WMS INDUSTRIES INC /DE/
Form 10-Q
May 05, 2010
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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 MARCH 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 ¨ 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: 57,956,557 shares of common stock, $0.50 par value, were outstanding at April 30, 2010.

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PART I. FINANCIAL INFORMATION

ITEM 1. FINANCIAL STATEMENTS

WMS INDUSTRIES INC.

CONDENSED CONSOLIDATED STATEMENTS OF INCOME

For the Three and Nine Months Ended March 31, 2010 and 2009

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

(Unaudited)

	Three Months Ended March 31,		Nine Months Ended March 31,	
	2010	2009	2010	2009
REVENUES:				
Product sales	$ 123.9	$ 114.0	$ 325.8	$ 316.2
Gaming operations	73.6	66.8	225.9	194.4
Total revenues	197.5	180.8	551.7	510.6
COSTS AND EXPENSES:				
Cost of product sales(1)	57.6	53.4	154.9	154.1
Cost of gaming operations(1)	14.0	10.1	43.5	34.0
Research and development	26.7	24.8	79.1	72.7
Selling and administrative	38.0	37.0	107.8	105.6
Depreciation (1)	16.7	17.3	50.9	51.4
Total costs and expenses	153.0	142.6	436.2	417.8
OPERATING INCOME	44.5	38.2	115.5	92.8
Interest expense	(0.4)	(0.9)	(2.9)	(3.1)
Interest income and other income and expense, net	1.1	0.6	4.2	6.5
Income before income taxes	45.2	37.9	116.8	96.2
Provision for income taxes	12.2	13.5	37.5	32.4
NET INCOME	$ 33.0	$ 24.4	$ 79.3	$ 63.8
Earnings per share:				
Basic	$ 0.57	$ 0.50	$ 1.43	$ 1.29
Diluted	$ 0.55	$ 0.43	$ 1.32	$ 1.10
Weighted-average common shares:				
Basic common stock outstanding	57.9	48.8	55.4	49.3
Diluted common stock and common stock equivalents	60.1	58.2	60.3	59.1

(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	$ 1.1	$ 1.1	$ 3.2	$ 3.0
Cost of gaming operations	$ 10.8	$ 13.0	$ 33.8	$ 39.5

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

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WMS INDUSTRIES INC.

CONDENSED CONSOLIDATED BALANCE SHEETS

March 31, 2010 and June 30, 2009

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

	March 31, 2010 (unaudited)	June 30, 2009
ASSETS		
CURRENT ASSETS:		
Cash and cash equivalents	$ 144.3	$ 135.7
Restricted cash and cash equivalents	17.1	19.0
Total cash, cash equivalents and restricted cash	161.4	154.7
Accounts and notes receivable, net	255.3	214.2
Inventories	58.9	43.1
Other current assets	44.1	38.0
Total current assets	519.7	450.0
NON-CURRENT ASSETS:		
Gaming operations equipment, net of accumulated depreciation of $239.7 and $211.3, respectively	62.4	68.0
Property, plant and equipment, net of accumulated depreciation of $89.8 and $73.9, respectively	179.2	158.8
Intangible assets, net	99.1	99.3
Deferred income tax assets	29.5	31.2
Other assets, net	51.9	48.7
Total non-current assets	422.1	406.0
TOTAL ASSETS	$ 941.8	$ 856.0
LIABILITIES AND STOCKHOLDERS EQUITY		
CURRENT LIABILITIES:		
Accounts payable	$ 50.9	$ 50.4
Accrued compensation and related benefits	21.6	27.9
Other accrued liabilities	41.2	37.4
Total current liabilities	113.7	115.7
NON-CURRENT LIABILITIES:		
Deferred income tax liabilities	18.3	17.8
Long-term debt	9.9	115.0
Other non-current liabilities	11.7	16.1
Total non-current liabilities	39.9	148.9
Commitments, contingencies and indemnifications (see Note 11)		
STOCKHOLDERS EQUITY:		
Preferred stock (5.0 shares authorized, none issued)		
Common stock (200.0 and 100.0 shares authorized and 59.0 and 51.0 shares issued, respectively)	29.5	25.5

Additional paid-in capital	421.7	311.9
Retained earnings	375.4	296.1
Accumulated other comprehensive income	(1.5)	3.3
Treasury stock, at cost (1.0 and 1.8 shares, respectively)	(36.9)	(45.4)
Total stockholders equity	788.2	591.4
TOTAL LIABILITIES AND STOCKHOLDERS EQUITY	$ 941.8	$ 856.0

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 Nine Months Ended March 31, 2010 and 2009

(in millions of U.S. dollars)

(Unaudited)

	2010	2009
CASH FLOWS FROM OPERATING ACTIVITIES		
Net income	$ 79.3	$ 63.8
Adjustments to reconcile net income to net cash provided by (used in) operating activities:		
Depreciation	50.9	51.4
Amortization of intangible and other assets	16.7	14.4
Share-based compensation	14.9	12.7
Other non-cash items	(0.5)	16.8
Deferred income taxes	1.5	8.4
Tax benefit from the exercise of stock options	(13.2)	(0.3)
Change in operating assets and liabilities	(70.6)	(36.0)
Net cash provided by operating activities	79.0	131.2
CASH FLOWS FROM INVESTING ACTIVITIES		
Purchase of property, plant and equipment	(39.4)	(41.1)
Additions to gaming operations equipment	(30.2)	(36.6)
Payments to acquire or license intangible and other assets	(6.4)	(9.3)
Net cash used in investing activities	(76.0)	(87.0)
CASH FLOWS FROM FINANCING ACTIVITIES		
Cash received from exercise of stock options and employee stock purchase plan	32.0	0.9
Tax benefit from exercise of stock options	13.2	0.3
Purchases of treasury stock	(37.0)	(40.5)
Proceeds from borrowings under revolving credit facility		50.0
Repayments of borrowings under revolving credit facility		(50.0)
Debt issuance costs	(1.7)	
Other	(0.9)	
Net cash provided by (used in) financing activities	5.6	(39.3)
Effect of Exchange Rates on Cash and Cash Equivalents		(1.5)
INCREASE IN CASH AND CASH EQUIVALENTS	8.6	3.4
CASH AND CASH EQUIVALENTS, beginning of period	135.7	100.8
CASH AND CASH EQUIVALENTS, end of period	$ 144.3	$ 104.2

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, (US GAAP) for complete financial statements. The Condensed Consolidated Financial Statements should therefore be read in conjunction with the Consolidated Financial Statements and Notes thereto included in our Annual Report on Form 10-K for the fiscal year ended June 30, 2009. The accompanying unaudited interim Condensed Consolidated Financial Statements have been prepared in accordance with U.S. generally accepted accounting principles 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 months. In addition, quarterly revenues and net income may increase when we receive a larger number of product approvals or a new jurisdiction allows gaming. Operating results for the three and nine months ended March 31, 2010 are not necessarily indicative of the results that may be expected for the fiscal year ending June 30, 2010. 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, 2009.

We have production facilities in the United States, with development and distribution offices located in the United States, Argentina, Australia, Austria, Canada, China, Italy, Mexico, the Netherlands, South Africa, Spain, and the United Kingdom.

We market our gaming machines in two principal ways. First, product sales includes the sale to casinos and other gaming machine operators of new and used gaming machines and VLTs, conversion kits, parts, amusement-with-prize gaming machines, equipment manufactured under original equipment manufacturing agreements 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 net win, which is the earnings generated by casino patrons playing the gaming machine, (2) fixed daily fees or (3) a percentage of the amount wagered or a combination of a fixed daily fee and a percentage of the amount wagered. We categorize our lease arrangements into five groups: wide-area progressive (WAP) participation gaming machines; local-area progressive (LAP) participation gaming machines; stand-alone participation gaming machines; 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.

We are engaged in one business segment: the design, manufacture, and distribution of gaming machines (video and mechanical reel type) and video lottery terminals (VLTs) for customers in legalized gaming jurisdictions worldwide. Data for product sales and gaming operations is only maintained on a consolidated basis as presented in our 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 Condensed Consolidated Statements of Income and cost of gaming operations equipment and related accumulated depreciation included in our Condensed Consolidated Balance Sheets).

2. PRINCIPAL ACCOUNTING POLICIES

Revenue Recognition

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

Our revenue recognition policy for both product sales and gaming operations is to record revenue when all the following criteria are met:

- Ø Persuasive evidence of an agreement exists;

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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)

- Ø The price to the customer is fixed or determinable;
- Ø Delivery has occurred, title has been transferred, and any acceptance terms have been fulfilled;
- Ø No significant contractual obligations remain; and
- Ø Collectibility is reasonably assured.

We recognize revenue when the criteria listed above are met. We defer revenue for any undelivered units of accounting. Deliverables are divided into separate units of accounting if:

- Ø each item has value to the customer on a stand-alone basis; and
- Ø delivery of any undelivered item is considered probable and substantially in our control.

Product Sales

We sell gaming machines and VLTs typically with payment terms of 30 to 90 days. In certain circumstances, we offer extended payment terms typically for up to one year but in limited cases for longer terms up to three years, which obligation may be secured by the related gaming machines and may accrue interest recognized at market rates. In fiscal 2009, due to the slowing economy and credit availability challenges our customers experienced, we implemented a program to increase the amount of extended terms offered to select customers. We expect to continue this program throughout fiscal 2010. Revenues are reported net of incentive rebates, imputed interest or discounts. We annually investigate sales contracts with extended payment terms in excess of one year to determine if there is sufficient history to prove assurance of collectibility under the original sales contract payment terms. Based upon this investigation, we have concluded that adequate supporting historical documentation exists to conclude collectibility is probable for sales contracts with extended payment terms of 36 months or less. Our product sales contracts do not include specific performance, cancellation, termination, and refund type provisions.

Our services for initial gaming machine installation, as well as standard warranty and technical support, are not separately priced components of our sales arrangements and are included in our revenues when the associated product sales revenue is recognized. Labor costs for gaming machine installs and participation placements, as well as labor costs associated with performing routine maintenance on participation gaming machines are included in selling and administrative expenses. We accrue for the cost of installing gaming machines sold to our customers at the time of sale, based on the percent of such gaming machines that we expect to install for our customers. We capitalize the costs to install gaming operations equipment.

Gaming Operations

We earn gaming operations revenues from leasing gaming machines, VLTs and other leased equipment, and earn royalties from third parties under license agreements to use our game content and intellectual property.

For WAP leasing agreements, revenues are recognized for each gaming machine based upon a percentage of coin-in, which is the amount of coins, currency and credits wagered on the gaming machine, or a combination of a fixed daily fee and a percentage of coin-in. Participating casinos pay a percentage of the coin-in from WAP gaming machines directly to us for services related to the design, assembly, installation, operation, maintenance, and marketing of the WAP systems and to administer the progressive jackpot funding. Revenues are recognized as earned when collectibility is reasonably assured. WAP systems entail a configuration of numerous electronically linked gaming machines located in multiple casino properties within a single gaming jurisdiction, which are connected to our central WAP computer system via a network of communications equipment. WAP system gaming machines differ from non-linked gaming machines in that they build a progressive jackpot with every wager until a player hits the top award winning combination. We fund WAP progressive jackpots won by casino patrons.

A LAP system electronically links gaming machines within a single casino to a site controller which builds a series of small progressive jackpots within that specific casino based on every wager made on the LAP system; whereas a WAP jackpot system links gaming machines in multiple casinos to a progressive jackpot within a single gaming jurisdiction. Each casino funds LAP progressive jackpots won by patrons of its casino.

