WMS INDUSTRIES INC /DE/
Form 10-Q
February 09, 2011
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# UNITED STATES

# SECURITIES AND EXCHANGE COMMISSION

**WASHINGTON, D.C. 20549**

# FORM 10-Q

**(Mark One)**

x **QUARTERLY REPORT PURSUANT TO SECTION 13 OR 15(d) OF THE SECURITIES EXCHANGE ACT OF 1934**
**FOR THE QUARTERLY PERIOD ENDED DECEMBER 31, 2010**

**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)**

| | |
|---|---|
| **Delaware** | **36-2814522** |
| **(State or other Jurisdiction of** | **(I.R.S. Employer** |
| **incorporation or organization)** | **Identification No.)** |

**800 South Northpoint Blvd.**

**Waukegan, IL 60085**

**(Address of Principal Executive Offices)**

**(847) 785-3000**

**(Registrant s telephone number, including area code)**

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

Indicate by check mark 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 x No ¨

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 | x | Accelerated filer | ¨ |
| Non-accelerated filer | ¨ (Do not check if a smaller reporting company) | 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 x

Indicate the number of shares outstanding of each of the issuer s classes of common stock, as of the latest practicable date: 57,609,677 shares of common stock, $0.50 par value, were outstanding at February 4, 2011.

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## PART I. FINANCIAL INFORMATION

## ITEM 1. FINANCIAL STATEMENTS

**WMS INDUSTRIES INC.**

**CONDENSED CONSOLIDATED STATEMENTS OF INCOME**

**For the Three and Six Months Ended December 31, 2010 and 2009**

**(in millions of U.S. dollars and millions of shares, except per share amounts)**

**(Unaudited)**

| | Three Months Ended December 31, | | Six Months Ended December 31, | |
|---|---|---|---|---|
| | 2010 | 2009 | 2010 | 2009 |
| **REVENUES:** | | | | |
| Product sales | $ 127.2 | $ 113.1 | $ 238.4 | $ 201.9 |
| Gaming operations | 72.7 | 75.8 | 149.0 | 152.3 |
| **Total revenues** | 199.9 | 188.9 | 387.4 | 354.2 |
| **COSTS AND EXPENSES:** | | | | |
| Cost of product sales(1) | 63.1 | 55.5 | 120.2 | 97.3 |
| Cost of gaming operations(1) | 15.6 | 15.3 | 30.1 | 29.5 |
| Research and development | 30.1 | 25.9 | 58.8 | 52.4 |
| Selling and administrative (see Note 3) | 38.1 | 35.8 | 80.2 | 69.8 |
| Depreciation(1) | 16.3 | 16.9 | 32.1 | 34.2 |
| **Total costs and expenses** | 163.2 | 149.4 | 321.4 | 283.2 |
| **OPERATING INCOME** | 36.7 | 39.5 | 66.0 | 71.0 |
| Interest expense | (0.2) | (0.5) | (0.6) | (2.5) |
| Interest income and other income and expense, net | 2.4 | 1.2 | 3.9 | 3.1 |
| Income before income taxes | 38.9 | 40.2 | 69.3 | 71.6 |
| Provision for income taxes | 11.9 | 13.7 | 22.8 | 25.3 |
| **NET INCOME** | $ 27.0 | $ 26.5 | $ 46.5 | $ 46.3 |
| **Earnings per share:** | | | | |
| Basic | $ 0.47 | $ 0.45 | $ 0.80 | $ 0.86 |
| Diluted | $ 0.46 | $ 0.44 | $ 0.78 | $ 0.77 |
| **Weighted-average common shares:** | | | | |
| Basic common stock outstanding | 57.8 | 58.3 | 58.0 | 54.2 |
| Diluted common stock and common stock equivalents | 59.1 | 60.6 | 59.3 | 60.4 |

(1) Cost of product sales and cost of gaming operations exclude the following amounts of depreciation, which are included in the depreciation line item:

| | | | | |
|---|---|---|---|---|
| Cost of product sales | $ 1.2 | $ 1.0 | $ 2.4 | $ 2.1 |
| Cost of gaming operations | $ 9.2 | $ 11.2 | $ 18.7 | $ 23.0 |

The accompanying Notes are an integral part of these Condensed Consolidated Financial Statements.

