

WMS INDUSTRIES INC /DE/  
Form 10-K  
August 29, 2011  
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**UNITED STATES**  
**SECURITIES AND EXCHANGE COMMISSION**

Washington, D.C. 20549

**FORM 10-K**

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

JUNE 30, 2011 FOR THE FISCAL YEAR ENDED JUNE 30, 2011

OR

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

FOR THE TRANSITION PERIOD FROM TO

Commission file number 1-8300

# WMS INDUSTRIES INC.

(Exact name of registrant as specified in its charter)

<b>Delaware</b> (State or other jurisdiction of incorporation or organization)	<b>36-2814522</b> (I.R.S. Employer Identification Number)
<b>800 South Northpoint Blvd., Waukegan, Illinois</b> (Address of principal executive offices)	<b>60085</b> (Zip Code)

Registrant's telephone number, including area code: (847) 785-3000

## Securities registered pursuant to Section 12(b) of the Act:

Title of each class	Name of each Exchange on which registered
Common Stock, \$0.50 par value	New York Stock Exchange

Securities registered pursuant to Section 12(g) of the Act: None.

Indicate by check mark if the registrant is a well-known seasoned issuer, as defined in Rule 405 of the Securities Act. Yes  No

Indicate by check mark if the registrant is not required to file reports pursuant to Section 13 or Section 15(d) of the Act. Yes  No

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

Indicate by check mark whether the registrant has submitted electronically and posted on its corporate website, if any, every Interactive Data File required to be submitted and posted pursuant to Rule 405 of Regulation S-T (§232.405 of this chapter) during the preceding 12 months (or for such shorter period that the registrant was required to submit and post such files.) Yes  No

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Indicate by check mark if disclosure of delinquent filers pursuant to Item 405 of Regulation S-K (§229.405 of this chapter) is not contained herein, and will not be contained, to the best of registrant's knowledge, in definitive proxy or information statements incorporated by reference in Part III of this Form 10-K or any amendment to this Form 10-K.

Indicate by check mark whether the registrant is a large accelerated filer, an accelerated filer, a non-accelerated filer, or a smaller reporting company. See the definitions of large accelerated filer, accelerated filer and smaller reporting company in Rule 12b-2 of the Exchange Act. (Check one):

Large accelerated filer  Accelerated filer  Non-accelerated filer  Smaller reporting company

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

The aggregate market value of the shares of common stock held by non-affiliates of the registrant as of the last business day of the second fiscal quarter ended December 31, 2010 was \$2,600,217,687 based on the closing price of the common stock as reported on the New York Stock Exchange of \$45.24 per share. For the purposes of this calculation, it is assumed that directors and executive officers of the registrant are affiliates.

On August 22, 2011, the number of shares of common stock outstanding was 55,729,276 shares.

**Documents Incorporated By Reference:** Portions of the Registrant's definitive proxy statement to be filed on or about October 20, 2011, with the Securities and Exchange Commission are incorporated by reference in Part III of this Report.

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**CAUTIONARY NOTE**

*This report contains statements that do not relate to historical or current facts, but are forward-looking statements within the meaning of the Private Securities Litigation Reform Act of 1995. These statements relate to analyses and other information based on forecasts of future results and estimates of amounts not yet determinable. These statements may also relate to future events or trends, our future prospects and proposed new products, services, developments or business strategies, among other things. These statements can generally (although not always) be identified by their use of terms and phrases such as anticipate, appear, believe, continue, could, estimate, expect, indicate, intend, may, plan, possible, predict, project, pursue, will, would, and other similar terms and phrases, as well as the use of the future tense. Forward-looking statements in this Annual Report on Form 10-K speak only as of the date hereof, and forward looking statements in documents incorporated by reference speak only as the date of those documents. Unless otherwise required by law, we undertake no obligation to publicly update or revise these forward-looking statements, whether as a result of new information, future events or otherwise.*

Examples of forward-looking statements in this report include, but are not limited to, the following categories of expectations about:

- Ø Our ability to introduce new products that perform well in the relevant market;
- Ø Industry replacement demand and new casino openings and expansions;
- Ø The impact of the economy on our global business;
- Ø The timing, features, benefits and expected success of new product introductions;
- Ø The timing of the introduction of and revenues from networked gaming systems and applications and online gaming;
- Ø Further market penetration of our products;
- Ø Increasing growth or contributions from certain non-gaming machine products and services;
- Ø Factors impacting future gross profit and operating margins and expectations about future tax rates;
- Ø Our ability to acquire, develop or protect intellectual property;
- Ø Our market share, competitive advantages and relative leadership position;
- Ø The advantages offered to customers by our products and product features;
- Ø Gaming growth, expansion and new market opportunities;

- Ø Legislative or regulatory developments and related market opportunities;
- Ø Financial results for fiscal years 2012 and 2013;
- Ø Our ability to benefit from and effectively integrate and utilize licensed or acquired intellectual property and technologies;
- Ø Expanding our product lines and improving our position in related markets;
- Ø Demand for operating leases by customers;
- Ø Future costs of our restructuring; and
- Ø Our access to and the availability of capital and credit resources to fund future operating requirements, capital expenditures and payment obligations.

Actual results could differ materially from those expressed or implied in our forward-looking statements. Our future financial condition and results of operations, as well as any forward-looking statements, are subject to change and to inherent known and unknown risks and uncertainties. See Item 1A. Risk Factors, in this report for a discussion of these and other risks and uncertainties. Although we believe that the expectations reflected in our forward-looking statements are reasonable, any or all of our forward-looking statements may prove to be incorrect. Consequently, no forward-looking statements are guaranteed.

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**PART I**

**ITEM 1. BUSINESS**

**General**

WMS Industries Inc. ( WMS or the Company ) serves the legalized gaming industry by designing, manufacturing and distributing games, video and mechanical reel-spinning gaming machines and video lottery terminals ( VLTs ) to authorized customers in legal gaming jurisdictions worldwide. Our products are installed in all of the major regulated gaming jurisdictions in the United States, as well as in approximately 140 international gaming jurisdictions. We either sell our products outright, which we include in our product sales business, or we lease our products in our gaming operations business, which consists of the placement of leased and participation gaming machines. We also derive revenue as part of our product sales business from the sale of parts, conversion kits and, until the disposition of our Systems in Progress GmbH subsidiary ( SiP ) in July 2011, gaming related systems for smaller international casinos and, in our gaming operations business, from licensing our gaming themes and other intellectual property to third parties. Our fiscal year begins on July 1 and ends on June 30.

We seek to develop games and gaming machines that offer high entertainment value to casino patrons and generate greater revenues for casinos and other gaming machine operators than the games and gaming machines offered by our competitors. Our gaming products feature advanced graphics, digital sound and engaging games, and most games incorporate secondary bonus rounds. Certain games are based on licensed, well-recognized brands such as *MONOPOLY*<sup>®</sup>, *BATTLESHIP*<sup>®</sup>, *THE WIZARD OF OZ*<sup>™</sup> and *THE LORD OF THE RINGS*<sup>™</sup> and substantially all of our gaming machines utilize technologies and intellectual property licensed from third parties. In designing our games and gaming machines, our designers, engineers, artists and development personnel build upon our over 60 years of experience in designing and developing novel and entertaining products from jukeboxes and pinball games to video and arcade games and, now, gaming machines for the gaming industry. We utilize our unique *Player Driven Innovation*<sup>™</sup> approach in the development of new games and technologies to create innovative products.

Our primary manufacturing facility is located in the United States, with development or distribution offices in the United States, Argentina, Australia, Canada, China, India, Mexico, South Africa, Spain and the United Kingdom. For information about our revenues and assets outside of the United States, see Note 16. Information on Geographic Areas to our Consolidated Financial Statements. We conduct our business through our subsidiaries, including WMS Gaming Inc. ( WMS Gaming ), Orion Financement Company B.V. ( Orion Gaming ) and SiP, which market our products under the WMS, WMS Gaming, Orion Gaming and SiP trademarks. In September 2010, we closed our Orion Gaming manufacturing facility and in June 2011, we sold this facility and began winding down the support of our Orion Gaming product lines, which will occur over fiscal 2012. In July 2011, we sold SiP. These two subsidiaries were immaterial to our Consolidated Balance Sheets, Consolidated Statements of Income and Consolidated Statements of Cash Flows.

We have only one business segment. Data for product sales and gaming operations is only maintained on a consolidated basis as presented in our Consolidated Financial Statements, with no additional separate data maintained for product sales and gaming operations (other than the revenue and cost of revenues information included in our Consolidated Statements of Income and gaming operations equipment and related accumulated depreciation included in our Consolidated Balance Sheets). For information about our revenues, net income, assets, liabilities, stockholders equity and cash flows, see our Consolidated Financial Statements and Item 7. Management's Discussion and Analysis of Financial Condition and Results of Operations .

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WMS was incorporated in Delaware on November 20, 1974 under the name Williams Electronics, Inc. WMS succeeded in the amusement game business that had been conducted for almost 30 years prior to 1974 by our predecessors and entered the gaming machine market beginning in the 1990 s. Our principal executive offices are located at 800 South Northpoint Blvd. Waukegan, Illinois 60085, and our telephone number is



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(847) 785-3000. Our Internet website address is [www.wms.com](http://www.wms.com). Information contained on our website is not part of this Report. Through our Internet website, we make available, free of charge, our Annual Report on Form 10-K, quarterly reports on Form 10-Q, current reports on Form 8-K and amendments to those reports, as soon as reasonably practical after the information has been filed with or furnished to the Securities and Exchange Commission ( SEC ). **We will also provide electronic or paper copies of these reports free of charge upon request to our principal executive office, Attention: Investor Relations.** Copies of any materials we file with the SEC are also available at the SEC's Public Reference Room at 100 F Street, N.E. Washington, D.C. 20549. Information on the operation of the Public Reference Room may be obtained by calling the SEC at 1-800-SEC-0330. In addition, the SEC maintains an Internet site that contains reports, proxy and information statements and other information regarding issuers that file electronically with the SEC at [www.sec.gov](http://www.sec.gov).

## Company and Product Overview

Our products consist of innovative and differentiated games, video gaming machines, mechanical reel gaming machines and VLTs. We were one of the original developers and pioneers of video gaming machines in the U.S. market and through a continued focus on creativity and innovation, we have introduced a variety of new and differentiated products to the gaming machine market. We strive to develop highly entertaining games that incorporate engaging game play, themes, intellectual properties and advanced technologies, exciting winning combinations, advanced graphics and digital music and sound effects. A gaming machine and a VLT consist of three primary elements: (1) the gaming machine cabinet hardware; (2) the operating system software; and (3) the game theme software. Each gaming machine contains operating system software that we refer to as a game platform . The game platform manages the software needed to operate the gaming machine. Game platforms and the related computer systems are constantly updated and revised to keep pace with the ever-increasing complexity of modern game play, technology and regulatory requirements. The change in these requirements is driven by, among other things, changes in consumer demand, capacity, security and regulation. *CPU-NXT*<sup>®</sup> and *CPU-NXT2* are the primary game platforms for substantially all our video and mechanical reel gaming machine and VLT product offerings.

Our games typically integrate secondary bonus rounds as additions to the primary game to create a game-within-a-game for more exciting and interactive play. If players attain certain winning combinations on the primary game, they continue on to play a secondary game for a chance at winning additional bonuses without additional wagering. The player can win in both the primary game and the secondary game. In our secondary bonus games, the player has various choices to make regarding the bonus features. For example, in some games the player can select from a variety of tokens or characters to obtain or reveal the bonus and, in other games, the player is awarded free spins. Amusing, entertaining and familiar graphics and musical themes add to the player appeal of our games.

We generate revenue in two principal ways. First, we generate product sales revenues from the sale to casinos and other licensed gaming machine operators of new and used gaming machines and VLTs, conversion kits for existing gaming machines (including game theme, hardware or operating system conversion kits) and parts. Second, we earn gaming operations revenues from leasing gaming machines and VLTs to casinos and other licensed gaming machine operators. In addition, beginning in fiscal 2011, we earn revenues from the online gaming casino we operate in the United Kingdom and software revenues from networked gaming applications. We also earn royalties from third parties, who maintain license agreements with us to use our game content and other intellectual property.

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Revenue information for the past three years includes (\$ in millions):

	2011	% of Revenue	2010	% of Revenue	2009	% of Revenue
Revenues:						
Product sales	\$ 489.2	62.5%	\$ 460.9	60.2%	\$ 438.5	62.1%
Gaming operations	294.1	37.5	304.2	39.8	267.9	37.9
Total revenues	\$ 783.3	100.0%	\$ 765.1	100.0%	\$ 706.4	100.0%

See Item 7. Management's Discussion and Analysis of Financial Condition and Results of Operations and our Consolidated Financial Statements.

**Product Sales**

We offer the following products for sale:

- Ø *Video gaming machines.* Our video gaming machines contain games where casino patrons wager multiple coins on multiple pay-lines, in our WMS *Bluebird*<sup>®</sup>, *Bluebird2* and *Bluebird xD* branded gaming cabinets, that combine advanced graphics, digital music and sound effects and secondary bonus games. In many of our video products, the primary game features a video screen that simulates traditional mechanical reel spinning action. In addition, we have developed games that have innovative variations on the movement and play action of the symbols on the video screen, such as our *Cascading Reels*<sup>™</sup> and *Rotating Wild*<sup>®</sup> effects. In the bonus round, the video screen can display a variety of amusing, interactive themed content. Depending on the game, the player can wager hundreds of coins per play. We have a strong player following in this product segment since the successful introduction of our *Reel em In*<sup>®</sup> game in 1997. With the introduction of new games and the significant expansion of our video game library since 1997, we undertook a new strategy in fiscal 2007 that segregates our video for-sale games into three categories: *G+*<sup>®</sup>, Classic and Innovation. Each product category has its own distinguishable player interface and game play features that visually communicate the game play experiences that each video game offers. In the fourth quarter of fiscal year 2011, we successfully introduced the *G+ Deluxe* series as a new level of the *G+* category, including optional game statistics, increased win celebrations and synchronized lighting and audio effects. We introduced 45 new video games for sale during fiscal 2011, compared to 29 new video games in fiscal 2010.
- Ø *Mechanical reel gaming machines.* Our product line of mechanical reel gaming machines in our *Bluebird*, *Bluebird2* and *Bluebird xD* cabinets include five-reel and three-reel, single-line, multi-line, multi-coin games that are powered by the same *CPU-NXT* and *CPU-NXT2* operating systems as our video gaming machines. Our mechanical reel products feature state-of-the-art lighting and sound elements that make our gaming machines stand out on a casino floor. With the launch of our *Bluebird2* mechanical reel gaming machines in fiscal 2009, all of our mechanical reel gaming machines now feature our *Transmissive Reels*<sup>®</sup> technology, which combines both traditional mechanical reel spinning technology with video technology in a single gaming machine. We introduced 35 new mechanical reel games in fiscal 2011 compared to 30 mechanical reel games in fiscal 2010.
- Ø *Parts sales, conversion kits and used games.* We sell replacement parts and game conversion kits for our *Bluebird*, *Bluebird2* and *Bluebird xD* gaming machines. We also sell *CPU-NXT2* hardware and operating system conversion kits, which enable casinos to upgrade *Bluebird* gaming machines to obtain all the features and functionality of the *CPU-NXT2* operating system and the networked gaming functionality for a lesser price compared to the purchase of a new *Bluebird2* networked-enabled gaming machine. An active market exists mostly outside of North America for used gaming machines. When we receive a gaming machine on trade-in, we estimate a carrying value for the gaming machine based on the condition of the gaming machine, as well as our experience in selling used gaming machines and such estimates could change due to changes in demand in general for used gaming machines. We sell these

trade-ins as-is or refurbish the used gaming machines before resale. We also sell participation

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gaming machines, after refurbishment, as used gaming machines when we no longer need them in our gaming operations business. We expect that our revenues from these sources will increase in the future as our installed base of sold gaming machines continues to grow.

A summary distribution by major category of our product sales revenues is as follows (\$ in millions):

	Year Ended June 30,		
	2011	2010	2009
Video gaming machines	64.8%	58.1%	64.6%
Mechanical reel gaming machines	17.6	26.0	21.0
Other product sales:			
Conversions	6.3	7.6	7.0
Used gaming machines	7.6	4.1	3.8
Other revenues	3.7	4.2	3.6
<b>Total</b>	<b>100.0%</b>	<b>100.0%</b>	<b>100.0%</b>

**Gaming Operations**

Our gaming operations business includes the following:

- Ø *Participation games.* Participation games are gaming machines with games all owned by us that we lease to customers based upon any of the following lease payment methods: (1) a percentage of the amount wagered, called coin in or a combination of a fixed daily fee and a percentage of the amount wagered; (2) a percentage of the net win, which is the earnings generated by casino patrons playing the gaming machine; or (3) fixed daily fees. We are able to lease these gaming machines and games on a participation basis because of their superior earnings performance and/or the popularity of the brand that generates higher wagering and net win to the casinos or gaming machine operators than the gaming machines we sell outright. Our participation games include the following categories:
  - Ø *Wide-Area Progressive ( WAP ) participation games.* WAP games are electronically linked gaming machines that are located across multiple casinos within a single gaming jurisdiction, or across Native American gaming jurisdictions. The linked gaming machines contribute to and compete for large, system-wide progressive jackpots and are designed to increase gaming machine play for participating casinos by giving the players the opportunity to win a larger jackpot than on a non-linked gaming machine. We create WAP games using our proprietary brands and licensed brands such as *MONOPOLY*, including *MONOPOLY Grand Hotel*<sup>®</sup>, *MONOPOLY Big Event*<sup>®</sup>, *MONOPOLY Around the Globe*<sup>®</sup>, *THE WIZARD OF OZ*, *THE PRICE IS RIGHT*<sup>®</sup>, *TIME MACHINE*<sup>®</sup>, and *Reel em In Compete To Win*. We operate WAP systems in Arizona, Colorado, Mississippi, Missouri, Nevada and New Jersey and in Native American casinos. We often leverage our WAP games by also using them on local-area progressive systems or stand-alone participation gaming machines in those jurisdictions where we do not operate a WAP system. WAP participation games typically are leased where the lease payment is based on a percentage of the amount wagered or a combination of a fixed daily fee plus a percentage of the amount wagered. WAP participation games generate our highest daily lease rate and gross profit contribution; however, the gross margin percentage is below the other two types of participation categories because we are responsible for funding the WAP jackpot award, which we expense as cost of gaming operations in our Consolidated Statements of Income.
  - Ø *Local-Area Progressive ( LAP ) participation games.* A LAP system electronically links gaming machines that are located within a single casino to a progressive jackpot for that specific casino. Our LAP gaming machines feature games using our proprietary brands, *Jackpot Party Progressive*<sup>®</sup>, *Life of Luxury*<sup>®</sup> *Progressive*, *Hot Hot Super Jackpot*<sup>®</sup> *Progressive*, *Goldfish*<sup>®</sup>

*Race for the Gold*<sup>®</sup> and *Money to Burn*<sup>®</sup> *Multiplying Progressive*, as well as licensed brands such as *HAPPY DAYS* .

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In fiscal 2011, we introduced *THE GODFATHER*<sup>®</sup> game, another new brand for WMS, which is the first multi-level progressive that allows players to win their way to higher progressive levels. Available in two unique base themes, players triggering the multi-level progressive can wager portions of their progressive win on a chance to earn higher price levels. Our LAP products leverage both exclusive brand names and game play intellectual property, and typically offer players the chance to win multiple progressive jackpots, all of which tend to drive up the average bet on these games. Net win per gaming machine on LAP systems is generally similar to non-linked stand-alone gaming machines on a casino floor. LAP participation games are leased where we earn revenue based on a percentage of the daily net win of the gaming machine or a fixed daily fee.

- Ø *Stand-alone participation games.* We lease certain participation games on a non-linked basis, which we call stand-alone games. Our stand-alone games feature titles, among others, under the *MONOPOLY* and *PRESS YOUR LUCK* brands and, in those jurisdictions where we do not operate a WAP system, *THE WIZARD OF OZ*, *TOP GUN*<sup>®</sup> and *TIME MACHINE* based games. Our stand-alone gaming machines generally feature larger, more elaborate top boxes and provide game play experiences not possible on a single screen game or on gaming machines that we sell. Stand-alone participation games are leased and we earn revenue based on a percentage of the daily net win of the gaming machine or a fixed daily fee, or for our games utilizing our *Adaptive Gaming*<sup>®</sup> technology, *STAR TREK* and *THE LORD OF THE RINGS*, on a percentage of the amount wagered on the game.

In prior years we disclosed the categories of our participation gaming machines based on the type of game placed on the gaming machine; WAP, LAP and Stand-alone. Beginning July 1, 2010, we modified our installed participation base categories to show the breakout of these gaming machines based on the revenue models that generate the lease payments: percentage of coin-in, percentage of net win and daily lease rate. This change does not impact our total participation revenues or gross profits, nor our total installed base of participation gaming machines or the average revenue per day. We believe these new categories provide stockholders with better perspective about how we generate our participation revenues. The prior year disclosure of the participation-installed base categories included in the table below reflects the current year presentation.

The components of our installed base of participation games were as follows (using our new basis of presentation):

	Year Ended June 30,					
	2011	% of Installed Base	2010	% of Installed Base	2009	% of Installed Base
Percentage of coin-in units at year end	3,780	38.3%	3,765	36.1%	2,868	27.7%
Percentage of net win units at year end	3,072	31.1	3,334	32.0	3,959	38.3
Daily lease units at year end	3,018	30.6	3,322	31.9	3,523	34.0
Total installed participation base units at year end	9,870	100.0%	10,421	100.0%	10,350	100.0%
Average participation installed base during the year	10,046		10,298		9,666	

Other gaming operations revenues are derived from:

- Ø *Casino-owned daily fee games.* This category consists of gaming machines for which the casino purchases the base gaming machine and leases the top-box and game from us at a lower fixed daily lease payment than if they were to lease the entire gaming machine. Casino-owned daily fee games typically feature a second liquid crystal display ( LCD ) screen in the top-box that provides additional entertaining bonus experiences for the player. In the case of products offered as casino-owned daily fee games, we also give casinos the option to either lease the complete gaming machine, top box and game (in which case the unit is classified as a stand-alone participation game), or to purchase outright the base



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gaming machine, top box and game at a premium price (in which case the revenue is classified as product sales revenue).

- Ø *Video lottery terminal leases.* Our VLTs include both video and mechanical reel gaming machines. They feature advanced graphics, digital sound effects and music and incorporate many of the same features from our other gaming machines. We offer a variety of multi-game and single-themed VLTs. Our VLTs may be operated as stand-alone units or may interface with central monitoring systems operated by government agencies. Our VLTs typically are located in places where casino-style gaming is not the only attraction, such as racetracks, bars and restaurants. In some jurisdictions, VLT operators can only lease our VLTs, in which case the lease payments are classified as other gaming operations revenues. In certain jurisdictions, VLT operators can purchase outright our VLTs, in which case the purchases are classified as product sales revenues. We do not include leased VLTs in our installed base of participation games.
- Ø *Leased-for-sale games.* Some customers prefer to lease our gaming machines under an operating lease arrangement rather than to purchase them. In these cases, we enter into an operating lease for the gaming machine, either for a fixed daily fee or a percentage of the net win of the gaming machine. Often, the customer is given the option to purchase the leased gaming machine at the end of the lease term at fair value. We do not include gaming machines leased under operating lease agreements in our installed base of participation games. We believe that more customers may desire to enter into this type of lease as they do not have to allocate capital or upfront cash payments to purchase the gaming machines, and we expect to enter into more operating leases in the years ahead. With operating leases, we record the revenues over the term of the lease, as opposed to an outright product sale where we record the revenue when the product ships and all of our revenue recognition criteria have been met.
- Ø *Licensing.* We derive revenue from licensing our games and intellectual property to third parties. Methods for determining the license or royalty revenue vary, but generally are based on a fixed amount for each licensed game purchased, placed or shipped in a period, or a fixed daily royalty amount for each game. Licensing revenues have declined over the last two years as our licensing agreements reached their termination dates and we elected not to renew these agreements and we have now directly entered the markets covered by these agreements. Our agreement with Stargames Corporation Pty. Ltd. ended in January 2008 and the resulting sell off period ended in fiscal 2010. Our agreement with Multimedia Games Inc. ended June 30, 2009 although there are on-going annual fees owed for continued use of our games. Our agreement with Bally Technologies, Inc. ( Bally Technologies ) with respect to distribution of WMS game themes in Class II markets in Florida terminated March 26, 2008 and the agreement for distribution of WMS game themes to Class II markets in Washington expired December 31, 2009.
- Ø *Class II and centrally determined systems:* In fiscal 2010, we began offering video and mechanical reel gaming machines and VLT s for Class II and certain VLT markets where the game outcome is determined on a central server system which we provided through an agreement with Bluberi Gaming Technologies Inc. ( Bluberi ), a Canadian-based technology firm. In fiscal 2011, we purchased a copy of the central system software from Bluberi, and we are now operating the system ourselves, although we have continuing payment obligations to Bluberi. These Class II systems primarily operate in Native American casinos in Washington, Florida and Oklahoma. In certain of these jurisdictions, our customers rent the gaming machine through an operating lease arrangement, in which case the lease payments are shown as gaming operations revenues and in other jurisdictions customers purchase the gaming machines in which case the revenues will be shown as product sales revenues. In each case, for the use of the central determination system, we receive either a fixed daily fee or a percentage of the net win generated by the gaming machines or VLT s connected to the system.
- Ø *Networked gaming.* We believe that server-enabled networked gaming ( NG ) will be the next significant technology deployed in the gaming machine industry. NG refers to a networked gaming system that links groups of server-enabled gaming machines to a remote server or servers in each casino s data center. Once the gaming machines are connected to the server-enabled network, data can



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transfer between the servers and the gaming machines in real time and new applications, game functionality and system-wide features can be enabled on the gaming machines from the remote server. These networks will require regulatory approval in gaming jurisdictions prior to any implementation and, in time, will represent a significant addition to our existing portfolio of products. We have been introducing the foundational technologies and hardware for NG to the market through our new participation product lines since the September 2006, quarter and we continued to implement this strategy in fiscal 2011 leading up to the launch of our *WAGE-NET*<sup>®</sup> NG system and our first portal application family, *Ultra Hit Progressive*<sup>®</sup> ( UHP ) and first UHP application, *Jackpot Explosion*<sup>®</sup> after receipt on April 21, 2011 of our first regulatory approval from Gaming Laboratories International, Inc. ( GLI ).