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We also offer participation gaming machines on a non-linked basis, which we call stand-alone games. Stand-alone and LAP progressive participation lease agreements are based on either a pre-determined percentage of the daily net win of each gaming machine or a fixed daily rental fee, or for one specific product, a percentage of the coin-in.

Casino-owned daily fee lease agreements are for a fixed daily fee per day. Casino-owned daily fee games are games for which we sell the base gaming machine without a game theme to the casino at a normal sales price excluding the game theme, earn a normal product sales gross profit and then earn a lower ongoing daily fee from leasing the top box and game theme to the casino. All components or elements of the arrangement are delivered at the time of physical delivery of the gaming machine and we have no further obligation to refresh or change the game theme. Revenue recognized for casino-owned daily fee game lease arrangements is not material to our Condensed Consolidated Financial Statements. We exclude casino-owned daily fee gaming machines from our installed base of participation gaming machines.

VLTs may be operated as stand-alone units or may interface with central monitoring systems operated by government agencies. Our leased VLTs typically are located in places where casino-style gaming is not the only attraction, such as racetracks, bars and restaurants, and are usually operated by the lottery organization of the jurisdiction. Our lease revenues are based on a fixed percentage of daily net win of the VLTs or a fixed daily lease rate. We exclude our leased VLTs from our installed base of participation gaming machines.

Some customers prefer to lease our standard for-sale gaming machines as an option rather than to purchase them. In these cases, we lease the game and the gaming machine, either for a fixed daily fee or as a percentage of the net win of the gaming machine. We do not include leased for-sale units in our installed base of participation gaming machines.

Under agreements with licensees who are generally located in geographic areas or operate in markets where we are not active, we license our games, artwork, and other intellectual property. Currently these arrangements are not material to our financial results. License royalties are recorded as earned when the licensee purchases or places the game or other intellectual property, and collectibility is reasonably assured.

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 the start of our fiscal year of adoption, which is July 1, 2009. While the adoption of these two ASU s changed our revenue recognition policies beginning in fiscal 2010, the impact on our Condensed Consolidated Financial Statements was not significant to either the nine months ended March 31, 2010, or had these ASU s been applied retroactively, to the fiscal years ended June 30, 2009, 2008 or 2007, as we had vendor specific objective evidence (VSOE) for all elements of our multiple deliverable arrangements.

ASU No. 2009-13 replaces and significantly changes the existing 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 arrangement, to all deliverables based on their relative selling price (i.e., 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). In the September 2009, December 2009 and March 2010 quarters, we used VSOE to value all elements in our multiple deliverable arrangements and did not use either TPE or ESP. These new revenue recognition standards will have more impact on our revenue recognition when we launch our networked gaming system and related software applications in fiscal 2011.

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WMS INDUSTRIES INC.

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(Unaudited)

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 *Bluebird®2* gaming machines and revenues generated from the sales of gaming related systems by our subsidiary Systems in Progress GmbH (SiP) 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.

Effective July 1, 2009, Topic 985 primarily effects our SiP revenues and will impact future networked gaming (NG) revenues because SiP and future NG revenues are derived from computer software applications and systems to be sold or leased. As we begin to commercialize NG software applications through multiple deliverable arrangements in fiscal 2011, the application of Topic 985 will require us to obtain VSOE for undelivered NG 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. NG refers to a networked gaming system that links groups of server-enabled gaming machines to a server in the casino data center.

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 March 31, 2010 and 2009 and $18.3 million and $15.9 million for the nine months ended March 31, 2010 and 2009, respectively.

Fair Value Measurements

We apply the provisions of FASB 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. The adoption of Topic 820 effective July 1, 2009 did not have a material impact on our Consolidated Financial Statements.

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;

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

(Unaudited)

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

The only assets subject to fair value measurement in accordance with Topic 820 were investments in various money market funds totaling approximately $92.5 million at March 31, 2010 and approximately $96.6 million at June 30, 2009. 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.

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. On a quarterly basis, 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. Bad debt expense for the three months ended March 31, 2010 and 2009 was $0.7 million respectively for both periods. Bad debt expense for the nine months ended March 31, 2010 and 2009 was $1.8 million and $4.3 million, respectively. The expense in the nine months ended March 31, 2009 was higher due to the impact of the economic turndown and resulting increase in customer bankruptcy filings during that period.

The following summarizes the components of current and long-term accounts and notes receivable, net;

	March 31, 2010	June 30, 2009
Current:		
Accounts receivable	$ 124.0	$ 105.6
Notes receivable	134.4	112.6
Allowance for doubtful accounts	(3.1)	(4.0)
Current accounts and notes receivable, net	$ 255.3	$ 214.2
Long-term, included in Other assets, net:		
Notes receivable	$ 40.5	$ 39.6

Allowance for doubtful accounts	(1.3)	(1.3)
Long-term notes receivable, net	$ 39.2	$ 38.3
Total accounts and notes receivable, net	$ 294.5	$ 252.5

Our policy is to generally not record interest on receivables after the invoice payment becomes past due. A receivable is considered past due if payments have not been received within agreed upon invoice terms. 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 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. As of March 31, 2010 and June 30, 2009 respectively, the fair value of the accounts and notes receivable, net, approximated the carrying value.

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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 Principal Accounting Policies

For a description of our other principal accounting policies, see Note 2, Principal Accounting Policies, to the Consolidated Financial Statements and Notes thereto in our Annual Report on Form 10-K for the fiscal year ended June 30, 2009.

Recently Issued Accounting Standards

In September 2006, the FASB issued Topic 820, *Fair Value Measurements*. Topic 820 defines fair value, establishes a framework for measuring fair value in accordance with generally accepted accounting principles, and expands disclosures about fair value measurements. Topic 820 does not require any new fair value measurements, but provides guidance on how to measure fair value by providing a fair value hierarchy used to classify the source of the information. Subsequent to the issuance of Topic 820, the FASB issued a provision to Topic 820, *Effective Date of FASB Statement Topic 820*. This provision delays the effective date of Topic 820 for all non-financial assets and non-financial liabilities, except those that are recognized or disclosed at fair value in the financial statements on a recurring basis. For the instruments subject to the effective date delay under Topic 820, the effective date to adopt the fair value provisions for us was July 1, 2009. On October 10, 2008, the FASB issued another provision under Topic 820, *Determining the Fair Value of a Financial Asset When the Market for That Asset Is Not Active*. This provision does not change the fair value measurement principles in Topic 820, but rather provides guidance for the application of those measurement principles in the extreme inactive markets that existed at that time. We adopted Topic 820 effective July 1, 2009 and the adoption had no material impact on our Consolidated Financial Statements.

In April 2008, the FASB issued FASB ASC 350-30-65-1, *Determination of the Useful Life of Intangible Assets* (Topic 350-30-65-1). Topic 350-30-65-1 amends the factors that should be considered in developing renewal or extension assumptions used to determine the useful life of a recognized intangible asset under ASC 350-30, *Goodwill and Other Intangible Assets* (Topic 350-30). Previously, under the provisions of ASC 350-30, an entity was precluded from using its own assumptions about renewal or extension of an arrangement where there was likely to be substantial cost or material modifications. Topic 350-30-65-1 removes the requirement of Topic 350-30 for an entity to consider whether an intangible asset can be renewed without substantial cost or material modification to the existing terms and conditions and requires an entity to consider its own experience in renewing similar arrangements. Topic 350-30-65-1 is effective for fiscal years beginning after December 15, 2008. We adopted Topic 350-30-65-1 effective July 1, 2009 and the adoption had no material impact on our Consolidated Financial Statements.

In June 2009, the FASB issued ASC 105 *Accounting Standards Codification and Hierarchy of Generally Accepted Accounting Principles*, which establishes the Codification as the single source of authoritative US GAAP. This statement is effective for interim and annual financial statements issued after September 15, 2009 and has changed the way we reference accounting standards in this Form 10-Q and in future disclosures.

In October 2009, the FASB issued ASU No. 2009-13, *Multiple-Deliverable Revenue Arrangements* and ASU No. 2009-14 *Certain Revenue Arrangements That Include Software Elements*. 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 and the adoption did not have a material impact on our Consolidated Financial Statements. See the Revenue Recognition section in Note 2 Principal Accounting Policies to the Condensed Consolidated Financial Statements and Notes thereto in this report.

In April 2010, the FASB issued ASU No. 2010-16, *Accruals for Casino Jackpot Liabilities*, 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 WAP accounting in our Consolidated Financial Statements.

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3. EARNINGS PER SHARE

Basic and diluted earnings per share are calculated as follows:

	Three Months Ended March 31,		Nine Months Ended March 31,	
	2010	**2009**	**2010**	**2009**
Net income	$ 33.0	$ 24.4	$ 79.3	$ 63.8
After tax interest expense and amortization of issuance cost on convertible subordinated notes		0.5	0.5	1.5
Diluted earnings (numerator)	$ 33.0	$ 24.9	$ 79.8	$ 65.3
Basic weighted average common shares outstanding	57.9	48.8	55.4	49.3
Dilutive effect of stock options	1.0	0.6	1.2	1.0
Dilutive effect of restricted common stock and warrants	0.4	0.1	0.4	0.1
Dilutive effect of convertible subordinated notes	0.8	8.7	3.3	8.7
Diluted weighted average common stock and common stock equivalents (denominator)	60.1	58.2	60.3	59.1
Basic earnings per share of common stock	$ 0.57	$ 0.50	$ 1.43	$ 1.29
Diluted earnings per share of common stock and common stock equivalents	$ 0.55	$ 0.43	$ 1.32	$ 1.10
Common stock equivalents excluded from the calculation of diluted earnings per share because their impact would render them anti-dilutive	1.0	3.0	1.0	2.2

Included in our anti-dilutive common stock equivalents for the three months and nine months ended March 31, 2010 are warrants to purchase 0.5 million shares, of our common stock, which are contingent upon future events that were issued to Hasbro Inc. and Hasbro International, Inc. These warrants are excluded from the diluted share calculation because the vesting criteria have not been met. See Note 12, Equity Compensation Plan Warrants to our Consolidated Financial Statements and Notes thereto in our Annual Report on Form 10-K for the fiscal year ended June 30, 2009.

4. INVENTORIES

Inventories consisted of the following:

	March 31, 2010	June 30, 2009

Raw materials and work-in-process	$	38.9	$	26.8
Finished goods		20.0		16.3
Total inventories	$	58.9	$	43.1

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 $0.8 million and $4.2 million for three months ended March 31, 2010 and March 31, 2009, respectively and $2.1 million and $12.1 million for the nine months ended March 31, 2010 and 2009, respectively. These charges are classified in cost of product sales in our Condensed Consolidated Statements of Income. The inventory write-downs were greater in the nine months ended March 31, 2009 as we transitioned to our new *Bluebird2* product which was launched in the December 2008 quarter and, as a result, demand for our *Bluebird* product line abated more rapidly than expected due to the popularity of the *Bluebird2* product.