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**WMS INDUSTRIES INC.**

**CONDENSED CONSOLIDATED BALANCE SHEETS**

**December 31, 2010 and June 30, 2010**

**(in millions of U.S. dollars and millions of shares)**

| | December 31, 2010 (unaudited) | June 30, 2010 |
|---|---|---|
| **ASSETS** | | |
| **CURRENT ASSETS:** | | |
| Cash and cash equivalents | $ 106.8 | $ 166.7 |
| Restricted cash and cash equivalents | 16.7 | 17.9 |
| **Total cash, cash equivalents and restricted cash** | 123.5 | 184.6 |
| Accounts and notes receivable, net | 279.7 | 274.5 |
| Inventories | 68.4 | 57.8 |
| Other current assets | 41.5 | 38.1 |
| **Total current assets** | 513.1 | 555.0 |
| **NON-CURRENT ASSETS:** | | |
| Gaming operations equipment, net of accumulated depreciation of $257.6 and $247.2, respectively | 74.4 | 64.7 |
| Property, plant and equipment, net of accumulated depreciation of $108.0 and $95.4, respectively | 169.4 | 189.8 |
| Intangible assets, net | 140.2 | 99.1 |
| Deferred income tax assets | 23.5 | 33.4 |
| Other assets, net | 89.4 | 65.0 |
| **Total non-current assets** | 496.9 | 452.0 |
| **TOTAL ASSETS** | $ 1,010.0 | $ 1,007.0 |
| **LIABILITIES AND STOCKHOLDERS EQUITY** | | |
| **CURRENT LIABILITIES:** | | |
| Accounts payable | $ 60.9 | $ 63.4 |
| Accrued compensation and related benefits | 8.7 | 25.1 |
| Other accrued liabilities | 47.6 | 52.3 |
| **Total current liabilities** | 117.2 | 140.8 |
| **NON-CURRENT LIABILITIES:** | | |
| Deferred income tax liabilities | 21.0 | 20.1 |
| Other non-current liabilities | 12.3 | 12.2 |
| **Total non-current liabilities** | 33.3 | 32.3 |
| Commitments, contingencies and indemnifications (see Note 12) | 0.0 | 0.0 |
| **STOCKHOLDERS EQUITY:** | | |
| Preferred stock (5.0 shares authorized; none issued) | 0.0 | 0.0 |
| Common stock (200.0 shares authorized; 59.7 shares issued) | 29.8 | 29.8 |
| Additional paid-in capital | 435.7 | 435.5 |

| | | |
|---|---|---|
| Treasury stock, at cost (1.6 and 0.9 shares, respectively) | (60.7) | (34.3) |
| Retained earnings | 455.5 | 409.0 |
| Accumulated other comprehensive income | (0.8) | (6.1) |
| **Total stockholders equity** | 859.5 | 833.9 |
| **TOTAL LIABILITIES AND STOCKHOLDERS EQUITY** | $ 1,010.0 | $ 1,007.0 |

The accompanying Notes are an integral part of these Condensed Consolidated Financial Statements.

