accounting for Stock-Based Compensation Transition and Disclosure. SFAS No. 148 amends SFAS No. 123, Accounting for Stock-Based Compensation to provide alternative methods of transition for a voluntary change to the fair value method of accounting for stock-based employee compensation. It also amends the disclosure provisions of SFAS No. 123 and APB Opinion No. 28, Interim Financial Reporting, to require disclosure in the summary of significant accounting policies of the effects of an entity's accounting with respect to stock-based employee compensation on reported net income and earnings per share in annual and interim financial statements. The disclosure provisions of SFAS No. 148 are effective for interim or annual periods beginning after December 15, 2002. We adopted the disclosure provisions of SFAS No. 148 in the quarter ending March 31, 2003, and such adoption did not have a material impact on our financial position and results of operations.

In January 2003, the FASB issued FIN 46, Consolidation of Variable Interest Entities, (VIEs). FIN 46 establishes standards for determining under what circumstances VIEs should be consolidated with their primary beneficiary, including those to which the usual condition for consolidation does not apply. FIN 46 also requires disclosures about unconsolidated VIEs in which we have a significant variable interest. The consolidation requirements of FIN 46 apply immediately to VIEs created after January 31, 2003. The consolidation requirements apply to older entities in the first fiscal year or interim period beginning after June 15, 2003. Certain disclosure requirements apply in all financial statements issued after January 31, 2003. The adoption of this Statement did not have a material impact on our financial position and results of operations.

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In April 2003, the FASB issued SFAS No. 149, Amendment of Statement 133 on Derivative Instruments and Hedging Activities. SFAS No. 149 amends and clarifies financial accounting and reporting for derivative instruments, including certain derivative instruments embedded in other contracts (collectively referred to as derivatives) and for hedging activities under SFAS No. 133, Accounting for Derivative Instruments and Hedging Activities. This statement is effective for contracts entered into or modified after June 30, 2003, and for hedging relationships designated after June 30, 2003. We do not expect the adoption of this Statement will have a material impact on our financial position and results of operations.

In May 2003, the FASB issued SFAS No. 150, Accounting for Certain Financial Instruments with Characteristics of both Liabilities and Equity. SFAS No. 150 establishes standards for how an issuer classifies and measures certain financial instruments with characteristics of both liabilities and equity. It requires that an issuer classify a financial

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instrument that is within its scope as a liability (or an asset in some circumstances). Many of these instruments were previously classified as temporary equity. SFAS No. 150 will be effective for financial instruments entered into or modified after May 31, 2003, and otherwise shall be effective at the beginning of the first interim period beginning after June 15, 2003. The adoption of this Statement did not have a material impact on our financial position and results of operations.

**LIQUIDITY AND CAPITAL RESOURCES**

At June 30, 2003, we had unrestricted cash and cash equivalents of \$19.0 million, compared to \$15.2 million at September 30, 2002. Our working capital at June 30, 2003 was \$22.2 million, compared to \$11.5 million at September 30, 2002.

As of June 30, 2003, 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	
Long-term debt <sup>(1)</sup>	\$ 1,737	\$ 3,285	\$ 1,245	\$	\$ 6,267
Capital leases <sup>(2)</sup>	958	1,933			2,891
Operating leases <sup>(3)</sup>	1,399	2,003	1,943	668	6,013
Purchase commitments <sup>(4)</sup>	2,925	1,875			4,800
Payments due under employment agreement <sup>(5)</sup>	250	500	500	2,645	3,895
Gaming facility development arrangements <sup>(6)</sup>	6,400				6,400
<b>Total</b>	<b>\$ 13,669</b>	<b>\$ 9,596</b>	<b>\$ 3,688</b>	<b>\$ 3,313</b>	<b>\$ 30,266</b>

(1) Consists of various three to five year loans for the purchase of automobiles and property and equipment at an overall average annual interest rate of 8.0%, and a five-year loan related to financing our corporate aircraft at an annual interest rate of LIBOR plus 2.75%.

(2) Consists of various three-year capital leases for property and equipment at an overall average annual interest rate of 8.4%.

(3) Consists of operating leases for our facilities and office equipment that expire at various times through 2007.