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5. INTANGIBLE ASSETS

General

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

	March 31, 2010	June 30, 2009
Goodwill	$ 19.3	$ 19.9
Finite lived intangible assets, net	91.5	88.3
Indefinite lived intangible assets	3.6	3.6
Less: royalty advances and licensed or acquired technologies, short-term	(15.3)	(12.5)
Total long-term intangible assets	$ 99.1	$ 99.3

Goodwill

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

Goodwill balance at June 30, 2009	$ 19.9
Additions	
Foreign currency translation adjustment	(0.6)
Goodwill balance at March 31, 2010	$ 19.3

Other Intangible Assets

Other intangible assets consisted of the following:

		March 31, 2010			June 30, 2009		
	Useful Life (Years)	Cost	Accumulated Amortization	Net	Cost	Accumulated Amortization	Net
Finite lived intangible assets:							
Royalty advances for licensed brands, talent, music and other	1 -15	$ 91.7	$ (55.2)	$ 36.5	$ 79.8	$ (44.2)	$ 35.6
Licensed or acquired technologies	1- 15	47.6	(12.5)	35.1	42.6	(9.6)	33.0
Patents	4-17	22.9	(5.3)	17.6	20.9	(4.2)	16.7
Customer relationships	6	4.5	(2.8)	1.7	4.7	(2.3)	2.4

Trademarks	4	1.3	(0.7)	0.6	1.1	(0.5)	0.6
Total		$ 168.0	$ (76.5)	$ 91.5	$ 149.1	$ (60.8)	$ 88.3
Indefinite lived intangible assets:							
Acquired brand names		$ 3.6	$	$ 3.6	$ 3.6	$	$ 3.6

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The following table summarizes cash additions to finite lived intangible assets during the nine months ended March 31, 2010:

	Total Additions
Finite lived intangible assets:	
Royalty advances for licensed brands, talent, music and other	$ 11.9
Licensed or acquired technologies	5.0
Patents	2.0
Trademarks	0.2
Total	$ 19.1

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

Amortization expense for our finite-lived intangible assets was $5.2 million and $4.4 million for the three months ended March 31, 2010 and 2009, respectively and $15.8 million and $11.0 million for the nine months ended March 31, 2010 and 2009, respectively.

The estimated aggregate amortization expense for finite live intangible assets for each of the next five years is as follows:

2010 (remaining three months of fiscal year)	$ 5.6
2011	17.6
2012	9.2
2013	7.1
2014	4.7
2015	2.6

The estimated aggregate future intangible amortization as of March 31, 2010 does not reflect the significant commitments we have for future payments for royalty advances and licensed or acquired technologies. If we determine that we may not realize the net book value of any of the finite lived intangible assets or value of commitments, we would record an immediate charge against earnings up to the full amount of the value of these assets or commitments in the period in which such determination is made. See Note 11, Commitments, Contingencies and Indemnifications to the Condensed Consolidated Financial Statements and Notes thereto in this report.

6. INCOME TAXES

We, or one of our subsidiaries, files income tax returns in the U.S. Federal, various state, local and foreign jurisdictions. Our provision for income taxes for interim periods is based on an estimate of the effective annual income tax rate. The provision differs from income taxes currently payable because certain items of income and expense are recognized in different periods for financial statement purposes than for income tax return purposes. The estimated effective income tax rate was approximately 27.0% and 35.6% for the three months ended March 31, 2010 and 2009, respectively and 32.1% and 33.7% for the nine months ended March 31, 2010 and 2009, respectively. 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 R&D tax credit legislation effective as of December 31, 2009 which had the impact of reducing our earnings per diluted share by $0.01. Assuming that the R&D tax credit is not reinstated in the June 2010 quarter, we expect our effective tax rate will be between 36% and 37% for our June 2010 quarter.

As of March 31, 2010, we had $2.5 million of gross unrecognized tax benefits, excluding accrued interest and penalties of $0.2 million. Of the total unrecognized tax benefits, including accrued interest and penalties, $2.3 million (net of the Federal benefit) represents the portion that, if recognized, would impact the effective tax rate.

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The reconciliation of the beginning and ending gross unrecognized income tax benefits, excluding accrued interest and penalties for the nine months ended March 31, 2010 is as follows:

Balance at June 30, 2009	$ 7.0
Additions related to prior year tax positions	
Reductions related to prior year tax positions	(0.3)
Additions related to current year positions	0.4
Reductions due to settlements and payments	(4.6)
Balance at March 31, 2010	$ 2.5

We are currently under audit in a major state for fiscal years 2004 thru 2007. Approximately $0.2 million of unrecognized income tax benefits are currently subject to this audit. At this time, we believe appropriate provisions for all outstanding issues have been made for all jurisdictions and all open years. As a result of the recent completion of the Internal Revenue Service audits, we are no longer subject to any significant U.S. Federal income tax examinations for the years before fiscal 2008. We are no longer subject to any significant local or foreign income tax examinations by tax authorities for years before fiscal 2006.

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7. CONVERTIBLE SUBORDINATED NOTES AND REVOLVING CREDIT FACILITY

Convertible Subordinated Notes

At March 31, 2010, we had $9.9 million of Convertible Subordinated Notes (Notes) remaining outstanding, bearing interest at 2.75%, maturing on July 15, 2010. The remaining Notes are convertible at any time into an aggregate of 0.8 million shares of our common stock at a conversion price of $13.19 per share, subject to adjustment. The Notes are not callable. We pay interest on the Notes semi-annually on January 15 and July 15 of each year. The conversion of the Notes to common stock is dependent on individual holders choices to convert, which is dependent on the spread of the market price of our stock above the conversion strike price of $13.19 per share, and would reduce our annual interest expense.

As of March 31, 2010, the fair value of the Notes was $31.6 million. The fair value of our convertible fixed rate debt is significantly dependent on the market price of our common stock into which it can be converted. We have classified our Notes outstanding at March 31, 2010 as a long-term liability because we have the ability and intent to refinance them under the amended and restated revolving credit agreement we entered into on September 25, 2009.

During the nine months ended March 31, 2010, we issued approximately 7.9 million shares of our common stock $0.50 par value per share, upon the early conversion to common stock of $105.1 million principal amount of our Notes, in several separate transactions in the September 2009 and December 2009 quarters. The aggregate impact of the conversion of the $105.1 million of Notes to common stock resulted in a pre-tax charge of $0.9 million for the inducement payments and the accelerated pre-tax write-off of the proportional deferred financing costs of $0.5 million. The total pre-tax charge in fiscal 2010 will be more than offset by savings from reduced interest payments through the remaining term of the Notes, resulting in a favorable pre-tax net benefit to fiscal 2010 net income of approximately $1.4 million. As a result of the conversion of the Notes during the nine months ended fiscal 2010, our long-term debt has been reduced by $105.1 million and common stock and additional paid-in capital have increased by an aggregate of $105.1 million.

We have no maturities of debt or sinking fund requirements through June 30, 2010.

Revolving Credit Facility

On September 25, 2009, we entered into an amended and restated revolving credit agreement with a group of five banks. The amended and restated revolving credit agreement provides for borrowings up to $150 million through September 30, 2012 with the ability to expand the facility to $200 million from the existing lenders willing to increase their commitments or from additional lenders with the consent of the administrative agent. 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 acquire companies, declare dividends, incur additional debt, make any distribution to holders of any shares of capital stock, or purchase or otherwise acquire shares of our common stock. The maximum leverage ratio is 3.25x through December 31, 2010, and 3.0x thereafter, and is computed as total indebtedness outstanding at the end of each quarter divided by the trailing twelve months earnings before interest, taxes, depreciation and amortization, including share-based compensation and non-cash charges (Adjusted EBITDA) as defined in the agreement. The minimum interest coverage ratio is 2.5x and is computed as trailing twelve months Adjusted EBITDA divided by trailing twelve months interest charges as defined in the revolving credit agreement.

The agreement also defines permitted restricted payments related to cash dividends, and cash repurchases of our common stock and at March 31, 2010, approximately $145.5 million was available for such purposes. The agreement also contains certain limitations on, among other items, the amount and types of additional indebtedness, liens, investments, loans, advances, guarantees and acquisitions. No amounts were outstanding under the amended and restated revolving credit facility at March 31, 2010. As of March 31, 2010, we maintained an aggregate cash balance of $19.3 million in non-interest bearing accounts with two of the new banks in our amended and restated revolving credit facility.

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Whether or not we have current borrowings outstanding under our revolving credit facility, we are required to maintain certain negative covenants and two financial ratios: a leverage ratio and an interest coverage ratio. We were in compliance with all of the negative covenants and financial ratios required by our revolving credit facility as of March 31, 2010.

8. STOCKHOLDERS EQUITY AND EQUITY COMPENSATION PLAN

General

Effective December 10, 2009 our stockholders voted to increase our authorized common stock to 200.0 million shares at $0.50 par value. Prior to that date, our authorized common stock was 100.0 million shares. Additionally, we have 5.0 million shares of $0.50 par value preferred stock authorized. The preferred stock is issuable in series, and the relative rights and preferences and the number of shares in each series are to be established by our Board of Directors.

On December 10, 2009, our stockholders approved the adoption of a restatement of the WMS Industries Inc. Incentive Plan (2009 Restatement) (the 2009 Restated Incentive Plan) increasing the number of shares available for grant by 3.8 million.

Common Stock Repurchase Program

On August 3, 2009, our Board of Directors authorized the repurchase of an additional $75 million of our common stock over the following twenty-four months increasing our remaining repurchase authorization to approximately $150 million. This authorization increased the existing program, previously authorized on August 4, 2008, from $150 million to $225 million and extended the expiration date to August 3, 2011. During the nine months ended March 31, 2010, we purchased 1.0 million shares for approximately $40.0 million at an average cost of $39.32, while during the nine months ended March 31, 2009 we purchased 1.6 million shares for approximately $35.5 million at an average cost of $22.15 per share. As of March 31, 2010, we had approximately $109 million remaining of our repurchase authorization. Pursuant to the authorization, purchases may be made from time to time in the open market, through block purchases or in privately negotiated transactions. The timing and actual number of shares repurchased will depend on market conditions. At March 31, 2010, we had purchased approximately $3.0 million of our common stock which was settled and paid for in April 2010. At June 30, 2008, we had purchased approximately $5.0 million of our common stock which, was settled and paid in fiscal 2009.

Equity Compensation Plan

A summary of information with respect to share-based compensation expense included in our Condensed Consolidated Statements of Income for the nine months ended March 31, 2010 and 2009 respectively are as follows:

	2010	**2009**
Cost of product sales	$ 0.2	$ 0.1
Research and development	4.9	4.1
Selling and administrative	9.8	8.5
Share-based compensation expense included in pre-tax income	14.9	12.7
Income tax benefit related to share-based compensation	(5.6)	(4.8)

Share-based compensation expense included in net income	$ 9.3	$ 7.9
Diluted earnings per share impact of share-based compensation expense	$ 0.15	$ 0.13

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Stock Options

For the nine months ended March 2010, we granted stock options to certain of our employees. The number of options awarded to each person varied. For options granted in the nine months ended March 2010 the range in fair value on the dates of grant was from $16.84 $18.73 per share. We determined grant-date fair value of stock options based on the Black-Scholes methodology using the following range of assumptions depending on the characteristics of the option grant: risk-free interest rates between 2.03%   2.29%; expected life between 4.5   4.75 years; expected volatility of 0.49; and 0.0% dividend yield. Stock option activity was as follows for the nine months ended March 31, 2010:

	Number of Stock Options	Weighted Average Exercise Price per Share	Weighted Average Remaining Contractual Term (in years)	Aggregate Intrinsic Value(1)
Stock options outstanding at June 30, 2009	5.3	$ 22.37	5.4	$ 49.1
Granted	0.5	42.08		
Exercised	(1.6)	18.97		
Expired or Cancelled				
Forfeited	(0.1)	29.04		
Stock options outstanding at March 31, 2010	4.1	$ 26.00	5.1	$ 65.7
Stock options exercisable at March 31, 2010	2.3	$ 21.69	4.7	$ 47.1

(1) Intrinsic value is defined as the amount by which the fair market value of the underlying stock exceeds the exercise price of the stock option.

At March 31, 2010 there was $11.8 million of total stock option compensation expense related to non-vested stock options not yet recognized, which is expected to be recognized over a weighted average period of 2.9 years.