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**WMS INDUSTRIES INC.**

**CONDENSED CONSOLIDATED STATEMENTS OF CASH FLOWS**

**For the Six Months Ended December 31, 2010 and 2009**

**(in millions of U.S. dollars)**

**(Unaudited)**

| | 2010 | 2009 |
|---|---|---|
| **CASH FLOWS FROM OPERATING ACTIVITIES** | | |
| Net income | $ 46.5 | $ 46.3 |
| Adjustments to reconcile net income to net cash provided by (used in) operating activities: | | |
| Depreciation | 32.1 | 34.2 |
| Amortization of intangible and other assets | 9.9 | 11.2 |
| Share-based compensation | 10.6 | 9.9 |
| Other non-cash items | 5.0 | 2.4 |
| Deferred income taxes | 10.9 | 0.4 |
| Tax benefit from the exercise of stock options | (6.5) | (12.1) |
| Change in operating assets and liabilities | (64.0) | (54.5) |
| **Net cash provided by operating activities** | 44.5 | 37.8 |
| **CASH FLOWS FROM INVESTING ACTIVITIES** | | |
| Purchase of property, plant and equipment | (29.2) | (27.1) |
| Additions to gaming operations equipment | (30.9) | (19.8) |
| Payments to develop, license or acquire intangible and other assets | (11.1) | (5.8) |
| **Net cash used in investing activities** | (71.2) | (52.7) |
| **CASH FLOWS FROM FINANCING ACTIVITIES** | | |
| Cash received from exercise of stock options and employee stock purchase plan | 9.6 | 27.6 |
| Tax benefit from exercise of stock options | 6.5 | 12.1 |
| Purchases of treasury stock | (50.0) | (15.0) |
| Debt issuance costs | 0.0 | (1.7) |
| Other | 0.0 | (0.9) |
| **Net cash provided by / (used in) financing activities** | (33.9) | 22.1 |
| **Effect of exchange rates on cash and cash equivalents** | 0.7 | 0.1 |
| **INCREASE /(DECREASE) IN CASH AND CASH EQUIVALENTS** | (59.9) | 7.3 |
| **CASH AND CASH EQUIVALENTS**, beginning of period | 166.7 | 135.7 |
| **CASH AND CASH EQUIVALENTS**, end of period | $ 106.8 | $ 143.0 |

The accompanying Notes are an integral part of these Condensed Consolidated Financial Statements.

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**WMS INDUSTRIES INC.**

**NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS**

**(tabular amounts in millions of U.S. dollars and millions of shares, except per share amounts)**

**(Unaudited)**

**1. BASIS OF PRESENTATION AND BUSINESS OVERVIEW**

The accompanying unaudited interim Condensed Consolidated Financial Statements of WMS Industries Inc. ( WMS , we , us or the Company have been prepared pursuant to the rules and regulations of the Securities and Exchange Commission (the SEC ) for quarterly reports on Form 10-Q and do not include all of the information and note disclosures required by U.S. generally accepted accounting principles ( U.S. GAAP ) for complete financial statements. The accompanying Condensed Consolidated Financial Statements should therefore be read in conjunction with the Consolidated Financial Statements and Notes thereto for the fiscal year ended June 30, 2010 included in our Annual Report on Form 10-K filed with the SEC on August 26, 2010. The accompanying unaudited interim Condensed Consolidated Financial Statements have been prepared in accordance with U.S. GAAP and reflect all adjustments of a normal, recurring nature that are, in the opinion of management, necessary for a fair presentation of results for these interim periods.

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. 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. Operating results for the three and six months ended December 31, 2010 are not necessarily indicative of the results that may be expected for the fiscal year ended June 30, 2011. For further information refer to our Consolidated Financial Statements and Notes thereto included in our Annual Report on Form 10-K for the fiscal year ended June 30, 2010.

We are engaged in one business segment: to 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. We have a production facility in the United States with development and distribution offices located in the United States, Argentina, Australia, Austria, Canada, China, India, Mexico, the Netherlands, South Africa, Spain and the United Kingdom.