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

(5) Represents the present value of the expected future payments due, based on life expectancy tables, to Gordon Graves for his non-compete agreement entered into under his Employment Agreement, further discussed under PART I Item 1. Financial Statements Commitments and Contingencies.

(6) Represents commitments for payments toward development and construction and/or expansion of tribal gaming facilities.

During the nine months ended June 30, 2003, we generated cash from operations of \$22.8 million, compared to \$29.3 million for the same period in 2002. This decrease was primarily the result of an increase in cash used for purchases of inventory of \$5.1 million and an increase in notes receivable of \$4.4 million, partially offset by an increase in net income to \$24.3 million for the nine months ended June 30, 2003, from \$18.5 million for the same period in 2002, and an increase in amortization and depreciation expense of \$4.6 million.

Cash used in investing activities was \$25.8 million for the nine months ended June 30, 2003, compared to \$23.0 million for the same period in 2002. The increase was the result of an increase in amounts advanced for real property and land improvements related to the development of tribal gaming facilities of \$4.8 million, offset by a decrease in cash capital expenditures to \$21.0 million for the nine months ended June 30, 2003, compared to \$23.0 million during the for the same period of 2002. During the nine months ended June 30, 2003, cash capital expenditures consisted of \$8.9 million related to the placement of player stations and related gaming equipment, \$4.7 million related to costs incurred during

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the nine months for tribal gaming facilities, \$3.4 million related to internally developed software, \$869,000 related to the purchase of portable buildings used for temporary expansion of gaming facilities, and the remaining \$3.1 million related to corporate infrastructure and other asset purchases.

Cash provided by financing activities was \$6.7 million for the nine months ended June 30, 2003, compared to \$8.4 million for the same period in 2002. For the nine months ended June 30, 2003, we received proceeds from the exercise of stock options and warrants and the related tax benefit totaling \$2.9 million, compared to \$7.8 million during the same period in 2002. Cash flow provided by financing activities for the nine months ended June 30, 2003 also included proceeds from long-term debt of \$2.5 million drawn on the term loans under the Credit Facility and \$1.7 million related to financing our corporate aircraft.

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### ***Capital Resources***

Our projected capital expenditures for the remainder of the year will consist of player stations and related gaming equipment that are placed with our Class II customers under participation arrangements, substantial capital outlays in connection with the joint development of new and expanded tribal gaming facilities, for the build-out of the central system for the New York Lottery project described in further detail below, and may include substantial capital expenditures in connection with potential acquisitions. In pursuing our acquisition strategy and our strategy to partner with current and prospective customers to jointly develop tribal gaming facilities that will house our player stations, 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 player stations that we are able to place in service during the year, and the number and size of tribal gaming facilities we choose to develop. Additional capital expenditures will be required for player stations if we are successful in introducing our games into new markets, such as the charity bingo market. In addition to manufacturing our own, we also purchase player stations from Bally and WMS, and licenses from Bally, WMS and Mikohn.

In May 2002, the New York Lottery notified us that it had selected us as the winning vendor to provide the central system for video lottery games to be operated at certain New York State racetracks. On December 17, 2002, we executed a definitive agreement to provide the central system, and submitted it to the New York Lottery. On April 10, 2003, a final approved and signed contract was obtained from the New York State Comptroller and Attorney General. During January 2003, we secured \$12.0 million in vendor-based financing to lease equipment for the New York Lottery project and the build-out of the central system. As of June 30, 2003, we had acquired \$3.3 million of the anticipated \$15.8 million in equipment and third-party software required to develop, produce and implement the central system. During the nine months ended June 30, 2003, we also capitalized \$1.6 million related to the internal development of a central system, and expect to capitalize additional internal development costs in the future.

During the nine months ended June 30, 2003, we entered into three development agreements (further described under **PART I** Item 1. Financial Statements - Commitments and Contingencies ) with our customers to provide up to \$15.7 million towards the construction of a new tribal gaming facility and the expansion of two facilities. The development agreements typically require that some or all of the construction advances be repaid to us. As of June 30, 2003, we had advanced a total of \$9.3 million under such agreements, and expect to advance the remaining \$6.4 million over the next twelve months.