Restricted Stock Awards Grants

We grant restricted stock and restricted stock units to certain employees and members of our Board of Directors, which vest from a range of two to four years on the grant date anniversary. Restricted stock share and restricted stock unit activity was as follows for the nine months ended March 31, 2010:

	Restricted Stock Shares	Weighted Average Grant-Date Fair Value(1)

Nonvested balance at June 30, 2009	0.3	$	27.53
Granted	0.1		44.28
Vested	(0.1)		30.08
Nonvested balance at March 31, 2010	0.3	$	29.67

	Restricted Stock Units (including Performance -based Stock Units)		Weighted Average Grant-Date Fair Value(1)
Nonvested balance at June 30, 2009	0.3	$	28.53
Granted	0.1		44.02
Vested	(0.1)		29.10
Nonvested balance at March 31, 2010	0.3	$	34.29

(1) For restricted stock, grant-date fair value is equal to the closing market price of a share of our common stock on the grant date.

At March 31, 2010 there was $11.9 million of total restricted stock award compensation expense related to non-vested awards not yet recognized, which is expected to be recognized over a weighted average period of 2.4 years.

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Equity-Based Performance Units

In September 2009, we granted equity-based performance units, which will vest upon achievement of performance goals set by our Board of Directors. The shares of stock ultimately issued to participants will be dependent upon the extent to which the financial performance goals over the three year period ended June 30, 2012 are achieved, if at all or exceeded, and can result in shares issued ranging from: (1) nothing to the extent certain minimum threshold goals are not met, (2) a percentage from 10% to 99% for the achievement and surpassing of the threshold goals up to but not including achievement of the target goals, (3) 100% of the granted amount if the target goals are met, to (4) a percentage more than 100% and up to 200% of the granted amount to the extent the target goals are exceeded. We expense the originally granted fair value of equity-based performance units outstanding over the performance period based on our current assessment of achievement of the performance goals. In August 2009, shares related to the equity-based performance units with a three-year measurement period ending June 30, 2009 were issued in accordance with the performance matrix approved at grant date in 2006. In accordance with the grant agreements, we issued shares of common stock equal to 73.3% of the number of units granted as adjusted for our three-for-two stock split in June 2007. Equity-based performance unit activity was as follows for the nine months ended March 31, 2010:

	Equity-based Performance Units	Weighted Average Grant-Date Fair Value(1)
Nonvested balance at June 30, 2009	0.4	$ 23.92
Granted	0.1	44.28
Vested	(0.1)	16.95
Forfeited	(0.1)	19.07
Nonvested balance at March 31, 2010	0.3	$ 34.21

(1) For equity-based performance units, grant-date fair value is equal to the closing market price of a share of our common stock on the grant date.

Employee Stock Purchase Plan

Effective July 1, 2009, we adopted an Employee Stock Purchase Plan (ESPP) as defined under Section 423 of the Internal Revenue Code allowing eligible employees to elect to make contributions through payroll deductions which will be used to purchase our common stock at a purchase price equal to 85% of the fair value of a share of common stock on the date of purchase. We have reserved 500,000 shares for issuance under the ESPP. For the nine months ended March 31, 2010, participants purchased 37,060 shares under this plan at an average cost of $36.12.

9. COMPREHENSIVE INCOME

Comprehensive income consists of the following:

	Three Months Ended March 31,		Nine Months Ended March 31,	
	2010	2009	2010	2009
Net income	$ 33.0	$ 24.4	$ 79.3	$ 63.8
Foreign currency translation adjustment	(5.0)	(3.0)	(4.8)	(9.6)
Total comprehensive income	$ 28.0	$ 21.4	$ 74.5	$ 54.2

10. SUPPLEMENTAL DISCLOSURE OF CASH FLOW INFORMATION

The net amount of gaming operations machines transferred to inventory, a non-cash investing activity, was $1.8 million and $1.1 million for the nine months ended March 31, 2010 and 2009, respectively.

For other non-cash transactions related to income taxes and the conversion of Notes, see Note 6, Income Taxes and Note 7, Convertible Subordinated Notes and Revolving Credit Facility , respectively to the Condensed Consolidated Financial Statements and Notes thereto in this report.

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11. COMMITMENTS, CONTINGENCIES AND INDEMNIFICATIONS

We routinely enter into license agreements with others for the use of intellectual properties and technologies in our products. These agreements generally provide for royalty advances and license fee payments when the agreements are signed and minimum commitments, which are cancellable in certain circumstances.

At March 31, 2010, we had total royalty and license fee advances and payments made and potential future royalty and license fee commitments as follows:

	Minimum Commitments
Total royalty and license fee commitments	$ 234.7
Advances and payments made	(136.3)
Potential future payments	$ 98.4

As of March 31, 2010, we estimate that potential future royalty payments in each fiscal year will be as follows:

	Minimum Commitments
2010 (remaining three months of fiscal year)	$ 0.5
2011	14.1
2012	15.4
2013	15.9
2014	16.3
2015	14.8
Thereafter	21.4
Total	$ 98.4

Indemnifications

We have agreements in which we may be obligated to indemnify other parties with respect to certain matters. Generally, these indemnification provisions are included in sales orders and agreements arising in the normal course of business under which we customarily agree to hold the indemnified party harmless against claims arising from a breach of representations related to matters such as title to assets sold and licensed, defective equipment or certain intellectual property rights. Payments by us under such indemnification provisions are generally conditioned on the other party making a claim. Such claims are typically subject to challenge by us and to dispute resolution procedures specified in the particular sales order or contract. Further, our obligations under these agreements may be limited in terms of time and/or amount and, in some instances, we may have recourse against third parties. It is not possible to predict the maximum potential amount of future payments under these indemnification agreements due to the conditional nature of the obligations and the unique facts of each particular agreement. Historically, we have not made any payments under these agreements that have been material individually or in the aggregate. As of March 31, 2010, we were not aware of any obligations arising under indemnification agreements that would require material payments.

We have agreements with our directors and certain officers that require us, among other things, to indemnify them against certain liabilities that may arise by reason of their status or service as directors or officers. We have also agreed to indemnify certain former officers and directors of acquired companies. We maintain director and officer insurance, which may cover our liabilities arising from these indemnification obligations in certain circumstances. As of March 31, 2010, we were not aware of any obligations arising under these agreements that would require material payments.

Special Purpose Entities and Derivative Instruments

We do not have any special purpose entities for investment or the conduct of our operations. We have not entered into any derivative financial instruments, although we have granted stock options, restricted stock, equity based performance units and deferred stock units to our employees, officers, directors and consultants and warrants to a licensor, and we have issued the Notes.

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Performance Bonds

We have performance and other bonds outstanding of $1.7 million at March 31, 2010, $1.0 million of which is attributed to one customer related to product sales, and we are liable to the issuer in the event of exercise due to our non-performance under the contract. Events of non-performance do not include the financial performance of our products.

Letters of Credit

Outstanding letters of credit issued under our line of credit to ensure payment to certain vendors and government agencies totaled $0.7 million at March 31, 2010.

WMS Licensor Arrangements

Our sales agreements that include software and intellectual property licensing arrangements contain a clause whereby we indemnify the third-party licensee against liability and damages (including legal defense costs) arising from any claims of patent, copyright, trademark, or trade secret infringement. Should such a claim occur, we could be required to make payments to the licensee for any liabilities or damages incurred. Historically, we have not incurred any significant cost due to the infringement claims. As we consider the likelihood of incurring future costs to be remote, no liability has been accrued.

Self-Insurance

We are self-insured for various levels of general, umbrella, directors and officers, fiduciary, property, crime, workers compensation, electronic errors and omissions, employment practices and automobile collision insurance, as well as employee medical, dental, prescription drug and disability coverage. We purchase stop-loss coverage to protect against unexpected claims. Accrued insurance claims and reserves include estimated settlements for known claims, and estimates of claims incurred but not reported.

Product Warranty

We generally warrant our new gaming machines sold in the U.S. for a period of 90 days, while we generally warrant our gaming machines sold internationally for a period of 180 days to one year. Our warranty costs have not been significant.

12. LITIGATION

On October 2, 2003, La Societe de Loteries du Quebec (Loto-Quebec) filed claims against us and Video Lottery Consultants Inc., a subsidiary of International Game Technology, (VLC) in the Superior Court of the Province of Quebec, Quebec City District (200-06-000017-015). The pleadings alleged that Loto-Quebec would be entitled to be indemnified by the manufacturers of Loto-Quebec s VLTs, specifically WMS and VLC, if the class action plaintiffs, described below, were successful in the pending class action lawsuit against Loto-Quebec. In July 2008, we entered into a settlement agreement with Loto-Quebec under which Loto-Quebec agreed to suspend the action in warranty against us in exchange for our agreement to continue cooperating with the defense of the class action lawsuit against Loto-Quebec and, in the event of an adverse outcome in such lawsuit against Loto-Quebec, to arbitration of any warranty claim by Loto-Quebec.

The class action lawsuit discussed in Loto-Quebec s claim was brought on May 18, 2001 against Loto-Quebec in the Superior Court of the Province of Quebec. It alleged that the members of the class developed a pathological gambling addiction by using Loto-Quebec s VLTs and that Loto-Quebec, as owner, operator and distributor of VLTs, failed to warn players of the alleged dangers associated with VLTs. Loto-Quebec and the class-action plaintiffs reached a court approved settlement in March 2010. Loto-Quebec has indicated it does not expect to pursue arbitration of any claims against us under the terms of our settlement agreement, but the time period for a final election by Loto-Quebec under the settlement agreement has not expired. At this time we cannot predict whether Loto-Quebec will pursue any claims and what the ultimate outcome may be of any such claims.

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ITEM 2. 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 in our Annual Report on Form 10-K for the fiscal year ended June 30, 2009 (Form 10-K). 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 our Form 10-K. 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.

Product names mentioned in this Report are trademarks of WMS Gaming Inc., except for the following: G2E is a registered trademark of the American Gaming Association and Reed Elsevier Inc. G2S and S2S are registered trademarks of the Gaming Standards Association.

OVERVIEW

Our mission is: through imagination, talent and technology, we create and provide the world s most compelling gaming experiences. We design, manufacture and distribute gaming machines and video lottery terminals (VLTs) for customers in legalized gaming jurisdictions worldwide. Our products consist primarily of video gaming machines, mechanical reel gaming machines and VLTs. Our gaming machines are installed in all of the major regulated gaming jurisdictions in the United States, as well as in over 100 international gaming jurisdictions. In fiscal 2011 we expect to provide fully networked business service solutions to our customers which are aimed at increasing the revenue generating capabilities and operational efficiency of casino gaming floors and that use industry standard communication protocols in order to be interoperable with our competitor s systems that utilized the industry standard communication protocol in their gaming systems.

We generate revenue in two principal ways: product sales and gaming operations, as further described below. The financial market crisis that began in 2008 has disrupted credit and equity markets worldwide and has led to a weakened global economic environment. The effect of the weakened global economy and the fallout from the financial market crisis has been a challenge for our industry. Some gaming operators delayed or canceled construction projects, resulting in fewer new casino openings and expansions in calendar year 2010 than in calendar 2009, coupled with many customers reducing their annual capital budgets for calendar 2009 with only modestly higher replacement capital budgets in calendar 2010. The economic crisis reduced disposable income for casino patrons and resulted in fewer patrons visiting casinos. In anticipation of the further lengthening of the replacement cycle and in response to the challenging economic environment, we reduced the number of new employees we hired in fiscal 2009 and thus far in fiscal 2010, and took actions to contain non-payroll related spending. In fiscal 2010, we remain focused on controlling spending and prioritizing capital expenditures and other discretionary items. The economic crisis lowered the number of new units we sold in fiscal 2009 and this continued in the first three quarters of fiscal 2010.