We market our gaming machines in two principal ways. First, product sales include the sale to casinos and other gaming machine operators of new and used gaming machines and VLTs, conversion kits (including game, hardware or operating system conversions), parts, amusement-with-prize gaming machines and gaming related systems for smaller international casino operators. Second, we license our game content and intellectual property to third parties for distribution and we lease gaming machines and VLTs to casinos and other licensed gaming machine operators for payments based upon (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. The installed base of our participation gaming machines consists of: wide-area progressive ( WAP ) participation gaming machines; local-area progressive ( LAP ) participation gaming machines; and stand-alone participation gaming machines. We also enter into leases for casino-owned daily fee games and gaming machine, VLT and other leases. We refer to WAP, LAP and stand-alone participation gaming machines as participation games and when combined with casino-owned daily fee games, royalties we receive under license agreements with third parties to utilize our game content and intellectual property, and gaming machine, VLT and other lease revenues, we refer to this business as our gaming operations.

Data for product sales and gaming operations is only maintained on a consolidated basis as presented in our accompanying Condensed Consolidated Financial Statements, with no additional separate data maintained for product sales and gaming operations (other than the revenues and costs of revenues information included in our accompanying Condensed Consolidated Statements of Income and gaming operations equipment and related accumulated depreciation included in our accompanying Condensed Consolidated Balance Sheets).

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**WMS INDUSTRIES INC.**

**NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS**

**(tabular amounts in millions of U.S. dollars and millions of shares, except per share amounts)**

**(Unaudited)**

**2. PRINCIPAL ACCOUNTING POLICIES**

***Accounts Receivable, Notes Receivable, Allowance for Doubtful Accounts and Bad Debt Expense***

We carry our accounts and notes receivable at face amounts less an allowance for doubtful accounts and imputed interest. Our policy is to generally charge interest on notes receivables until the note receivable is deemed non-performing. A note receivable is considered non-performing if payments have not been received within 180 days of the agreed upon terms.

We file Uniform Commercial Code (UCC) liens on almost all domestic trade accounts and notes receivable with terms greater than 90 days, which secures our interest in the gaming machines underlying the trade and note receivable until the receivable balance for the gaming machines is fully paid. The majority of our domestic customers are not rated by the credit rating agencies but for those customers who do have credit ratings the Standard and Poor s credit ratings ranged from BBB+ to D at December 31, 2010. Where possible we seek advance deposits, collateral, pledge agreements or foreign bank letters of credit on international trade accounts and notes receivable. However, most of our international trade accounts and notes receivable are not collateralized. Currently we have not sold and do not plan to sell our accounts or notes receivable to third parties, so we do not have any off-balance sheet liabilities for factored receivables.

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.

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. Additionally, customers in many of our international markets require and receive standard payment terms of 90 to 180 days. Our recent international expansion has required us to provide, in certain jurisdictions, financing terms of 18 to 36 months. In addition, as a result of the financial market crisis which began in 2008 and disrupted credit and equity markets worldwide which 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 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. 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 receivable balances and reduced our cash provided by operating activities. Total receivables increased by $28.8 million from $326.2 million at June 30, 2010 to $355.0 million at December 31, 2010. While a portion of this increase relates to the 9.2% increase in revenues in the trailing twelve month period ended December 31, 2010 compared to the trailing twelve months ended December 31, 2009, and the impact of a higher percentage of the December 2010 quarter shipments being shipped in the third month of the quarter compared to December 2009, we believe that the majority of this increase is due to the impact of providing an expanded amount of extended payment terms. The collection of these receivables in future periods will increase the amount of cash flow provided by operating activities and reduce our total receivables and increase our cash balance.

With regard to notes receivable, interest income is recognized ratably over the life of the note receivable and any related fees or costs to establish the notes are charged to expense as incurred, as they are considered insignificant. Actual or imputed interest, if any, is determined based on current market rates at the time the note originated and is recorded in Interest income and other income and expense, net, ratably over the payment period. The interest rates on outstanding notes receivable ranged from 5.25% to 10.0% at December 31, 2010.