Ø *Online gaming.* In the December 2010 quarter, we launched a business-to-consumer ( B2C ), online casino website for residents in the United Kingdom, although we did not begin to market the site until February 2011. Our *Jackpotparty.com* online casino offers a variety of our popular slot games and certain card and table games. The success of our gaming content, technology foundation and e-commerce capabilities should allow us to provide online capabilities to consumers in other jurisdictions when they legalize online gaming. In the future, we also expect to be able to provide business-to-business online gaming capabilities to potential customers. In the United States, federal legislators and certain state legislators and governments in Canada and Europe are considering legalizing certain forms of online gaming, which, if passed, could expand our revenue opportunities depending on the type of online gaming approved. The breadth and timing of these opportunities remain uncertain due to the political process in each of these jurisdictions, as well as the difficult credit environment facing our customers and the risk of continued economic uncertainty.

### ***Business Development***

We have an active business development group that coordinates our efforts to expand our product offerings and helps ensure we have access to intellectual properties and technologies needed for our business. We have been very active in licensing and acquiring intellectual properties, technologies and brands from third parties, investing \$24.9 million, \$8.3 million and \$13.5 million in fiscal 2011, 2010 and 2009, respectively. See Note 14. Commitments, Contingencies and Indemnifications to our Consolidated Financial Statements.

### **Industry Overview**

The gaming industry is a large and dynamic worldwide marketplace, subject to extensive local jurisdictional regulations. Casino and other legal gaming operators continuously seek to increase their revenue growth and profitability. The importance of gaming machine revenue to casino operators' profitability has created demand for gaming machines that have the ability to generate superior net daily win. As a result, gaming equipment manufacturers have increasingly focused on enhancing the overall entertainment value and appeal of games and gaming machines, which drives the demand for the replacement of older games and gaming machines. The earnings performance of our products is the primary driver of customer demand. See Overview included in Item 7. Management's Discussion and Analysis of Financial Condition and Results of Operations.

Demand for our products is also driven by:

- Ø The replacement cycle of gaming machines at existing casinos;
- Ø Casino expansions and new casino openings;
- Ø Opening of new gaming jurisdictions;

- Ø Expansion of our product line and introduction of new technologies;
- Ø Entering new distribution channels and markets not previously served; and
- Ø Our reputation, reliability and after-sales service support.

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The recession and financial market crisis that began in 2008 has continued to disrupt the economy worldwide, reduced consumer discretionary spending and has led to a weakened global economic environment, all of which have been significant challenges for our industry. The economic crisis reduced disposable income for casino patrons and resulted in fewer patrons visiting casinos and lower spending by those patrons who did visit casinos. This has resulted in lower industry-wide unit demand from gaming operators and lower play levels on gaming machines in most gaming jurisdictions. As a result, gaming operators delayed or canceled construction projects, resulting in fewer new casino openings and expansions in calendar year 2010 and even fewer in 2011, coupled with many customers reducing their annual capital budgets for replacing gaming machines for calendar 2009 with only modestly higher replacement capital budgets in calendar 2010 and anticipated for calendar 2011 and 2012. We have been faced with these macroeconomic challenges for over two years.

In the United States, Native American casinos represent a significant portion of the market. Native American gaming differs from the traditional commercial casino market in that it is regulated under the Indian Gaming Regulatory Act of 1988, which classifies legalized gaming as follows:

- Ø Class I gaming includes traditional Native American social and ceremonial games. Class I gaming is regulated exclusively at the Native American tribe level;
- Ø Class II gaming includes bingo, electronic aids to bingo, and, if played at the same location where bingo is offered, pull-tabs and other games similar to bingo. Class II gaming is regulated by individual Native American tribes, with the National Indian Gaming Commission having concurrent jurisdiction; and
- Ø Class III gaming includes all other forms of gaming that are not included in either Class I or Class II, including our traditional gaming machines and is permissible only pursuant to either (1) a compact agreement entered into between the tribe and the host state, where such compact has been approved by the Secretary of the Interior and published in the Federal Register; or (2) Class III Procedures issued by the Secretary of the Interior.

We believe technology changes and developments during the last decade that drove the demand for the past replacement cycles were: (1) the development of video gaming machines that simulate mechanical reel gaming machines, (2) the introduction of gaming machines with secondary bonus rounds, (3) printed ticket payouts instead of coin payouts and (4) low denomination wagering coupled with local-area and wide-area progressive jackpots. We expect technology to continue to be a significant element that drives demand, along with the emphasis by casinos for the types of gaming products that deliver higher net win per gaming machine. Once the gaming machines are connected to the network, data can pass in real time between the servers and the gaming machines, which will enable new applications, game functionality and system-wide features. These networks will require regulatory approval in each gaming jurisdiction prior to any implementation and will represent an important addition to our existing portfolio of product offerings.

## **Business Strategy**

In order to continue to grow revenues, profits and cash flow, we have been executing on five key business strategic priorities throughout the last three fiscal years, and because of the financial and operating success achieved with this focus, we expect to continue to execute on these strategic priorities in fiscal 2012. However, given the continuing lower levels of capital spending by casinos over the last three years, with no leading indicators that demand will increase in the near-term, we conducted a thorough review of our product plans and business strategies at the end of fiscal 2011 and the beginning of fiscal 2012. We still believe our long-term vision and business strategy are intact but, as a result of this review, we are refining our product plans and restructuring our organization.

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Specifically, we are streamlining our product management and product development functions, simplifying product plans and further prioritizing on-time commercialization of new game themes, products and portal gaming applications for our core product sales and gaming operations businesses. These actions are expected to

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better direct resources and focus on near-term revenue opportunities and will reduce our overall organizational staffing by approximately 10% to a level that better correlates with the current operating environment, while maintaining our ability to create great games that engage current players and attract new players. We expect these actions to further strengthen our operating efficiencies and effectiveness, meaningfully reduce costs and improve our operating margin. Some of the product and operational decisions made in this review led to the impairment, restructuring, asset write-downs and other pre-tax charges of \$24.0 million recorded in the June 2011 quarter with an additional \$11 million to \$14 million of pre-tax charges expected in the September 2011 quarter, largely to complete the restructuring as discussed in Item 7. Management's Discussion and Analysis of Financial Condition and Results of Operations .

Our five business strategic priorities are as follows:

Strategic Priorities One and Two: *Leverage Our Product Development Expertise to Introduce Innovative New Games and Expand Our Product Sales Offerings to: 1) Increase our Ship Share in the United States and Canada and 2) Expand and Grow Our International Business:* We have over 60 years of experience developing fun, humorous and entertaining products in a variety of industries. During the past seven years, we have enhanced our product development efforts by adding key management, design personnel and software engineers to our product development group. We added facilities and organized our game development group into a studio team structure that continues to promote innovation while driving a more focused development approach. We place substantial emphasis on our *Player Driven Innovation* process that incorporates player feedback and market research into our development process in order to create game content and gaming experiences that appeal to casino patrons. We develop, acquire and license intellectual property and advanced technologies that we believe enable innovative and appealing games which, coupled with a focused product portfolio management plan, allows us to expand our offering of differentiated products to casino operators. We believe our product development capabilities, combined with the additional functionalities and enhanced features of our advanced technologies and gaming platforms, enable us to optimize the entertainment value of our products, continue to expand our product offerings and increase our global market penetration. We offer our products in several different cabinet styles, which help increase overall demand and substantially all of the games we develop are designed to be used on our *Bluebird2* and *Bluebird xD* the cabinet styles. The major areas of hardware development include cabinet style, technical capability, circuit board design and related programming and button decks and displays.

We are dependent, in part, on innovative new products, new casino openings, casino expansions, continued market penetration, new market opportunities and new distribution channels to generate growth. Each gaming machine requires a game software platform to manage the gaming machine hardware and deliver the game theme software. Gaming software platforms are constantly updated to keep pace with the increasing complexity of game play requirements, regulatory requirements and expected future game theme software releases.

We first commercialized our innovative *Bluebird* gaming machines in the December 2003 quarter. *Bluebird* gaming machines incorporate features such as an ergonomic design, 19-inch digital, high-resolution flat screen monitors for the video version of the product that can display advanced graphics generated by our *CPU-NXT* operating system, simultaneous coin-in/coin-out and cashless capabilities, as well as sound systems that reduce peripheral, distracting noises. Since the product launch, we have shipped over 158,000 new *Bluebird* gaming machines. In fiscal 2011, we notified our customers that we were winding down the support for our original *Bluebird* gaming machines with no new game content to be developed after July 1, 2012; but would continue to service and supply replacement parts and provide an extensive existing library of game content through July 2015.

In the December 2008 quarter, we began the global launch of a new gaming machine, *Bluebird2*, which contains advanced technologies that enable this gaming machine to support gaming in the networked gaming world. The *Bluebird2* gaming machine contains dual 22-inch LCD displays for enhanced video display and a programmable button panel where the amounts bet per line and the number of lines played can change with each new game. The *Bluebird2* gaming machine is networked gaming capable and supports all of the peripheral

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devices of the original *Bluebird* gaming machine. The *Bluebird2* gaming machine also incorporates an improved sound system developed exclusively for our gaming machines. The new audio system is designed with innovative directional sound technology, allowing the player to experience lifelike sound reproduction similar to that of a live production. The *Bluebird2* gaming machine is slimmer than our *Bluebird* cabinet and requires less space on a casino floor, allowing casino operators to place more gaming machines in the same space. The *Bluebird2* gaming machine uses our *CPU-NXT2* operating system, which provides higher resolution graphics, faster computing power and greater memory than the original *Bluebird* cabinet. Demand for this product in fiscal 2009 and 2010 exceeded our expectations and *Bluebird2* gaming machines accounted for 69% of new units shipped in fiscal 2011 and since launch, we have shipped over 45,000 *Bluebird2* gaming machines. We offer customers the ability to upgrade their *Bluebird* gaming machines to be networked-enabled through the purchase of hardware and operating system upgrade kits.

In June 2010, we began the global launch of our latest gaming machine, *Bluebird xD*, to replace our *Bluebird* slant gaming cabinets. The *Bluebird xD* has a player centric ergonomic design that allows all aspects of networked gaming. The ergonomic design provides optimal player seating-positions and an integrated footrest for maximum comfort. The *Bluebird xD* gaming machine contains a 22-inch high definition top screen with a lower 22-inch high definition display screen for optimum viewing angles with reduced glare along with dynamic and fully programmable button panels. The *Bluebird xD* gaming machine also incorporates an advanced sound system, which enables the player to hear soft sounds at low volume levels and still allow the player to appreciate the impact of the louder special effects. The *Bluebird xD* gaming machines offer the player-comfort features of the traditional slant version of our gaming cabinets but with a smaller footprint than the traditional slant cabinet, allowing casino operators to place more gaming machines in the same space. We are seeing strong demand for this product and in fiscal 2011, *Bluebird xD* units accounted for 26% of total global shipments, or over 6,200 new units.

While different cabinet styles can enhance the player's gaming experience, we continue to believe that the game itself is the key factor that determines the popularity and earnings performance of the gaming machine. We conduct extensive market research with players to determine what they want, whether the products we are developing meet with their expectations and to identify brands we should attempt to license and technologies we should develop, license or acquire to enhance the player's experience. After the restructuring we announced in the September 2011 quarter, we now have six game development studios, which are based around the globe, that utilize the results of the market research in the ongoing development of new games and gaming experiences.

Through our focus on developing the industry's most innovative and player-pleasing products, in fiscal 2011 we launched the following new products:

- Ø **Portal applications:** The first commercially available WMS portal application family, UHP, is available on both video and mechanical reel games. UHP adds a secondary mystery progressive bonus experience on top of a selection of our base game themes. The first UHP application, *Jackpot Explosion*, features a bubbling volcano that displays imminent jackpots on the base game screen, the gaming machine's top screen, as well as on strategically located signage. As coin-in increases and the triggers for the award of the progressive jackpot are approached, robust visuals of a volcano filling with lava are displayed and ambient sounds are amplified to celebrate the big win. UHP is available in both a bank-level solution and full NG solution. We also received regulatory approval for the second UHP theme, *Piggy Bankin'* and the first theme, *Peng Wins*, in the second portal family of applications, *Winner's Share*, early in fiscal 2012.
- Ø **Alice®:** The *Alice* game theme takes the successful WMS bonus bank technology to a new level. Available in identical 30-line video and mechanical versions, the *Alice* theme comes with five unique, randomly triggered features available in both the *Alice and the Mad Party®* and *Alice and the Enchanted Mirror®* themes. Additionally, each game theme features a unique bonus round.
- Ø **G+ Deluxe Game theme series** This series of game themes takes the standard WMS *G+* game play to a new level with 30 percent larger, highly detailed reel symbols, optional game statistics, amped-up win



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celebrations and synchronized lighting and audio effects. Featuring large, very attractive reel symbols, exciting game play videos, game statistics of wins and losses, big win, super big win and mega big win animations, the G+ Deluxe series offers players unique and engaging experiences.

For the United States and Canada, we believe that WMS and four of its competitors (International Game Technology Inc. ( IGT ), Bally Technologies, Aristocrat Leisure Ltd ( Aristocrat ) and Konami Co. Ltd. ( Konami ) account for over 90% of all new units shipped. Based on information publicly available from each of these companies, we believe that our annual share of total units shipped amongst these five companies has grown from just over 20% in fiscal 2009 to just over 25% in fiscal 2011 because of the popularity of our products with players and the resulting high earnings performance that our products have generated for casino operators.

In fiscal 2010, we expanded our revenue opportunities by directly entering three markets we had previously served through content licensing agreements with third parties who sold their gaming machines containing our game content into these markets: Class II and central determination markets, New South Wales, Australia and Mexico. We began directly pursuing the Class II and central determinant market in the United States and Canada after the expiration of game content licensing agreements with third parties who had previously been distributing our products into these markets. We worked throughout fiscal 2010 to obtain the necessary regulatory approvals for the largest of the Class II markets in the United States. To serve this market, we initially entered into an agreement to utilize the central determinant system capabilities of Bluberi and we expect to combine our existing library of for-sale games with this proven system for the Class II and central determinant markets. In the December 2010 quarter, we acquired a copy of the central determinant system software from Bluberi, which enables us to directly provide the system to customers and have better control over the system and its ongoing development, as well as be more responsive to our customers' needs.

In New South Wales, Australia, we entered into a distribution agreement with eBet Ltd., a publicly traded Australian company, which received regulatory approval and began to distribute our *Bluebird2* gaming machines and the first three game themes in the March 2010 quarter. We have since received additional game theme approvals, and in fiscal 2011 received approvals for our *Transmissive Reels* gaming machines. Due to the popularity and earnings performance of our products, shipments and revenues in this market continued to increase.

In May 2009, certain Mexican casino operators sought an interpretation from Mexican regulators of their respective gaming licenses that allowed for another category of game in addition to the existing popular bingo games. Permits have subsequently been interpreted to allow electronic drawing of numbered games, which is similar to Las Vegas-styled games, but cashless. This enabled us to directly enter that market. Our *Bluebird* and *Bluebird2* gaming machines and games were well accepted and, as a result of their good earnings performance, demand increased throughout fiscal 2010 and 2011. While we sold product into these new markets in fiscal 2010 and 2011, we expect to increase our penetration in these markets in the years ahead.

In November 2010, we signed our first agreement with one of the operators for the new VLT market in Italy. While introduction of product in this market has been delayed and is subject to satisfaction of incremental regulatory requirements that were recently introduced, we are continuing to pursue this market and expect to begin a field trial of our products in fall 2011. Although much effort is still needed before the first revenue-earning WMS gaming machines are approved in Italy, we anticipate we will see the first shipments in late fiscal 2012 or fiscal 2013. More international markets, like Italy, are considering VLT's and electronic bingo as a path to gaming expansion, and Greece recently enacted legislation for VLT's.

In each of the prior three fiscal years, we have earned an immaterial amount of our revenues and operating income from selling Orion and SiP products in international markets. As part of our product plan and business strategy review conducted at the end of fiscal 2011 and beginning of fiscal 2012, we decided to wind down support for the Orion product over the coming year and we wrote-down the \$3.4 million *Orion* brand name asset and recorded write-downs of Orion inventory in the June 2011 quarter. In addition, we completed the sale of SiP in July 2011.





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We continue to achieve benefits from the opening of new international offices and the addition of new geographically dispersed sales account executives. We have international offices in Argentina, Australia, Canada, China, India, Mexico, South Africa, Spain and the United Kingdom. Our Australia office houses an internationally focused game development studio, our United Kingdom office houses our online gaming marketing staff, the India office performs a variety of product development operations and the Argentina, Australia, Canada, China, Mexico, the South Africa, Spain and the United Kingdom offices provide distribution functions and a United Kingdom office also supports our online gaming operations. Prior to our restructuring in the September 2011 quarter, we had a game development studio in the United Kingdom.

We are authorized to conduct business in approximately 140 international gaming jurisdictions. International new unit shipments accounted for 38.6% of global shipments in fiscal 2011, compared to 35.4% in fiscal 2010 and 36.6% in fiscal 2009. Overall, international new unit shipments have increased, as growth in Mexico and New South Wales, Australia, and Singapore coupled with modest growth in Asia and Latin America, more than offset lower shipments to Europe, which remains impacted by the challenging economic environment. As a result of our continued focus on creating innovative new games and products for our product sales business, our direct launch into new markets worldwide, the expansion of existing casinos and opening of new casinos and new jurisdictions and continued penetration of existing markets and entering new distribution channels, we expect to grow our global product sales revenues, profits and cash flow.

Strategic Priority Three: *Maximize the Return on Invested Capital of Our Participation Games and Exclusive Licenses of Popular Brands:* Certain of our games and products are only available through lease arrangements where we earn a daily lease rate that is based on either a percentage of the net win, a percentage of the coin-in or a fixed daily lease rate. We invest our capital in the placement of these leased gaming machines and since late fiscal 2007, our business strategy has been to maximize our return on invested capital in this business. A key element of our success has been to limit the number of units of each game theme installed in each casino. The result is that due to the popularity of the games, with a limited supply, the performance of the games has remained high for a longer period. We have also removed participation gaming machines from lower performing casinos and placed them in higher performing casinos to enhance our return on investment. Most of our new participation game themes that we launched in fiscal 2011, resulted in replacing our existing participation gaming machines and we upgraded a portion of our installed base from *Bluebird* gaming machines to *Bluebird2* and *Bluebird xD* gaming machines. We experienced delays in getting approvals for certain of our new participation game themes in fiscal 2011 and by not having new game themes to replace some of our older game themes, we experienced a higher level of removals of participation gaming machines than in the prior two years. As a result, the average installed base of these gaming machines decreased by 2.4% in fiscal 2011, compared to an increase by 6.5% in fiscal 2010 and 10.2% in fiscal 2009, while our average daily lease rate, which we disclose as average revenue per day, decreased by 1.0% in fiscal 2011 compared to an increase of 9.4% in fiscal 2010 and 10.4% in fiscal 2009.

For many of our participation game themes we utilize popular brands and intellectual property from third parties. As the exclusive licensee of the *MONOPOLY* brand for use with gaming machines, we have converted a popular board game brand into a successful line of superior-earning gaming machines. In fiscal 2009, we announced an extension and expansion of our agreement with Hasbro Inc. and Hasbro International, Inc. (collectively, Hasbro), which allows us to continue to use the *MONOPOLY* brand through calendar 2016 with extension options through 2019 and also allows us to use certain other of Hasbro's board game brands, such as *BATTLESHIP*, *YAHTZEE* and *CLUE*<sup>®</sup>. We launched *YAHTZEE* in fiscal 2011 and expect to launch the other two game themes in fiscal 2012.

We also have licensed additional brands, including *THE WIZARD OF OZ*, *THE PRICE IS RIGHT*, *THE LORD OF THE RINGS* and *STAR TREK*, which we use to create series of new participation games utilizing these brands. In July 2011 we signed an amendment of our license to use *THE WIZARD OF OZ* brand through 2020. By combining the name recognition of these brands with creative game content and design, we are able to lease these products to casinos and other licensed gaming machine operators as participation games, generating a high-margin recurring revenue stream for ourselves, as well as for the casinos. We continue to pursue new licensed brands based on the feedback from focus group testing of casino patrons.

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Beginning in fiscal 2007, we began introducing new product lines in our participation business that utilized our licensed and internally developed portfolio of intellectual properties and technologies. These leased participation products provided casino patrons new gaming experiences that they could not experience on the products that we sell to casinos. These intellectual properties and technologies contained elements of the foundational technologies for networked gaming, in advance of when the networked systems will be commercialized. Subsequently, we have introduced new games for each of these product lines and in fiscal 2008, we began introducing participation products that combined the technologies of two or more of these new product lines in one product. In fiscal 2009, we introduced a fourth new gaming platform: *Adaptive Gaming*. These new participation product lines are as follows:

- Ø *Community Gaming*<sup>®</sup>: The first of the new product lines was introduced in the September 2006 quarter with the *MONOPOLY Big Event* game. *Community Gaming* is intended to build a table-game-like camaraderie amongst the players as all of the qualifying players on a bank of *Community Gaming* machines play for a common bonus outcome. The *Community Gaming* experience consists of a bank of gaming machines linked to an overhead video screen that displays the bonus round. When the *Big Event* bonus triggers, a server that controls the overhead video screen enables all qualifying players on the bank to enter the bonus round and win together. *MONOPOLY Big Event* has been providing players with their first exposure to the excitement of a true communal gaming experience, and we followed this in fiscal 2008, with *PRESS YOUR LUCK Big Event* and *Bigger Bang Big Event* games and have evolved the platform in 2010 with the introduction of *THE PRICE IS RIGHT* and *MONOPOLY Bigger Event Big Money Spin*. This new platform has been the primary driver of the growth in our installed footprint of stand-alone participation gaming machines. We had nearly 1,600 *Community Gaming* machines installed in our participation base at June 30, 2011.
- Ø *Sensory Immersion*: The second new product line to debut was our Sensory Immersion platform with the *TOP GUN* game launched in March 2007, and we followed this with *THE WIZARD OF OZ* game launched in October 2007. This new product line utilizes our *CPU-NXT2* operating system with real-time, 3-D animation and a special audio system, including a surround sound chair, to offer a multi-sensory player experience. In fiscal 2009, we launched *DIRTY HARRY*<sup>®</sup>: *MAKE MY DAY* and *TIME MACHINE* and followed those with *THE WIZARD OF OZ Ruby Slippers* in fiscal 2010. In fiscal 2011, we successfully introduced *THE WIZARD OF OZ The Great and Powerful OZ*. At June 30, 2011, our installed base of Sensory Immersion gaming machines was over 2,200 units. More importantly, the uniqueness of this platform coupled with its game mechanics is providing casino customers with high coin-in and net win, and was a significant contributor to our average daily revenue per unit in fiscal 2009, 2010 and 2011.
- Ø *Transmissive Reels*: This product line was the third new product line introduced in our participation business and was launched in the June 2007 quarter. By overlaying video animation directly over mechanical reels, *Transmissive Reels* combines the appeal of mechanical reel gaming with the visually engaging interactive real-time, 3-D animation of video gaming machines. In fiscal year 2009, we launched *THE WIZARD OF OZ Transmissive Reels* gaming machines and have continued the line with new *MONOPOLY* and *THE WIZARD OF OZ* themes annually. In fiscal 2011, we successfully introduced *THE WIZARD OF OZ Wicked Riches*<sup>®</sup>. At June 30, 2011, we had nearly 1,500 of the *Transmissive Reels* participation gaming machines installed, and with the launch of our *Bluebird2* gaming machines in the December 2008 quarter, all of our for sale mechanical reel *Bluebird2* gaming machines contain the *Transmissive Reels* technology.
- Ø *Adaptive Gaming*: We launched this product line in the September 2008 quarter with the *STAR TREK* game. With this new product line, a player can establish a unique user name and password to log into any *STAR TREK* game in any casino in any jurisdiction. By connecting these games through our wide-area network to WMS data centers, once the player terminates a gaming session, the player's status will be saved. Then when the same player logs on to another *STAR TREK* game at that same casino or in any other casino and uses the same unique user name and password, the player's game will start again where the player last ended the game. In addition, if the player completes all of the bonus rounds in the first

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episode of *STAR TREK*, the second episode is enabled for that player and when all of the bonus rounds in the second episode are completed, a third *STAR TREK* episode is enabled for that player and this continues on. We have now introduced 5 different *STAR TREK* episodes. We will be introducing new episodes of the *STAR TREK* game in fiscal 2012. In the June 2009 quarter, we launched *Reel em In Compete to Win* that uses the *Adaptive Gaming* technology. This game allows the players to compete for 3 possible bonus events that are randomly triggered on a *Reel em In Compete to Win* bank of gaming machines. This game displays a leader board for each specific casino as well as a nationwide leader board. The game also displays the players rank and their last ten bonuses earned. In late June 2010, we launched *THE LORD OF THE RINGS* game, which enhances the *Adaptive Gaming* experience by allowing players to save their progress when they log out of the game and enables them to unlock new bonus rounds as they advance through the game. In addition, through an online casual gaming site developed by WMS called *Player s Life*<sup>®</sup>, if players use their same user name and password to log into that website, they can play casual games online and if certain outcomes are achieved, unlock additional miles on their journey that will be available when they go to the casino and play *THE LORD OF THE RINGS* games again. *Players Life* Web Services provides operators with a suite of applications that can be used along with our game theme content and system applications to enhance player engagement and create integrated online (web-based) and offline (real-life) player experiences. Players can use these tools to explore the possibilities at their leisure in the casino, at home and on the road. Accordingly, *Players Life* Web Services encourages repeat player visits to the casinos and helps operators extract valuable information to fine tune their businesses and improve marketing efforts. *Player s Life* Web Services is a distinctive new way to entertain players and keep them engaged in the gaming experience including, for the first time, the ability to influence their own game experiences. At June 30, 2011, we had over 1,100 *Adaptive Gaming* machines installed.

In mid-fiscal 2011, we also launched an online gaming casino website for residents of the United Kingdom, [Jackpotparty.com](http://Jackpotparty.com). The website features popular WMS slot games, a selection of table and card games and certain gaming features not currently available on other online gaming sites. We plan to gradually expand this business into other jurisdictions as appropriate, based on our assessment of legal requirements and market opportunities.