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. For fiscal 2009, *Bluebird2* units accounted for 35% of our total new units shipped and with the continuing transition in the market to this new product, accounted for approximately 81% of new unit shipments in the nine months ended March 31, 2010. We sold more new units in the March 2010 quarter than in the March 2009 quarter due to the popularity of our products enabling us to increase our share of units shipped in the United States and Canada. We believe that as the economy continues to improve, the capital budgets of our customers will increase, the replacement demand in future years will improve, and we ll also experience an increase in demand from casino expansions and new casino openings.

We believe several recent developments fueled by the challenging economic situation will benefit us in 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. The breadth and timing of these opportunities remains 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. In fiscal 2010 we also expanded our channels of distribution by entering several markets that we had not directly served by introducing our gaming machines and new products. We are focused on expanding our initial presence in the Class II and central determinant markets and the Mexico market as it moves to Class III style gaming, and entering the New South Wales, Australia market, as well as opportunities for new or expanded gaming in Italy, Singapore, Spain and Taiwan.

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Product Sales

Product sales revenue includes the sale of new and used gaming machines and VLTs, parts, conversion kits (including game theme and/or operating system conversions), amusement-with-prize (AWP) gaming machines, gaming-related systems for smaller international casino operators and equipment manufactured under original equipment manufacturing (OEM) agreements to casinos and other licensed gaming machine operators. We derive product sales revenue from the sale of the following:

Ø Multi-line, multi-coin video gaming machines, in our *Bluebird, Bluebird2* and Orion Financement Company (Orion Gaming) *Twinstar* and *Twinstar2*-branded gaming machines;

Ø Mechanical reel-spinning gaming machines in our *Bluebird* and *Bluebird2* branded gaming machines;

Ø Beginning in the June 2010 quarter, *Bluebird xD* branded gaming machines for the global market and *Helio s* branded machine offered in international markets under the Orion Gaming name;

Ø Video poker machines in our *Bluebird* and *Bluebird2* branded gaming machines, which are primarily offered as a casino-owned daily fee game, where the casino purchases the base gaming machine without a game theme and then leases the top box and game theme for a lower lease price point;

Ø Replacement parts and conversion kits for our legacy, *Bluebird*, *Bluebird2, Twinstar, Twinstar2* and AWP gaming machines, and *CPU-NXT*® and *CPU-NXT2* upgrade kits;

Ø Used gaming machines that are acquired on a trade-in basis or that were previously placed on a participation basis;

Ø AWP gaming machines in certain international markets;

Ø Gaming-related systems, including linked progressive systems and slot accounting systems applicable to smaller international casinos; and

Ø Gaming machines in legacy, *Bluebird* and *Twinstar* cabinets in limited cases under OEM agreements with certain third parties.

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 themes and intellectual property. 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 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 without a game theme and pays a lower daily lease fee for the top box and game theme;

Ø Leased gaming machines;

Ø Video lottery terminals; and

Ø Licensing revenues from licensing our game themes and intellectual properties to third parties.

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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 or expansion projects currently in process, but the breadth and timing of such opportunities remains uncertain due to the difficult credit environment facing our customers and the risk of continued economic uncertainty. We believe that gaming operators replacement buying demand will begin to improve in calendar 2010, as we believe, in general, that casino capital budgets are modestly higher than they were for calendar 2009.

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

1. *Priority:* Drive growth in our gaming operations business, while selectively investing our capital deployed in this business.

Quarter Ended March 2010 Result: During the three months ended March 31, 2010, our average installed base of participation gaming machines increased 4.6% over the prior year and, at March 31, 2010, our total installed participation footprint stood at 10,287 units compared to 9,901 units at March 31, 2009. Growth in the installed base was primarily led by our WAP gaming machines, which at March 31, 2010 comprised 31.6% of the footprint compared to 21.6% at March 31, 2009. The WAP footprint increased to 3,246 units at March 31, 2010 and was up 1,109 units or 52% compared to March 31, 2009, largely reflecting the successful launch of new WAP games. The increase in WAP games was partially offset by lower units of our stand-alone and LAP gaming machines at March 31, 2010. A shift in strategy in fiscal 2007 to focus on return on investment of our gaming operations assets coupled with a higher percentage of installed base being higher earning WAP gaming machines helped result in revenue per day for the quarter ended March 31, 2010 increasing by 8.5% to $76.37 per day from $70.37 per day for the March 2009 quarter. This strategy includes limiting the number of gaming machines for specific new themes at each casino and re-deploying gaming machines from casinos generating lower revenue per day to casinos generating higher revenue per day. By controlling the initial placement of new participation products, we continued to reduce the capital invested in gaming operations. An 8.5% improvement in the average daily revenue, coupled with the 4.6% improvement in the average installed base, produced a 13.5% year-over-year increase in participation revenue in our gaming operations business to $70.4 million for the quarter ended March 31, 2010, which attests to the continued strong play levels and player appeal of our participation products.

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

Quarter Ended March 2010 Result: The United States and Canadian replacement cycle has been abnormally low and the challenges facing our industry and the overall economy have continued, thus overall industry demand has been reduced. Even in this challenging environment our year-over-year new unit shipment volume was up 10.6% from the prior year quarter reflecting an increase in U.S. and Canadian shipments. To further diversify our revenue streams, we announced late in fiscal 2009 that we would directly enter the Class II, electronic bingo and central determinant market following expiration of our previous licensing agreements for those markets. Through an alliance with Bluberi Gaming Technologies Inc. (Bluberi), a Canadian-based technology firm, over time we will combine our existing library of over 200 for-sale games with Bluberi s proven system capabilities for the Class II, electronic bingo and central determinant markets. We shipped our first gaming machines to a Class II market in the September 2009 quarter, and shipments grew in the December 2009 and March 2010 quarters, and we expect to increase shipments into these markets in the June 2010 quarter. We expect to launch our new *Bluebird xD* gaming cabinet in the June 2010 quarter and, given the initial customer response at recent industry trade shows, we expect strong demand for this new product. We are dependent, in part, on innovative new products, casinos 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 for the quarter ended March 31, 2010, such expenses were $26.7 million, up $1.9 million, or 7.7%, 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.

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

Quarter Ended March 2010 Result: Shipments to international markets represented 33.6% of our total new unit shipments in the quarter ended March 31, 2010, compared with 38.2% for the prior year quarter. During the March 2010 quarter, international new unit shipments decreased 9.5% from the prior year quarter, as economic challenges are evident in some regions, principally Western European and Latin American markets, as well as the impact of the higher mix of premium *Bluebird2* units. In late fiscal 2008, Orion Gaming launched its new *Twinstar2* gaming machine and its new *N-Able* operating system that we expect will drive greater demand for Orion Gaming products in the future. In January 2010, we had the formal product launch of a new value-priced gaming cabinet called *Helios* that will be targeted at select international markets where the economics of the facilities do not justify the premium priced points of the *Bluebird, Bluebird2* or Orion Gaming s *Twinstar or Twinstar2* gaming machines. In the March 2010 quarter we successfully completed the second of two required field trials of our *Bluebird2* gaming machines in New South Wales, Australia and 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 earned our first revenues in the March 2010 quarter. We shipped our first direct shipment of gaming machines into Mexico in the June 2009 quarter and expanded shipments to this market in each of the first three quarters of fiscal 2010. We continue to make progress in preparing for the opening of the new VLT market in Italy. Although much effort is still needed before the first gaming machines are placed in Italy, we anticipate we will see the first shipments in mid-fiscal 2011. Also, we continue to achieve benefits from the opening of new international offices and the addition of new geographically dispersed sales account executives. We also expect that the launch of the new *Bluebird xD* gaming cabinet and our new value-priced *Helios* cabinet in Spring 2010 will benefit our shipments into the international markets.

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

Quarter Ended March 2010 Result: For the quarter ended March 31, 2010, our overall gross margin decreased by 120 basis points to 63.7% as an improvement in product sales margin was more than offset by the expected decline in gaming operations margin. Product sales gross margin was 53.5% compared with 53.2% in the year-ago period, which reflects ongoing success from continuous improvement efforts, including supply chain enhancements and lower inventory obsolescence charges, partially offset by new unit sales to new distribution channels that carry slightly lower margins. We continue to implement our lean sigma and strategic sourcing initiatives, and we are realizing positive results, and we believe these initiatives will continue to drive margin improvement in future years. We expect to benefit from higher average selling prices in future periods coupled with an expanded volume of business that should result in greater volume discounts from our suppliers and enable us to spread our manufacturing overhead costs over a larger number of units thereby reducing cost per unit and increasing gross margin per unit. Gross margin from gaming operations was 81.0% in the March 2010 quarter compared with 84.9% in the prior-year period, primarily reflecting the impact of the higher mix of WAP units in the installed base, unfavorable jackpot expense and the impact of lower high-margin royalty revenues.

Our operating margin improved 140 basis points to 22.5% for the quarter ended March 31, 2010 from 21.1% in the prior year quarter. 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 spending includes 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 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.

5. *Priority:* Increase our cash flow from operations.

Quarter Ended March 2010 Result: For the quarter ended March 31, 2010 we had cash provided by operations of $41.2 million compared to $30.1 million of cash provided by operations in the prior year, for a change of $11.1 million. The net cash provided by operations for the quarter ended March 31, 2010 reflects higher net income and improve changes in operating assets and liabilities, partially offset by lower depreciation, deferred income taxes and non-cash items.

In addition, our cash flows used in investing activities were $10.6 million lower for the quarter end March 31, 2010 compared to the prior year quarter, primarily driven by lower property, plant and equipment purchases. The installed footprint of participation gaming machines at March 31, 2010 increased 386 units or 3.9% over March 31, 2009. During the March 2010 quarter our investment in gaming operations equipment totaled $10.4 million, compared to the $8.5 million invested in the prior year quarter. Our total cash, cash equivalents and restricted cash as of March 31, 2010, rose 4.3% to $161.4 million from $154.7 million as of June 30, 2009 and increased slightly from December 31, 2009. We paid approximately $22.0 million for repurchases of our common stock in the quarter ended March 31, 2010 compared to $10.0 million in the prior year quarter.

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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; seek acquisitions that can extend our international presence, increase our intellectual property portfolio and expand our earnings potential; and, when appropriate, repurchase shares in the open market or in privately negotiated transactions. For the quarter ended March 31, 2010, our research and development spending was $26.7 million, which was 7.7% higher compared to the prior year. In the March 2010 quarter, we spent $12.3 million on additions to property, plant and equipment, $10.4 million on additions to gaming operations equipment and $0.6 million to acquire or license intangible and other assets. During the quarter ended March 31, 2010, we paid approximately $22.0 million to repurchase 579,020 shares of our common stock in the open market at an average cost of $38.06. At March 31, 2010 we recorded a liability for $3.0 million for an additional 71,200 shares repurchased which traded prior to March 31, 2010 but were settled in early April 2010.

NG

We believe that server-enabled networked gaming (NG) will be the next significant technology advancement in the gaming machine industry. NG refers to a networked gaming system that links groups of server-enabled gaming machines to a server or servers in each casino s data center. Once the gaming machines are connected to the server-enabled network, new applications, game functionality, and system-wide features can be enabled on the gaming machines from the server. These networks will require regulatory approval in gaming jurisdictions prior to any implementation and 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 2010 leading up to the full commercial launch of our *WAGE-NET*® NG system that we now expect later in calendar year 2010.