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**WMS INDUSTRIES INC.**

**NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS**

**(tabular amounts in millions of U.S. dollars and millions of shares, except per share amounts)**

**(Unaudited)**

The following summarizes our current and long-term accounts and notes receivable, net;

| | December 31, 2010 | June 30, 2010 |
|---|---|---|
| Current: | | |
| Accounts receivable | $ 123.1 | $ 130.0 |
| Notes receivable | 160.0 | 147.6 |
| Allowance for doubtful accounts | (3.4) | (3.1) |
| Current accounts and notes receivable, net | $ 279.7 | $ 274.5 |
| Long-term, included in Other assets, net: | | |
| Notes receivable | $ 75.3 | $ 52.0 |
| Allowance for doubtful accounts | 0.0 | (0.3) |
| Long-term notes receivable, net | $ 75.3 | $ 51.7 |
| Total accounts and notes receivable, net | $ 355.0 | $ 326.2 |

The following summarizes the components of total accounts and notes receivable, net at December 31, 2010:

| | December 31, 2010 | Balances that are over 90 days past due |
|---|---|---|
| Accounts Receivable | | |
| Domestic | $ 65.3 | $ 2.2 |
| International | 57.8 | 3.6 |
| Accounts Receivable Subtotal | 123.1 | 5.8 |
| Notes Receivable | | |
| Domestic | 79.9 | 2.2 |
| International | 155.4 | 0.1 |
| Notes Receivable Subtotal | 235.3 | 2.3 |
| Allowance for doubtful accounts | (3.4) | 0.0 |

| | | | | |
|---|---|---|---|---|
| Total accounts and notes receivable, net | $ | 355.0 | $ | 8.1 |

At December 31, 2010, 2.3% of our total accounts and notes receivable was due over 90 days. Accounts and notes receivable from international customers in Mexico, Argentina, Peru and Canada at December 31, 2010 were approximately: $51.3 million, $37.8 million, $24.8 million and $19.6 million, respectively.

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**(Unaudited)**

On a routine basis, but at least quarterly, we evaluate our receivables and establish the allowance for doubtful accounts based on a combination of specific customer circumstances, credit conditions and our history of write-offs and collections. We consider a variety of factors in this evaluation, including the receivables aging and trends thereof for customer balances, past experience with customers who pay outside of payment terms and news related to individual customers, especially if the news calls into question the customer s ability to fully pay balances owed. Our bad debt expense is most significantly impacted by bankruptcy filings by our casino customers and pre-bankruptcy reported exposures of individual casino customers. 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 the receivables for which we have not been paid, but our receivables 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.

We recorded $0.4 million of bad debt expense in the three months ended December 31, 2010 which was comparable to the three months ended December 31, 2009. In addition, we recorded $1.8 million of bad debt expense in the six months ended December 31, 2010 compared to $1.1 million in the six months ended December 31, 2009 and $3.1 million in fiscal 2010 and $7.1 million in fiscal 2009. Our bad debt expense was higher in fiscal 2009 due to a greater number and dollar amount of bankruptcy filings due to the challenging economic times.

Modifications to original financing terms are an exception to our cash collection process. If a customer requests a modification of financing terms during the collection process, we evaluate the credit risk of the proposed modification, try to obtain additional consideration for such modification, seek additional security and recognize any additional consideration ratably over the remaining new financing term. As a result of the financial crisis that began in 2008, such modifications have increased, but in general, the modification of original financing terms have not been material to our total accounts and notes receivable balance. 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.

The fair value of notes receivable is estimated by discounting expected future cash flows using current interest rates at which similar loans would be made to borrowers with similar credit ratings and remaining maturities. At December 31, 2010 and June 30, 2010 respectively, the fair value of the accounts and notes receivable, net, approximated the carrying value.

***Fair Value Measurements***

We apply the provisions of FASB Accounting Standards Codification ( ASC ) 820, *Fair Value Measurements* ( Topic 820 ) to our financial assets and financial liabilities. Topic 820 defines fair value as the exchange price that would be received for an asset or paid to transfer a liability (an exit price) in the principal or most advantageous market for the asset or liability in an orderly transaction between market participants on the measurement date. Topic 820 also establishes a fair value hierarchy, which requires an entity to maximize the use of observable inputs when measuring fair value.