We believe that our existing unrestricted cash and cash equivalents and cash from operations can sustain our current operations, which could include a portion of the financing required from us in connection with development projects, depending upon the timing and mix of those projects. In addition, we maintain a \$15 million Credit Facility (further described under **PART I** Item 1. Financial Statements - Significant Accounting Policies ) with Comerica Bank, subject to certain availability calculations, to provide access to funds that might be required for working capital needs resulting from the timing of our development activities and player station placements. There can be no assurance, however, that our business will continue to generate cash flow at current levels. 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. There can be no assurance that sufficient funds will be available 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 450,000 shares of our common stock, effective April 2000, and an additional 1,500,000 shares of our common stock, effective September 2001. The timing and total number of shares repurchased will depend upon prevailing market conditions and other investment opportunities. During fiscal 2002, we repurchased 606 shares of our Common Stock at an average cost of

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\$28.33. During fiscal 2001, we repurchased 831,865 shares of our Common Stock at an average cost of \$6.31. During the nine months ended June 30, 2003, we settled stockholders' notes receivable in exchange for 30,858 shares of our Common Stock, at a price of \$20.87 per share. At June 30, 2003, we had approximately 3.4 million options outstanding, with exercise prices ranging from \$1.33 to \$30.95 per share. Of the options outstanding, approximately 1.3 million were exercisable at June 30, 2003.

### **CONTINGENCIES**

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

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### **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 expressions. Such statements are subject to a number of uncertainties that could cause the actual results to differ materially from those projected. Such factors include, but are not limited to, the uncertainties inherent to the outcome of any litigation of the type described in this quarterly report under PART II Item 1. Legal Proceedings, as well as those other factors as described under Item 1. Business Risk Factors, contained in our Annual Report on Form 10-K for the fiscal year ended September 30, 2002, and as described under Risk Factors in our Quarterly Reports on Form 10-Q that we file within 45 days of the end of our first three fiscal quarters in fiscal year 2003, which are incorporated herein by this reference. Given these uncertainties, readers of this Quarterly Report are cautioned not to place undue reliance upon such statements.

### **RISK FACTORS**

The following risk factors could materially and adversely affect our operating results and could cause actual events to differ materially from those predicted in any forward-looking statements related to our business.

**We face legal and regulatory uncertainties that threaten our ability to conduct our business, increase our cost of doing business and divert substantial management time away from our operations.**

Virtually all of our business relates to gaming activities on Native American lands. These activities are subject to federal regulation under the Johnson Act, IGRA, the rules and regulations adopted by gaming commissions established by Native American tribes to regulate gaming, and by state and local authorities to the extent the gaming activities constitute Class III gaming.

The Johnson Act broadly defines illegal games and illegal equipment to include any machine or mechanical device designed primarily for gambling, that, when operated, delivers money to a player as the result of the application of an element of chance. Trying to accommodate this broad definition of illegal games and illegal equipment within the provisions of IGRA that are expressly intended to encourage the legal use by tribes of Class II electronic, computer, or other technological aids has created a continuing source of friction between regulatory authorities, vendors of Class II games and electronic player stations, and the Native American customers who use these Class II games and player stations at their gaming facilities. On June 17, 2002, the NIGC published final rules, effective July 16, 2002, defining the terms electronic, computer or other technological aids, electronic or electromechanical facsimile, and games similar to bingo as used in IGRA, which may over time provide guidance and greater clarity in this area.



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In a recent decision of the United States Court of Appeals for the Tenth Circuit (*Seneca-Cayuga Tribe of Oklahoma, et al. vs. National Indian Gaming Commission, et al.*, decided April 17, 2003), a federal court for the first time considered the applicability of the Johnson Act to Class II gaming in light of the June 17, 2002, NIGC regulations, and held that the Johnson Act did not prohibit the use of devices that constituted technological aids within the meaning of IGRA. In reaching its decision, the Tenth Circuit gave significant deference to the NIGC and its rule-making process that defined technological aids. Similar deference to the NIGC in adopting these new regulations was afforded by the United States Court of Appeals for the Eighth Circuit in a case decided in favor of the Santee Sioux Tribe of Nebraska in March, 2003. We cannot predict whether the decisions of the Eighth and Tenth Circuits will be followed as law by other courts, absent an appeal to the Supreme Court that upholds either decision. However, should the case be followed by other courts, the threat of enforcement actions by the Department of Justice, or DOJ, should be significantly reduced.