In the June 2011 quarter, we began receiving regulatory approvals for the commercial version of our *WAGE-NET* NG system, the UHP portal application family and the *Jackpot Explosion* theme and after installing the commercial version of the NG software, we began to earn revenues from the placement of the portal application and theme. Since these first approvals, we have subsequently received approvals on *Piggy Bankin*<sup>®</sup>, the second theme in the UHP family, the second portal family, *Winner s Share*, and the first theme in that family, *Peng-Wins*. We have other portal application families that we expect will receive regulatory approval in fiscal 2012, as well as additional themes in fiscal 2012 and beyond for each of the portal application families. The *WAGE-NET* system and portal applications create new value for casino operators by allowing them to mix and match WMS video and mechanical reel base games with secondary integrated NG bonus applications. This serves to keep base game themes fresh, boost game performance and create a superior experience for players, all while providing hundreds of new ways for casino operators to differentiate their floor. We anticipate the rollout of NG systems to take multiple years, similar to the last technology rollout of ticket payouts instead of coin payouts. We have developed several value-added applications from which we expect to earn revenues as we commercialize the NG system.

Our gaming operations revenue and gross profit, along with the improved return on capital deployed in our gaming operations business also are key contributors behind the operating cash flow we generate. By continuing to focus on return on investment in our participation business and introducing innovative new participation games and products, we intend to continue to grow our participation revenues, profitability and cash flows.

Strategic Priority Four: *Drive Margin Improvements*: Our gross margin and operating margins grew in fiscal 2009 and 2010, but declined in fiscal 2011. Total gross margin, exclusive of depreciation and distribution expense, was 60.1%, 64.0% and 63.5% for fiscal 2011, 2010 and 2009, respectively, while our operating margin

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was 14.1%, 21.9% and 19.3% for the same periods, respectively. The decline in margins in Fiscal 2011 was attributable to the \$31.8 million of impairment, restructuring, assets write-downs and other charges we incurred, lower product sales gross margin related to the launch of our *Bluebird xD* product line at a lower product sales margin than expected, combined with a higher amount of lower-margin used gaming machine revenue at a declining gross margin, a lower amount of higher-margin conversion revenue and higher-margin gaming operations revenues being only 37.5% of total revenues compared to 39.8% in fiscal 2010. Our restructuring efforts reduced our headcount, which we expect will lead to lower payroll related costs and improved operating margins in fiscal 2012. In addition, we have cross-functional teams focused on margin improvement and several of our strategy deployment projects focus on different aspects of margin improvement. Our product sales gross margin benefits from the higher average selling price of new units, along with higher-margin premium priced products that we sell and our gaming operations gross margin benefits from higher average revenue per day from our leased participation games. We continue to implement lean sigma initiatives (i.e. processes which help us focus on improving quality and eliminating non-value added steps) to further our process improvement initiatives and improve the flow of our business transactional processes. We also expect to benefit from raw material sourcing initiatives and, once the replacement cycle shortens, from an expanded volume of business, which should result in greater volume discounts of raw material component parts from our suppliers and enable us to spread our manufacturing overhead cost over a larger number of units thereby reducing cost per unit. Our changes to organization structure that we implemented at the end of fiscal 2011 and beginning of fiscal 2012 are also expected to make our operations more efficient in fiscal 2012 and beyond. We believe these initiatives will continue to drive margin improvement in future years, especially with the margin improvement progress on our new *Bluebird xD* product line throughout fiscal 2011. In addition, through disciplined cost management, we continue to expect to realize operating leverage from higher revenues as our total operating costs are not expected to grow at the same percentage as revenues.

Our research and development costs increased as a percentage of revenues to 14.9% in fiscal 2011, including the 40-basis point impact of write-downs of intellectual property assets, from 13.8% of revenues in fiscal 2010 and in total increased \$11.1 million, or 10.5%, over the prior year. Our selling and administrative expenses declined by 30-basis points as a percentage of revenue to 19.2% in fiscal 2011 and in total increase by \$1.6 million, or 1.1%, over the prior year. Our depreciation expense increased as a percentage of revenue to 9.1% in fiscal 2011 from 8.8% in fiscal 2010 and increased \$3.9 million, or 5.8%, over the prior year. We expect that our research and development and selling and administrative expenses will decline as a percentage of revenues in fiscal 2012 but that depreciation expense will increase as a percentage of revenues due to higher levels of new capital spending in fiscal 2011 and anticipated for fiscal 2012 in our gaming operations business. By continuing to drive margin improvements, we believe we will be able to increase net income and generate the necessary capital to fund the other elements of our business strategy.

Strategic Priority Five: *Increase Cash Flow from Operations*: Our cash flow from operations has remained strong throughout the past three fiscal years as a result of strong net income and non-cash expenses, partially offset by increased working capital needs as our business grows. Our cash flow from operations was \$157.1 million in fiscal 2011, \$130.3 million in fiscal 2010 and \$179.2 million in fiscal 2009. Our cash flows from investing activities were higher by \$48.4 million in fiscal 2011 of which \$22.4 million was due to an accelerated effort to replace our *Bluebird* participation gaming machines with new *Bluebird2* and *Bluebird xD* gaming machines, \$16.6 million due to higher investing in intangible and other assets and \$9.4 million higher capital spending on property, plant and equipment. Our cash flows used in financing activities increased by \$86.7 million primarily due to \$56.5 million from an accelerated level of share repurchases under the new \$300-million authorization our Board of Directors approved in August, 2010 and a \$32.8 million lower favorable impact from the exercise of stock options.

Throughout fiscal 2010 and 2011 we continued to selectively grant a higher level of extended payment terms, and as a result our total accounts and notes receivable days sales outstanding was 161 days at June 30, 2011, up 23 days from 138 days at June 30, 2010. However, the aging of our accounts and notes receivable improved between those time periods, despite the financial challenges that our customers faced. In fiscal 2011,

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our inventory turns decreased to 4.1x turns compared to 4.4x turns in the prior year. We also achieved better management of our accounts payable, which improved cash flow from operations. Our cash and cash equivalents balance, inclusive of restricted cash and cash equivalents, decreased from \$184.6 million at June 30, 2010 to \$105.0 million at June 30, 2011 primarily due to more aggressive share repurchases, as we more than doubled the amount of shares repurchased over fiscal 2009 and 2010.

The priorities for the utilization of our cash flow are to: continue to enhance stockholder value by emphasizing internal and external investments to develop, license and acquire advanced technologies and intellectual property; increase our investment in gaming operations to update our installed base from *Bluebird* cabinets to *Bluebird2* and *Bluebird xD* cabinets and for operating lease units; seek acquisitions that can extend our presence and product lines, increase our intellectual property portfolio and expand our earnings potential; and, when appropriate, repurchase shares in the open market or in privately negotiated transactions. We expect that with the continued execution of all of the business strategies discussed above, that our cash flow from operations will continue to increase in fiscal 2012.

### **Design, Research and Product Development**

We are continually developing new games to refresh the installed base of our gaming machines and implementing new hardware, operating system and software technologies and functionality to enhance player entertainment. We utilize our unique *Player Driven Innovation* approach to develop new games and technologies, which has resulted in the creation of innovative products. We also perform market tests of our products with the cooperation of casino operators to assess reliability and player appeal of new games, new hardware, new operating system and software technologies. Our gaming machines and games are usually designed and programmed by our internal engineering staff and game development studios. Our game design teams operate in a studio environment that encourages creativity, productivity and cooperation among designers.

Our Chicago research and development facility is a state-of-the-art technology campus that houses most of our research and development team, including four game development studios and we are currently enlarging this facility to provide for growth. We have additional game development studios in Las Vegas and Sydney and additional research and development staff in Atlanta, Chicago, Las Vegas and Reno. Each of our game development studios works concurrently on multiple games and is staffed with producers, software developers, graphic artists, mathematicians and game developers. Earlier in fiscal 2011, we opened a research and development facility in Pune, India. In some cases, we may outsource testing and graphic design functions to independent firms under contract to us. In addition, we have a defined process to review new game ideas submitted by third parties for consideration by us to license, develop and commercialize.

In July 2009, we opened the *Casino Evolved Advanced Technology Lab* ( CEATL ) at our technology campus in Chicago, Illinois. The CEATL is a dynamic collaborative research and development laboratory focused on advancing the development of products that highlight our leadership in evolving the casino slot floor to a networked environment for the benefit of casino operators and their customers. It also serves as a platform for the future evolution of products and services that will allow entertaining gaming content to be enabled on new platforms.

During fiscal 2011, 2010 and 2009, we expensed \$117.0 million, \$105.9 million, and \$98.4 million, respectively, of design, research and product development costs, including \$3.0 million in fiscal 2011 related to the write-down of intellectual property assets. We expect amounts spent on research and development will represent around 13% of total revenues in fiscal 2012 as we expand our product development initiatives by designing games, system applications and gaming machines that enhance the player experience and drive profitability for us and casino operators and as we continue the roll out of our networked gaming and online gaming operations. For further discussion of networked gaming and online gaming, see Item 7. Management's Discussion and Analysis of Financial Condition and Results of Operations.

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### **Sales and Marketing**

We are authorized to sell or lease our gaming machines to casinos in 212 tribal jurisdictions, 31 state jurisdictions and 140 other legalized gaming jurisdictions worldwide. See **Government Regulation** below. In most gaming jurisdictions, we sell our gaming machines directly, rather than through distributors, which we believe allows us to provide superior customer service and enhances profitability. No single customer, including corporate customers with multiple casino properties, accounted for 10% or more of our revenues in fiscal 2011, 2010 or 2009.

We sell and lease our gaming machines through 37 salespeople in offices in several United States locations, and 15 salespeople in international locations. Our salespeople earn a salary and commissions. The sale of gaming machines takes place throughout our fiscal year and the order sizes typically range from a small quantity of units to several hundred units. We conduct one-on-one meetings with our customers to demonstrate our products at their locations, host customers at private demonstrations in our offices and at other locations and participate in various trade shows domestically and internationally each year. In certain cases, we respond to competitive requests for proposals from private and public entities who are seeking to purchase gaming machines. We advertise in trade and consumer publications that appeal to casino operators, their employees and casino patrons. Usually, with the launch of a featured product or product category, we will design web-based learning experiences for both employees and customers. We use thematic and interactive web-based micro sites as a means to educate our customers and players about our products, and allow them to learn and explore different aspects of our products at their convenience, while also providing instant win and sweepstakes prizes.

Our field service team is a customer-focused organization, responsible for attending to the needs of our customers. Our field service technicians install, remove and convert gaming machines at the customer's request, work with our customers in performing routine maintenance on participation gaming machines owned by us that are located at our customers' casinos, initiate sales of replacement parts and conversion kits and assist with general maintenance of gaming machines owned by our customers. We also have a centralized call center that allows us to be even more responsive to our customers' needs.

In response to rapidly changing slot technology and the need for casinos to have vendor-neutral, consistent, and easily accessible training specifically targeted to slot floor personnel, we launched *Slot Machine University*<sup>®</sup> in fiscal 2007. *Slot Machine University* is an interactive, online training and certification program ([www.slotmachineuniversity.com](http://www.slotmachineuniversity.com)) applicable for professionals working in all facets of slot technology and is the first of its kind to meet the strict requirements for the International Association for Continuing Education and Training accreditation. *Slot Machine University* offers a universal learning solution that helps individuals working in slot technology to support and maintain the wide variety of gaming machines and networked systems used in the gaming industry. Course topics encompass basic slot functionality appropriate for beginning technicians to advanced networking skills required for the future networked gaming environment. As we continue to grow our business internationally, we intend to translate *Slot Machine University* into various languages to support our customers. Courses are offered on a subscription basis, and we believe this service demonstrates our commitment to listen and respond to our customers' evolving needs.

For international markets, we have translated our most popular games into Spanish, Portuguese, French, Italian and Mandarin Chinese. No single country outside of the United States accounted for 10% or more of our revenues in fiscal 2011, 2010 or 2009. Revenues derived from customers outside of the United States accounted for approximately \$260 million, \$218 million and \$221 million for fiscal 2011, 2010 and 2009, respectively. Geographic revenue information is determined by country of destination. Substantially all international sales are made in United States dollars. Revenue from participation games has been primarily limited to Canada and the United States, and we expect this trend to continue. See Note 16. Information on Geographic Areas, to our Consolidated Financial Statements.

Our normal payment terms are 30 to 90 days. We have historically provided extended payment terms to our customers for periods from 120 days through 36 months, with interest payable for terms greater than 12 months





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at prevailing rates, which are generally collateralized by the related gaming machines sold, although the value of the gaming machines, if repossessed, may be less than the receivable balance outstanding. Additionally, customers in many of our international markets receive standard payment terms of 90 to 365 days. Our recent international expansion has necessitated us to provide, in certain jurisdictions, a greater amount of financing terms of 18 to 36 months. In addition, in fiscal 2010 we entered new markets where the existing payment terms were over similar extended periods: Mexico and New South Wales, Australia.

Also, as a result of the financial market crisis, which began in 2008 and led to reduced consumer discretionary spending and a weakened global economic environment, beginning in the March 2009 quarter we began and have continued to provide a greater amount of extended payment terms to select customers. This expanded extended payment term program is expected to continue for the foreseeable future, until the global economy and consumer discretionary spending improve and customer demand for extended payment terms abates. Typically, these sales result in a higher selling price and, if financed over periods longer than 12 months, incur interest at rates in excess of our borrowing rate, both of which provide added profitability to the sale. We believe our competitors have also expanded their use of extended payment terms to finance customer receivables. In aggregate, we believe that by expanding our use of extended payment terms, we have provided a competitive response in our market and that our revenues have been favorably impacted. Customers consider numerous factors in determining whether to issue a sales order to us including, among others, expected earnings performance of the gaming machines (which we believe is the most significant decision factor), selling price, the value provided for any trade-in of used gaming machines, parts and game conversion kit support and payment terms. If we ceased providing an expanded amount of extended payment terms, we believe we would not be competitive for some customers in the market place and that our revenues and profits would likely decrease.

At the end of fiscal 2011, we began to offer select customers operating lease agreements over 36 to 60 months, which provide for monthly payment terms over the course of the lease. We expect the number of operating lease agreements to increase in fiscal 2012.

## **Competition**

The gaming machine market is highly competitive and is characterized by the continuous introduction of new games, new gaming machines and new technologies. Our ability to compete successfully in this market is based, in large part, upon our ability to:

- Ø Develop and offer games and gaming machines with higher earnings performance than the games and gaming machines offered by our competitors;
- Ø Create an expanding and constantly refreshed portfolio of games;
- Ø Identify and develop or obtain rights to commercially marketable intellectual properties;
- Ø Adapt our products for use with new technologies;
- Ø Implement product innovation;
- Ø Offer mechanical and electronic reliability;

- Ø Generate brand recognition;
- Ø Implement effective marketing and customer support; and
- Ø Offer competitive prices and lease terms.

We estimate that about 25 companies in the world manufacture gaming machines and VLTs for legalized gaming markets. Of these companies, we believe that Aristocrat, Bally, IGT, Konami, Lottomatica's G-Tech Holdings subsidiaries Atronic Casino Technology and Speilo Manufacturing Inc., Multimedia Games, Inc., Novomatic Group of Companies and WMS have the preponderance of this worldwide market. In the categories

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of video and mechanical reel gaming machines, we compete with market leader IGT, as well as Aristocrat, Aruze Corp., Lottomatica's Atronic Casino Technology subsidiary, Bally, Franco Gaming Ltd., Konami, Multimedia Games, Inc., the Novomatic Group of Companies and Unidesa Gaming and Systems. In the VLT category, we compete primarily with Bally, IGT, Lottomatica's G-Tech Holdings and Speilo subsidiaries and Scientific Games Corp.

Our competitors vary in size from small companies with limited resources to a few large multi-national corporations with greater financial, marketing and product development resources than ours. The larger competitors, particularly IGT, have an advantage in being able to spend greater amounts than us to develop new technologies, games and products that are attractive to players and customers. In addition, some of our competitors have developed, sell or otherwise provide to customers security, centralized player tracking and accounting systems, which allow casino operators to accumulate accounting and performance data about the operation of gaming machines.

## **Manufacturing**

We currently manufacture substantially all of our gaming machines at our facility in Waukegan, Illinois. We are continuously reconfiguring our assembly lines in order to lower our manufacturing lead times, eliminate wasteful activities, improve productivity and effectively increase our production capacity. We completed an expansion of our Waukegan facility in July 2007 to a total of 350,000 square feet in order to consolidate under one roof warehousing and distribution activities that were maintained at outside-leased facilities, which improved production efficiencies. We also refurbish used gaming machines at our Las Vegas facility. We expect to implement a few finishing lines in both our Las Vegas and Barcelona offices in fiscal 2012 that will allow us to be more responsive to customer demand. These lines will allow for the completion and testing of our gaming machine assemblies, which will be mostly assembled in our Waukegan facility.

Manufacturing commitments are generally based on sales orders from customers. However, due to uneven order flow from customers, component parts common to all gaming machines are purchased and assembled into a partial product that are inventoried in order to be able to quickly fill final customer orders. Our manufacturing processes generally consist of assembling component parts and sub-assemblies into a complete gaming machine. Through the use of lean sigma processes in the design of our new *Bluebird2* gaming machine and setting up the supply chain processes for this gaming machine, we expect to achieve our operating and strategic sourcing initiatives, and we currently can ship a standard black *Bluebird2* gaming machine within two weeks of receiving the signed customer order, which is less than the lead time for our original *Bluebird* product.

We generally warrant our new gaming machines sold in the U.S. for a period of 365 days, while we warrant our gaming machines sold internationally for a period of 180 days to one year. We provide several after-sale services to our customers including customer education programs, 24-hour customer service telephone hot line, a website for technical support, field service support programs and spare parts programs. Our warranty costs have not been significant. We also sell used gaming machines, including products made by us as well as those produced by our competitors which we have taken back as trade-ins from our customers. Generally, we acquire used gaming machines as trade-ins toward the purchase of new gaming machines. While a small secondary market exists in the United States, used gaming machines are typically sold direct by us internationally or to United States-based distributors and then resold in international markets where the higher price point of a new gaming machine may be too costly. Where appropriate, we incur costs to recondition our used gaming machines for resale or we may elect to destroy the used gaming machines. We also sell used gaming machines in lots on an as is basis to licensed used equipment brokers and customers.

The raw materials used in manufacturing our gaming machines include various metals, plastics, wood, glass and numerous component parts, including electronic subassemblies, computer boards and LCD screens. We believe that our sources of supply of component parts and raw materials are generally adequate and we have few sole-sourced parts.



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We continue to implement cost savings and efficiency initiatives and focus on best practices, including lean sigma, in order to improve the efficiency of our manufacturing processes and reduce time to fulfill orders. We continue to make improvements in sourcing and supply management, in inventory and warehouse management and other manufacturing processes. We are implementing a new sales operations strategy in an effort to produce gaming machines more ratably throughout the quarter, with the goal of significantly reducing quarter-end compression in manufacturing. We also have ongoing initiatives, such as new product introduction, enhanced strategic sourcing and supplier management, value engineering the products and designing products for both ease of manufacturability and installation, that we expect will help improve gross margins in future years.

### **Patent, Trademark, Licenses, Copyright and Product Protection**

Each game, gaming machine and associated equipment embodies a number of separately protected intellectual property rights, including trademarks, copyrights and patents. We believe these intellectual property rights are significant assets to our business in the aggregate. During fiscal 2011, 2010 and 2009, we utilized three technologies licensed from two separate third parties in substantially all of the products we sold or leased. The three licenses are for: (1) ticket-in ticket-out technology licensed from the Anchor Gaming subsidiary of IGT and (2) *CPU-NXT* operating system which was originally designed by a third party software developer, Sierra Design Group ( SDG ), now a wholly-owned subsidiary of Bally; and (3) we have a ten-year non-exclusive, royalty-bearing patent cross-license agreement with IGT for intellectual property evidenced by certain patents owned by each of us relating to computing and networked gaming infrastructures, expiring in 2018. The ticket-in ticket-out license runs through the life of the patents and the *CPU-NXT* license is perpetual. In addition, intellectual properties from two other licensors were utilized in leased units that generated over 10% of our total revenues. See **Brand Licenses and Technology** below.

We seek to protect our investment in research and development and the unique and distinctive features of our products and services by maintaining and enforcing our intellectual property rights. Our capitalized patents, trademarks and licenses have remaining useful lives of up to 8, 5 and 5 years, respectively. We believe that the expiration of those patents, trademarks and licenses with expiration dates in the near future will not have a material impact on our business. See Note 8. **Intangible Assets** to our Consolidated Financial Statements.

We have obtained patent protection covering many of our products. We were granted 44 U.S. patents during fiscal 2011, and continue to apply for many patents in the United States and elsewhere to protect inventions in our products and resulting from our research and development efforts. We generally seek to obtain trademark protection in the U.S. for the names or symbols under which we market and license our significant products and game concepts. We also rely on our copyrights, trade secrets and proprietary know-how. In addition, some of our most popular gaming machines are based on trademarks and other intellectual property licensed from third parties. We file for patent rights and trademark protection internationally in a number of key countries, based upon the nature of the patent or trademark, the laws of the given country and our anticipated product placements in that country.

### **Brand Licenses and Technology**

We believe that our use of licensed brand names and related intellectual property contributes to the appeal and success of our products, and that our future ability to license, acquire or develop new brand names is important to our continued success. Therefore, we continue to invest in the market positioning of WMS and the awareness and recognition of our brand names and brand names that we license.

Certain of our games are based on popular brands licensed from third parties, such as Hasbro, Fremantle Media North America, CBS Studios Inc., Turner Entertainment Co. and Warner Bros. Consumer Products Inc. Typically we are obligated to make minimum guaranteed royalty payments over the term of the license agreement and to make advanced payments against those commitments. The licensor typically must

inspect and

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approve any use of the licensed property. In addition, each license typically provides that the licensor retains the right to exploit the licensed property for all other purposes, including the right to license the property for use with any products not related to gaming machines.

On June 11, 2009, we entered into a new long-term license agreement with Hasbro whereby we agreed to license certain intellectual property and proprietary rights owned or controlled by Hasbro in titles such as *MONOPOLY*, *BATTLESHIP*, *YAHTZEE* and *CLUE* for use in our chance-based electronic gaming machines. The agreement was effective April 1, 2009 and has an initial term through December 31, 2016. We have the right to extend the license for an additional three-year term if certain conditions are satisfied. We currently have approvals for more than 60 *MONOPOLY* branded games, including 16 *MONOPOLY* WAP games. Over the last three fiscal years, we added 19 *MONOPOLY* games to our participation game portfolio.

On October 31, 2006, we entered into a long-term license agreement with Warner Bros. Consumer Products Inc. ( Warner Bros. ) under which we license certain intellectual property owned or controlled by Warner Bros. for the 1939 motion picture *The Wizard of OZ* for use in our gaming machines. We amended this agreement in July 2011 so that it now runs through 2020. Other licensed brands we use in our products include: an exclusive agreement to develop, market and distribute games using the brands *THE PRICE IS RIGHT*; *THE LORD OF THE RINGS*; *HAPPY DAYS*; and *STAR TREK*, among others.

Several of our competitors have pooled their intellectual property patents that provide cashless gaming capabilities, specifically ticket-in ticket-out technology. Using this technology, when casino patrons cash out from a gaming machine they receive a printed ticket instead of coins. We have a non-exclusive, royalty-bearing license for certain patents related to this technology with IGT through the expiration date of the relevant patents and we pass through the license fee to our customers for our product sales business.

The original operating system for our *Bluebird* gaming machines, *CPU-NXT*, was developed in 2003 by Sierra Design Group Inc. We have a perpetual license to use this technology and have no continuing payment obligation for this license. Our *CPU-NXT2* operating system was developed internally and is based on *CPU-NXT*. We expect to launch our new *CPU-NXT3* operating system in late 2012, and it too is based on the original *CPU-NXT* system.

In February 2008, we entered into a ten-year non-exclusive, royalty-bearing patent cross-license agreement with IGT. This agreement provides for a cross license of intellectual property evidenced by certain patents owned by each of us relating to computing and networked gaming infrastructures.

## **Government Gaming Regulation**

### ***General***

We sell our games and gaming machines in legal gaming jurisdictions worldwide. The manufacture and distribution of gaming equipment and related software is subject to regulation and approval by various city, county, state, provincial, federal, tribal and foreign agencies.

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We believe we hold all of the licenses and permits necessary to conduct our business. In all, we are authorized to sell or lease our gaming machines to casinos in 383 jurisdictions worldwide, including approximately 140 international gaming jurisdictions.

We and our key personnel have obtained or applied for all approvals necessary to maintain compliance with these regulatory agency requirements. The regulatory requirements vary among jurisdictions, but the majority of jurisdictions require licenses, permits or findings of suitability for the company, individual officers, directors,



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major stockholders and key employees, and documentation of qualification. We must satisfy all conditions for each gaming license or permit. Our gaming equipment also must be approved either by a gaming agency lab or a private lab authorized by the gaming authority.

In some jurisdictions, regulators monitor not only the activities within their own jurisdiction but also activities that occur in other jurisdictions to ensure that the entities it licenses are in compliance with local standards on a worldwide basis. Nevada is such a jurisdiction. The Nevada gaming authorities require us and our gaming subsidiary, WMS Gaming, to maintain Nevada standards of conduct for all of our gaming activities and operations worldwide. To make our compliance efforts more efficient, we have centralized all licensing, compliance and non-product approval gaming regulatory matters, including the shipment of gaming equipment and related software worldwide.

The gaming industry is complex and constantly evolving, particularly in new jurisdictions. We continue to devote significant resources to ensure regulatory compliance throughout our company. Additionally, we have an active gaming compliance committee consisting of one outside consultant and two members of our board of directors that works in concert with our compliance department to avoid any appearances of impropriety as a result of a business relationship or new market opportunity. We have never been denied a gaming-related license, nor have our licenses ever been suspended or revoked.

Since the gaming law requirements of many jurisdictions are similar, we are not including descriptions of all jurisdictions due to the number of jurisdictions to which we are subject. For more information concerning the regulatory schemes to which we are subject, we have filed as an exhibit to this Annual Report on Form 10-K a description of the Nevada regulations. The description of the Nevada regulations is a representative example of the gaming regulations to which we are subject. See Exhibit 99. Gaming Regulations.

### **Seasonality**

See Item 7. Management's Discussion Analysis of Financial Condition and Results of Operations Results of Operations Seasonality.