Topic 820 describes three levels of inputs that may be used to measure fair value:

Level 1 Inputs are unadjusted quoted prices in active markets for identical assets or liabilities that the reporting entity has the ability to access at the measurement date.

Level 2 Inputs to the valuation method include:

- Ø Quoted prices for similar assets or liabilities in active markets;
- Ø Quoted prices for identical or similar assets or liabilities in inactive markets;
- Ø Inputs other than quoted prices that are observable for the asset or liability;
- Ø Inputs that are derived principally from or corroborated by observable market data by correlation or other means; and

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**WMS INDUSTRIES INC.**

**NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS**

**(tabular amounts in millions of U.S. dollars and millions of shares, except per share amounts)**

**(Unaudited)**

- Ø If the asset or liability has a specified (contractual) term, the Level 2 input must be observable for substantially the full term of the asset or liability.

Level 3 Inputs to the valuation methodology are unobservable and significant to the fair value measurement.

As of December 31, 2010, the only assets subject to fair value measurement in accordance with Topic 820 were investments in various money market funds totaling approximately $51.4 million. These money market investments are included in our cash and cash equivalents and restricted cash on the Condensed Consolidated Balance Sheets and are considered Level 1 securities valued at quoted market prices.

***Cost of Product Sales, Cost of Gaming Operations and Selling and Administrative Expenses***

Cost of product sales consists primarily of raw materials, labor and overhead. These components of cost of product sales also include licensing and royalty charges, inbound and outbound freight charges, purchasing and receiving costs, inspection costs and internal transfer costs.

Cost of gaming operations consists primarily of licensing and royalty charges, WAP jackpot expenses, telephone costs, gaming operations taxes and fees and spare parts.

Selling and administrative expenses consist primarily of sales, marketing, distribution, installation and corporate support functions such as administration, information technology, legal, regulatory compliance, human resources and finance. The costs of distribution were $6.6 million and $5.6 million for the three months ended December 31, 2010 and 2009 and $13.1 million and $11.7 million for the six months ended December 31, 2010 and 2009, respectively.

***Research and Development Costs***

We account for research and development costs in accordance with FASB Topic 730, *Accounting for Research and Development Costs*. ( Topic 730 ). Accordingly, costs associated with product development are expensed as incurred and included in research and development in our Condensed Consolidated Statements of Income, other than costs of computer software as described below.

***Costs for Computer Software***

We purchase, license and incur costs for computer software, which will be utilized in the products we sell or lease. Such costs are capitalized under FASB Topic 985, *Accounting for the Costs of Computer Software to be Sold, Leased or Otherwise Marketed*, ( Topic 985 ). According to Topic 985, costs incurred in creating computer software are charged to expense when incurred as research and development until technological feasibility has been established and such costs are then capitalized up to the date the computer software is available for general release to customers. Generally, the computer software we develop reaches technological feasibility when a working model of the computer software is available. Computer software that we purchase or license for use in our products generally has been commercialized in our industry or other industries and has met the technological feasibility criteria prior to our purchase or license and, therefore, we capitalize the payments made for such purchase or license. Annual amortization of capitalized computer software costs is recorded on a product by product basis at the greater of the amount computed using (a) the ratio that current gross revenues for a product bear to the total of past and anticipated future gross revenues for that product or (b) the straight-line method over the remaining estimated economic life.

For our game themes and operating system computer products, we have determined that such products reach technological feasibility when internal testing is complete and the product is ready to be submitted to the gaming regulators for approval. We incur regulatory approval costs for our game themes and operating system products after technological feasibility is achieved which we capitalize. Regulatory approval costs related to projects that are discontinued are expensed when the determination to discontinue is made.