All Native American tribes are required by IGRA to adopt ordinances to regulate gaming as a condition of their right to conduct gaming on Native American lands. These ordinances often include the establishment of gaming commissions that make their own judgment about whether an activity is Class II or Class III gaming. Generally, this independent judgment has been exercised for games introduced into the market, prior to any determination of legality by the NIGC. Historically, when the NIGC has determined that an activity is Class III gaming after it has been introduced, tribes have either been unwilling to continue the activity or have litigated the matter in federal court.

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Notwithstanding the recent decisions of the Eighth and Tenth Circuits and the new regulations adopted by the NIGC, we believe that the legality of our activities remains subject to regulatory challenges, litigation, and enforcement actions by multiple regulatory bodies. Any such action could materially and adversely affect our ability to install and operate our games and electronic player stations, could be costly to defend, and could divert management's time and attention away from our operations. See *Certain Risk Factors*. We are awaiting an opinion from the NIGC on Reel Time Bingo; if the NIGC rules that Reel Time Bingo is a Class III game, or imposes requirements as a condition to issuing a favorable Class II opinion that render our games less enjoyable than other competing sources of gaming or entertainment, we may lose revenue in the Class II market.

We cannot assure you that new laws and regulations relating to our business will not be enacted, or that existing laws and regulations will not 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 player stations, games and systems, and our ability to generate revenues from some or all of our Class II games. Regulatory uncertainty also increases our cost of doing business. We dedicate significant time and incur significant expense on new game development without any assurance that the NIGC or other federal, state and local agencies or Native American governments will agree that each of our games meets applicable regulatory requirements. We also devote significant time and expense in 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.

**We are awaiting an opinion from the NIGC on Reel Time Bingo; if the NIGC rules that Reel Time Bingo is a Class III game, or imposes requirements as a condition to issuing a favorable Class II opinion that render our games less enjoyable than other competing sources of gaming or entertainment, we may lose revenue in the Class II market.**

On April 15, 2002, we received an Advisory Opinion from the Deputy General Counsel of the NIGC, stating that MegaNanza and its related family of games were Class III games as defined by IGRA. On April 18, 2002, we filed a lawsuit against the NIGC in the United States District Court for the Northern District of Oklahoma, seeking a judicial declaration that our MegaNanza family of games are Class II games. MegaNanza operates in what is called "nonstandard sequence," or in a "bonanza-bingo" style, meaning that the ball draw occurs before bingo cards are sold to players. On June 14, 2002, the NIGC, represented by and acting through the DOJ, filed a motion to dismiss the case, claiming the Court lacked jurisdiction on various procedural grounds. After the NIGC Commissioner issued a Notice of Violation, or NOV, to our largest MegaNanza customer on June 17, 2002, the court granted our motion seeking the issuance of a temporary restraining order against the NIGC from taking any enforcement actions against any of our customers for playing MegaNanza.

Notwithstanding the existence of the temporary restraining order against the NIGC, as a result of the issuance of the NOV, our largest MegaNanza customer and certain other customers discontinued playing MegaNanza, and requested that we install Reel Time Bingo, a "standard sequence" bingo game, meaning that the ball draw occurs after the bingo cards are sold.

On September 10, 2002, the Court granted the motion by the DOJ to dismiss our action for lack of jurisdiction by the Court, which did not address the substantive merits of our claim that MegaNanza was a legal Class II game. As a consequence of the dismissal, the temporary restraining order was dissolved, and the NIGC was no longer prohibited from issuing additional NOVs or from taking further enforcement actions. We appealed the granting of the motion to dismiss to the United States Court of Appeals for the Tenth Circuit. Prior to the Tenth Circuit's taking any action on our appeal, we entered into a Settlement Agreement with the NIGC that established a "fast-track" process for the NIGC to consider and issue its opinion on the classification of a version of Reel Time Bingo. We have already introduced one of these versions, and we intend to introduce others in the future that will completely replace MegaNanza. In return for the fast-track process, we immediately dismissed with prejudice our pending appeal before the Tenth Circuit.