### **Employees**

As of June 30, 2011, we employed 1,880 persons, including 230 that are internationally based. Approximately 257 of our domestic employees are represented by the International Brotherhood of Electrical Workers (the IBEW). Our collective bargaining agreement with the IBEW relates to our Waukegan, Illinois manufacturing facility and under a new agreement entered into in June 2011, now expires on June 30, 2014. We believe that our relations with our employees are satisfactory.

As a result of the restructuring we announced in the September 2011 quarter and the sale of our SiP business in July 2011, we expect to reduce our employee headcount to approximately 1,700 persons, including a reduction of approximately 30 of our collective bargaining unit employees.

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**ITEM 1A. RISK FACTORS**

We urge you to carefully review the following discussion of the specific risks and uncertainties that affect our business. These include, but are not limited to, the following:

***Gaming licenses, regulatory approvals and gaming legislation impact the ability to operate our business and sell and lease our products:***

- Ø The manufacture and distribution of gaming machines is subject to extensive federal, state, local and foreign regulations and taxes. Most of the jurisdictions in which we operate require licenses, permits, documentation of qualification, including evidence of financial stability and other forms of approval of our company and our officers, directors, major security holders and key personnel, along with our products. Licenses, approvals or findings of suitability may be revoked, suspended or conditioned. The loss of a license in one jurisdiction could trigger the loss of a license or affect our eligibility for a license in another jurisdiction. In addition, gaming authorities may levy fines against us or seize our assets if we violate gaming laws or regulations. We cannot assure you that we will be able to obtain or maintain all necessary registrations, licenses, permits or approvals, that the licensing process will not result in delays or adversely affect our operations and our ability to maintain key personnel, or that complying with these regulations will not increase our costs.
- Ø The gaming authorities in some jurisdictions may investigate companies or individuals who have a material relationship with us or our security holders to determine whether the selected individual or security holder is acceptable to those gaming authorities. Any such investigated company, individual or security holder must pay the costs of the investigation and such an investigation may be time consuming and distracting to our operations. Failure of companies, individuals or security holders to cooperate with any such investigation could negatively impact our ability to obtain or maintain our licenses. Additionally the regulatory review process and licensing requirements may preclude access to new third-party technologies if those parties either are not willing to subject themselves to review or do not meet regulatory requirements.
- Ø Each of our games and gaming machine hardware and software must be approved in each jurisdiction in which it is placed, and we cannot assure you that a particular game and gaming machines, hardware or software will be approved in any jurisdiction. Our networked gaming technology will require regulatory approval in gaming jurisdictions prior to any shipment or implementation and we cannot assure you that we will receive these additional approvals we would need to offer the product in other gaming jurisdictions.
- Ø To expand into new jurisdictions, we may need to be licensed, obtain approvals of our products and/or seek licensure of our officers, directors, major security holders, key personnel or business partners. If we fail to seek, do not receive or receive a revocation of a license in a particular jurisdiction for our games and gaming machines, hardware or software, we cannot sell or place on a participation or leased basis our products in that jurisdiction.
- Ø Delays in, amendments to or repeals of legislation approving gaming or the expansion of gaming in jurisdictions in which we operate or plan to commence operations, may adversely affect our operations. Delays in approvals of our customers' operations or expansions of their operations may adversely affect our operations.
- Ø Some jurisdictions require gaming manufacturers to obtain regulatory approval before engaging in certain transactions, such as business combinations, reorganizations, borrowings, stock offerings and share repurchases. Obtaining regulatory approvals can be time consuming and costly. We cannot assure you that we will be able to obtain or maintain all necessary approvals or that the approval process will not result in delays or changes to our business plans.

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*Our business is vulnerable to changing economic conditions and current unfavorable economic conditions have impacted and could continue to negatively impact our business:*

- Ø Existing unfavorable general economic conditions reduce disposable income of casino patrons and result in fewer patrons visiting casinos. This decline in disposable income could result in reduced play levels on our participation gaming machines, causing our cash flows and revenues from these products to decline. Additionally, higher airfares, gasoline prices and other costs may adversely affect the number of players visiting our customers' casinos. Current unfavorable economic conditions have also resulted in a tightening in the credit markets, decreased liquidity in many financial markets and resulted in significant volatility in the credit and equity markets. Any significant or prolonged decrease in consumer spending on leisure activities could greatly affect the casino industry, causing some or all of our customers to decrease spending or ultimately declare bankruptcy, each of which would adversely affect our business.
  
- Ø A decline in the relative health of the gaming industry and the difficulty or inability of our customers to obtain adequate levels of capital to finance their ongoing operations reduces their resources available to purchase our products and services, which adversely affects our revenues. If we experience a significant unexpected decrease in demand for our products, we could incur losses and also be required to increase our inventory obsolescence charges.
  
- Ø Furthermore, current unfavorable economic conditions have and could continue to impact the ability of our customers to make timely payments to us. In mid-fiscal 2009, we began implementing a program to provide a greater than historical amount of extended payment term financing arrangements to certain of our customers, which could increase our collection risk. We have continued this program throughout fiscal 2011 and this program will likely continue until the economy and consumer discretionary spending improves. Our bad debt expense, inclusive of a \$1.4 million impairment charge for a Venezuelan customer, increased by \$2.2 million to \$5.3 million as our total accounts and notes receivable in fiscal 2011 increased by \$40 million compared to fiscal 2010. We experienced fewer customers filing for protection under the bankruptcy laws in fiscal 2011 than in fiscal 2010. If customers are not able to pay us, we may incur additional provisions for bad debt related to lack of collectability of certain receivables.
  
- Ø We recently reduced our global workforce by approximately 10% and expect to incur pre-tax charges of between \$11 and \$14 million primarily for cash severance costs and other expenses in the September 2011 quarter. The charges that we expect to incur in connection with the restructuring are subject to a number of assumptions, and actual results may differ. We may also incur other charges not currently contemplated due to events that may occur as a result of, or associated with, the restructuring. The workforce reduction and any future workforce or other expense reductions may have an adverse impact on our development activities, costs and our ability to attract and retain key personnel. In addition, as a result of fiscal 2011 performance, we will not pay cash bonuses and will postpone normal merit salary increases by a few months, which may have an adverse impact on morale and our ability to attract and retain key personnel.
  
- Ø In late fiscal 2011 we began to offer select customers operating lease agreements over 36 to 60 months, which provide for monthly payments and revenue recognition over the term of the lease in contrast to product sales where the revenue is recognized upon shipment of the gaming machines and satisfaction of all revenue earning requirements. Entering into operating leases instead of product sales agreements reduces our revenues in the accounting period when the transaction commences. We expect the number of operating leases to increase in fiscal 2012, but cannot predict the level of customer demand for these arrangements. If customer demand for operating lease terms exceeds our expectations, the arrangements may result in a shortfall in the expected product sales revenues recognized in a specific quarter and an increase in the recurring revenue that would be recognized over future periods.

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***Our revenue and profitability depend on our ability to continue to develop, in a timely basis, new technologies and high earning products that appeal to the player and are free from hardware or software anomalies and cannot be fraudulently manipulated:***

- Ø The gaming machine business is characterized by the rapid development of new technologies and the introduction of new products using such technologies. We must continually adapt our products to incorporate new technologies and if we cannot adapt, or do not timely adapt new technologies our operations may be adversely impacted.
- Ø The success of a newly introduced technology, such as networked gaming, is dependent on our casino customers' acceptance of a dynamic change in the way they manage their casino floors. While we have designed our *WAGE-NET* networked gaming system to support our customers' existing investment in our *Bluebird* and *Bluebird2* products, such acceptance may nevertheless only build gradually over time. Delays in acceptance by our customers of new technologies have and may continue to adversely affect our operations.
- Ø Our success depends upon our ability to adapt our manufacturing capabilities and processes to meet the demands of producing new and innovative products. Because our newer products are generally more technologically sophisticated than those we have produced in the past, we must continually refine our production capabilities to meet the needs of our product innovation. If we cannot efficiently adapt our manufacturing infrastructure to meet the needs of our product innovations, or if we are unable to make upgrades to our production capacity in a timely manner, our business could be negatively impacted.
- Ø Our success also depends on continually developing and successfully marketing new games and gaming machines with strong and sustained player appeal. A new game or gaming machine will be accepted by casino operators only if we can show that it is likely to produce more revenue and net win to the casino operator than our existing products or our competitors' products in some cases. Gaming machines can be installed in casinos on a trial basis, and only after a successful trial period are the gaming machines purchased by the casinos. Additionally, we are at risk that customers may cancel orders for products that are not performing to expectations at other casinos. If a new product does not achieve significant market acceptance, we may not recover our development, regulatory approval and promotion costs.
- Ø Participation gaming machines are replaced on short notice by casino operators if the gaming machines do not meet and sustain revenue and profitability expectations. Therefore, these gaming machines are particularly susceptible to pressure from competitors, declining popularity, changes in economic conditions and increased taxation and are at risk of replacement by the casinos, which would end our recurring revenues from these gaming machines unless they can be placed with another customer or repurposed.
- Ø Our success depends on our ability to avoid, detect, replicate and correct software and hardware anomalies and fraudulent manipulation of our gaming machines. All of our games are designed with security features to prevent fraudulent activity. However, we cannot guarantee that these features will effectively stop all fraudulent activities. If our security features do not prevent fraud, we could adversely be affected.
- Ø Our gaming machines have experienced anomalies and fraudulent manipulation in the past. Games and gaming machines may be replaced by casinos and other gaming machine operators if they do not perform according to expectations, or may be shut down by regulators. The occurrence of anomalies in, or fraudulent manipulation of, our gaming machines may give rise to claims for lost revenues and related litigation by our customers and may subject us to investigation or other action by gaming regulatory authorities including suspension or revocation of our gaming licenses, or disciplinary action. Additionally, in the event of such issues with our gaming machines, substantial engineering and marketing resources may be diverted from other projects to correct these issues, which may delay our other projects.

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- Ø In fiscal 2011, we experienced delays in launching new products due to the new technologies we were imbedding in our participation products and as a result of not having as many new participation game themes approved, some of our older game theme performance lagged resulting in a higher level of removals of participation gaming machines, which caused a reduction in the installed base. We cannot assure you that we will be able to obtain or maintain all necessary approvals or that the approval process will not result in delays or changes to our business plans.
  
- Ø Our network gaming applications interface with each gaming machine operating system software that we refer to as a game platform . The game platform manages the software needed to operate the gaming machine. Our network gaming applications, game platforms and the related computer systems are constantly updated and revised to keep pace with the ever-increasing complexity of modern game play, technology and regulatory requirements. We cannot assure you that we will be able to obtain, maintain or manage the level of complexities arising from network gaming applications and gaming platforms and obtain all necessary approvals or that the approval process will not result in costly delays, lost network gaming application revenue or changes to our business plans.

***We are dependent on our intellectual property and trade secrets and must ensure we are licensed to use intellectual property and trade secrets owned by others:***

- Ø Our competitors have been granted patents covering, among other items, numerous gaming machine features, bonusing techniques and related technologies. If our products use processes or other subject matter that is claimed under our competitors' patents, or if other companies obtain patents claiming subject matter that we use, those companies may bring infringement actions against us. We might then be forced to discontinue the affected products or be required to obtain licenses from the company holding the patent, if it is willing to give us a license, in order to continue to develop, manufacture or market our products. We might also be found liable for treble damage claims relating to past use of the patented subject matter if the infringement is found to be willful.
  
- Ø Substantially all of our gaming machines utilize trademarks and other intellectual properties licensed from third parties. Our future success may depend upon our ability to obtain, retain and/or expand licenses for popular intellectual properties in a competitive market. In the event that we cannot renew and/or expand existing licenses, we may be required to discontinue or limit our use of the games or gaming machines that use the licensed technology or bear the licensed marks.
  
- Ø Our success may depend in part on our ability to obtain trademark protection for the names or symbols under which we market our products and to obtain copyright protection and patent protection of our proprietary technologies, intellectual property and other game innovations. We cannot assure you that we will be able to build and maintain goodwill in our trademarks or obtain trademark or patent protection, that any trademark, copyright or issued patent will provide competitive advantages for us or that our intellectual properties will not be successfully challenged or circumvented by competitors.
  
- Ø We also rely on trade secrets and proprietary know-how. We enter into confidentiality agreements with our employees and independent contractors regarding our trade secrets and proprietary information, but we cannot assure you that the obligation to maintain the confidentiality of our trade secrets or proprietary information will be honored. Despite various confidentiality agreements and other trade secret protections, our trade secrets and proprietary know-how could become known to, or independently developed by, competitors.
  
- Ø We have entered into multiple agreements to license intellectual property and technologies that, as of June 30, 2011, had a net book value of \$120.2 million and total potential future commitment of \$89.3 million, including contingent payments. We also have other finite lived intangible assets, including patents and trademarks, with aggregate net book value of \$16.2 million as of June 30, 2011. If we determine that we may not realize the value of any of the finite lived intangible net assets or commitments, we would record an immediate charge against earnings up to the full amount of these net

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assets or commitments in the period in which such determination is made. See Note 8. Intangible Assets to our Consolidated Financial Statements for further information on the amount of intellectual property and technologies recorded on our Consolidated Balance Sheets and Note 14. Commitments, Contingencies and Indemnifications to our Consolidated Financial Statements for further information on total potential future commitments.

***Our industry is competitive:***

- Ø The gaming machine business is intensely competitive. Some of our competitors are large companies with greater financial, marketing and product development resources than ours. In addition, new competitors may enter our key markets. Obtaining space and favorable placement on casino gaming floors is a competitive factor in our industry. Competitors with a larger installed base of gaming machines than ours have an advantage in obtaining and retaining the most space and best positions in casinos.
- Ø In addition, some of our competitors have developed and sell or otherwise provide to customers centralized player tracking and accounting systems, which allow casino operators to accumulate accounting and performance data about the operation of gaming machines. By not having such systems, we are at a competitive disadvantage.
- Ø Our profitability is somewhat dependent on our ability to successfully enter into new markets and new channels of distribution, such as networked gaming software applications and online gaming. We cannot assure you that new markets or channels of distribution will become available or that our products will receive the proper regulatory approvals, be accepted by customers or casino players or will perform as well in these markets as they have in our traditional markets.
- Ø In certain sales of new gaming machines and placement of participation gaming machines we have offered free gaming machines and/or free conversion kits, while at the same time we continue to charge our customers for gaming machines and conversion kits, including CPU-NXT and CPU-NXT2 upgrade kits. We cannot be sure that competitive pressure will not cause us to increase the number of free gaming machines and conversion kits that we are expected to offer to our customers, which would decrease the revenue we expect to receive and reduce our gross profit.
- Ø We have expanded our use of extended payment term financing of customer's purchases over the last three years and expect to continue providing a higher level of extended payment term financing until the economy improves and demand from our customers for such financings abates. We believe that our competitors have also increased the amount of extended payment term financings offered to customers. As some of our competitors are larger than WMS they may be able to provide a greater amount or better terms than we can and that may impact demand for our products. We began to offer operating lease agreements to customers in late fiscal 2011 and similarly, our larger competitors may be able to provide a greater amount or better terms than we can and that may impact demand for our products. In addition both extended payment term financing and operating leases result in a delay in our receipt of cash, which reduces our cash balance and financial flexibility to respond to changing economic events.

***Our business is subject to political, market and financial risks:***

- Ø The gaming industry can be affected by public opinion of gaming. In the event that there is a decline in public acceptance of gaming, either through unfavorable legislation affecting the introduction of gaming into emerging markets, or through legislative and regulatory changes, including tax increases in existing gaming markets, our ability to continue to sell and lease our gaming machines in those markets and jurisdictions would be adversely affected. We cannot assure you that public opinion will continue to support legalized gaming.
- Ø Our gross margins are impacted by decreases to our selling prices or our average daily revenue in our gaming operations business and increases to our costs of products sold including higher material costs



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due to the fluctuating commodities markets, higher labor costs and increased freight charges reflecting escalating gas prices. We may experience lower gross margins in the future if any of these events occurs.

- Ø We face risks associated with doing business in international markets related to political and economic instability and related foreign currency fluctuations. Unstable governments and changes in treaties and legislation may affect the international gaming market with respect to gaming regulation, taxation, tariffs and import duties and the legality of gaming in some markets. Additionally, we may have increased costs in connection with complying with international laws.
- Ø Compliance with applicable environmental, health and safety laws and regulations, including new regulations requiring higher standards, may increase our costs, limit our ability to utilize our current supply chain and force design changes to our products. These changes could reduce the net realizable value of our inventory, which would result in an immediate charge to our Consolidated Statements of Income. Non-compliance could negatively impact our operations and financial position as a result of fines, penalties and the cost of mandated remediation or delays to our manufacturing.
- Ø If we cannot maintain and execute adequate internal control over financial reporting or implement required new or improved controls that provide reasonable assurance of the reliability of the financial reporting and preparation of our Consolidated Financial Statements for external use, we may suffer harm to our reputation, fail to meet our public reporting requirements on a timely basis or be unable to properly report on our business and the results of our operations. Additionally, the inherent limitations of internal control over financial reporting may not prevent or detect all misstatements or fraud, regardless of the adequacy of those controls.
- Ø Our credit facility contains financial covenants which may restrict our ability to, among other things, make certain levels of capital expenditures; incur additional debt; incur liens; change the nature of our business; merge with or acquire other companies, liquidate or dissolve; limit share repurchases; and sell, transfer, lease or dispose of all or substantially all of our assets.

***New products, such as networked gaming, may be subject to complex revenue recognition standards, which could materially affect our financial results:***

- Ø As we introduce new products and our commercial transactions become increasingly complex, additional analysis and judgment is required to account for them and to recognize revenues in accordance with generally accepted accounting principles. Transactions may include multiple element arrangements and/or software components and applicable accounting principles or regulatory product approval delays could change the timing of revenue recognition and could adversely affect our financial results for any given period. Fluctuations may occur in our revenues and related deferred revenues and reflect our continued shift toward more multiple element contracts that include systems and software.

***We are dependent on our employees:***

- Ø The loss or unavailability of one or more of our executive officers or the inability to attract or retain key employees in the future could have an adverse effect on our operations. Our recent work force reduction and bonus and salary related decisions may have an adverse impact on our ability to attract and retain key personnel.
- Ø Our ability to continue to develop new technologies and create innovative products depends on our ability to recruit and retain talented employees. A lack of skilled technical workers could delay or negatively impact our business plans.
- Ø Our manufacturing facility in the United States is dependent on union employees that are represented by the IBEW under a collective bargaining agreement that was renegotiated in June 2011 and now expires on June 30, 2014. While we believe our relations with our



employees are satisfactory, we cannot predict

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whether we will be successful in negotiating a new collective bargaining agreement without any disruptions in our manufacturing. Any disruption in our manufacturing could have an adverse effect on our revenues and expenses.

*The existence of our preferred stock could adversely affect the market price of our common stock.*

- Ø Our certificate of incorporation authorizes the issuance of five million shares of preferred stock with designations, rights and preferences that may be determined from time to time by the board of directors. Accordingly, our board has broad power, without stockholder approval, to issue preferred stock with dividend, liquidation, conversion, voting or other rights that could adversely affect the voting power or other rights of the holders of our common stock. Our board of directors could use preferred stock to discourage, delay or prevent a change in control. The existence of the preferred stock, however, could adversely affect the market price of our common stock.

## **ITEM 1B. UNRESOLVED STAFF COMMENTS**

None.

## **ITEM 2. PROPERTIES**

### *Manufacturing Facility & Corporate Headquarters*

Our main manufacturing facility and corporate headquarters is located in Waukegan, Illinois, a suburb of Chicago, where we own a facility of more than 350,000 square feet that houses our manufacturing and corporate administrative personnel and also includes warehouse space. This facility was built in 1995 and expanded and improved in both 1998 and 2007. The 2007 expansion enabled us to bring under one roof raw materials and finished goods that had previously been stored at separate third-party warehouses. The fiscal 2007 expansion of our Waukegan facility ensures that it will be adequate in capacity and condition to satisfy our expected future growth requirements.

### *Chicago Technology Campus*

Our engineering and game development headquarters is located in Chicago, Illinois, where we own multiple facilities that in the aggregate contain more than 164,000 square feet that house our Chicago engineering and game development personnel and our marketing and commercial operation teams. Our main Chicago facility was renovated into a research and development center in 2001 and subsequently we have acquired other properties to house our expanding workforce. We currently are in the midst of constructing a new 120,000 square foot research and development facility, which will be contiguous to our main Chicago facility, and we expect to complete this addition in late fiscal 2012 to accommodate a portion of our engineering and game development staff. The Chicago technology campus supports the global leadership of our game development and technology efforts and engineering and game development for all North American markets and certain international markets. We also own a parcel of land and building down the street from our Chicago technology campus, which we renovated in fiscal 2009 for use by our commercial operations team.

### *Reno*

In fiscal 2011, we completed the construction of an approximately 53,000 square foot facility that we occupied in December 2010. This facility allowed for all of our Reno-based employees to be located in one facility and provides for future expansion.

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### *Netherlands*

In fiscal 2011, we announced the shutdown of our main facility in the Netherlands and the consolidation of its operations into our operations in Spain, the United Kingdom and other locations to streamline and enhance our sales, marketing and support functions. In the September 2010 quarter, we recorded a charge for the closing of this facility, which included a write-down to fair market value of our facility, and we subsequently sold this facility in June 2011.

### *Leased Facilities*

In addition to the principal and material physical properties described above that we own, we maintain leased space worldwide, none of which is material to our Consolidated Financial Statements.

## **ITEM 3. LEGAL PROCEEDINGS**

### *Securities Claims*

On May 25, 2011, a putative class action was filed against us and certain of our executive officers in the U.S. District Court for the Northern District of Illinois by Wayne C. Conlee (the Conlee lawsuit). The lawsuit alleges that, during the period from November 1, 2010 to April 11, 2011 (the date the Company pre-announced its third quarter fiscal 2011 financial results), the Company made material misstatements and omitted material information related to its fiscal year 2011 guidance. Plaintiff seeks to certify a class of stockholders who purchased stock between these dates. The lawsuit specifically alleges violations of (i) Section 10(b) of the Securities Exchange Act of 1934, as amended (the 34 Act), and Rule 10b-5 promulgated thereunder and (ii) Section 20(a) of the 34 Act. The complaint seeks unspecified damages. On August 4, 2011, the Court granted plaintiff's motion to appoint lead plaintiff and lead counsel, and plaintiff has 60 days from this order to file an Amended Complaint, if any. Defendants have 45 days to answer or otherwise to respond after an Amended Complaint is filed or after defendants receive notice that plaintiff will not be filing an Amended Complaint.

On June 29, 2011, a derivative action was filed in the U.S. District Court for the Northern District of Illinois by David Garay against the current board of directors of the Company as well as a former director (the Garay lawsuit). The Company is named as a nominal defendant. The complaint asserts essentially the same allegations that were made in the Conlee lawsuit about the Company's fiscal year 2011 guidance and alleges the following causes of action: (i) breach of fiduciary duty, (ii) gross mismanagement, (iii) contribution and indemnification from the individual defendants in the event future claims are made against the Company as a result of the individual defendant's alleged misconduct, (iv) abuse of control and (v) waste of corporate assets. The complaint seeks unspecified damages. By agreement of the parties, plaintiff in the Garay lawsuit has agreed to stay further proceedings until resolution of any motion to dismiss that the Company may elect to file in the Conlee lawsuit.

On July 22, 2011, an additional derivative action was filed in the U.S. District Court for the Northern District of Illinois by the Plumbers & Pipefitters Local 152 Pension Fund and UA Local 152 Retirement Annuity Fund against the Company's current board of directors, a former director, and certain of our officers (the Pipefitters lawsuit and, collectively with the Conlee and Garay lawsuits, the Securities Litigation). The Company is named as a nominal defendant. The facts alleged in the Pipefitters lawsuit are similar to those alleged in the Conlee and Garay lawsuits but also include allegations of insider trading in connection with alleged sales of WMS stock made by certain officers and directors in the November 2010 period. The Pipefitters lawsuit specifically alleges the following causes of action: (i) breach of fiduciary duty, (ii) waste of corporate assets, (iii) unjust enrichment, and (iv) indemnification and contribution from the individual defendants in the event future claims are

made against the Company as a result of the individual defendant's alleged misconduct. In addition to unspecified damages, the Pipefitters lawsuit seeks injunctive relief requiring the Company to adopt strengthened corporate governance policies and measures to prevent insider trading as well as disgorgement of the alleged wrongful profits. Defendants have requested that plaintiffs in the Pipefitters lawsuit agree to consolidate the Pipefitters lawsuit with the Garay lawsuit and stay the case pending resolution of any motion to dismiss that the Company may elect to file in the Conlee lawsuit.

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Although we believe that we have meritorious defense to the claims made in the Securities Litigation and intend to contest the lawsuits vigorously, it is too early in these proceedings to predict the outcome of the Securities Litigation or to reasonably estimate possible losses, if any, related to these lawsuits.

Pursuant to our Bylaws and the indemnification agreements with each member of the Board of Directors and officers, the Company is indemnifying and defending each of the individual defendants named in the Securities Litigation.

### *B Plus & Related Party Claims*

On April 9, 2010, B Plus Giocolegale Ltd. ( B Plus ) filed an action against WMS Gaming International SL (Spain), WMS International SL (Italy) and WMS International SL (the Netherlands) in the tribunal civil court in Rome, Italy. WMS Gaming International SL is an indirect, wholly owned subsidiary of the Company. The complaint contains two counts, alleging (i) breach of contract arising from WMS Gaming's termination of a sales order to supply certain slot machines and (ii) pre-contractual liability arising from WMS Gaming's decision to terminate negotiation relating to potential distribution of WMS products in the Italian market (the Italian Proceedings ). The claim for breach of contract was subsequently withdrawn, and the complaint, as amended, seeks aggregate damages of 127.2 million or such other amount, which the court may award. On May 25, 2011, the Judge for the tribunal civil court in Rome ruled that no further evidence is required for a decision and further noting that the entity with which B Plus contemplated a business arrangement was solely the U.S. company, WMS Gaming Inc., which was not named as a defendant in the Italian Proceedings. The judge's ruling also set a hearing for closing arguments on July 10, 2013. No further activity is expected in the Italian Proceeding prior to that date.