Our vision for NG expands on the basic functionality of downloadable games, remote configuration of betting denominations and central determination of 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. Fiscal 2007 was highlighted by the successful launch of our *Community Gaming*® participation product line, made possible by using a server outside the gaming machine to drive the bonusing activity for an entire bank of gaming machines, thereby creating a true communal gaming experience. In fiscal 2007, we also commercialized the next step forward in computing power and capability with our *CPU-NXT2* operating system and platform, which is also the basis for our server-enabled *Bluebird2* gaming machines that we launched in the December 2008 quarter. *CPU-NXT2* also drives our *Transmissive Reels*® participation product line and real-time, 3D graphics and surround sound capabilities for our Sensory Immersion participation product line. We combined an interactive see-through liquid crystal display (LCD) with the traditional appeal of authentic mechanical spinning reels to make *Transmissive Reels* a potential fixture for mechanical reel gaming machines on the NG slot floor. We launched *Adaptive Gaming*®, another key component to our NG technology in July 2008. We conducted a soft launch of our new server-ready *Bluebird2* gaming machines in the September 2008 quarter with the commercial launch beginning in the December 2008 quarter. At the *G2E*® trade show in November 2008 and the IGE trade show in January 2009, we also demonstrated the inter-operability of our *WAGE-NET* system, *Bluebird2* gaming machines using the *CPU-NXT2* operating system and new games with other manufacturers products and systems using industry standard communication protocols developed by the Gaming Standards Association (GSA): *G2S*® and *S2S*®.

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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 May 2008, we received GLI approval on the first-point release of our *WAGE-NET* NG system, incorporating GSA communication standards and basic NG functionality, which as part of a technical beta test was placed at a popular tribal casino. We received GLI approval for the second-point release of *WAGE-NET* in January 2009, which is in a technical beta test at a popular casino on the East Coast. This version was also implemented in a technical beta test in a Gulfport, Mississippi casino, which was successfully concluded and received Mississippi Gaming Commission approval in October 2009. In July 2008, we received approval for the first-point release of *WAGE-NET* from the Nevada gaming regulators and began a field trial at a popular Las Vegas strip casino. In December 2008, after successful completion of the field trial, we obtained the approval by the Nevada Gaming Commission of the first generation *WAGE-NET* system, including the remote configuration and downloadable applications. This version of *WAGE-NET* is GSA compliant, demonstrates our total commitment to support open architecture and standards-based protocols that our casino customers want and should expect. This version was subsequently enhanced and is currently on a field trial at two casinos in Las Vegas. We recently received regulatory approval and in February 2010 commenced a field trial of this version of *WAGE-NET* system at a popular casino in Canada. We further refined *WAGE-NET* with additional features and functionality in another point release of the software and this version has been submitted to the Nevada Gaming Regulators and GLI. We expect the commercial version of the *WAGE-NET* system to be submitted to various gaming regulators in the June 2010 quarter, with approvals and commercial product launch to occur in the December 2010 quarter.

Common Stock Repurchase Program

On August 3, 2009, our Board of Directors authorized the repurchase of an additional $75 million of our common stock over the following twenty-four months increasing our remaining repurchase authorization to approximately $150 million. This authorization increases the existing program, previously authorized on August 4, 2008, from $150 million to $225 million and extended the expiration date to August 3, 2011. During the nine months ended March 31, 2010, we purchased 1.0 million shares for approximately $40.0 million at an average cost of $39.32, while during the nine months ended March 31, 2009 we purchased 1.6 million shares for approximately $35.5 million at an average cost of $22.15 per share. As of March 31, 2010, we had approximately $109 million remaining of our repurchase authorization. Pursuant to the authorization, purchases may be made from time to time in the open market, through block purchases or in privately negotiated transactions. The timing and actual number of shares repurchased will depend on market conditions. At March 31, 2010, we had purchased approximately $3.0 million of our common stock which was settled and paid for in April 2010. At June 30, 2008, we had purchased approximately $5.0 million of our common stock which, was settled and paid in fiscal 2009.

CRITICAL ACCOUNTING POLICIES AND ESTIMATES

For a description of our critical accounting policies and estimates, refer to Item 7, Management Discussion and Analysis of Financial Condition and Results of Operations to our Annual Report on Form 10-K for the fiscal year ended June 30, 2009 and Note 2 Principal Accounting Policies Revenue Recognition to the Condensed Consolidated Financial Statements and Notes thereto in this report. We have not made any changes in critical accounting policies and estimates other than the change to revenue recognition described in the accompanying footnotes to our Consolidated Financial Statements during the three and nine months ended March 31, 2010.

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. In addition, quarterly revenues and net income may increase when we receive a larger number of product approvals or a new jurisdiction allows gaming. Operating results for the three and nine months ended March 31, 2010 are not necessarily indicative of the results that may be expected for the fiscal year ending June 30, 2010. 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, 2009.

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Three Months Ended March 31, 2010 Compared to Three Months Ended March 31, 2009

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

	Three Months Ended March 31, 2010	Three Months Ended March 31, 2009	Increase (Decrease)	Percent Increase (Decrease)
Product Sales Revenues				
New unit sales revenues	$ 105.7	$ 95.5	$ 10.2	10.7%
Other product sales revenues	18.2	18.5	(0.3)	(1.6)
Total product sales revenues	$ 123.9	$ 114.0	$ 9.9	8.7
New units sold	6,618	6,431	187	2.9
Average sales price per new unit	$ 15,976	$ 14,854	$ 1,122	7.6
Gross profit on product sales revenues(1)	$ 66.3	$ 60.6	$ 5.7	9.4
Gross margin on product sales revenues(1)	53.5%	53.2%	30bp	0.6
Gaming Operations Revenues				
Participation revenues	$ 70.4	$ 62.0	$ 8.4	13.5
Other gaming operations revenues	3.2	4.8	(1.6)	(33.3)
Total gaming operations revenues	$ 73.6	$ 66.8	$ 6.8	10.2
WAP gaming machines at period end	3,246	2,137	1,109	51.9
LAP gaming machines at period end	2,177	2,369	(192)	(8.1)
Stand-alone gaming machines at period end	4,864	5,395	(531)	(9.8)
Total installed participation base at period end	10,287	9,901	386	3.9
Average participation installed base	10,237	9,785	452	4.6
Average revenue per day per participation machine	$ 76.37	$ 70.37	$ 6.00	8.5
Installed casino-owned daily fee games at period end	444	666	(222)	(33.3)
Average casino-owned daily fee games installed base	434	771	(337)	(43.7)
Gross profit on gaming operations revenues(1)	$ 59.6	$ 56.7	$ 2.9	5.1
Gross margin on gaming operations revenues(1)	81.0%	84.9%	(390)bp	(4.6)
Total revenues	**$ 197.5**	**$ 180.8**	**$ 16.7**	**9.2**
Total gross profit(1)	**$ 125.9**	**$ 117.3**	**$ 8.6**	**7.3**
Total gross margin(1)	**63.7%**	**64.9%**	**(120)bp**	**(1.8)**
Total operating income	**$ 44.5**	**$ 38.2**	**$ 6.3**	**16.5**
Total operating margin	**22.5%**	**21.1%**	**140bp**	**6.6**

bp basis points
(1) As used herein, gross profit and gross margin exclude depreciation and distribution expense.

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Revenues and Gross Profit

Total revenues for quarter ended March 2010 increased 9.2% or $16.7 million, over the March 2009 quarter, reflecting:

- Ø A $10.2 million, or 10.7%, increase in new unit sales revenue as a result of:
  - Ø A 187 unit, or 2.9%, increase in new units sold as:
    - Ø New units sold in the United States and Canada totaled 4,392 units, an increase of 10.6%, due to a 23% increase in U.S. and Canadian replacement market shipments partially offset by lower new casino and expansion demand;
    - Ø International new units sold decreased 9.5% from the prior year to 2,226 units, reflecting economic challenges and tightening credit markets across international regions, especially the Western European and Latin American markets; and
    - Ø Sales of mechanical reel products totaled 2,217 units, or approximately 33.5% of total new units sold compared to 19.8% of units sold in the prior year.
  - Ø A 7.6% increase in the average selling price of new gaming machines to a $15,976, principally reflecting the greater sales mix of premium-priced products, which included the sale of approximately 5,900 *Bluebird2* gaming machines, representing approximately 89.3% of our total new unit sales compared to approximately 3,000 *Bluebird2* gaming machines sold or 46.8% of total units sold for the prior year period.
- Ø A $0.3 million, or 1.6%, decrease in other product sales revenues, as revenue from game conversion kit sales, parts and other higher margin items were largely flat as were revenues from sales of used gaming machines and other low margin items:
  - Ø We sold approximately 2,200 used gaming machines during the March 2010 quarter at lower prices, primarily competitor product, compared to approximately 1,400 used gaming machines in the prior year period; and
  - Ø We earned revenue on approximately 3,000 game conversion kits in the March 2010 quarter, compared to approximately 2,700 game conversion kits in the prior year period, and the average selling price achieved was relatively flat compared to the fiscal 2009 period.
- Ø An $8.4 million, or 13.5%, growth in participation revenues due primarily to:
  - Ø A 4.6% increase, or 452 units, in the average installed base of participation gaming machines in the March 2010 quarter driven by the 1,109 unit growth in our WAP gaming machines partially offset by an anticipated reduction in the LAP and stand-alone installed base. The stand-alone installed base decreased by 531 units primarily due to certain game series coming to the end of their life cycle. The LAP units in the installed base at March 31, 2010 decreased by 192 units compared to the prior year period. The WAP units in the installed base at March 31, 2010 was 51.9% or 1,109 units higher than at March 31, 2009, reflecting continued strong performance of our Sensory Immersion and *Transmissive Reels* product lines. Our

controlled roll-out strategy of new games has led to the desired result of a higher level of incremental footprint for the WAP units. The WAP installed base accounted for 31.6% and 21.6% of the installed base at March 31, 2010 and 2009, respectively.

- Ø Overall average revenue per day increased by $6.00, or 8.5%, principally reflecting the mix shift in the installed base to a higher percentage of WAP units which have a higher revenue per day than LAP and stand-alone games and our active program to relocate low-performing participation gaming machines to casinos where we expect higher performance, partially offset by lower casino play levels due to a continuing challenging economy.

Ø A $1.6 million, or 33.3%, decrease in other gaming operations revenues 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 and we elected to not renew such agreements so we can directly enter these markets and sell our gaming machines and game content directly rather than through licenses, such as Class II and the Mexican and Australian markets. The reduction in royalty revenues from the prior year period from these expired license agreements was not material to our Consolidated Financial Statements. Although we expect that future royalty revenues will be lower as a result of these expirations, we also expect our product sales and gaming operations revenue to increase and, over time, expect those revenues to exceed the previously recorded levels of royalty revenue.

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- Ø We have other license agreements that have termination dates within the next twelve months that were not material to our Consolidated Financial Statements for the quarter ended March 31, 2010.

Total gross profit, as used herein excluding depreciation and distribution expense, increased 7.3%, or $8.6 million, to $125.9 million for the quarter ended March 31, 2010 from $117.3 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 $6.6 million and $5.6 million in the quarter ended March 31, 2010 and 2009, respectively, in selling and administrative expenses. This improvement reflects:

- Ø Gross margin on product sales revenues was 53.5% for the March 2010 quarter, compared to 53.2% for the prior year period. Gross margin for fiscal 2009 reflects continued operating improvements, primarily resulting from our lean sigma and strategic sourcing initiatives, coupled with $3.4 million in lower excess and obsolete inventory charges, partially offset by new unit sales to distribution channels that carry a slightly lower margin. We incurred higher excess and obsolete inventory charges in the prior year period as we prepared for customers transitioning to our new *Bluebird2* gaming cabinet.