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We, along with several of our tribal customers remain in discussions with the NIGC regarding the attributes of a version of RTB 2 that the NIGC would require before it will issue its opinion on a version of RTB 2. We believe that several of the attributes of RTB 2 recently requested by the NIGC are not required by applicable law, NIGC regulations or case law, but rather represent preferences and, therefore, should not be germane to the classification of RTB 2. Indeed, several of the recently requested changes have been found by every federal district and appeals court to have considered the issue as being permissible attributes of Class II gaming. Despite these differences, we remain optimistic that we will ultimately receive a satisfactory opinion from the NIGC that a version of RTB 2 is a legal Class II game; however, no assurance to that effect can be given due to the uncertainties inherent in dealing with any federal agency.

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Once the NIGC opinion is issued, the Settlement Agreement stipulates the NIGC is required to notify all Class II tribes of its position on electronic bonanza-bingo style games. We believe that once the competitive landscape is leveled, that our technology and gaming development teams will continue to develop new and exciting games that are superior to those of the competition, and that we will capture a meaningful portion of the entertainment dollars in the Class II market that are currently played on competitors' bonanza-bingo style games.

We cannot predict what the opinion of the NIGC will be, or what enforcement actions, if any, the NIGC will take against bonanza-bingo style games or other non-Class II games offered by our competitors.

### **Our future performance will depend on our ability to introduce new games and enhancements that are widely accepted and played.**

Our revenue growth has been driven primarily by our technological innovations and the increased size and use of our installed player station base. Our New Generation gaming platform allows us to produce games that play faster than our Legacy games and generate increased revenues for us and for our customers. In January 2001, we introduced MegaNanza, our first game based on the New Generation platform. In June 2002, we introduced our second game based on the New Generation platform, Reel Time Bingo, a high-speed standard sequence bingo game.

Our future performance will depend on our ability to successfully and cost-effectively develop and introduce new and enhanced games that will be widely accepted both by our tribal customers and their end users. Our New Generation platform enables us to more effectively launch new games that we believe are more entertaining for end users, thus providing us and our customers with greater revenues.

However, we may experience delays in game development in the future, or we may not be successful in developing, introducing and marketing new games or game enhancements on a timely and cost effective basis. In addition, our new games may be subject to challenge by the NIGC, the DOJ, or some other regulatory or law enforcement agency based on IGRA, the Johnson Act or some other regulatory mandate. If we are unable, for technological or other reasons, to develop and introduce new games or enhancements of 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 NIGC enforcement policies cause us to continue facing competition from bonanza-bingo style games or other non-Class II games offered by our competitors, our business would be seriously harmed.

### **We are dependant upon a few customers who are based in Oklahoma.**

For the nine months ended June 30, 2003, two tribes in Oklahoma accounted for approximately 22% and 18% of our gaming revenues.

The significant concentration of our customers in Oklahoma means that:

Local economic changes may adversely affect our customers, and therefore our business, more suddenly and disproportionately than would changes in national economic conditions; and

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Our business would be materially and adversely affected if Oklahoma were to adopt Class III gaming by establishing compacts with our Oklahoma customers.

The loss of any of these tribes as our customers would have a material and adverse effect upon our financial condition and results of operations. See Certain Risk Factors We do not rely upon the term of our customer contracts to retain the business of our customers.

**We compete for customers and end users with other vendors of Class II and Class III games. We also compete for end users with other forms of entertainment. To remain competitive, the NIGC must even-handedly enforce its own rules and regulations, and we must continue to develop new game themes and systems that appeal to end users.**

We compete with other Class II vendors for customers, primarily on the basis of the amount of profit our gaming products generate for our customers in relation to gaming products offered by other vendors. 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. In addition, our new or modified gaming products intended for the Class II market must be designed and operated to meet Class II gaming requirements that are evenly enforced against all Class II vendors. We cannot assure you that we will continue to develop

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and introduce appealing new game themes and systems that meet the emerging requirements of Class II gaming in a timely manner, or at all. In addition, there can be no assurance that others will not independently develop games similar to our Class II games, or that competitors will not introduce non-Class II games that unfairly compete in the Class II market.