On February 21, 2011, WMS Gaming initiated an action in the Commercial Court of the High Court of Justice, Queen's Bench Division, in London, England against B Plus for declaratory relief of no liability for the alleged breach of contract or pre-contractual liability claims of B Plus. On April 25, 2011, B Plus counterclaimed in the London proceeding asserting claims for breach of contract in connection with the termination of the sales order and damages for the wrongful termination of negotiations for distributions of product in Italy (the counterclaim, together with WMS Gaming's claims before the Commercial Court are referred to as the UK Proceedings ). On September 8, 2011, the Commercial Court has scheduled a hearing for B Plus motion to postpone or stay the UK Proceedings pending resolution of the Italian Proceedings.

On May 23, 2011, St. Maarten Games N.V. ( SMG ) filed an action against WMS Gaming in the Court of First Instance in Sint Maarten, alleging, in principal, that it is a party or third party beneficiary of the sales order entered into between WMS Gaming and B Plus and claiming relief for the alleged wrongful cancellation and/or breach of that agreement by WMS Gaming (the Sint Maarten Proceedings ). SMG also alleges that it is an affiliate of B Plus. The claim seeks equitable relief through the delivery of the games and accessories covered by the order plus damages for each day of delay and payment of damages in the amount of U.S. \$19.7 million plus costs. The initial hearing for this matter is scheduled for October 18, 2011. WMS Gaming has not yet responded to this complaint.

While the outcome of the Italian Proceedings cannot be predicted, we believe that we have meritorious defenses to the claims in that proceeding and do not currently expect an adverse ruling in that action that would be material to WMS. With respect to both the UK Proceedings and the Sint Maarten Proceedings, it is too early in each of these cases to predict the outcome or to reasonably estimate possible losses, if any. We believe, however, that we have meritorious defenses to the counterclaims in the UK Proceeding and to the claims in the Sint Maarten Proceeding and intend to defend these proceedings vigorously.

**Table of Contents****ITEM 4. REMOVED AND RESERVED**

*Product names mentioned in this Report are trademarks of WMS Gaming Inc., except for the following marks: BATTLESHIP, CLUE, MONOPOLY and YAHTZEE are trademarks of Hasbro, Inc; DIRTY HARRY is a trademark of Warner Bros. Consumer Products Inc.; G2S and S2S are trademarks of the Gaming Standards Association; HAPPY DAYS and STAR TREK are trademarks of CBS Studios Inc.; PRESS YOUR LUCK and THE PRICE IS RIGHT are trademarks of FremantleMedia Operations BV; THE GODFATHER is a trademark of Paramount Pictures; THE LORD OF THE RINGS is a trademark of The Saul Zaentz Company d/b/a Middle-earth Enterprises under license to New Line Productions, Inc.; THE WIZARD OF OZ is a trademark of Turner Entertainment Co.; TIME MACHINE is a trademark of Next Generation Entertainment (Aust) Pty Limited.*

**PART II****ITEM 5. MARKET FOR REGISTRANT'S COMMON EQUITY, RELATED STOCKHOLDER MATTERS AND ISSUER PURCHASES OF EQUITY SECURITIES**

Our common stock, par value \$0.50, trades publicly on the New York Stock Exchange ( NYSE ) under the symbol WMS. On August 22, 2011, there were approximately 584 holders of record of our common stock.

The following table shows the high and low sale prices of our common stock for the two most recent fiscal years, as reported on the NYSE:

	High	Low
<b>Fiscal Year Ended June 30, 2011</b>		
First Quarter	\$ 41.64	\$ 35.04
Second Quarter	49.11	37.73
Third Quarter	48.08	34.38
Fourth Quarter	37.98	27.97
<b>Fiscal Year Ended June 30, 2010</b>		
First Quarter	\$ 44.89	\$ 28.92
Second Quarter	50.11	37.71
Third Quarter	44.21	35.59
Fourth Quarter	51.77	39.17

**Dividend Policy**

No cash dividends were declared or paid on our common stock during fiscal 2011 or 2010. Our ability to pay future cash dividends will depend upon, among other things, our earnings, anticipated expansion, capital requirements and financial condition. We do not expect to pay cash dividends in the foreseeable future.

**Revolving Credit Facility**

On September 25, 2009, we entered into an amended and restated revolving credit agreement with a group of five banks. The revolving credit facility requires that we maintain certain negative covenants and two financial ratios: a leverage ratio and an interest coverage ratio. These negative covenants and financial ratios could limit our ability to among other things, declare dividends, make any distribution to holders of any shares of capital stock or purchase or otherwise acquire shares of our common stock. At June 30, 2011, based upon the leverage ratio as defined, no limitations exist for permitted restricted payment purposes. Permitted restricted payments are defined under the revolving credit facility as certain cash dividends or cash stock repurchases within a specific dollar amount.



**Table of Contents****Issuance of Unregistered Securities**

None

**Repurchases of Common Shares**

On August 2, 2010, our Board of Directors announced it was terminating the existing share repurchase program and replacing it with a new \$300 million share repurchase program that expires on August 2, 2013. The timing and actual number of shares repurchased will depend on market conditions. All shares will be held in our treasury for possible future use. During fiscal year 2011, we purchased approximately 4.6% of our common shares outstanding, or 2.8 million shares, in open market purchases for approximately \$101.5 million at an average cost of \$36.69 per share, while during fiscal year 2010, we purchased 1.1 million shares for approximately \$45.0 million at an average cost of \$39.61. During fiscal year 2009, we purchased 1.6 million shares for approximately \$35.5 million at an average cost of \$22.15. At June 30, 2011, we had approximately \$198.5 million remaining of our current share repurchase authorization.

The following table provides information relating to repurchases of our common shares for the fourth quarter of fiscal 2011:

Period		Total Number of Shares Purchased	Average Price Paid Per Share	Total Number of Shares Purchased as Part of Publicly Announced Plans or Programs	Maximum Number (Or Approximate Dollar Value) of Shares that May Yet Be Purchased under the Plans or Programs
April 1, 2011	April 30, 2011	300	\$ 32.28	300	\$ 220,013,767
May 1, 2011	May 31, 2011	628,564	31.98	628,564	\$ 199,910,957
June 1, 2011	June 30, 2011	45,800	29.80	45,800	\$ 198,546,100
Total		674,664	\$ 31.83	674,664	\$ 198,546,100

See Note 12. Stockholders' Equity - Common Stock Repurchase Program and Note 19. Subsequent Events to our Consolidated Financial Statements.

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**Performance Graph**

The following graph reflects the cumulative total return (change in common stock price) of a \$100 investment in our common stock for the five fiscal years ended June 30, 2011 in comparison to the Standard and Poor's 500 Composite Index and our peer group. The peer group consists of Aristocrat Leisure Ltd., Bally Technologies, Inc., International Game Technology and Shuffle Master, Inc. The common stock price performance included in this graph is not necessarily indicative of future common stock price performance.

The following graph is not soliciting material, is not deemed filed to be filed with the SEC and is not incorporated by reference in any filing by us under the Securities Act of 1933, as amended (the Securities Act) or the Exchange Act, whether made before or after the date hereof and irrespective of any general incorporation language in any such filing.

**Table of Contents****ITEM 6. SELECTED FINANCIAL DATA**

The data as of June 30, 2011 and 2010 and for the years ended June 30, 2011, 2010 and 2009 are derived from our audited Consolidated Financial Statements and related Notes that are included elsewhere in this Report. The data as of June 30, 2009, 2008 and 2007 and for the years ended June 30, 2008 and 2007 are derived from our audited Consolidated Financial Statements and related Notes that are included in other reports previously filed with the Securities and Exchange Commission.

The selected financial data should be read in conjunction with Item 7. Management's Discussion and Analysis of Financial Condition and Results of Operations and our Consolidated Financial Statements.

	2011	Fiscal Year Ended June 30,			2007
		2010	2009	2008	
		(in millions, except per share amounts)			
<b>Statement of Operations Data:</b>					
Revenues	\$ 783.3	\$ 765.1	\$ 706.4	\$ 650.1	\$ 539.8
Impairment and restructuring(1)	22.2				
Operating income	110.4	167.9	136.6	104.4	74.2
Income before income taxes	123.6	170.5	140.4	105.6	71.7
Provision for income taxes	42.6	57.6	48.2	38.1	22.8
Net income(1)(2)(3)(4)(5)	\$ 81.0	\$ 112.9	\$ 92.2	\$ 67.5	\$ 48.9
<b>Earnings Per Share:</b>					
Basic	\$ 1.40	\$ 2.02	\$ 1.87	\$ 1.34	\$ 1.01
Diluted	\$ 1.37	\$ 1.88	\$ 1.59	\$ 1.15	\$ 0.86
<b>Weighted-Average Common Shares:</b>					
Basic common stock outstanding	57.7	56.0	49.2	50.2	48.4
Diluted common stock and common stock equivalents	59.0	60.4	59.1	60.6	59.6
<b>Dividends Per Common Share</b>	\$	\$	\$	\$	\$
<b>Purchases of Treasury Stock</b>	\$ 101.5	\$ 45.0	\$ 40.5	\$ 35.0	\$
<b>Cash Flow Data:</b>					
Net cash provided by (used in):					
Operating activities	\$ 157.1	\$ 130.3	\$ 179.2	\$ 186.2	\$ 118.9
Investing activities	(157.0)	(108.6)	(113.8)	(117.8)	(158.8)
Financing activities	(77.0)	9.7	(29.8)	(5.2)	35.6
Effect of exchange rates on cash and cash equivalents	0.9	(0.4)	(0.7)	0.4	2.4
Increase (decrease) in cash and cash equivalents	\$ (76.0)	\$ 31.0	\$ 34.9	\$ 63.6	\$ (1.9)

	2011	2010	As of June 30,		2007
			2009	2008	
			(in millions)		
<b>Balance Sheet Data:</b>					
Cash and cash equivalents	\$ 90.7	\$ 166.7	\$ 135.7	\$ 100.8	\$ 37.2
Working capital	345.1	414.2	334.3	296.7	255.5
Total accounts and notes receivable, net	366.2	326.2	252.5	206.2	180.4
Total assets	1,046.3	1,007.0	856.0	772.7	655.7
Long-term debt(2)			115.0	115.0	115.0
Stockholders' equity(2)	855.9	833.9	591.4	510.8	433.6

(1) Net income in fiscal 2011 includes \$16.6 million of net after-tax charges, or \$0.28 per diluted share, which includes \$14.3 million, or \$0.24 per diluted share, of net after-tax impairment and restructuring charges comprised of \$11.8 million or \$0.20 per diluted share for net after-tax non-cash asset impairments (including \$6.8 million net of taxes for impairment of technology licenses, \$2.1 million net of



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taxes for impairment of the *Orion* brand name, \$2.0 million net of taxes for an impairment charge to write-down the value of the Orion Gaming facility in the Netherlands to fair value upon closing the facility and \$0.9 million net of taxes for impairment of receivables related to government action to close casinos in Venezuela); and \$2.5 million or \$0.04 per diluted share for after-tax restructuring charges (primarily separation costs); along with \$5.9 million of after-tax charges, or \$0.10 per diluted share, for asset write-downs and other charges (including charges for inventory write-downs related to winding down the *Orion* and original *Bluebird* product lines); partially offset by \$2.5 million or \$0.04 per diluted share from after-tax cash proceeds of litigation settlement and \$0.02 per diluted share benefit recorded in income taxes related to the period January 1, 2010 through June 30, 2010 from the retroactive reinstatement of the Federal research and development tax credit. See Note 4. Impairment and Restructuring Charges to our Consolidated Financial Statements.

- (2) Net income in fiscal 2010 includes a \$3.6 million net tax benefit from a lower effective income tax rate resulting from discrete tax items, primarily the favorable completion of federal income tax audits through fiscal 2007. In fiscal 2010, we issued 8.7 million of our common shares upon the early conversion to common stock of \$115.0 million principal amount of our 2.75% Convertible Subordinated Notes ( Notes ). As a result of the conversion of all of our Notes, our long-term debt has been eliminated and stockholders equity has increased by \$115.0 million. See Note 11. Revolving Credit Facility and Convertible Subordinated Notes to our Consolidated Financial Statements.
- (3) Net income in fiscal 2009 includes a \$3.1 million after-tax gain from a cash settlement of trademark litigation and a \$1.1 million income tax benefit related to the period January 1, 2008 through June 30, 2008 due to the retroactive reinstatement of the Federal research and development tax credit in December 2008.
- (4) Net income in fiscal 2008 includes a \$2.3 million after-tax write-down to net realizable value of a technology license.
- (5) Net income in fiscal 2007 includes a \$1.0 million after-tax charge for expenses associated with management separation costs during the period and a \$0.7 million income tax benefit related to the period January 1, 2006 through June 30, 2006, due to the retroactive reinstatement of the Federal research and development tax credit in December 2006.

## ITEM 7. MANAGEMENT'S DISCUSSION AND ANALYSIS OF FINANCIAL CONDITION AND RESULTS OF OPERATIONS

*The following discussion and analysis should be read in conjunction with our Consolidated Financial Statements and Notes thereto included elsewhere in this Report. This discussion and analysis also contains forward-looking statements and should also be read in conjunction with the disclosures and information contained in Cautionary Note and Item 1A. Risk Factors in this Report. The following discussion and analysis is intended to enhance the reader's understanding of our business environment.*

*As used in this Report, the terms we, us, our and WMS mean WMS Industries Inc., a Delaware corporation, and its subsidiaries. All references to years, unless otherwise noted, refer to our fiscal year, which ends on June 30. All references to quarters, unless otherwise noted, refer to the quarters of our fiscal year.*

## OVERVIEW

Our mission is: through imagination, talent and technology, we create and provide the world's most compelling gaming experiences. We serve the legalized gaming industry by designing, manufacturing and distributing games, video and mechanical reel-spinning gaming machines and video lottery terminals ( VLTs ) to authorized customers in legal gaming venues worldwide. Our products are installed in all of the major regulated gaming jurisdictions in the United States, as well as in approximately 140 international gaming jurisdictions. We generate revenue in two principal ways: product sales and gaming operations, as further described below. In fiscal 2010, we expanded the markets where we directly distribute our products by launching directly into Class II gaming markets in the United States and entering the Mexican and New South Wales, Australia markets and we continued to further penetrate these markets in fiscal 2011. We had previously served these markets through content licensing agreements with third parties for our game themes. In the December 2010 quarter, we launched an online casino site for residents in the United Kingdom, although we did not begin to market the site until February 2011. In the June 2011 quarter we received the first regulatory approval for our *WAGE-NET* networked gaming system, the first family of portal applications, *UltraHit Progressive* ( UHP ), and the first game in the UHP family, *Jackpot Explosion*. In fiscal 2012, we expect to further penetrate each of the new markets and businesses we have entered over the last two years and look to further expand our distribution channels.

The recession and financial market crisis that began in 2008 has continued to disrupt the economy worldwide, reduced consumer discretionary spending and has led to a weakened global economic environment, all of which have been significant challenges for our industry. In calendar 2008 and 2009, some gaming operators



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delayed or canceled construction projects, resulting in fewer new casino openings and expansions in calendar 2010 and even fewer in calendar 2011, coupled with many customers reducing their annual capital budgets for replacing gaming machines. The economic crisis reduced disposable income for casino patrons and resulted in fewer patrons visiting casinos and lower spending by those patrons who did visit casinos. The economic crisis and increased competition from our competitors lowered the number of new units we sold in fiscal 2010, and this continued in fiscal 2011.

With no leading indicators showing any significant increase in replacement demand for the rest of calendar 2011 or calendar 2012, we conducted a thorough review of our business strategies and product plans late in fiscal 2011 and early fiscal 2012. As a result of the strategic review, we announced that we are refining our product plans and restructuring our organization to sharpen emphasis on our game content and product development strengths. Specifically, we are streamlining our product management and product development functions, simplifying product plans and further prioritizing on-time commercialization of new game themes, products and portal gaming applications for our core product sales and gaming operations businesses. Based upon our decisions stemming from our product and strategy review, in the three-month period ended June 30, 2011, we recorded \$24.0 million of net pre-tax charges, or \$0.26 per diluted share, which includes \$18.4 million, or \$0.20 per diluted share, of pre-tax impairment and restructuring charges comprised of \$16.0 million or \$0.17 per diluted share for non-cash asset impairments (including \$11.0 million for impairment of technology licenses, \$3.4 million for impairment of the *Orion* brand name and \$1.4 million of impairment of receivables related to government action to close casinos in Venezuela) and \$2.4 million or \$0.03 per diluted share for restructuring charges (primarily separation costs), along with \$9.6 million of pre-tax charges, or \$0.10 per diluted share, for asset write-downs and other charges (including inventory charges related to winding down the *Orion* and original *Bluebird* product lines), partially offset by \$4.0 million or \$0.04 per diluted share from cash proceeds of litigation settlement. For the twelve-months ended June 30, 2011, impairment and restructuring charges also include the \$3.8 million of pre-tax charges incurred in the September 2010 quarter related to closing WMS' main Netherlands facility that previously had been included in selling and administrative expense, of which \$2.4 million was a non-cash, pre-tax charge for the write-down to fair market value of property, plant and equipment and \$1.4 million was pre-tax separation charges. Fiscal 2011 also includes a \$0.02 per diluted share benefit recorded in income taxes in the December 2010 quarter related to the period January 1, 2010 through June 30, 2010 from the retroactive reinstatement of the Federal research and development tax credit. We also announced that we expected to record between \$11 million and \$14 million of charges in the September 2011 quarter largely to complete the restructuring, which is expected to reduce our global headcount by about 10%.

We had expected that with our launch of the network gaming-enabled *Bluebird2* gaming machines in the December 2008 quarter, concurrent with certain of our competitors launching their networked gaming-enabled products, the industry would experience an improvement in the replacement cycle, which has been at an abnormally low level for the past few years. However, as discussed above, the economy slowed just as the new gaming machines were being launched, so we did not see the expected improvement in the replacement cycle. Even with the adverse economic environment and its impact on our industry causing customers to constrain their capital budgets, we launched our *Bluebird2* gaming machines in the December 2008 quarter with premium features at a significantly higher price, and demand outpaced our expectations. In late June 2010 we launched another new networked-enabled gaming machine, *Bluebird xD*, as the replacement for our original *Bluebird* slant cabinets and it too had a significantly higher price, and once again demand outpaced our expectations. For fiscal 2010, *Bluebird2* units accounted for 83% of our total new units shipped and, with the launch of the *Bluebird xD* product in fiscal 2011, *Bluebird xD* accounted for 26% of new unit shipments while *Bluebird2* units accounted for approximately 69% of new unit shipments in fiscal 2011. We believe that as the economy improves and gaming operators see meaningful improvements in their profitability and cash flows, they will increase their annual capital budgets for replacement units, which will improve the replacement demand in future years, although we cannot predict when this will occur or the rate of increase in their capital budgets. In addition, we expect to experience only a modest increase in demand from casino expansions and casino openings in new and expanding gaming jurisdictions beginning in calendar 2012.

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We review certain financial measures in assessing our financial condition and operating performance not only in connection with creating our forecasts and in making comparisons to financial results from prior periods, but also in making comparisons to our competitors' financial results and our internal plans. We focus on fluctuations in revenue, number of new units sold, average selling price, average participation installed base and average revenue per day, cost and gross margin on both products sales and gaming operations and also pay close attention to our operating income, operating margin, net income, diluted earnings per share, total cash, accounts and notes receivable, inventories and accounts payable and cash flows from operations as they are key indicators of our performance. We also measure changes in selling and administrative ( S&A ) expenses as a percent of revenue, which indicate management's ability to control costs, as well as changes in research and development ( R&D ) costs as a percent of revenue, which demonstrate investment in technology and product development. Finally, we measure depreciation expense as a percentage of revenues an indicator of the current cost of capital expenditures, primarily in our gaming operations business.

The measures listed above are not a comprehensive list of all factors considered by us in assessing our financial condition and operating performance, and we may consider other individual measures as required by trends and discrete events arising in a specific period, but they are the key indicators and these measures are discussed herein.

We believe several recent developments fueled by the challenging economic situation could expand our revenue opportunities over the long term. In the United States, legislators have passed or are considering enabling new or expanded gaming legislation in Ohio, Illinois, Kansas, Iowa, Maryland, California, New Hampshire, Maine and Massachusetts. Internationally, Singapore opened as a new market in fiscal 2010 and a new VLT market in Italy has opened in fiscal 2011, although the growth of this market has been delayed due to regulatory requirements. In addition, legislation has been passed or discussed in Greece, Brazil, Japan and Taiwan that could open new market opportunities. In the United States, federal legislators and certain state legislators and governments in Canada and Europe are considering legalizing certain forms of online gaming, which if passed could expand our revenue opportunities. The breadth and timing of these opportunities remain uncertain due to the political process in each of these jurisdictions, as well as the difficult credit environment facing our customers and the risk of continued economic uncertainty.

### ***Product Sales***

Product sales revenue includes the sale to casinos and other gaming machine operators of new and used gaming machines and VLTs, parts and conversion kits (including game theme, hardware or operating system conversions). In September 2011 we closed our Orion Financement Company ( Orion Gaming ) manufacturing facility and, in June 2011, we sold this facility and began winding down the support of our Orion Gaming product lines, which will occur over fiscal 2012. In July 2011, we sold our Systems In Progress GmbH subsidiary ( SiP ). These two subsidiaries were immaterial to our Consolidated Balance Sheets, Consolidated Statements of Income and Consolidated Statements of Cash Flows. In fiscal 2011, we also notified our customers that we were winding down the support for our *Bluebird* gaming machines with no new game content available after July 1, 2012 but would continue to service and supply replacement parts through July 2015. We derive product sales revenue from the sale of the following:

- Ø Multi-line, multi-coin video gaming machines, in our *Bluebird*, *Bluebird2* and *Bluebird xD* and Orion Gaming *Twinstar* , *Twinstar2* and *Helios* branded gaming machines;
- Ø Mechanical reel-spinning gaming machines in our *Bluebird*, *Bluebird2* and *Bluebird xD* branded gaming machines;
- Ø Replacement parts and conversion kits for our *Bluebird*, *Bluebird2*, *Bluebird xD*, *Twinstar*, *Twinstar2*, *Helios* and *CPU-NXT* and *CPU-NXT2* upgrade kits; and



- Ø Used gaming machines manufactured by us or our competitors that are acquired on a trade-in basis or that were previously placed on a participation basis.

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### *Gaming Operations*

We earn gaming operations revenues from leasing participation games, gaming machines and VLTs, and earn royalties that we receive from third parties under license agreements to use our game content and intellectual property. Effective July 1, 2010, we changed the format for the categories that we disclose for our participation installed base from prior years to show the breakout of these gaming machines based on the revenue model that generates the lease payments paid to WMS. We are using this new format because we believe it provides greater transparency as to how we earn our revenues. This new format had no impact on our revenues, our total participation installed base or the average revenue per day of our participation installed base.

Our gaming operations include the following product lines:

- Ø Participation games, which are gaming machines owned by us that we lease based upon any of the following payment methods: (1) a percentage of the net win, which is the casino's earnings generated by casino patrons playing the gaming machine; (2) fixed daily fees; or (3) a percentage of the amount wagered ( coin-in ) or a combination of a fixed daily fee plus a percentage of the amount wagered. We have the ability to lease these gaming machines on a participation basis because of the superior performance of the game and/or the popularity of the brand, which generates higher wagering and net win to the casinos or gaming machine operators than the gaming machines we sell outright. Participation games include:
  - Ø Wide-area progressive ( WAP ) participation games;
  - Ø Local-area progressive ( LAP ) participation games; and
  - Ø Stand-alone participation games.
- Ø Casino-owned daily fee games, where the casino or gaming machine operator purchases the base gaming machine and pays a lower daily lease fee for the top box and game;
- Ø Gaming machines placed at casinos under operating lease arrangements;
- Ø VLTs;
- Ø Revenues from licensing our game content and intellectual properties to third parties;
- Ø Revenues from our online gaming casino in the United Kingdom, which was launched in November 2010; and
- Ø Beginning in June 2011, networked gaming revenues where the casinos or other gaming machine operators use our *WAGE-NET* networked gaming system to link groups of gaming machines to remote servers in their locations that allows casinos and other gaming machine operators to purchase new applications and system-wide features for distribution over the *WAGE-NET* system.

**OUR FOCUS**

We continue to operate in a challenging economic environment and the combination of economic uncertainty, lower demand for replacement products and reduced opportunities from new or expanded casinos has negatively impacted our industry. We expect to benefit from certain new and expansion projects currently in process, but the breadth and timing of such opportunities remains uncertain due to the difficult economic environment facing our customers and the lack of meaningful improvement in their profitability and cash flows. We believe that gaming operators' replacement capital budgets will be relatively flat in calendar 2012 from calendar 2011.

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As we navigate these macroeconomic challenges, we remain focused on five key strategic priorities: 1) grow our United States and Canadian market share by innovating differentiated products; 2) expand the breadth and profitability of our international business; 3) drive growth in our gaming operations business, while selectively investing our capital deployed in that business; 4) improve our gross margins and operating margins; and 5) increase our cash flow from operations.

1. *Strategic Priority:* Grow our United States and Canadian market share by innovating differentiated products.

*Fiscal 2011 Result:* The United States and Canadian replacement cycle has been abnormally low for several years and the challenges facing our industry and the overall economy have continued, all of which have reduced overall industry demand. We believe capital budgets for replacing gaming machines improved modestly for calendar 2011 over calendar 2010; however, new casino openings and casino expansions declined over prior-year levels. In this challenging environment, our year-over-year new unit shipment volume was down 7.8% from the prior-year. To further diversify our revenue streams, in fiscal 2010 we directly entered the Class II and central determinant market following expiration of our previous licensing agreements for those markets. Our first Class II gaming machines were shipped in the September 2009 quarter, and we expect to continue to penetrate this market directly as we receive additional regulatory approvals. In fiscal 2011, we purchased a copy of the central system software from Bluberi Gaming Technologies Inc. ( Bluberi ), and we are now operating the system ourselves, although we have continuing payment obligations to Bluberi. We launched our new *Bluebird xD* gaming cabinet late in the June 2010 quarter and, given initial customer response, we had strong demand for this new product in fiscal 2011 amounting to 36% of the total units shipped to customers in the United States and Canada. We are dependent, in part, on innovative new products, replacement demand and casino expansions and new market opportunities to generate growth. We have continued to invest in research and development activities to be able to offer creative and high earning products to our customers and in fiscal 2011, such expenses were \$117.0 million or 14.9% of revenues, including \$3.0 million of write-down charges for intellectual property assets, up \$11.1 million, or 10.5%, compared to the prior-year. Expansion and new market opportunities may come from political action as governments look to gaming to provide tax revenues in support of public programs and view gaming as a key driver for tourism. Based on publicly disclosed information, we believe our share of new units shipped among the five major gaming machine companies serving the United States and Canadian gaming market, was flat at 25% in fiscal 2011 and in fiscal 2010, including units shipped and placed under operating lease arrangements.