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**WMS INDUSTRIES INC.**

**NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS**

**(tabular amounts in millions of U.S. dollars and millions of shares, except per share amounts)**

**(Unaudited)**

We account for costs incurred to develop computer software for internal use in accordance with FASB Topic 350, *Accounting for the Costs of Computer Software Developed or Obtained for Internal Use* ( Topic 350 ). Any costs incurred during preliminary project stages are expensed; costs incurred during the application development stages are capitalized and costs incurred during the post-implementation/operation stages are expensed. Once the software is substantially complete and ready for its intended use, we depreciate the capitalized asset cost over its estimated useful life.

Based on revisions to our plans regarding the external distribution of our *WAGE-NET*® Networked Gaming system in the second quarter of fiscal year 2011 and because the software had previously reached technological feasibility and was still in the development stage awaiting approval of the commercial version of the computer software by various gaming regulators, we now treat costs associated with the development of our Network Gaming system under Topic 985. This change had no impact on the results of operations for the three and six months ended December 31, 2010. As of October 1, 2010, we reclassified $34.4 million of capitalized computer software costs for the *WAGE-NET* Networked Gaming system from property and equipment to intangible assets. We expect to begin amortization of this intangible asset when the gaming regulators approve the commercial version of the Network Gaming system in the coming quarters.

***Other Principal Accounting Policies***

For a description of our other principal accounting policies, see Note 2, Principal Accounting Policies, to the Consolidated Financial Statements and the Notes thereto in our Annual Report on Form 10-K for the fiscal year ended June 30, 2010.

***Recently Issued Accounting Standards***

In April 2010, the FASB issued Accounting Standards Update ( ASU ) No. 2010-16, *Accruals for Casino Jackpot Liabilities* ( ASU No. 2010-16 ), which clarifies when a casino entity is required to accrue a jackpot liability. ASU No. 2010-16 will be effective for fiscal years beginning on or after December 15, 2010, which for WMS would be our fiscal year beginning July 1, 2011. Early adoption is permitted. We are currently evaluating the impact of applying the provisions of this guidance to our WAP accounting on our Consolidated Financial Statements.

In July 2010, the FASB issued ASU No. 2010-20, *Disclosures about the Credit Quality of Financing Receivables and the Allowance for Credit Losses* ( ASU No. 2010-20 ) to provide greater disclosure about an entity s allowance for credit losses and the credit quality of its financing receivables. We adopted ASU No. 2010-20 as of December 31, 2010 and the adoption had no material impact on our Consolidated Financial Statements.

**3. FACILITY CLOSING COSTS**

In the quarter ended September 30, 2010, 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 in order to streamline and enhance our sales, marketing and support functions. This action resulted in a pre-tax charge of $3.8 million during the quarter ended September 30, 2010, consisting of accrued employee severance and related taxes of $1.7 million, which was paid on October 1, 2010, and a non-cash impairment charge of $2.1 million to write down the main facility to fair market value as determined by a third party real estate appraisal firm.

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**WMS INDUSTRIES INC.**

**NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS**

**(tabular amounts in millions of U.S. dollars and millions of shares, except per share amounts)**

**(Unaudited)**

## 4. EARNINGS PER SHARE

Basic and diluted earnings per share are calculated as follows:

| | Three Months Ended December 31, | | Six Months Ended December 31, | |
|---|---|---|---|---|
| | 2010 | 2009 | 2010 | 2009 |
| Net income | $ 27.0 | $ 26.5 | $ 46.5 | $ 46.3 |
| After tax interest expense and amortization of issuance cost on convertible subordinated notes | 0.0 | 0.0 | 0.0 | 0.5 |
| Diluted earnings (numerator) | $ 27.0 | $ 26.5 | $ 46.5 | $ 46.8 |
| Basic weighted average common shares outstanding | 57.8 | 58.3 | 58.0 | 54.2 |
| Dilutive effect of stock options | 1.0 | 1.2 | 1.0 | 1.2 |
| Dilutive effect of restricted common stock and warrants | 0.3 | 0.3 | 0.3 | 0.4 |
| Dilutive effect of convertible subordinated notes | 0.0 | 0.8 | 0.0 | 4.6 |
| Diluted weighted average common stock and common stock equivalents (denominator) | 59.1 | 60.6 | 59.3 | 60.4 |
| Basic earnings per share of common stock | $ 0.47 | $ 0.45 | $ 0.80 | $ 0.86 |
| Diluted earnings per share of common stock and common stock equivalents | $ 0.46 | $ 0.44 | $ 0.78 | $ 0.77 |
| Common stock equivalents excluded from the calculation of diluted earnings per share because their impact would render them anti-dilutive | 1.4 | 0.9 | 1.8 | 1.0 |