As the market grows, and the rules and regulations governing Class II gaming are clarified by court decisions and by improved rule-making and enforcement procedures at the NIGC, we anticipate increased competition in the interactive electronic Class II gaming market. As a result, we believe new competitors with significant gaming experience and financial resources will enter the market. 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 retained by our customers from their installed base of player stations will become a more significant factor, one that may require us to change the terms of our participation arrangements with customers. Consequently, we believe that a simple business model based upon the average hold per player station per day 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.

**We are seeking to expand our business by jointly developing or expanding gaming and related facilities with our customers. We have limited experience with these activities and may not realize a satisfactory return, if any, on our investment, and we could lose some or all of our investment.**

We are jointly developing gaming and related facilities on Native American land where we can install our games and player stations. During the nine months ended June 30, 2003, we entered into three such agreements to jointly develop and provide financing to construct and/or expand three tribal gaming facilities. We also may seek to enter into strategic relationships and provide financing and development services for new or expanded gaming and related facilities for our customers. We cannot assure you that the anticipated benefits of any strategic relationship or financing will be realized.

In connection with one or more of those transactions, we may:

- Issue additional equity securities which would dilute existing stockholders;
- Extend secured and unsecured credit which may not be repaid;
- Incur debt on terms unfavorable to us or that we are unable to repay; and
- Incur contingent liabilities.

We have limited experience in these types of activities. Accordingly, a strategic relationship, development effort or financing 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 not realize a satisfactory return, if any, on our investment, and we could lose some or all of our

investment. See Part I Item 1. Financial Statements Commitments and Contingencies Development Agreement.

**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 growth strategy includes selling our games and technology into segments of the gaming industry other than Native American gaming, principally the charity bingo market and new jurisdictions authorizing VLTs. In April 2003, we finalized and executed a contract with the New York Lottery to provide the central system for video lottery games to be operated at New York State racinos.

These activities 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 basis. In addition, federal laws relating to gaming, such as the Johnson Act, which regulates slot machines and similar gambling devices, would also apply to new video lottery jurisdictions, absent authorized state law exemptions. If we were to expand into these new markets, we would expect to encounter legal and regulatory uncertainties similar to those we face in our Native American gaming business. Successful

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growth in accordance with this strategy may require us to make certain changes to our games to ensure that they comply with applicable regulatory regimes, and may require us to obtain additional licenses. Importantly, 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 cannot assure you that we will be successful in entering into other segments of the gaming industry.

Generally, our selling games and technology into new market segments involves a number of 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 continue to function effectively within these new segments;
- Whether we have enough experience to accurately predict revenues and expenses in these new segments; and
- Whether entering such segments will divert management attention and resources from our traditional business.

If we are unable to effectively develop and operate within these segments, then entering into these new segments could have a material adverse effect on our business, operating results and financial condition. Moreover, if we are unsuccessful in our attempt to diversify to new lines of business, or if a specific project such as the New York Lottery racino project generates significantly less revenue than anticipated, our ability to grow and diversify our revenue streams may be impaired.

### **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, there is no assurance that others will not independently develop similar technology or that secrecy will not be breached. The issuance of a patent does not necessarily mean that our technology does not infringe upon the intellectual property rights of others. Accordingly, we cannot assure you that we will not be 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 could be costly and time consuming, but may be 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 software shipments. We also rely on technology provided by third-party vendors which, if disrupted, could suspend play on some of our player stations.**

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 software shipments. Furthermore, we might be forced to limit the features available in our current or future software offerings.



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

**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, and we have no written contract with our largest customer. We do not rely upon the stated term of our customer contracts to retain the business of our customers. We rely instead upon providing competitively superior player stations, 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 non-renewal, which could materially and adversely affect our earnings and financial condition.