2. *Strategic Priority:* Expand the breadth and profitability of our international business.

*Fiscal 2011 Result:* Shipments to international markets represented 38.6% of our total new unit shipments in fiscal 2011, compared with 35.4% for the prior-year, and total units were 9,340 in fiscal 2011 compared to 8,826 in fiscal 2010. During fiscal 2011, international new unit shipments increased 5.8% from the prior-year, as growth in Mexico and New South Wales, Australia, coupled with modest growth in Asia and Latin America, more than offset lower shipments to Europe, which remains impacted by the challenging economic environment. We directly entered two new markets in fiscal 2010 that we had previously served through content licensing arrangements: New South Wales, Australia and Mexico. In the March 2010 quarter in New South Wales, Australia, we began shipping products as our distributor received regulatory approval for our *Bluebird2* gaming machine and the first three game themes. We have since received additional game theme approvals and approval of our mechanical reel gaming machines using our *Transmissive Reels* technology and, due to the popularity and earnings performance of our products, shipments and revenues increased in fiscal 2011. We expect continued growth in fiscal 2012, subject to any adverse change in gaming regulations in that market. We shipped our first direct shipment of gaming machines into Mexico in the June 2009 quarter and expanded shipments to this market in fiscal 2010 and further penetrated this market in fiscal 2011. In November 2010, we signed our first agreement with one of the operators for the new VLT market in Italy. While introduction of product in this market has been delayed and is subject to satisfaction of

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incremental regulatory requirements that were recently introduced, we are continuing to pursue this market and expect to begin a field trial of our products in fall 2011. Although much effort is still needed before the first revenue-earning WMS gaming machines are approved in Italy, we anticipate we will see the first shipments in late fiscal 2012 or fiscal 2013, which will be operating lease agreements rather than product sales. Expansion into the Italian market could be limited however, due to the recent new requirements for all manufacturers, which are being evaluated. Other international markets are also considering VLTs and electronic bingo as a path to gaming expansion and recently VLT legislation was passed in Greece. Also, we continue to achieve benefits from the opening of new international offices and the addition of new geographically dispersed sales account executives. We launched the new *Bluebird xD* gaming cabinet late in the June 2010 quarter, which are benefiting our shipments into the international markets in fiscal 2011 and accounted for 10% of total new units shipments to international markets in fiscal 2011.

3. *Strategic Priority:* Drive growth in our gaming operations business, while selectively investing our capital deployed in that business.

*Fiscal 2011 Result:* During the year ended June 30, 2011, our average installed base of participation gaming machines decreased 2.4% over the prior-year and, at June 30, 2011, our total installed participation footprint stood at 9,870 units compared to 10,421 units at June 30, 2010. Our average revenue per day declined 1% in fiscal 2011 from fiscal 2010. Our focus in fiscal 2011 was to increase the percentage of the installed base that were coin-in gaming machines as they generate the highest gross profit dollars of the three lease models and to convert a portion of our installed base from *Bluebird* gaming machines to new *Bluebird2* or *Bluebird xD* gaming machines. We were successful in increasing the percentage of coin-in gaming machines in our installed base to 38.3% of the installed base at June 30, 2011 from 36.1% of the installed base at June 30, 2010, although this was because of the decrease in the installed base, as the actual number of coin-in units was relatively flat. We were successful in converting a portion of the installed base to new *Bluebird2* and *Bluebird xD* gaming machines, although this required a higher capital investment than the amount invested over the last two years. We invested \$65.9 million in gaming operations capital in fiscal 2011 compared to \$43.5 million in fiscal 2010. We expect that the amount of capital invested in gaming operations will remain at a higher level for the next two years as we continue converting the remaining two-thirds of the installed base from *Bluebird* gaming machines to new *Bluebird2* and *Bluebird xD* gaming machines. In fiscal 2011, we experienced delays in launching new products due to the new technologies we were imbedding in our participation products and as a result of not having as many new participation game themes approved, some of our older game theme performance lagged resulting in a higher level of removals of participation gaming machines, which caused a reduction in the installed base. We expect that with an anticipated increase in participation game themes beginning in mid-fiscal 2012 that we can begin to reverse the trend from fiscal 2011 in the second half of fiscal 2012.

4. *Strategic Priority:* Improve our gross margins and operating margins.

*Fiscal 2011 Result:* Both our gross margin and operating margin declined in fiscal 2011 from fiscal 2010. For the year ended June 30, 2011, our overall gross margin declined by 390-basis points to 60.1% resulting from a 470-basis point decrease to 48.1% in our product sales gross margin largely attributable to the 100-basis point impact of inventory and asset write-downs and other charges, lower-margins achieved on our new *Bluebird xD* product line, coupled with a higher amount of lower-margin used gaming machines sales and a declining margin achieved on such sales and a lower amount of high margin conversion sales. We implemented a plan to increase the *Bluebird xD* gross margin in the September 2010 quarter and realized continued improvement throughout fiscal 2011, although the gross margin is still below that achieved on the *Bluebird2* gaming machines. We will continue to work to increase the *Bluebird xD* gross margin in fiscal 2012. We continue implementing our lean sigma and strategic sourcing initiatives, and we continue to realize positive results. We believe these initiatives will continue to drive margin improvement in future years. Gross margin in our gaming operations business was 80.0% in fiscal 2011 inclusive of the 60-basis point impact of asset write-downs and other

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charges, compared to 80.8% in fiscal 2010. Once the economy improves and replacement demand increases in the future, we would expect to benefit from higher average selling prices and lease revenues coupled with an expanded volume of business that should result in greater volume discounts from our raw material suppliers and enable us to spread our manufacturing overhead costs over a larger number of units thereby reducing average cost per unit. We also expect our gaming operations business will expand beginning in the second half of fiscal 2012 with both the installed base and revenue per day increasing.

Our operating margin declined to 14.1% in fiscal 2011 from 21.9% in fiscal 2010. Of this 780-basis point decline in operating margin, 400-basis points resulted from \$31.8 million of charges for impairments, restructuring, asset write-down and other charges, coupled with a lower amount of higher-margin gaming operations revenues (37.5% in fiscal 2011 compared to 39.8% in fiscal 2010), lower product sales gross margin and higher operating costs.

Through disciplined cost management, we expect to realize operating leverage from higher revenues as our total operating costs are not expected to grow at the same percentage as revenues and we will benefit from lower payroll-related costs as a result of 10% lower headcount upon completion of the restructuring we announced in the September 2011 quarter. Our research and development spending increased to 14.9% as a percentage of revenues in fiscal 2011 and includes the 40-basis impact of the write-down on intellectual property assets and the ongoing investment we are making to create intellectual property and advanced technologies that will power our innovative products in the future and support our existing product lines. We expect that these costs as a percentage of revenue will decline to 13% of revenue in fiscal 2012. We believe our product development capabilities, combined with additional functionalities and enhanced features of our advanced technologies and gaming platforms, enable us to optimize the entertainment value of our products and improve our gross margins and operating margins. We expect selling and administrative expenses to decline as a percentage of revenues in fiscal 2012, but due to higher capital spending in our gaming operations business and the launch of both the networked gaming and online gaming business in fiscal 2011, that depreciation expense will increase as a percentage of revenues in fiscal 2012.

5. *Strategic Priority:* Increase our cash flow from operations and invest in growing our business.

*Fiscal 2011 Result:* For the year ended June 30, 2011, net cash provided by operations grew 20.6% over the prior-year reflecting an increase of \$26.8 million to \$157.1 million. The annual results reflect the year-over-year increase in depreciation, the non-cash portion of the impairment and restructuring charges, an increase in other non-cash items (including the impact of the non-cash portion of inventory, other asset write-downs and other charges), a smaller unfavorable impact of tax-related items and a smaller unfavorable impact from changes in operating assets and liabilities (primarily related to a lower increase in fiscal 2011 in total accounts and notes receivable and inventory), partially offset by lower net income, lower amortization and a decline in share-based compensation. Net cash used in investing activities for the year ended June 30, 2011 increased by \$48.4 million to \$157.0 million from a year ago due to the \$22.4 million increase in capital spending on additions to gaming operations equipment during the last year as the Company continues to transition its installed base of participation units to *Bluebird2* and *Bluebird xD* cabinets, a \$9.4 million increase in capital expenditures for property, plant and equipment and higher payments of \$16.6 million to acquire or license intangible and other assets. Net cash used in financing activities increased by \$86.7 million, primarily due to higher stock repurchase activity, which totaled \$101.5 million in fiscal 2011 compared to \$45.0 million in fiscal 2010 and \$32.8 million from lower stock option exercises compared with fiscal 2010.

The priorities for the utilization of our cash flow are to: continue to enhance stockholder value by emphasizing internal and external investments to create and license advanced technologies and intellectual property; continue to invest in our gaming operations business to convert the installed base to new product lines and for operating lease agreements; seek acquisitions that can extend our presence and product lines, increase our intellectual property portfolio and expand our earnings potential; and, when appropriate, repurchase shares in the

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open market or in privately negotiated transactions. For the year ended June 30, 2011, our research and development spending increased \$11.1 million over the prior-year and we spent \$66.2 million on property, plant and equipment, \$65.9 million on additions to gaming operations equipment, \$24.9 million to acquire or license intangible and other assets, and we funded approximately \$101.5 million of common stock repurchases.

### *Networked Gaming*

We believe that server-enabled networked gaming ( NG ) will be the next significant technology development in the gaming machine industry. NG refers to a networked gaming system that links groups of server-enabled gaming machines to a remote server or servers in each casino's data center. Once the gaming machines are connected to the server-enabled network, data can transfer between the servers and the gaming machines in real time and new applications, game functionality and system-wide features can be enabled on the gaming machines from the remote server. These networks will require regulatory approval in each gaming jurisdiction prior to any implementation and, in time, will represent a significant addition to our existing portfolio of products. We have been introducing the foundational technologies and hardware for NG to the market through our new participation product lines since the September 2006 quarter and we continued to implement this strategy in fiscal 2011 leading up to the receipt on April 22, 2011 of our first regulatory approval for the *WAGE-NET* system, the first portal application family, *Ultra Hit Progressive* ( UHP ) and first UHP theme, *Jackpot Explosion*, from Gaming Laboratories International, Inc. ( GLI ). In June 2011, we began earning revenues from networked gaming applications after installing the commercial version of the NG software. Since these first approvals we have subsequently received approvals on the second theme in the UHP family, *Piggy Bankin* , and the first theme in the second portal family, *Winner's Share*, titled *Peng-Wins*. Nevada regulators recently approved the commercial version of our *Jackpot Explosion* portal application; and our field trial – the final step to achieve approval in Nevada on the remote configuration and download portion of our *WAGE-NET* system was completed in August 2011 and we received approval from the Nevada Gaming Commission related to the interoperability of our NG system with one of the slot accounting systems used by casinos. We expect to receive approval in Nevada for interoperability with other slot accounting systems in the future. We have received additional jurisdictional approval in Michigan, and are progressing with field trials in several additional jurisdictions with approvals expected in the near future. Currently, we have over 300-networked gaming machines running at 17 locations.

Our vision for NG expands on the basic functionality of downloadable games, remote configuration of betting denominations and server-based game outcomes, and emphasizes enhanced game play and excitement for the player. In a networked environment, we believe game play will no longer be limited to an individual gaming machine; rather, we believe NG will permit game play to be communal among many players. We also expect that with networked gaming machines we will be able to offer system-wide features and game functionality along with applications that add value to casino operators' operations. We will continue NG development, working with our competitors and customers to ensure the future is powered by an open architecture approach where games, networks, servers and software from multiple suppliers are compatible with each other through the use of industry standard communication protocols.

Our path to the NG marketplace takes elements of our technology road map and converts them into commercializable products in advance of the launch of the full functionality of NG systems. Beginning in fiscal 2007, we introduced a series of products and functionalities, all building towards NG systems, including our *Community Gaming*<sup>®</sup> participation product line, our *CPU-NXT2* operating system and platform, which is also the basis for our server-enabled *Bluebird2* and *Bluebird xD* gaming machines, Sensory Immersion gaming, *Transmissive Reels* gaming, *Adaptive Gaming*, and progress on interoperability of our *WAGE-NET* system, *Bluebird2* gaming machines using the *CPU-NXT2* operating system with other manufacturers' products and systems using industry standard communication protocols developed by the Gaming Standards Association ( GSA ): *G2S* and *S2S*<sup>®</sup>.

In February 2008, we entered into a ten-year non-exclusive, royalty-bearing patent cross-license agreement with International Game Technology Inc. ( IGT ). This agreement provides for a cross license of intellectual property evidenced by certain patents owned by each of us relating to computing and NG infrastructures. In November 2010 we entered into a 7-year royalty free, non-exclusive license agreement with Konami Gaming





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Inc. ( Konami ) whereby Konami will adopt our *WAGE-NET* system as its networked gaming system. Both WMS and Konami will perform additional programming to make our respective games and applications, and, in Konami's case, their slot accounting system interoperable.

## **OTHER KEY FISCAL 2011 ACTIVITIES**

### ***Common Stock Repurchase Program***

See Note 12. Stockholders' Equity - Common Stock Repurchase Program and Note 19. Subsequent Events to our Consolidated Financial Statements.

## **CRITICAL ACCOUNTING ESTIMATES**

Our Consolidated Financial Statements were prepared in conformity with accounting principles generally accepted in the United States. Accordingly, we are required to make estimates incorporating judgments and assumptions we believe are reasonable based on our experience, contract terms, trends in our company and the industry as a whole, as well as information available from other outside sources. Our estimates affect amounts recorded in our Consolidated Financial Statements and actual results may differ from initial estimates. Our accounting policies, including those involving critical accounting estimates, are more fully described in Note 2. Principal Accounting Policies to our Consolidated Financial Statements.

We consider the following accounting estimates to be the most critical to fully understand and evaluate our reported financial results. They require us to make subjective or complex judgments about matters that are inherently uncertain or variable. Senior management discussed the development, selection and disclosure of the following accounting estimates, considered most sensitive to changes from external factors, with the Audit and Ethics Committee of our Board of Directors.

### ***Revenue Recognition***

We evaluate the recognition of revenue based on the criteria set forth in the following accounting guidance: Financial Accounting Standards Board ( FASB ) Topic 605, *Revenue Recognition* ( Topic 605 ) or FASB Topic 985, *Software* ( Topic 985 ).

### ***Recent Updates to Topics 605 and 985***

In October 2009, the FASB issued Accounting Standards Update ( ASU ) No. 2009-13, *Multiple-Deliverable Revenue Arrangements* ( ASU No. 2009-13 ) and ASU No. 2009-14 *Certain Revenue Arrangements That Include Software Elements* ( ASU No. 2009-14 ). As permitted under these ASU's, we early adopted both of these ASU's on a prospective basis effective July 1, 2009, the beginning of our 2010 fiscal year. Accordingly, this guidance is being applied to all new or materially modified revenue arrangements entered into since July 1, 2009. While the

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adoption of these two ASU s changed our revenue recognition policies beginning in fiscal 2010, the impact on our Consolidated Financial Statements was not significant to either the year ended June 30, 2010 or, had these ASU s been applied retroactively, to the fiscal year ended June 30, 2009, as we had vendor specific objective evidence ( VSOE ) for all elements of our multiple deliverable arrangements and we had not deferred any hardware revenues because an entire customer arrangement had been accounted for as software. These new revenue recognition standards will have more impact on our revenue recognition as we now launch our networked gaming system and related software applications in fiscal 2012.

ASU No. 2009-13 replaces and significantly changes the previous separation criteria for multiple-deliverable revenue arrangements, by eliminating the criteria for objective and reliable evidence of fair value for each deliverable. ASU No 2009-13 also eliminates the use of the residual method of allocation of consideration among deliverables and requires, instead, that arrangement consideration be allocated, at the inception of the

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arrangement, to all deliverables based on their relative selling price (the relative selling price method). When applying the relative selling price method, a hierarchy is used for estimating the selling price based first on VSOE, then third-party evidence (TPE) and finally management's estimate of the selling price (ESP).

Prior to July 1, 2009, when multiple product deliverables were included under a sales arrangement, we allocated revenue to each unit of accounting based upon its respective fair value against the total contract value and deferred revenue recognition on those deliverables where we did not meet all of the requirements of revenue recognition. We allocated revenue to each unit of accounting, which typically consisted of gaming machines and additional game themes the customer can receive in the future, based on fair value as determined by VSOE. VSOE of fair value for all elements of a multiple deliverable arrangement is based upon the normal pricing and discounting practices for those products and services when sold individually.

ASU No 2009-14 amends the scope of software revenue recognition to exclude all tangible products containing both software and non-software components that function together to deliver the product's essential functionality. As a result, certain products that were previously accounted for under the scope of software revenue recognition guidance in Topic 985 will no longer be accounted for as software. Prior to July 1, 2009, we had determined sales of certain of our products, specifically *Bluebird2* gaming machines and revenues generated from the sales of gaming related systems, included software that was more than incidental to the product as a whole and accordingly were accounted for under the scope of software revenue recognition guidance in Topic 985. Effective July 1, 2009, with the adoption of ASU No. 2009-14, we no longer apply software revenue recognition guidance from Topic 985 to our *Bluebird2* gaming machine sales as the software and non-software components of the *Bluebird2* gaming machine function together to deliver the product's essential functionality.

Topic 985 primarily will impact future networked gaming revenues because networked gaming revenues are derived from computer software applications and systems to be sold or leased. As we begin to fully commercialize networked gaming software applications through multiple deliverable arrangements in fiscal 2012, the application of Topic 985 will require us to obtain VSOE for undelivered networked gaming software applications in a multiple deliverable arrangement before revenue can be recognized on the subsequent delivery of a software application that is part of the multiple deliverable arrangement. This may delay the recognition of revenue and increase deferred revenues and deferred costs. Networked gaming refers to a networked gaming system that links groups of networked-enabled gaming machines to a server in the casino data center.

The application of this policy affects that amount of our revenues, accounts and notes receivable and deferred revenues. Other than the adoption of ASU No. 2009-13 and ASU No. 2009-14, effective July 1, 2009 in fiscal 2011, 2010 and 2009, we had no material changes in the critical accounting estimates arising from the application of this policy and we do not anticipate material changes in the near term. See Note 2. Principal Accounting Policies - Revenue Recognition to our Consolidated Financial Statements.

### *Allowances for Slow-Moving and Obsolete Inventories*

We value inventory based on estimates of potentially excess and obsolete inventory after considering forecasted demand and forecasted average selling prices. However, forecasts are subject to revisions, cancellations and rescheduling. Actual demand may differ from anticipated demand, and such differences may have a material effect on our Consolidated Financial Statements. Demand for parts inventory is subject to technical obsolescence. Inventory on hand in excess of forecasted demand is written down to net realizable value.

An active market exists mostly outside of North America for used gaming machines. When we receive a gaming machine on trade-in, we estimate a carrying value for the gaming machine based on the condition of the gaming machine, as well as our experience in selling used

gaming machines and such estimates could change due to changes in demand in general for used gaming machines. We sell these trade-ins as-is or refurbish the used gaming machines before resale. We also sell participation gaming machines as used gaming machines. Therefore, we review our used gaming machine inventory for impairment on a quarterly basis. Actual demand

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for new and used gaming machines may differ from anticipated demand, and such differences may have a material effect on our Consolidated Financial Statements. We sold nearly 9,300 and over 8,500 used gaming machines in fiscal 2011 and 2010, respectively.

During fiscal 2011, 2010 and 2009 we recorded provisions for inventory write-downs of \$7.1 million, \$3.8 million and \$13.3 million, respectively. Fiscal 2010 and 2011 reflect lower write-downs as we transition our customer base from *Bluebird* to *Bluebird2* and *Bluebird xD* gaming machines, but fiscal 2011 does include \$4.9 million of inventory and other assets write-downs related to the winding down of our *Orion* and original *Bluebird* product lines over the coming year as part of our strategic review.

The application of this policy affects the amount of our inventory and cost of product sales. In fiscal 2011, 2010 and 2009, we had no material changes in the critical accounting estimates arising from the application of this policy and we do not anticipate material changes in the near term. See Note 2. Principal Accounting Policies Inventories and Note 6. Inventories to our Consolidated Financial Statements.

### ***Participation Gaming Machine Depreciation and Net Realizable Value***

We depreciate the *Bluebird*, *Bluebird2* and *Bluebird xD* branded participation gaming machines over a three-year useful life to residual value, while we depreciate the participation top boxes over a one-year useful life. We depreciate refurbishment costs of our gaming operations equipment for periods from 12 months to 36 months. A material adverse impact could occur if the actual useful life of our gaming operations equipment is less than what was used in estimating depreciation expense, or if actual residual value is less than the anticipated residual value. At June 30, 2011 and 2010, we had \$86.8 million and \$64.7 million net book value of gaming operations equipment recorded in our Consolidated Balance Sheets. On a quarterly basis, we assess the carrying value of our gaming operations equipment and adjust the carrying value to net realizable value as appropriate based on expected future usage.

The application of this policy affects the level of our gaming operations equipment, accumulated depreciation on gaming operations equipment, cost of gaming operations, depreciation expense, income tax expense and deferred income tax assets and liabilities. In fiscal 2011, 2010 and 2009, we had no material changes in the critical accounting estimates arising from the application of this policy and we do not anticipate material changes in the near term. See Note 2. Principal Accounting Policies Gaming Operations Equipment and Property, Plant and Equipment and Note 7. Gaming Operations Equipment and Property, Plant and Equipment to our Consolidated Financial Statements.

### ***Intellectual Property and Licensed Technology Valuations***

We license intellectual property and technologies from third parties that we use in our games and gaming machines. At June 30, 2011 and 2010, we had \$120.2 million and \$68.2 million capitalized on our Consolidated Balance Sheets for such costs, along with commitments not on our Consolidated Balance Sheets for an additional \$89.3 million at June 30, 2011. As part of our contracts with the licensors, we typically provide a minimum guaranteed commitment and prepay royalties and license fees, usually at the time the contract is signed, even though the product may not be introduced until months or years later. We capitalize the royalty and license fee advances as intangible assets.

When products using the licensed intellectual property or technology begin to generate revenue, we begin amortization of the amount advanced. In cases where the advance represents a paid-up license, the advance is amortized based on the estimated life of the asset. In those cases where the license agreement provides for a royalty to be earned by the licensor for each gaming machine sold or placed on a lease, the advance is amortized based on the royalty rates provided in the license agreement. In both cases, the amortization of the advances is included in cost of

product sales if related to product sale revenues or cost of gaming operations if related to gaming operations revenues. We regularly evaluate the estimated future benefit of royalty and license fee

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advances, as well as minimum commitments not yet paid, to determine amounts unlikely to be realized from forecasted product sales revenues or gaming operations revenues. If actual or revised revenue forecasts fall below the initial estimate, then we may need to revise the remaining useful life and/or record a charge to write down any asset recorded to net realizable value or accrue for the shortfall between the guaranteed royalty for the period and the actual amount estimated to be earned.

On October 1, 2010, we reclassified \$34.4 million of capitalized computer software costs related to our network gaming system from Property, plant and equipment to Intangible assets. In June 2011, we reclassified \$13.4 million of capitalized computer software costs related to our online gaming system platform from Property, plant and equipment to Intangible assets. In June 2011, we recorded \$17.4 million of impairment charges and other charges to write-down licensed technologies, brand name and intellectual property assets to net realizable value stemming from changes in our business strategy and product plans resulting from a comprehensive review of our business. The application of this policy affects the level of our current assets, non-current assets, current liabilities, cost of product sales, cost of gaming operations, research and development expense and selling and general expense. In fiscal 2011, 2010 and 2009, other than the impairment and other charges recorded in fiscal 2011, we had no material changes in the critical accounting estimates arising from the application of this policy and we do not anticipate material changes in the near term. See Note 2. *Principal Accounting Policies* *Reclassifications and Costs of Computer Software Utilized in Products Sold or Leased*, Note 8. *Intangible Assets* and Note 14. *Commitments, Contingencies and Indemnifications* to our Consolidated Financial Statements.

## ***Income Tax Accounting***

We account for income taxes in accordance with FASB Topic 740, *Accounting for Income Taxes*. We conduct business globally and are subject to income taxes in U.S. Federal, state, local and foreign jurisdictions. Determination of the appropriate amount and classification of income taxes depends on several factors, including estimates of the timing and probability of realization of deferred income taxes, reserves for uncertain income tax positions and income tax payment timing.

We record deferred income tax assets and liabilities based on temporary differences between the financial reporting and tax bases of assets and liabilities, applying U.S., state and applicable foreign jurisdiction enacted tax rates expected to be in effect for the year in which the differences are expected to reverse. The ability to realize the deferred income tax assets is evaluated through the forecasting of taxable income, in each jurisdiction, using historical and projected future operating results, the reversal of existing temporary differences and the availability of tax planning strategies.

We apply an estimated annual effective income tax rate to our quarterly operating results to calculate the provision for income tax expense. In the event there is a significant, unusual or infrequent item recognized in our quarterly operating results, the income tax attributable to that item is recorded in the interim period in which it occurs. We modify our annual effective income tax rate if facts and circumstances change between quarters. Our effective income tax rates for fiscal 2011, 2010 and 2009 were 34.5%, 33.8% and 34.3%, respectively.

No taxes have been provided on certain undistributed foreign earnings that are planned to be indefinitely reinvested. If future events, including material changes in estimates of cash, working capital and long-term investment requirements necessitate that these earnings be distributed, an additional provision for withholding taxes may apply, which could materially affect our future effective income tax rate.

As a matter of course, we are regularly audited by various taxing authorities, and sometimes these audits result in proposed assessments where the ultimate resolution may result in our owing additional taxes. We establish reserves when, despite our belief that our tax return positions are appropriate and supportable under applicable tax law, we believe certain positions are likely to be challenged and we may not succeed in

realizing the income tax benefit. We evaluate these reserves each quarter and adjust the reserves and the related interest in



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light of changing facts and circumstances regarding the probability of realizing tax benefits, such as the progress of a tax audit or the expiration of a statute of limitations. We believe the estimates and assumptions used to support our evaluation of tax benefit realization are reasonable. However, final determinations of prior-year income tax liabilities, either by settlement with tax authorities or expiration of statutes of limitations, could be materially different than estimates reflected in our Consolidated Balance Sheets and historical income tax provisions in our Consolidated Statements of Income. The outcome of these final determinations could have a material effect on our income tax provision, net income or cash flows in the period in which that determination is made. We believe our income tax positions comply with applicable tax law and that we have adequately provided for any known income tax contingencies.