- Ø Gross margin on gaming operations revenues was 81.0% in the three months ended March 31, 2010, compared to 84.9% in the prior year period, reflecting the higher mix of WAP units and less favorable WAP jackpot expense experience Gaming operations gross margin was negatively impacted by an immaterial amount from lower royalty revenues primarily the 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, such as Class II gaming machines and the Mexican and Australian markets. We have other game content license agreements that have termination dates within the next twelve months that generated an immaterial amount of gross profit in the quarter ended March 31, 2010.

Operating Expenses

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

	Three Months Ended March 31,				Increase (Decrease)	
	2010		2009			
	Dollar	As % of Revenue	Dollar	As % of Revenue	Dollar	Percent
Research and development	$ 26.7	13.5%	$ 24.8	13.7%	$ 1.9	7.7%
Selling and administrative	38.0	19.2	37.0	20.5	1.0	2.7
Depreciation	16.7	8.5	17.3	9.6	(0.6)	(3.5)
Total operating expenses	$ 81.4	41.2%	$ 79.1	43.8%	$ 2.3	2.9%

Research and development expenses were up $1.9 million compared to the prior year period at $24.8 million. The current year spending reflects:

- Ø Our planned expanded product development initiatives for the continued creation of intellectual property and the ongoing expansion of our product portfolio;

- Ø The acceleration of our new systems and enterprise-wide system applications for our *Casino Evolved* suite of innovative, high-value products in preparation for the launch of NG systems later in calendar year 2010; partially offset by

- Ø Our efforts to contain costs.

Selling and administrative expenses increased 2.7%, or $1.0 million, to $38.0 million in the March 2010 quarter compared to $37.0 million in the prior year period. Selling and administrative expenses as a percentage of revenues decreased 130 basis points, as we continue to focus on effectively managing these costs. 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 the March 2010 quarter from the prior year period.

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Depreciation expense declined slightly by $0.6 million to $16.7 million in the quarter ended March 31, 2010 compared to $17.3 million in the prior year period. 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 gaming machines, coupled with a greater number of participation gaming machines having been depreciated to their residual value.

Operating Income and Operating Margin

Our operating income increased by $6.3 million or 16.5% in the March 2010 quarter on a 9.2% increase in total revenues. For the quarter ended March 2010, our operating margin of 22.5% represented a 140 basis point increase over the 21.1% operating margin achieved in the prior year period. This improvement was achieved by the improvements in product sales gross margin, coupled with higher-margin gaming operations accounting for 37.3% of total revenues in the quarter ended March 31, 2010 compared to 36.9% in the prior year period, and a decrease in operating expenses as a percent of sales by 260 basis points.

Interest Expense

We incurred interest expense of $0.4 million for the quarter ended March 31, 2010 compared to $0.9 million for the prior year period reflecting the impact of the early conversion of the $105.1 million of 2.75% convertible notes (Notes). During the March 2009 quarter, we also incurred interest on $25.0 million that we had borrowed on our revolving credit facility, which was repaid by the end of that quarter.

Interest Income and Other Income and Expense, Net

Interest income and other income and expense, net increased by $0.5 million to $1.1 million for the quarter ended March 31, 2010 compared to $0.6 million for the prior year period. The change is primarily due to interest income on a greater amount of extended payment term financings as long-term notes receivable during the March 2010 quarter were greater than in the March 2009 quarter.

Income Taxes

The estimated effective income tax rates were approximately 27.0% and 35.6% for the quarters ended March 31, 2010 and March 31, 2009, respectively.

The March 2010 quarter estimated effective tax rate reflects:

- Ø Impact of the completion of the Internal Revenue Service income tax audits for the fiscal years 2004 through 2007
- Ø Increased impact of permanent tax items in the first nine months of fiscal 2010; partially offset by
- Ø Increased income over fiscal 2009; and
- Ø Impact of the expiration on the Federal research and development tax credit as of December 31, 2009

The March 2009 quarter effective tax rate reflects:

- Ø The research and development tax credit which was reinstated retroactively in October 2008;
- Ø Increased income; and

- Ø A higher domestic manufacturing deduction.

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 R&D tax credit legislation effective as of December 31, 2009 which had the impact of reducing our earnings per diluted share by $0.01. Assuming that the R&D tax credit is not reinstated in the June 2010 quarter, we expect our effective tax rate will be between 36% and 37% for our June 2010 quarter.

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Earnings Per Share

Diluted earnings per share increased 27.9% on a 9.2% increase in revenues to $0.55 for the quarter ended March 31, 2010 from $0.43 for prior year period. Our diluted earnings per share for the quarter ended March 31, 2010 includes a $0.06 net benefit compared with the prior year period resulting from discrete income tax items, primarily related to the favorable completion of Federal income tax audits through fiscal 2007 that resulted in a $0.07 per diluted earnings per share benefit, partially offset by a $0.01 per diluted earnings per share reduction resulting from the expiration of the Federal research and development tax credit at December 31, 2009. The increase in earnings per share is attributable to increased net income for the quarter.

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Nine Months Ended March 31, 2010 Compared to Nine Months Ended March 31, 2009

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

	Nine Months Ended March 31,		Increase	Percent Increase
	2010	2009	(Decrease)	(Decrease)
Product Sales Revenues				
New unit sales revenues	$ 277.5	$ 271.6	$ 5.9	2.2%
Other product sales revenues	48.3	44.6	3.7	8.3
Total product sales revenues	$ 325.8	$ 316.2	$ 9.6	3.0
New units sold	17,868	19,441	(1,573)	(8.1)
Average sales price per new unit	$ 15,532	$ 13,972	$ 1,560	11.2
Gross profit on product sales revenues(1)	$ 170.9	$1,350	$20,816	

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Troubled Debt Restructurings:

The Company has allocated $491 thousand and $441 thousand of specific reserves on TDRs to customers whose loan terms have been modified in TDRs as of March 31, 2016 and December 31, 2015, respectively. There were no unfunded commitments to lend additional amounts to customers with outstanding loans that are classified as TDRs.

During the three month period ended March 31, 2016, the terms of certain loans were modified as TDRs. The modification of the terms of such loans included one or a combination of the following: a reduction of the stated interest rate of the loan; a deferral of scheduled payments with an extension of the maturity date; or some other modification or extension which would not be readily available in the market.

The following table presents loans by class modified as TDRs that occurred during the three month period ended March 31, 2016:

(Dollars in thousands)	Number of Contracts	Pre-Modification Outstanding Recorded Investment	Post-Modification Outstanding Recorded Investment
Primary residential mortgage	2	$ 1,133	$ 1,133
Total	2	$ 1,133	$ 1,133

The identification of the troubled debt restructurings did not have a significant impact on the allowance for loan losses.

There were no new TDRs that occurred during the three month period ending March 31, 2015.

There were no loans that were modified as TDRs for which there was a payment default, within twelve months of modification, during the three months ended March 31, 2016 and March 31, 2015.

In order to determine whether a borrower is experiencing financial difficulty, an evaluation is performed of the probability that the borrower will be in payment default on any of its debt in the foreseeable future without the modification. This evaluation is performed under the Company’s internal underwriting policy. At the time a loan is restructured, the Bank performs a full re-underwriting analysis, which includes, at a minimum, obtaining current financial statements and tax returns, copies of all leases, if applicable, and an updated independent appraisal of any property. A loan will continue to accrue interest if it can be reasonably determined that the borrower should be able to perform under the modified terms, that the loan has not been chronically delinquent (both to debt service and real estate taxes) or in nonaccrual status since its inception, and that there have been no charge-offs on the loan. Restructured loans with previous charge-offs would not accrue interest at the time of the TDR. At a minimum, six months of contractual payments would need to be made on a restructured loan before a loan may be considered for return to accrual status.

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4. DEPOSITS

Certificates of deposit, excluding brokered certificates of deposit over $250,000 totaled $120.1 million and $47.4 million at March 31, 2016 and 2015, respectively.

The following table sets forth the details of total deposits as of March 31, 2016 and December 31, 2015:

	March 31, 2016		December 31, 2015	
(In thousands)	$	%	$	%
Noninterest-bearing demand deposits	$457,730	15.04 %	$419,887	14.30 %
Interest-bearing checking	905,479	29.75	861,697	29.36
Savings	119,149	3.91	115,007	3.92
Money market	820,757	26.97	810,709	27.62
Certificates of deposit	446,833	14.68	434,450	14.80
Subtotal deposits	2,749,948	90.35	2,641,750	90.00
Interest-bearing demand - Brokered	200,000	6.57	200,000	6.81
Certificates of deposit - Brokered	93,630	3.08	93,720	3.19
Total deposits	$3,043,578	100.00%	$2,935,470	100.00%

The scheduled maturities of certificates of deposit, including brokered deposits, as of March 31, 2016 are as follows:

(In thousands)	
2016	$77,568
2017	102,202
2018	181,386
2019	65,310
2020	34,426
Over 5 Years	79,571
Total	$540,463

5. FEDERAL HOME LOAN BANK ADVANCES AND OTHER BORROWINGS

Advances from the Federal Home Loan Bank of New York (“FHLB”) totaled $83.7 million at March 31, 2016 and December 31, 2015, with a weighted average interest rate of 1.78 percent.

At March 31, 2016, advances totaling $71.7 million with a weighted average interest rate of 1.57 percent have fixed maturity dates. The fixed rate advances are secured by blanket pledges of certain 1-4 family residential mortgages totaling $382.4 million and multifamily mortgages totaling $961.3 million at March 31, 2016.

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Also at March 31, 2016, the Corporation had $12.0 million in variable rate advances, with a weighted average interest rate of 3.01 percent, that are noncallable for two or three years and then callable quarterly with final maturities of ten years from the original date of the advance. All of these advances are beyond their initial noncallable periods. These advances are secured by pledges of investment securities totaling $17.6 million at March 31, 2016.

The final maturity dates of the FHLB advances are scheduled as follows:

(In thousands)	
2016	$21,897
2017	23,897
2018	34,898
2019	3,000
2020	—
Over 5 years	—
Total	$83,692

Overnight borrowings with the Federal Home Loan Bank totaled $21.1 million with a weighted average interest rate of 0.49 percent and $40.7 million with a weighted average interest rate of 0.52 percent at March 31, 2016 and December 31, 2015, respectively.

6. BUSINESS SEGMENTS

The Corporation assesses its results among two operating segments, Banking and Peapack-Gladstone Bank's Private Wealth Management Division. Management uses certain methodologies to allocate income and expense to the business segments. A funds transfer pricing methodology is used to assign interest income and interest expense. Certain indirect expenses are allocated to segments. These include support unit expenses such as technology and operations and other support functions. Taxes are allocated to each segment based on the effective rate for the period shown.

Banking

The Banking segment includes lending and depository products and services, as well as various electronic banking services.

Private Wealth Management Division

Peapack-Gladstone Bank's Private Wealth Management Division includes asset management services provided for individuals and institutions; personal trust services, including services as executor, trustee, administrator, custodian and guardian; corporate trust services including services as trustee for pension and profit sharing plans; and other financial planning and advisory services.

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The following tables present the statements of income and total assets for the Corporation's reportable segments for the three months ended March 31, 2016 and 2015.