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

The NIGC has considered the provisions of the agreements under which we provide our Class II games, equipment and services, and has determined that these agreements are service agreements and are not management contracts. Management contracts are subject to additional regulatory requirements and oversight. Our contracts could be subject to further review at any time. Any further review of these agreements by the NIGC could require substantial modification to our agreements and result in their redesignation as management contracts, which could materially and adversely affect the terms on which we conduct our business.

### **If our key personnel leave us, our business will be significantly 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, our directors or any 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 American 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. State laws generally do not directly apply to Native American tribes and activities taking place on Native American lands, unless the tribe has a specific agreement or compact with the state or federal government allowing for the application of state law. In the absence of a conflicting federal or properly authorized state law, Native American law governs.

Our contracts with Native American customers provide that the law of the state in which a tribe is located will be the governing law of those contracts. We cannot assure you, however, that these choice-of-law clauses are enforceable.

***Sovereign Immunity; Applicable Courts.*** Native American tribes generally enjoy sovereign immunity from suit 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.

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Our contracts with Native American customers include a limited waiver of each tribe's sovereign immunity and 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. 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, which are courts of limited jurisdiction, may be difficult or impossible to obtain. There can be no assurance that we could effectively enforce any arbitration decision.

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**Any disruption in our network or telecommunications services could affect our ability to operate our games, which would result in reduced revenues and customer down time.**

If we lose the services of one or more of our telecommunications providers for any reason, we could experience disruption in our network availability and our games may experience down time as a result. This disruption to our business could result in a decrease in our revenue from the loss of play.

Our network is susceptible to outages due to fire, floods, power loss, break-ins, cyber attacks 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 in the areas in which we operate could have a material adverse effect on our results of operations 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 the 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.

**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 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 3. QUANTITATIVE AND QUALITATIVE DISCLOSURES ABOUT MARKET RISK**

We are not subject to any interest rate, exchange rate, or commodity price risks.

## **ITEM 4. CONTROLS AND PROCEDURES**

We maintain controls and other procedures that are designed to ensure that information required to be disclosed by us in reports that we file or submit under the Securities Exchange Act of 1934, as amended, is recorded, processed, summarized and reported within the time periods specified in the SEC's rules and forms. In response to recent legislation, we implemented changes to our disclosure controls and procedures,

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primarily to formalize and document procedures already in place and to establish a disclosure committee consisting of some of our officers and other management.

Within the 90-day period prior to our filing of this Report, and under the supervision and with the participation of our management, including our principal executive officer and principal financial officer, we evaluated the effectiveness of the design and operation of these disclosure controls and procedures. Based on this evaluation, our principal executive officer and principal financial officer concluded that our disclosure controls and procedures are effective.

We do not expect that our disclosure controls and procedures or our other internal controls can prevent all error and all fraud or that our evaluation of these controls and procedures can provide absolute assurance that all control issues and instances of fraud, if any, have been detected. The benefits of controls and procedures must be considered relative to their costs, and the design of any system of controls is based in part upon assumptions about the likelihood of future events. There can be no assurance that any design will succeed in achieving its stated goals under all potential future conditions. Over time, controls and procedures may become inadequate because of changes in conditions, or the degree of compliance with the policies or procedures may deteriorate. Because of these and other inherent limitations in controls and procedures, misstatements or omissions due to error or fraud may occur and not be detected.

Subsequent to the date of our evaluation described above, we have not made any significant changes, including corrective actions with regard to significant deficiencies or material weaknesses, in our internal controls or in other factors that could significantly affect these controls.

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**PART II**

**OTHER INFORMATION**

**ITEM 1. LEGAL PROCEEDINGS**

We are subject to litigation from time to time in the ordinary course of our business. See PART I Item 1. Financial Statements Commitments and Contingencies.

***Oneida Litigation.*** On June 27, 2002, the Oneida Indian Nation filed a complaint against us in the United States District Court for the Western District of Washington alleging our infringement of two patents owned by the Oneida Nation relating to a cashless system. On April 23, 2003, the parties agreed to dismiss the case without prejudice and with a tolling agreement.