We apply FASB Topic 740 *Accounting for Uncertainty in Income Taxes* ( Topic 740 ) to our uncertain tax positions. Under Topic 740, the benefits of income tax positions that are more likely than not of being sustained upon audit based on the technical merits of the tax position are recognized in our Consolidated Financial Statements; positions that do not meet this threshold are not recognized. For income tax positions that are at least more likely than not of being sustained upon audit, the largest amount of the benefit that is more likely than not of being sustained is recognized in our Consolidated Financial Statements.

At this time we believe appropriate provisions for all outstanding tax issues have been made for all jurisdictions and all open years. We are no longer subject to any significant Federal tax examinations by tax authorities for years before fiscal 2008, or state, local or foreign income tax examinations by tax authorities for years before fiscal 2004.

The application of this policy affects the level of our income tax expense, current income tax receivables and liabilities and current and non-current deferred income tax assets and liabilities. In the December 2010 quarter, we recorded the benefit from the retroactive reinstatement of the Federal research and development tax credit to January 1, 2010 of which \$0.02 applied to periods prior to fiscal 2011. In the March 2010 quarter, we had several discrete income tax items that netted out to a lower effective income tax rate which increased diluted earnings per share by \$0.06; primarily the completion of Federal income tax return audits by the Internal Revenue Service for fiscal 2004 through fiscal 2007 that resulted in a reduction of our liability for uncertain tax positions by \$4.6 million, or a \$0.07 per diluted share benefit, partially offset by the expiration of the Federal research and development tax credit effective as of December 31, 2009 which had the impact of reducing our earnings per diluted share by \$0.01. Other than the \$4.6 million reduction in the liability for uncertain tax positions as a result of the completion of the audit of our Federal income tax returns through fiscal 2007, in fiscal 2011, 2010 and 2009, we had no material changes in the critical accounting estimates arising from the application of this policy and we do not anticipate material changes in the near term. See Note 2. *Principal Accounting Policies Accounting for Income Taxes* and Note 10. *Income Taxes* to our Consolidated Financial Statements.

***Share-Based Compensation Expense***

We account for share-based compensation in accordance with the provisions of FASB Topic 718, *Share-Based Payment* ( Topic 718 ). Pre-tax share-based compensation expense was \$18.7 million, \$20.3 million, and \$18.0 million for fiscal 2011, 2010 and 2009, respectively. In fiscal 2011, we recorded a provision for equity-based performance units outstanding of \$0.8 million that relate to the thirty-six month periods ended June 30, 2011, 2012 and 2013, based on the current assessment of achievement of the performance goals. Additional charges will be recorded in future periods depending on the assessment of achievement of the performance goals. In fiscal 2010, we recorded a provision for equity-base performance units outstanding of \$4.0 million that relate to the thirty-six month periods ended June 30, 2010, 2011 and 2012, based on the then current assessment of achievement of the performance goals. In fiscal 2009, we recorded a provision for equity-base performance units outstanding of \$3.4 million that relate to the thirty-six month periods ended June 30, 2009, 2010 and 2011, based on the then current assessment of achievement of the performance goals.

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Under the fair value recognition provisions of Topic 718, stock-based compensation cost is estimated at the grant date based on the fair value of the award and is recognized as expense ratably over the requisite service period of the award. Determining the appropriate fair value model and calculating the fair value of share-based awards requires judgment, including estimating stock price volatility, forfeiture rates and expected life. If actual results differ significantly from these estimates, share-based compensation expense in our Consolidated Statements of Income could be materially impacted.

The application of this policy affects the level of our cost of product sales, cost of gaming operations, research and development expenses, selling and administrative expenses, additional paid-in capital and income tax expense. During fiscal 2011, 2010 and 2009, we had no material changes in the critical accounting estimates arising from the application of this policy and we do not anticipate material changes in the near term. See Note 2. Principal Accounting Policies Shared-Based Compensation Stock Option Assumptions and Note 13. Equity Compensation Plan to our Consolidated Financial Statements.

## **RECENTLY ISSUED ACCOUNTING STANDARDS**

See Note 2. Principal Accounting Policies Recently Issued Accounting Standards to our Consolidated Financial Statements.

## **RESULTS OF OPERATIONS**

### *Seasonality*

Sales of our gaming machines to casinos are generally strongest in the spring and slowest in the summer months, while gaming operations revenues are generally strongest in the spring and summer. Typically our total revenues are lowest in the September quarter and build in each subsequent quarter with the June quarter generating our highest total quarterly revenues, although in fiscal 2011 revenues were higher in the December quarter than the March quarter. In addition, quarterly revenues and net income may increase when we receive a larger number of approvals for new games from regulators than in other quarters, when a game or platform that achieves significant player appeal is introduced, if a significant number of new casinos open or existing casinos expand or if gaming is permitted in a significant new jurisdiction.

### *Impact of Inflation*

During the past three years, the general level of inflation affecting us has been relatively low. Our ability to pass on future cost increases in the form of higher sales prices will depend on the prevailing competitive environment and the acceptance of our products in the marketplace.

### *Net Charges*

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Given the continuing lower levels of capital spending by casinos over the last three years and with no leading indicators that demand will increase in the near-term, we conducted a thorough review of our product plans and business strategies at the end of fiscal 2011 and beginning of fiscal 2012. We still believe our long-term vision and business strategy is intact but, as a result of this review, we are refining our product plans and restructuring our organization. Specifically we are streamlining our product management and product development functions, simplifying our product plans and further prioritizing on-time commercialization of new game themes, products and portal applications. Some of the product and operational decisions made in this review led to the impairment, restructuring, asset write-downs and other charges, net of \$24.0 million, or \$0.26 per diluted share, recorded in the June 2011 quarter and \$27.8 million, or \$0.28 per diluted share, for fiscal 2011.

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The following table summarizes the detail of the net charges recorded in fiscal 2011 (in millions, except per diluted share amounts):

Description of Charges	Pre-tax amounts	Per diluted share
<b>Impairment and Restructuring Charges:</b>		
Non-cash Charges		
Impairment of licensed technologies and licensed brand	\$ 14.4	\$ 0.15
Impairment of property, plant and equipment and other asset write-downs	4.0	0.05
<b>Total non-cash charges</b>	<b>18.4</b>	<b>0.20</b>
Cash Charges		
Restructuring charges	3.8	0.04
<b>Total Impairment and Restructuring Charges</b>	<b>22.2</b>	<b>0.24</b>
<b>Charges for Asset Write-Downs:</b>		
Inventory and other asset write-downs (recorded in cost of product sales)	4.9	0.05
Other asset write-downs ( recorded in cost of gaming operations)	1.7	0.02
Intellectual property asset write-downs (recorded in research and development)	3.0	0.03
<b>Total Charges for Asset Write-downs</b>	<b>9.6</b>	<b>0.10</b>
<b>Total Impairment, Restructuring, Asset Write-downs and Other Charges</b>	<b>31.8</b>	<b>0.34</b>
Proceeds from litigation settlement (recorded in interest income and other income and expense, net)	(4.0)	(0.04)
Prior period impact from retroactive reinstatement of the Federal research and development tax credit (recorded in provision for income taxes)		(0.02)
<b>Total Net Charges</b>	<b>\$ 27.8</b>	<b>\$ 0.28</b>

Fiscal 2011 results includes \$27.8 million of net pre-tax charges, or \$0.28 per diluted share, which includes \$22.2 million, or \$0.24 per diluted share, of pre-tax impairment and restructuring charges comprised of \$18.4 million, or \$0.20 per diluted share, for non-cash asset impairments (including \$11.0 million for impairment of technology licenses, \$3.4 million for impairment of the *Orion* brand name) \$2.6 million for impairment charges to write-down the value of the Orion facility in the Netherlands to fair value upon closing of the facility and \$1.4 million for impairment of receivables related to government action to close casinos in Venezuela); and \$3.8 million or \$0.04 per diluted share for restructuring charges (primarily separation costs); along with \$9.6 million of pre-tax charges, or \$0.10 per diluted share, for asset write-downs and other charges (including charges for inventory write-downs related to winding down the *Orion* and original *Bluebird* product lines); partially offset by \$4.0 million or \$0.04 per diluted share from cash proceeds of litigation settlement and a \$0.02 per diluted share benefit recorded in the December 2010 quarter related to the period January 1, 2010 through June 30, 2010 from the retroactive reinstatement of the Federal research and development tax credit.

We expect to record additional charges of \$11 million to \$14 million in the September 2011 quarter largely to complete our restructuring which is expected to reduce our workforce by about 10%.

**Table of Contents****Fiscal Year Ended June 30, 2011 Compared to Fiscal Year Ended June 30, 2010 and 2009**

Below are our Revenues, Gross Margins and Key Performance Indicators. This information should be read in conjunction with our Consolidated Statements of Income (in millions, except unit, per unit and per day data):

	2011	Fiscal Year 2010	2009	Favorable (Unfavorable)			
				2011 vs. 2010		2010 vs. 2009	
				Dollar	Variance %	Dollar	Variance %
<b>Product Sales Revenues</b>							
New units revenues	\$ 403.2	\$ 387.6	\$ 375.1	\$ 15.6	4.0	\$ 12.5	3.3
Other product sales revenues	86.0	73.3	63.4	12.7	17.3	9.9	15.6
Total product sales revenues	\$ 489.2	\$ 460.9	\$ 438.5	\$ 28.3	6.1	\$ 22.4	5.1
New units sold	24,216	24,944	26,406	(728)	(2.9)	(1,462)	(5.5)
Average sales price per new unit	\$ 16,651	\$ 15,540	\$ 14,203	\$ 1,111	7.1	\$ 1,337	9.4
Gross profit on product sales revenue(1)	\$ 235.3	\$ 243.5	\$ 225.7	\$ (8.2)	(3.4)	\$ 17.8	7.9
Gross margin on product sales revenue(1)	48.1%	52.8%	51.5%	(470)bp	(8.9)	130bp	2.5
<b>Gaming Operations Revenues</b>							
Participation revenues	\$ 277.7	\$ 287.6	\$ 246.7	\$ (9.9)	(3.4)	\$ 40.9	16.6
Other gaming operations revenues	16.4	16.6	21.2	(0.2)	(1.2)	(4.6)	(21.7)
Total gaming operations revenues	\$ 294.1	\$ 304.2	\$ 267.9	\$ (10.1)	(3.3)	\$ 36.3	13.5
Installed Participation Base at Period End with Lease Payments based on:							
Percentage of coin-in units(2)	3,780	3,765	2,868	15	0.4	897	31.3
Percentage of net win units(2)	3,072	3,334	3,959	(262)	(7.9)	(625)	(15.8)
Daily lease rate units(2)(3)	3,018	3,322	3,523	(304)	(9.2)	(201)	(5.7)
Total installed participation base units at period end	9,870	10,421	10,350	(551)	(5.3)	71	0.7
Average participation installed base units	10,046	10,298	9,666	(252)	(2.4)	632	6.5
Average revenue per day per participation units	\$ 75.76	\$ 76.53	\$ 69.93	\$ (0.77)	(1.0)	\$ 6.60	9.4
Gross profit on gaming operations revenue(1)	\$ 235.4	\$ 245.9	\$ 223.2	\$ (10.5)	(4.3)	\$ 22.7	10.2
Gross margin on gaming operations revenues (1)	80.0%	80.8%	83.3%	(80)bp	(0.1)	(250)bp	(3.0)
<b>Total revenues</b>	<b>\$ 783.3</b>	<b>\$ 765.1</b>	<b>\$ 706.4</b>	<b>\$ 18.2</b>	<b>2.4</b>	<b>\$ 58.7</b>	<b>8.3</b>
<b>Total gross profit(1)</b>	<b>\$ 470.7</b>	<b>\$ 489.4</b>	<b>\$ 448.9</b>	<b>\$ (18.7)</b>	<b>(3.8)</b>	<b>\$ 40.5</b>	<b>9.0</b>
<b>Total gross margin(1)</b>	<b>60.1%</b>	<b>64.0%</b>	<b>63.5%</b>	<b>(390)bp</b>	<b>(6.1)</b>	<b>50bp</b>	<b>0.8</b>
<b>Total operating income</b>	<b>\$ 110.4</b>	<b>\$ 167.9</b>	<b>\$ 136.6</b>	<b>\$ (57.5)</b>	<b>(34.2)</b>	<b>\$ 31.3</b>	<b>22.9</b>
<b>Total operating margin</b>	<b>14.1%</b>	<b>21.9%</b>	<b>19.3%</b>	<b>(780)bp</b>	<b>(35.6)</b>	<b>260bp</b>	<b>13.5</b>
<b>Net income</b>	<b>\$ 81.0</b>	<b>\$ 112.9</b>	<b>\$ 92.2</b>	<b>\$ (31.9)</b>	<b>(28.3)</b>	<b>\$ 20.7</b>	<b>22.5</b>
<b>Earnings Per Share:</b>							
<b>Basic</b>	<b>\$ 1.40</b>	<b>\$ 2.02</b>	<b>\$ 1.87</b>	<b>\$ (0.62)</b>	<b>(30.7)</b>	<b>\$ 0.15</b>	<b>8.0</b>
<b>Diluted</b>	<b>\$ 1.37</b>	<b>\$ 1.88</b>	<b>\$ 1.59</b>	<b>\$ (0.51)</b>	<b>(27.1)</b>	<b>\$ 0.29</b>	<b>18.2</b>

bp basis points

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- (1) As used herein, gross profit and gross margin exclude depreciation and distribution expense.
- (2) In prior-years we disclosed the categories of our participation gaming machines based on the type of game placed on the gaming machine; WAP, LAP and Stand-alone. Beginning July 1, 2010, we modified our installed participation base categories to show the breakout of these gaming machines based on the revenue models that generate the lease payments: Percentage of coin-in, percentage of net win and daily lease rate. This change does not impact our total participation revenues or gross profits, nor our total installed base of participation gaming machines or the average revenue per day. We believe these new categories provide stockholders with better perspective about how our participation revenues are generated. The prior-year disclosure of the participation-installed base categories included in this table reflects the current year presentation.
- (3) Includes only participation game theme units. Does not include units with product sales game themes placed under fixed-term, daily fee operating leases.

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***Fiscal 2011 Compared to Fiscal 2010***

Total revenues for fiscal 2011 increased 2.4%, or \$18.2 million, over fiscal 2010, reflecting:

- Ø A \$15.6 million, or 4.0%, increase in new unit sales revenue as a result of:
  - Ø A 7.1% increase in the average selling price of new gaming machines to \$16,651, principally reflecting a greater sales mix of premium-priced products, including the sale of over 16,600 *Bluebird2* and 6,200 *Bluebird xD* gaming machines, representing in aggregate approximately 94.6% of our total new unit sales, compared to over 20,200 *Bluebird2* gaming machines sold, or 82.9% of new unit sales in fiscal 2010. Sales of new *Bluebird xD* units, which were launched in June 2010, accounted for 26.0% of new units sold in fiscal 2011 compared to 1.8% in fiscal 2010. The increase in average selling price was partially offset by:
  - Ø A 728 unit, or 2.9%, decrease in new units sold as:
    - Ø New units sold in the United States and Canada totaled 14,876 units, a decrease of 7.8%, due to a decline in shipments to new casino openings and expansions and replacement market shipments were also lower resulting from the slow economy and our customers' lower capital budgets in calendar 2010 with only a modest increase in capital budgets in calendar 2011.
    - Ø International new units sold increased 5.8% from the prior-year to 9,340 units from 8,826 units in fiscal 2010 and represented 38.6% of global shipments up from 35.4% in the prior-period primarily reflecting increased market penetration in Mexico and New South Wales, Australia, new markets we first entered directly in fiscal 2010, which more than offset the impact of continuing economic challenges across the European markets; and
    - Ø Sales of mechanical reel products totaled 5,018 units, or approximately 20.7% of total new units sold compared to 29.5% of units sold in the prior-year.
- Ø A \$12.7 million, or 17.3%, increase in other product sales revenues, reflecting higher revenues from lower-margin used gaming machines and higher parts sales revenues, partially offset by lower conversion revenues and other product sales revenues:
  - Ø We sold nearly 9,300 used gaming machines during fiscal 2011, compared to over 8,500 used gaming machines in the prior-year period. The average sales price of used gaming machines increased in fiscal 2011 as we sold more of our own used gaming machines which have higher prices and in fiscal 2010 we sold more of our competitors used gaming machines which have lower prices; and
  - Ø We earned revenue on approximately 8,200 conversion kits in fiscal 2011, compared to over 10,100 conversion kits in the prior-year period, and the average selling price achieved was higher than in fiscal 2010 due to more higher-priced hardware conversion sales.
- Ø Participation revenues were lower by \$9.9 million, or 3.4%, due primarily to:
  - Ø The average installed base of participation gaming machines in fiscal 2011 decreased to 10,046 units in fiscal 2011, down 252 units, or 2.4%, from an average of 10,298 units in fiscal 2010. The percentage of coin-in units in the installed base at June 31,

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2011, was 38.3% compared to 36.1% at June 30, 2010, although the actual number of such units was about flat between years. The average installed base for the year was negatively impacted in the June 2011 quarter from idle participation units in certain casinos that were closed due to flooding along the Mississippi, Missouri and Ohio rivers. The estimated impact from these idle units, including a significant number of high-performing coin-in units, totaled nearly 8,000 unit revenue days. As of August 1, 2011, all of these casinos have reopened. The percentage of net win units decreased by 262 units, or 7.9%, and the daily lease rate units in the installed base as of June 30, 2011 decreased by 304 units, or 9.2%, primarily due to certain game series coming to the end of their product life cycle and our not having enough new participation themes approved to refresh the installed base; and



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Ø Overall average revenue per day decreased slightly by \$0.77, or 1.0%, principally reflecting lower average revenue per day in our percentage of coin-in gaming machines.

Ø A \$0.2 million, or 1.2%, decrease in other gaming operations revenues as we experienced lower royalty revenues, partially offset by higher Class II and initial revenues from our new online gaming and networked gaming operations.

Total gross profit, as used herein excluding depreciation and distribution expense, decreased by 3.8%, or \$18.7 million, to \$470.7 million for fiscal 2011 from \$489.4 million for the prior-year period. Our gross margins may not be comparable to those of other entities as we include the costs of distribution, which amounted to \$24.7 million and \$23.9 million in fiscal 2011 and 2010, respectively, in selling and administrative expenses. Our overall gross margin decreased to 60.1% in fiscal 2011 from 64.0% in the prior-year period reflecting a change in the mix of our revenues as lower-margin product sales amounted to 62.5% of total revenues in fiscal 2011 compared to 60.2% in fiscal 2010 while higher-margin gaming operations revenues amounted to 37.5% of revenues in fiscal 2011 compared to 39.8% in fiscal 2010. In addition:

Ø Gross margin on product sales revenues was 48.1% for fiscal 2011, inclusive of the 100-basis point impact of \$4.9 million of inventory and asset write-downs and other charges recorded in the June 2011 quarter, compared to 52.8% for the prior-year period. Product sales gross margin for fiscal 2011 also reflects: lower initial gross margin on our new *Bluebird xD* gaming machines as we rolled out this new product and *Bluebird xD* units being a higher percentage of total new unit shipments, higher revenues from lower-margin other product sales revenues, particularly higher used gaming machine revenues coupled with a declining margin on such revenues, and lower high-margin conversion revenues; and

Ø Gross margin on gaming operations revenues was 80.0% for fiscal 2011, inclusive of the 60-basis point impact of \$1.7 million of asset write-down charges recorded in the June 2011 quarter, compared to 80.8% from the prior-year period, reflecting a greater number of percentage of coin-in gaming machines in the installed base, which have a lower gross margin, combined with unfavorable WAP jackpot expense experience and slightly lower average daily revenue per day.

We expect to generate modest revenue growth in fiscal 2012 and fiscal 2013 as we increase our global market penetration due to the popularity of our products, launch new products, expand market distribution opportunities, increase our average selling price with our premium *Bluebird2* and new *Bluebird xD* gaming machines, grow our participation installed base and average revenues per day through the introduction of new and innovative participation games and product lines and increase revenues from our online gaming and networked gaming operations that we launched in fiscal 2011. We expect improvements in our product sales gross margin resulting from lower asset write-down charges, the ongoing implementation of process improvements throughout the entire organization with the utilization of lean sigma tools to improve quality and eliminate waste, improved results from our strategic sourcing initiatives and the benefits from higher unit volumes and ongoing efforts to level the production schedule throughout each quarter.

*Operating Expenses*

Operating expenses were as follows (in millions of dollars):

	Year Ended June 30,				Increase/ (Decrease)	
	2011		2010		Dollar	Percent
	Dollar	As % of Revenue	Dollar	As % of Revenue		
Research and development	\$ 117.0	14.9%	\$ 105.9	13.8%	\$ 11.1	10.5%
Selling and administrative	150.0	19.2	148.4	19.4	1.6	1.1

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Impairment and restructuring charges	22.2	2.8			22.2	NA
Depreciation	71.1	9.1	67.2	8.8	3.9	5.8
Total operating expenses	\$ 360.3	46.0%	\$ 321.5	42.0%	\$ 38.8	12.1%

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Research and development expenses increased 10.5% to \$117.0 million in fiscal 2011, compared to \$105.9 million in the prior-year period. The year-over-year increase reflects:

- Ø Our planned expanded product development initiatives for the continued creation of intellectual property and the ongoing expansion of our product portfolio;
- Ø Higher costs to accelerate new applications for our *Casino Evolved* suite of innovative, high-value products in preparation for the launch of networked gaming;
- Ø \$3.0 million of charges to write-down intellectual property assets;
- Ø Increased payroll-related costs associated with headcount increases to accomplish the initiatives stated above; partially offset by
- Ø Cost containment measures we implemented, including the impact of lower performance-based incentives.

During fiscal 2011, we introduced 80 new WMS branded games for sale and 28 new participation and casino-owned daily fee games, compared to the introduction in fiscal 2010 of 59 new WMS branded games for sale and 29 new participation and casino-owned daily fee games.

We expect that research and development expenses will decrease as a percentage of revenues to around 13% in fiscal 2012 as we implement the changes to our product plan resulting from the comprehensive review of our business strategies and product plans at the end of fiscal 2011 and beginning of fiscal 2012. We will continue to spend research and development dollars on projects to ensure we stay at the forefront of innovation and creativity in our industry.

Selling and administrative expenses increased 1.1%, or \$1.6 million, to \$150.0 million in fiscal 2011, compared to \$148.4 million in the prior-year period while decreasing by 20-basis points as a percentage of revenues. The year-over-year increase reflects:

- Ø Increased payroll-related costs primarily related to headcount increases to support international expansion and overall growth in our business;
- Ø An increase in consulting expense of \$3.2 million due to increased technology consulting to upgrade our Oracle ERP system, and higher legal expense due to increased litigation; partially offset by
- Ø Cost containment measures we implemented, including the impact of lower performance-based incentives.

Fiscal 2011 includes \$22.2 million of net pre-tax charges, or \$0.24 per diluted share, of pre-tax impairment and restructuring charges comprised of \$18.4 million or \$0.20 per diluted share for non-cash asset impairments (including \$11.0 million for impairment of technology licenses, \$3.4 million for impairment of the *Orion* brand name, \$2.6 million for the impairment of the Orion facility in the Netherlands and \$1.4 million for impairment of receivables related to government action to close casinos in Venezuela) and \$3.8 million or \$0.04 per diluted share for restructuring charges, primarily separation charges. We expect to record additional charges of \$11 million to \$14 million in the September 2011

quarter largely to complete our restructuring which is expected to reduce our workforce by about 10%.

Depreciation expense increased by \$3.9 million to \$71.1 million in fiscal 2011, compared to \$67.2 million in the prior-year period. The increase in depreciation primarily reflects higher gaming operations equipment expenditures in fiscal 2011 and the depreciation of capitalized software costs for our networked gaming system and our online gaming systems, which we began depreciating in fiscal 2011 upon the launch of these new operations.

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### *Operating Income*

Our operating income decreased by \$57.5 million, or 34.2%, in fiscal 2011 on a 2.4% increase in total revenues. Our operating margin of 14.1% represented a 780-basis point decrease over the 21.9% operating margin achieved in the prior-year and was negatively impacted by 400-basis points because of the \$31.8 million of impairment, restructuring, assets write-downs and other charges recorded in fiscal 2011. This decrease reflects \$18.7 million in lower total gross profit inclusive of the \$6.6 million of inventory and other asset write-downs and other charges, and \$38.8 million in higher operating expenses inclusive of the \$22.2 million of impairment and restructuring charges and \$3.0 million of intellectual property write-downs included in research and development expenses.

For fiscal 2012 and 2013, we expect to achieve improvements in our operating margin as anticipated improvements in revenue and gross profits will be paired with expectations of lower impairment and restructuring charges and that research and development and selling and administrative expenses will be a lower percentage of overall revenues than in fiscal 2011, partially offset by depreciation expense increasing as a percentage of revenues.

### *Interest Expense*

We incurred interest expense of \$1.2 million for fiscal 2011 compared to \$3.2 million for the prior-year. The 2010 period includes approximately \$0.9 million of expenses related to inducement costs related to the early conversion by note holders of all \$115 million of issued our 2.75% Convertible Subordinated Notes ( Notes ), into common stock and related interest expense while these Notes were outstanding during fiscal 2010.

### *Interest Income and Other Income and Expense, Net*

Interest income and other income and expense, net was income of \$14.4 million and \$5.8 million for fiscal 2011 and 2010, respectively. The increase is primarily due to increases in interest income from increased extended payment term notes receivable and \$4.0 million, or \$0.04 per diluted share, from cash proceeds of litigation settlement.

### *Income Taxes*

The effective income tax rate was 34.5% in fiscal 2011 compared to 33.8% in fiscal 2010. The fiscal 2011 effective tax rate reflects:

Ø The retroactive reinstatement of the Federal research and development tax credit to January 1, 2010 of which approximately \$0.02 earnings per diluted share related to the period January 1, 2010 through June 30, 2010;

Ø Decreased income over fiscal 2010;

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- Ø Higher domestic manufacturing deduction due to a rate increase from 6% to 9%; partially offset by
  
- Ø Increased impact of foreign subsidiary startup losses without benefit and permanent tax items in fiscal 2011.