Included in our anti-dilutive common stock equivalents for the three months and six months ended December 31, 2010 and 2009 are warrants to purchase 500,000 shares of our common stock that were issued to Hasbro Inc. and Hasbro International, Inc. These warrants were excluded from the calculation because the vesting criteria are contingent upon future events and were not met. See Note 10. Stockholders Equity to our Consolidated Financial Statements and Notes thereto included in our Annual Report on Form 10-K for the fiscal year ended June 30, 2010.

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**(tabular amounts in millions of U.S. dollars and millions of shares, except per share amounts)**

**(Unaudited)**

## 5. INVENTORIES

Inventories consisted of the following:

| | December 31, 2010 | June 30, 2010 |
|---|---|---|
| Raw materials and work-in-process | $ 44.6 | $ 42.9 |
| Finished goods | 23.8 | 14.9 |
| Total inventories | $ 68.4 | $ 57.8 |

Cost elements included in work-in-process and finished goods include raw materials, direct labor and overhead expenses. We recorded raw material and finished goods inventory write-downs totaling approximately $0.1 million and $1.1 million for three months ended December 31, 2010 and December 31, 2009, respectively and $1.1 million and $1.3 million for the six months ended December 31, 2010 and 2009, respectively. These charges are classified in cost of product sales in our Condensed Consolidated Statements of Income.

## 6. INTANGIBLE ASSETS

***General***

Intangible assets recorded on our Condensed Consolidated Balance Sheets consisted of the following:

| | December 31, 2010 | June 30, 2010 |
|---|---|---|
| Goodwill | $ 19.0 | $ 17.9 |
| Finite lived intangible assets, net | 131.5 | 91.5 |
| Less: royalty advances and developed, licensed or acquired technologies, short-term | (10.3) | (10.3) |
| Total Long-term intangible assets, net | $ 140.2 | $ 99.1 |

The following table summarizes additions to other intangible assets including amounts classified as current during the six months ended December 31, 2010:

| | Total Additions |
|---|---|
| Finite lived intangible assets: | |
| Royalty advances for licensed brands, talent, music and other | $ 5.2 |

| | | |
|---|---|---|
| Developed, licensed or acquired technologies | | 8.8 |
| Patents, trademarks and other | | 1.3 |
| Foreign currency translation adjustment | | 0.0 |
| Total | $ | 15.3 |

Certain of our intangible assets including goodwill are denominated in foreign currency and, as such, include the effects of foreign currency translation.

***Goodwill***

The changes in the carrying amount of goodwill for the six months ended December 31, 2010 include:

| | |
|---|---|
| Goodwill balance at June 30, 2010 | $ 17.9 |
| Foreign currency translation adjustment | 1.1 |
| Goodwill balance at December 31, 2010 | $ 19.0 |

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**NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS**

**(tabular amounts in millions of U.S. dollars and millions of shares, except per share amounts)**

**(Unaudited)**

***Other Intangible Assets***

Other intangible assets consisted of the following:

| | Useful Life (Years) | December 31, 2010 Cost | Accumulated Amortization | Net | June 30, 2010 Cost | Accumulated Amortization | Net |
|---|---|---|---|---|---|---|---|
| Finite lived intangible assets: | | | | | | | |