***Other Litigation.*** We are a defendant in a lawsuit filed in the Federal Court for the Western District of Oklahoma alleging that we tortiously interfered with a contract between the plaintiff and a Native American tribe that granted the plaintiff the exclusive right to provide gaming machines to the tribe. In July 2003, the plaintiff stated its claim for damages in an amount ranging between \$5.6 million and \$13.2 million. The case was originally scheduled for a jury trial in August 2003, but at the plaintiff's request has been rescheduled for trial in September 2003. We believe that the plaintiff's cause of action is without merit and that we will prevail in the litigation. Accordingly, as of June 30, 2003, we have not recorded a provision for any losses that may result from the outcome of the trial; however, we can make no assurance as to the outcome, due to the inherent uncertainties in any jury trial.

**ITEM 6. EXHIBITS AND REPORTS ON FORM 8-K**

(a) Exhibits  
See Exhibit Index.

(b) Reports on Form 8-K

On April 29, 2003 we filed a Report on Form 8-K announcing the issuance of an earnings release for the three and six months ended March 31, 2003.

On August 5, 2003 we filed a Report on Form 8-K announcing the issuance of an earnings release for the three and nine months ended June 30, 2003.



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**SIGNATURES**

In accordance with the requirements of the Exchange Act, the Registrant caused this Report to be signed on its behalf by the undersigned, thereunto duly authorized.

Multimedia Games, Inc.

Dated August 14, 2003

By:

/s/ Craig S. Nousis

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Craig S. Nousis

Chief Financial and Principal Accounting Officer



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<u>EXHIBIT NO.</u>	<u>TITLE</u>	<u>LOCATION</u>
3.1	Amended and Restated Articles of Incorporation	(3)
3.2	Bylaws	(1)
10.1	Form of Integrated Gaming Services Agreement	(1)
10.2	Contingent Grand Prize Risk Assumption Agreement dated October 1, 1995, between the Company and SCA Promotions, Inc.	(2)
10.3	1994 Employee Stock Option Plan	(1)
10.4	1994 Director Stock Option Plan	(1)
10.5	1996 Stock Incentive Plan, as amended	(6)
10.6	President's Plan	(5)
10.7	1998 Senior Executive Stock Option Plan	(6)
10.8	2000 Stock Option Plan	(6)
10.9	2001 Stock Option Plan	(7)
10.10	Stockholder Rights Plan	(4)
10.11	Special Services Contract executed August 14, 2000 with John Winkelman	(8)
10.12	Consulting Agreement dated November 9, 2000 with Martin Keane	(8)
10.13	2002 Stock Option Plan	(9)
10.14	Employment Agreement executed March 26, 2003 between the Company and Gordon Graves	(9)
31.1	Certification of Chief Executive Officer pursuant to Section 302 of the Sarbanes Oxley Act of 2002.	(10)
31.2	Certification of Chief Executive Officer pursuant to Section 302 of the Sarbanes Oxley Act of 2002.	(10)
32.1	Certification Pursuant To U.S.C. Section 1350, as Adopted Pursuant to Section 906 of the Sarbanes-Oxley Act Of 2002.	(10)

(1) Indicates incorporated by reference to our Form 10-KSB filed with the Commission for the fiscal year ended September 30, 1994.

(2) Indicates incorporated by reference to our Form 10-KSB filed with the Commission for the fiscal year ended September 30, 1996.

(3) Indicates incorporated by reference to our Form 10-QSB filed with the Commission for the quarter ended March 31, 1997.

(4) Incorporated by reference to our Registration Statement on Form 8-A, filed with the Commission on October 23, 1998.

(5) Indicates incorporated by reference to our Form 10-KSB filed with the Commission for the fiscal year ended September 30, 1998.

(6) Incorporated by reference to our Registration Statement on Form S-8 filed with the Commission on December 1, 2000.

(7) Incorporated by reference to our Registration Statement on Form S-8 filed with the Commission on October 18, 2002 (File No. 333-100611).

(8) Incorporated by reference to our Registration Statement on Form S-3 (File No. 333-30721).

(9) Indicates incorporated by reference to our Form 10-Q filed with the Commission for the quarter ended March 31, 2003.

(10) Filed herewith.