The fiscal 2010 effective income tax rate reflects:

- Ø The favorable impact of the completion of the Internal Revenue Service ( IRS ) income tax audits for the fiscal years 2004 through 2007, resulting in a reduction of our liability for uncertain tax positions by \$4.6 million or \$0.07 per diluted share; and
  
- Ø Increased impact of permanent tax items in the fiscal year; partially offset by
  
- Ø Increased income over fiscal 2009; and

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- Ø Impact of the expiration of the Federal research and development tax credit as of December 31, 2009, which increased our provision for income taxes by \$0.01 per diluted share.

In early December 2010, the Federal research and development tax credit was reinstated retroactive to the beginning of calendar year 2010 and will continue through calendar year 2011. As the Federal research and development tax credit is scheduled to expire December 31, 2011, we expect our effective income tax rate for fiscal 2012 and 2013 to be approximately 36% to 37% assuming governments do not change statutory tax rates for those periods or reinstitute the Federal research and development tax credit.

### *Earnings Per Share*

Diluted earnings per share decreased 27.1%, or \$0.51, to \$1.37 in fiscal 2011 from \$1.88 for prior-year period on a 2.4% increase in revenues. The decrease in earnings per share in fiscal 2011 is attributable to the decrease in net income inclusive of \$0.28 per diluted shares of net charges, partially offset by lower diluted shares outstanding due to higher share repurchases in fiscal 2011. Our diluted earnings per share for fiscal 2010, includes a \$0.07 per diluted earnings per share benefit from discrete income tax items, primarily related to the favorable completion of the Federal income tax audits through fiscal 2007, partially offset by a \$0.01 per diluted earnings per share reduction resulting from the expiration of the Federal research and development tax credit as of December 31, 2009 and \$0.02 per diluted share of costs incurred related to the inducement of the Notes.

### *Fiscal 2010 Compared to Fiscal 2009*

#### *Revenues and Gross Profit*

Total revenues for fiscal 2010 increased 8.3%, or \$58.7 million, over fiscal 2009, reflecting:

- Ø A \$12.5 million, or 3.3%, increase in new unit sales revenue as a result of:
  - Ø A 9.4% increase in the average selling price of new gaming machines to \$15,540, principally reflecting the greater sales mix of premium-priced products, which included the sale of approximately 20,200 *Bluebird2* gaming machines, representing 82.9% of our total new unit sales compared to 9,229 *Bluebird2* gaming machines sold or 35.0% of new units sold in the prior-year.
  - Ø A 1,462 unit, or 5.5%, decrease in new units sold as:
    - Ø New units sold in the United States and Canada totaled 16,118 units, a decrease of 3.7%, due to lower industry demand resulting from the slow economy and our customers' lower capital budgets in calendar 2009 with only a modest increase in capital budgets in calendar 2010;
    - Ø International new units sold decreased 8.8% from the prior-year to 8,826 units, reflecting economic challenges and tightening credit markets across international regions, especially the European and Latin American markets; and

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- Ø Sales of mechanical reel products totaled 7,348 units, or approximately 29.5% of total new units sold, compared to 24.1% of units sold in the prior-year. We believe our customers reduced their capital spending on this product line in the first half of fiscal 2009 in advance of our launch of the new *Bluebird2* mechanical reel gaming machine with *Transmissive Reels* technology late in the March 2009 quarter.
  
- Ø A \$9.9 million, or 15.6%, increase in other product sales revenues reflecting higher sales of conversion kits, lower-margin used gaming machines, parts sales, and other revenues as:
  - Ø We earned revenue on sales of approximately 10,100 game conversion kits in fiscal 2010, which were up 7.9% compared to the conversion kit sales in the prior-year, while the average selling price achieved was lower than in fiscal 2009; and



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- Ø We sold approximately 8,500 used gaming machines during fiscal 2010, compared to approximately 4,900 used gaming machines in the prior-year.
- Ø A \$40.9 million, or 16.6%, growth in participation revenues due primarily to:
  - Ø A 6.5% increase, or 632 units, in the average installed base of participation gaming machines in fiscal 2010 driven by the growth in our percentage of coin-in gaming machines. The percentage of coin-in units were 36.1% of the installed base at June 30, 2010 and were 897 units, or 31.3% higher than at June 30, 2009, reflecting our focus in fiscal 2010 on increasing the percentage of coin-in units in the installed base. We were able to increase the percentage of coin-in installed base due to the continued strong earnings performance of our Sensory Immersion and *Transmissive Reels* participation product lines. The percentage of net win units in the installed base decreased by 625 units and the daily lease rate units decreased by 201 units primarily due to certain game series coming to the end of their life cycle. Our controlled roll-out strategy for new participation games has led to the desired result of a higher level of incremental footprint.
  - Ø Overall average revenue per day increased by \$6.60, or 9.4%, principally reflecting the mix shift in the installed base to a higher percentage of coin-in units which have a higher revenue per day than the percentage of net win or the daily lease rate units, coupled with our active program to relocate low-performing participation gaming machines to casinos where we expect higher performance, partially offset by lower levels of casino play due to a continuing challenging economy.
- Ø A \$4.6 million, or 21.7%, decrease in other gaming operations revenues during fiscal 2010 as we experienced lower royalty revenues as a result of game content license agreements to third parties for certain markets reaching the end of the license term. The reduction in royalty revenues resulting from these expired license agreements was not material to our Consolidated Financial Statements.

Total gross profit, as used herein excluding depreciation and distribution expense, increased 9.0%, or \$40.5 million, to \$489.4 million for fiscal 2010 from \$448.9 million for the prior-year. Our gross margins may not be comparable to those of other entities as we include the costs of distribution, which amounted to \$23.9 million and \$21.4 million in fiscal 2010 and 2009, respectively, in selling and administrative expenses. This improvement reflects a change in mix of our revenue sources as product sales revenues amounting to 60.2% of total revenues in fiscal 2010 compared to 62.1% in fiscal 2009 and gaming operations revenues amounting to 39.8% of total revenues in fiscal 2010 compared to 37.9% in fiscal 2009. In addition:

- Ø Gross margin on product sales revenues was 52.8% for fiscal 2010, compared to 51.5% for the prior-year. Gross margin for fiscal 2010 reflects continued operating improvements, primarily resulting from our lean sigma and strategic sourcing initiatives, coupled with a higher average selling price due to greater sales of premium gaming machines, including our new *Bluebird2* platform and \$9.5 million in lower excess and obsolete inventory charges, partially offset by a lower volume of business and a higher amount of lower margin used game sales and parts sales. We incurred higher excess and obsolete inventory charges in the prior-year as we prepared for customers transitioning to our new *Bluebird2* gaming cabinet.
- Ø Gross margin on gaming operations revenues was 80.8% for fiscal 2010, compared to 83.3% from the prior-year, reflecting the impact of higher mix of lower-margin coin-in units and less favorable WAP jackpot expense experience. Gaming operations gross margin was also negatively impacted during fiscal 2010 by 0.3% from lower royalty revenues as a result of license agreements for certain markets reaching the end of the license term and our election not to renew such agreements so we can directly enter these markets.

**Table of Contents***Operating Expenses*

Operating expenses were as follows (in millions of dollars):

	Year Ended June 30,				Increase/(Decrease)	
	2010		2009		Dollar	Percent
	Dollar	As % of Revenue	Dollar	As % of Revenue		
Research and development	\$ 105.9	13.8%	\$ 98.4	13.9%	\$ 7.5	7.6%
Selling and administrative	148.4	19.4	145.5	20.6	2.9	2.0
Depreciation	67.2	8.8	68.4	9.7	(1.2)	(1.8)
Total operating expenses	\$ 321.5	42.0%	\$ 312.3	44.2%	\$ 9.2	2.9%

Research and development expenses increased 7.6% or \$7.5 million to \$105.9 million in fiscal 2010, compared to \$98.4 million in the prior-year and represented 13.8% of fiscal 2010 revenues, which was virtually flat to the prior-year. The increased spending on research and development for fiscal 2010 included:

- Ø Our planned expanded product development initiatives for the continued creation of intellectual property and the ongoing expansion of our product portfolio;
- Ø Higher costs to accelerate new systems and enterprise-wide system applications for our *Casino Evolved* suite of innovative, high-value products in preparation for the launch later in calendar 2010 of networked gaming systems and online gaming in the United Kingdom;
- Ø Increased payroll-related costs associated with headcount increases to accomplish the initiatives stated above and higher performance-based incentive costs associated with improved operating performance; partially offset by our efforts to contain costs.

During fiscal 2010, we introduced 59 new WMS branded games for sale and 29 new participation and casino-owned daily fee games, compared to the introduction in fiscal 2009 of 61 new WMS branded games for sale and 26 new participation and casino-owned daily fee games.

Selling and administrative expenses increased 2.0%, or \$2.9 million, to \$148.4 million in fiscal 2010 compared to \$145.5 million in the prior-year. Selling and administrative expenses as a percentage of revenues decreased 120-basis points in fiscal 2010. The year-over-year change includes:

- Ø Increased payroll-related costs primarily related to headcount increases to support international expansion and overall growth in our business, and higher performance based incentive costs associated with improved operating performance; partially offset by
- Ø A reduction in legal expense in fiscal 2010 as the litigation cost for insurance claims related to Hurricane Katrina was substantially lower; and

Ø A reduction in bad debt expense to \$3.1 million in fiscal 2010 from \$7.1 million in the prior-year. The expense in fiscal 2009 was higher due to the impact of the economic downturn, which resulted in an increase in customer bankruptcy filings during that period.

Depreciation expense declined by \$1.2 million to \$67.2 million in fiscal 2010 compared to \$68.4 million in the prior-year. This reflects improved capital efficiencies achieved in the gaming operations business resulting from the ongoing disciplined rollout of new participation games resulting in lower capital spending and increased longevity of the participation games, coupled with a greater number of participation gaming machines having been depreciated to their salvage value.

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### *Operating Income*

Our operating income increased by \$31.3 million, or 22.9%, in fiscal 2010 on an 8.3% increase in total revenues. Our fiscal 2010 operating margin of 21.9% represented a 260-basis point increase over the 19.3% operating margin achieved in the prior-year. This improvement was achieved by the improvements in product sales gross margin and gaming operations gross margin, coupled with higher-margin gaming operations accounting for 39.8% of total revenues in fiscal 2010 compared to 37.9% in the prior-year, partially offset by operating expenses increasing by 2.9%.

### *Interest Expense*

We incurred interest expense of \$3.2 million for fiscal 2010 compared to \$4.0 million for the prior-year. The 2010 period includes approximately \$0.9 million of expenses related to inducement costs related to the early conversion by Note holders of all \$115 million of issued Notes into common stock. In fiscal 2009, we also incurred interest and fees on borrowings under our revolving credit facility but we did not borrow any monies under the facility in fiscal 2010. Fiscal 2010 results include higher amortization of debt issuance costs than fiscal 2009 results as a consequence of the amendment and restatement of our revolving credit agreement effective September 2009.

### *Interest Income and Other Income and Expense, Net*

Interest income and other income and expense, net decreased by \$2.0 million to \$5.8 million in fiscal 2010 compared to \$7.8 million for the prior-year, primarily due to a pre-tax gain of \$5.0 million from a cash settlement of trademark litigation in the fiscal 2009 period, partially offset by interest income rising from a greater amount of extended payment term financings than in fiscal 2009.

### *Income Taxes*

The effective income tax rate was 33.8% in fiscal 2010 compared to 34.3% in fiscal 2009. The fiscal 2010 effective tax rate reflects:

- Ø The favorable impact of the completion by the IRS of income tax audits for fiscal years 2004 through 2007 resulting in a reduction of our liability for uncertain tax positions by \$4.6 million or \$0.07 per diluted share; and
- Ø Increased impact of permanent tax items in fiscal 2010; partially offset by the
- Ø Increased income over fiscal 2009; and
- Ø Impact of the expiration of the Federal research and development tax credit as of December 31, 2009, which increased our provision for income taxes by \$0.01 per diluted share.

The fiscal 2009 effective income tax rate reflects:

Ø Higher domestic manufacturing deduction; and

Ø Reinstatement of the Federal research and development tax credit in October 2008, retroactive to the beginning of the calendar year 2008. The effective tax rate includes the credit earned from January 1, 2008 through June 30, 2008, which aggregated \$0.02 per diluted share, in addition to the Federal research and development tax credit earned during fiscal 2009.

*Earnings Per Share*

Diluted earnings per share increased 18.2% on an 8.3% increase in revenues to \$1.88 for year ended June 2010 from \$1.59 for prior-year. The increase in earnings per share is attributable to increased net income for the year partially offset by additional diluted common stock and common stock equivalents.

**Table of Contents****LIQUIDITY AND CAPITAL RESOURCES**

The recession and financial market crisis that began in 2008 has continued to disrupt the economy worldwide, reduced consumer discretionary spending and has led to a weakened global economic environment, all of which have been significant challenges for our industry. In calendar 2008 and 2009, some gaming operators delayed or canceled construction projects, resulting in fewer new casino openings and expansions in calendar year 2010 and even fewer in calendar 2011, coupled with many customers reducing their annual capital budgets for replacing gaming machines for calendar 2009 with only modestly higher replacement capital budgets in calendar 2010 and anticipated for calendar 2011. The economic crisis reduced disposable income for casino patrons and resulted in fewer patrons visiting casinos and lower spending by those patrons who did visit casinos. This has resulted in lower industry-wide unit demand from gaming operators and lower play levels on gaming machines in most gaming jurisdictions. We have been faced with these macroeconomic challenges for over two years.

Our cash flow from operations is largely dependent on our profitability and the amount of working capital necessary to support our revenue base. Therefore, in any given reporting period, the amount of cash consumed or generated by operations will primarily relate to the rate of revenue and profitability increase or decrease, and the increase or decrease in working capital required to operate our business. In periods when revenues are increasing, the expanded working capital needs will be funded from available cash, cash equivalents, cash flow from operations, and, if necessary, proceeds from our revolving credit facility or additional debt or additional equity offerings. We utilize these sources to fund investments in property, plant and equipment, gaming operations equipment and agreements to license or acquire third-party brands, intellectual properties or technologies that we have not developed internally. Also, we will from time to time issue or retire borrowings or repurchase equity in an effort to maintain a cost-effective capital structure consistent with our anticipated capital requirements. With the ongoing uncertainty in the credit and capital markets, there can be no assurance that other sources of capital will be available to us on acceptable terms or at all. Based on past performance and current expectation, we believe the combination of these resources will satisfy our needs for working capital, jackpot liabilities, capital expenditures and other liquidity requirements associated with our existing operations into the foreseeable future. Our primary sources of liquidity are:

- Ø Existing cash and cash equivalents;
- Ø Cash flows from operations; and
- Ø Debt capacity available under our revolving credit facility and, if necessary, additional debt or equity offerings.

Selected balance sheet accounts and data at June 30 are summarized as follows (\$ in millions):

	2011	2010	Increase/(Decrease)	
			Change	Percent
Total cash, cash equivalents, and restricted cash(1)	\$ 105.0	\$ 184.6	\$ (79.6)	(43.1)%
Total current assets (A)	497.5	555.0	(57.5)	(10.4)
Total assets	1,046.3	1,007.0	39.3	3.9
Total current liabilities (B)	152.4	140.8	11.6	8.2
Stockholders' equity	855.9	833.9	22.0	2.6
Net working capital (A) (B)	\$ 345.1	\$ 414.2	\$ (69.1)	(16.7)
Trailing-twelve month statistics:				
Average days outstanding for total accounts and notes receivable	161	138	23	16.7
Inventory turns	4.1	4.4	(0.3)	(6.8)

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- (1) Pursuant to various state gaming regulations, we maintain certain restricted cash accounts to ensure availability of funds to pay wide-area progressive jackpot awards either in lump sum payments or in installments. Cash, cash equivalents and restricted cash includes restricted cash of \$14.3 million and \$17.9 million as of June 30, 2011 and June 30, 2010, respectively. Cash required for funding WAP jackpot payments is considered restricted cash and is not available for general corporate purposes.

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Our net working capital at June 30, 2011 decreased \$69.1 million from June 30, 2010, and was primarily affected by the following components:

- Ø A decrease in cash, cash equivalents and restricted cash of \$79.6 million due primarily to \$101.5 million of share repurchases in fiscal 2011;
- Ø An increase in total accounts and notes receivable, net, of \$40.0 million, or 12.3%, to \$366.2 million compared to \$326.2 million at June 30, 2010, reflecting our efforts that began in fiscal 2009 to accommodate the increased demand by our customers for extended payment financing terms given the downturn in the economy coupled with growth in revenues from new markets we entered in fiscal 2010 that traditionally have required extended payment terms, specifically Mexico and New South Wales, Australia. Our days sales outstanding for both current and long-term account and notes receivable were 161 days at June 30, 2011, compared to 138 days at June 30, 2010;
- Ø An increase in inventories of \$9.3 million, or 16.1%, to \$67.1 million from \$57.8 million at June 30, 2011, due to higher finished goods inventory. Inventory turns were 4.1x at June 30, 2011, compared to 4.4x at June 30, 2010; and
- Ø An increase in current liabilities of \$11.6 million or 8.2% to \$152.4 million due to higher current taxes payable and other accrued liabilities partially offset by lower performance-based bonuses as employees were not paid a bonus under our annual cash bonus plan for fiscal 2011.

As described in Note 14. *Commitments, Contingencies and Indemnifications* to our Consolidated Financial Statements, we have royalty and license fee commitments for brand, intellectual property and technology licenses of \$89.3 million including contingent payments that are not recorded in our Consolidated Balance Sheets.

We believe that total cash, cash equivalents and restricted cash of \$105.0 million at June 30, 2011, inclusive of \$14.3 million of restricted cash, and cash flow from operations will be adequate to fund our anticipated level of expenses, cash to be invested in property, plant and equipment and gaming operations equipment, cash to be used to license or acquire brands, technologies or intellectual properties from third parties, the levels of inventories and accounts and notes receivable required in the operation of our business and any repurchases of common stock for the upcoming fiscal year. We take a prudent and conservative approach to maintaining our available liquidity while credit market and economic conditions remain unfavorable. We continue to focus on reinvesting in our business through our installed base of gaming operations machines, as well as other strategic capital deployment objectives to expand our geographic reach, product lines and customer base. We will cautiously deploy our capital in order to preserve maximum flexibility. For fiscal 2012 and fiscal 2013, we expect cash flow from operations to continue to be strong. We do not believe we will need to raise a significant amount of additional capital in the short-term or long-term, and we have access to our \$150-million revolving credit facility through September 30, 2012. We intend to extend or replace this facility prior to its expiration. Due to the current economic conditions and capital markets challenges, we can provide no guarantee that we will be able to negotiate such an agreement or that such agreement would not place further limitations on our operations. We will, however, assess market opportunities as they arise.

***Total Accounts and Notes Receivable and Bad Debt Reserves***

Our normal payment terms are 30 to 90 days. We have historically provided extended payment terms to some of our customers for periods from 120 days through 36 months. As a result of the financial market crisis which began in 2008 and disrupted credit and equity markets worldwide and led to reduced consumer discretionary spending and a weakened global economic environment, beginning in the March 2009 quarter we began and have continued to provide a greater amount of extended payment terms to select customers. This expanded extended payment term program is expected to continue until the global economy and consumer discretionary spending improves and customer demand for extended payment terms abates. Typically, these sales result in a higher selling price and, if financed over periods longer than 12 months, incur interest at



a rate in excess of our borrowing rate, both of which provide added profitability to the sale.

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Customers consider numerous factors in determining whether to issue a sales order to us including, among others, expected earnings performance of the gaming machines (which we believe is the most significant decision factor), selling price, the value provided for any trade-in of used gaming machines, parts and game conversion kit support and payment terms.

We believe our competitors have also expanded their use of extended payment terms. In aggregate, we believe that by expanding our use of extended payment terms, we have provided a competitive response in our market and that our revenues have been favorably impacted. We are unable to estimate the impact of this program on our revenues because gaming machine performance, rather than selling price and extended payment terms, is the most important driver of our sales process. If we ceased providing an expanded amount of extended payment terms, we believe we would not be competitive for some customers in the market place and that our revenues and profits would likely decrease.

The expansion of our use of extended payment terms has increased our current and long-term accounts and notes receivable balances and reduced our cash provided by operating activities. Total accounts and notes receivable increased by \$40.0 million from \$326.2 million at June 30, 2010 to \$366.2 million at June 30, 2011. While a portion of this increase relates to the 2.4% increase, or \$18.2 million, in revenues in the fiscal year 2011 compared to the fiscal 2010, we believe a majority of this increase is due to the impact of providing an expanded amount of extended payment terms. The collection of these accounts and notes receivable in future periods will increase the amount of cash flow provided by operating activities and reduce our total accounts and notes receivable and increase our cash balance.

We evaluate the adequacy of our allowance for bad debts at least on a quarterly basis. We consider a variety of factors in this evaluation, including the accounts and notes receivable aging and trends thereof for customer balances, past experience with customers who pay outside of payment terms, the legal environment and regulatory landscape and news related to individual customers especially if the news calls into question the customer's ability to fully pay balances owed. Accounts and notes receivables are evaluated individually for impairment (specific reserves) when collectability becomes uncertain due to events and circumstances that cause an adverse change in a customer's cash flows or financial condition. Accounts placed on specific reserve are evaluated for probability of collection, which is used to determine the amount of the specific reserve.

Our bad debt expense is most significantly impacted by bankruptcy filings by our customers and pre-bankruptcy reported exposures of individual customers. Due to our successful collection experience and our continuing operating relationship with casino customers and their businesses, it is infrequent that we repossess gaming machines from a customer in settlement of outstanding accounts or notes receivable balances. In those instances where repossession occurs, to mitigate our exposure on the related receivable, the repossessed gaming machines are subsequently resold in the used gaming machine market, however we may not fully recover the receivable from this re-sale.

For customers in the United States, at the time a customer files for bankruptcy, we typically have a security interest in the gaming machines for that portion of the total accounts and notes receivable, but our accounts and notes receivable related to all other revenue sources are typically unsecured claims. Due to the significance of our gaming machines to the on-going operations of our casino customers, in a bankruptcy filing we may be designated as a key vendor, which can enhance our position above other creditors in the bankruptcy.

During the fiscal year ended June 30, 2011, our bad debt expense totaled \$3.9 million plus we recorded \$1.4 million as an impairment charge and in aggregate the \$5.3 million represents 0.7% of revenues in such fiscal year, which compares to \$3.1 million of bad debt expense for the prior fiscal year, which represented 0.4% of revenues in the prior fiscal year. Our bad debt expense was higher in the year ended June 30, 2011 due to government action to close casinos in Venezuela leading to the impairment charge, which increased our total bad debt reserve to \$5.5 million at June 30, 2011 compared to \$3.4 million at June 30, 2010.



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### ***Excess and Obsolete Inventories***

Our inventory write-downs primarily arise from raw material parts becoming obsolete when replaced by a new part and we are unable to fully realize the value of the old part and from excess quantities of raw material inventory purchased for production of gaming machines which we cannot utilize. When we discontinue support of a gaming machine style, make significant changes to an existing gaming machine design or transition to a new gaming machine style, we may experience higher levels of inventory write-downs. We use forecasted demand planning in both purchasing and production processes and conduct quarterly reviews for excess and obsolete inventory. Any inventory write-downs are recorded in the period they are identified to reflect any anticipated inventory losses arising from inventory values in excess of cost or market.

As we introduce new gaming machines that utilize new raw material parts, we reduce the quantity of raw material purchases for existing gaming machines based upon anticipated customer demand and expected end-of-life production and support of the global installed base of the existing gaming machines. Favorable customer acceptance in excess of estimated customer demand for the new gaming machines can result in excess quantities of raw materials being on-hand for the existing gaming machines. In the December 2008 quarter, we introduced the new *Bluebird2* gaming machine and in June 2010 we introduced the new *Bluebird xD* gaming machine and in both cases the demand for these new gaming machines exceeded our expectation, resulting in fewer *Bluebird* gaming machines being sold. We seek to reduce excess raw materials through several strategies such as: (1) reselling them back to the supplier, (2) using them to maintain our installed base of leased gaming operations machines, (3) selling them to customers to support their existing gaming machines which are recorded as part sales, (4) using them to refurbish used gaming machines, (5) selling them to a third party or (6) scrapping them.

We have a defined process to control changes in the design of our gaming machines to reduce the possibility that we cannot utilize existing parts before new parts are implemented and therefore reduce the impact of obsolete inventory. We use the same six strategies noted above to reduce the impact of inventory write-downs for obsolete parts. In fiscal 2011, we decided to wind-down our support for our *Orion* and *Bluebird* gaming cabinets over fiscal 2012, which led to a higher level of inventory write-downs being recorded. Inventory write-downs for the year ended June 30, 2011 totaled \$7.1 million, including \$4.9 million of inventory and other assets write-downs in the June 2011 quarter, and compared to \$3.8 million of write-downs in fiscal 2010.

### ***Revolving Credit Facility and Convertible Subordinated Notes***

See Note 11. *Revolving Credit Facility and Convertible Subordinated Notes* to our Consolidated Financial Statements.

### ***Common Stock Repurchase Program***

See Note 12. *Stockholders' Equity - Common Stock Repurchase Program* and 19. *Subsequent Events* to our Consolidated Financial Statements.

### ***Cash Flows Summary***

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Cash flows from operating, investing and financing activities, as reflected in our Consolidated Statements of Cash Flows, are summarized in the following table (in millions):

	Year Ended June 30,			2011 to 2010 Change	2010 to 2009 Change
	2011	2010	2009		
Net cash provided by (used in):					
Operating activities	\$ 157.1	\$ 130.3	\$ 179.2	\$ 26.8	\$ (48.9)
Investing activities	(157.0)	(108.6)	(113.8)	(48.4)	5.2
Financing activities	(77.0)	9.7	(29.8)	(86.7)	39.5
Effect of exchange rates on cash and cash equivalents	0.9	(0.4)	(0.7)	1.3	0.3
Net increase (decrease) in cash and cash equivalents	\$ (76.0)	\$ 31.0	\$ 34.9	\$ (107.0)	\$ (3.9)