	Three Months Ended March 31, 2016		
(In thousands)	Banking	Wealth Management Division	Total
Net interest income	$21,990	$ 1,420	$23,410
Noninterest income	1,880	4,383	6,263
Total income	23,870	5,803	29,673
Provision for loan losses	1,700	—	1,700
Salaries and benefits	8,813	2,095	10,908
Premises and equipment expense	2,637	227	2,864
Other noninterest expense	3,917	1,517	5,434
Total noninterest expense	17,067	3,839	20,906
Income before income tax expense	6,803	1,964	8,767
Income tax expense	2,514	764	3,278
Net income	$4,289	$ 1,200	$5,489
Total assets for period end	$3,415,432	$ 53,252	$3,465,997

	Three Months Ended March 31, 2015		
(In thousands)	Banking	Wealth Management Division	Total
Net interest income	$ 18,570	$ 1,013	$ 19,583
Noninterest income	1,777	4,105	5,882
Total income	20,347	5,118	25,465
Provision for loan losses	1,350	—	1,350
Salaries and benefits	7,540	1,885	9,425
Premises and equipment expense	2,385	231	2,616
Other noninterest expense	2,495	1,232	3,727
Total noninterest expense	13,770	3,348	17,118
Income before income tax expense	6,577	1,770	8,347
Income tax expense	2,651	688	3,339
Net income	$ 3,926	$ 1,082	$ 5,008
Total assets for period end	$ 2,853,133	$ 26,324	$ 2,879,457

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7. FAIR VALUE

Fair value is the exchange price that would be received for an asset or paid to transfer a liability (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. There are three levels of inputs that may be used to measure fair values:

Level 1:	Quoted prices (unadjusted) for identical assets or liabilities in active markets that the entity has the ability to access as of the measurement date.
Level 2:	Significant other observable inputs other than Level 1 prices such as quoted prices for similar assets or liabilities; quoted prices in markets that are not active; or other inputs that are observable or can be corroborated by observable market data.
Level 3:	Significant unobservable inputs that reflect a company's own assumptions about the assumptions that market participants would use in pricing as asset or liability.

The Company used the following methods and significant assumptions to estimate the fair value:

Investment Securities: The fair values for investment securities are determined by quoted market prices (Level 1). For securities where quoted prices are not available, fair values are calculated based on market prices of similar securities (Level 2). For securities where quoted prices or market prices of similar securities are not available, fair values are calculated using discounted cash flows or other market indicators (Level 3).

Loans Held for Sale, at Fair Value: The fair value of loans held for sale is determined using quoted prices for similar assets, adjusted for specific attributes of that loan or other observable market data, such as outstanding commitments from third party investors (Level 2).

Derivatives: The fair values of derivatives are based on valuation models using observable market data as of the measurement date (Level 2). Our derivatives are traded in an over-the-counter market where quoted market prices are not always available. Therefore, the fair values of derivatives are determined using quantitative models that utilize multiple market inputs. The inputs will vary based on the type of derivative, but could include interest rates, prices and indices to generate continuous yield or pricing curves, prepayment rates, and volatility factors to value the position. The majority of market inputs are actively quoted and can be validated through external sources, including brokers, market transactions and third-party pricing services.

Impaired Loans: The fair value of impaired loans with specific allocations of the allowance for loan losses is generally based on recent real estate appraisals. These appraisals may utilize a single valuation approach or a combination of approaches including comparable sales and the income approach. Adjustments are routinely made in the appraisal process by the independent appraisers to adjust for differences between the comparable sales and income data available. Such adjustments are usually significant and typically result in a Level 3 classification of the inputs for determining fair value.

Other Real Estate Owned: Nonrecurring adjustments to certain commercial and residential real estate properties classified as other real estate owned (OREO) are measured at fair value, less costs to sell. Fair values are based on recent real estate appraisals. These appraisals may use a single valuation approach or a combination of approaches including comparable sales and the income approach. Adjustments are routinely made in the appraisal process by the independent appraisers to adjust for differences between the comparable sales and income data available. Such adjustments are usually significant and typically result in a Level 3 classification of the inputs for determining fair value.

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Appraisals for both collateral-dependent impaired loans and other real estate owned are performed by certified general appraisers (for commercial properties) or certified residential appraisers (for residential properties) whose qualifications and licenses have been reviewed and verified by Management. Once received, a member of the Credit Department reviews the assumptions and approaches utilized in the appraisal, as well as the overall resulting fair value in comparison with independent data sources such as recent market data or industry-wide statistics. Appraisals on collateral dependent impaired loans and other real estate owned (consistent for all loan types) are obtained on an annual basis, unless a significant change in the market or other factors warrants a more frequent appraisal. On an annual basis, Management compares the actual selling price of any collateral that has been sold to the most recent appraised value to determine what additional adjustment should be made to the appraisal value to arrive at fair value for other properties. The most recent analysis performed indicated that a discount up to 15 percent should be applied to appraisals on properties. The discount is determined based on the nature of the underlying properties, aging of appraisals and other factors. For each collateral-dependent impaired loan, we consider other factors, such as certain indices or other market information, as well as property specific circumstances to determine if an adjustment to the appraised value is needed. In situations where there is evidence of change in value, the Bank will determine if there is a need for an adjustment to the specific reserve on the collateral dependent impaired loans. When the Bank applies an interim adjustment, it generally shows the adjustment as an incremental specific reserve against the loan until it has received the full updated appraisal. As of March 31, 2016, all collateral-dependent impaired loans and other real estate owned valuations were supported by an appraisal less than 12 months old.

The following table summarizes, for the periods indicated, assets measured at fair value on a recurring basis, including financial assets for which the Corporation has elected the fair value option:

Assets Measured on a Recurring Basis

		Fair Value Measurements Using		
(In thousands)	March 31, 2016	Quoted Prices in Active Markets For Identical Assets (Level 1)	Significant Other Observable Inputs (Level 2)	Significant Unobservable Inputs (Level 3)
Assets:				
Available for sale:				
U.S. government-sponsored entities	$ 8,003	$ —	$ 8,003	$ —
Mortgage-backed securities-residential	166,987	—	166,987	—
SBA pool securities	7,409	—	7,409	—
State and political subdivisions	26,313	—	26,313	—
Single-Issuer Trust Preferred	2,358	—	2,358	—
CRA investment fund	2,980	2,980	—	—
Loans held for sale, at fair value	3,537	—	3,537	—
Derivatives:				

Loan level swaps	2,185	—	2,185	—
Total	$ 219,772	$ 2,980	$ 216,792	$ —
Liabilities:				
Derivatives:				
Cash flow hedges	$ (5,151)	$ —	$ (5,151)	$ —
Loan level swaps	(2,185)	—	(2,185)	—
Total	$ (7,336)	$ —	$ (7,336)	$ —

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Assets Measured on a Recurring Basis

		Fair Value Measurements Using		
(In thousands)	December 31, 2015	Quoted Prices in Active Markets For Identical Assets (Level 1)	Significant Other Observable Inputs (Level 2)	Significant Unobservable Inputs (Level 3)
Assets:				
Available for sale:				
Mortgage-backed securities-residential	$ 160,607	$ —	$ 160,607	$ —
SBA pool securities	7,520	—	7,520	—
State and political subdivisions	22,029	—	22,029	—
Single-Issuer Trust Preferred	2,535	—	2,535	—
CRA investment fund	2,939	2,939	—	—
Loans held for sale, at fair value	1,558	—	1,558	—
Derivatives:				
Cash flow hedges	104	—	104	—
Loan level swaps	1,106	—	1,106	—
Total	$ 198,398	$ 2,939	$ 195,459	$ —
Liabilities:				
Derivatives:				
Cash flow hedges	$ (1,434)	$ —	$ (1,434)	$ —
Loan level swaps	(1,106)	—	(1,106)	—
Total	$ (2,540)	$ —	$ (2,540)	$ —

The Corporation has elected the fair value option for certain loans held for sale. These loans are intended for sale and the Corporation believes that the fair value is the best indicator of the resolution of these loans. Interest income is recorded based on the contractual terms of the loan and in accordance with the Corporation’s policy on loans held for investment. None of these loans are 90 days or more past due nor on nonaccrual as of March 31, 2016 and December 31, 2015.

The following tables present residential loans held for sale, at fair value for the periods indicated:

(In thousands)	March 31, 2016	December 31, 2015
Residential loans contractual balance	$ 3,483	$ 1,536
Fair value adjustment	54	22

Total fair value of residential loans held for sale	$ 3,537	$ 1,558

There were no transfers between Level 1 and Level 2 during the three months ended March 31, 2016.

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The following table summarizes, for the periods indicated, assets measured at fair value on a non-recurring basis:

Assets Measured on a Non-Recurring Basis

		Fair Value Measurements Using		
(In thousands)	March 31, 2016	Quoted Prices in Active Markets For Identical Assets (Level 1)	Significant Other Observable Inputs (Level 2)	Significant observable Unobservable Inputs (Level 3)
Assets:				
Impaired loans:				
Primary residential mortgage	$ 285	$ —	$ —	$ 285
OREO	330	—	—	330
(In thousands)	December 31, 2015			
Assets:				
Impaired loans:				
Primary residential mortgage	$ 251	$ —	$ —	$ 251
OREO	330	—	—	330

Impaired loans that are measured for impairment using the fair value of the collateral for collateral dependent loans had a recorded investment of $346 thousand, with a valuation allowance of $61 thousand at March 31, 2016 and $299 thousand, with a valuation allowance of $48 thousand, at December 31, 2015.

At both March 31, 2016 and December 31, 2015, OREO at fair value represents one commercial property. The Company did not record a valuation allowance during either of the three months ended March 31, 2016 and March 31, 2015.

The carrying amounts and estimated fair values of financial instruments at March 31, 2016 are as follows:

		Fair Value Measurements at March 31, 2016 using			
(In thousands)	Carrying Amount	Level 1	Level 2	Level 3	Total
Financial assets					
Cash and cash equivalents	$77,919	$77,919	$—	$—	$77,919
Securities available for sale	214,050	2,980	211,070	—	214,050
FHLB and FRB stock	13,254	—	—	—	N/A
Loans held for sale, at fair value	3,537	—	3,537	—	3,537
Loans held for sale, at lower of cost					

or fair value	38,066	—	38,066	—	38,066
Loans, net of allowance for loan losses	3,000,380	—	—	3,001,458	3,001,458
Accrued interest receivable	7,497	—	636	6,861	7,497
Loan level swap derivatives	2,185	—	2,185	—	2,185
Financial liabilities					
Deposits	$3,043,578	$2,503,115	$545,024	$—	$3,048,139
Overnight borrowings	21,100	—	21,100	—	21,100
Federal home loan bank advances	83,692	—	84,862	—	84,862
Accrued interest payable	1,019	128	891	—	1,019
Cash flow hedge derivatives	5,151	—	5,151	—	5,151
Loan level swap derivatives	2,185	—	2,185	—	2,185

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The carrying amounts and estimated fair values of financial instruments at December 31, 2015 are as follows:

		Fair Value Measurements at December 31, 2015 using			
(In thousands)	Carrying Amount	Level 1	Level 2	Level 3	Total
Financial assets					
Cash and cash equivalents	$70,160	$70,160	$—	$—	$70,160
Securities available for sale	195,630	2,939	192,691	—	195,630
FHLB and FRB stock	13,984	—	—	—	N/A
Loans held for sale, at fair value	1,558	—	1,558	—	1,558
Loans held for sale, at lower of cost Or fair value	82,200	—	82,200	—	82,200
Loans, net of allowance for loan losses	2,887,386	—	—	2,865,601	2,865,601
Accrued interest receivable	6,820	—	562	6,258	6,820
Cash flow Hedges	104	—	104	—	104
Loan level swaps	1,106	—	1,106	—	1,106
Financial liabilities					
Deposits	$2,935,470	$2,407,300	$526,226	$—	$2,933,526
Overnight borrowings	40,700	—	40,700	—	40,700
Federal home loan bank advances	83,692	—	84,409	—	84,409
Accrued interest payable	957	128	829	—	957
Cash flow hedges	1,434	—	1,434	—	1,434
Loan level swaps	1,106	—	1,106	—	1,106

The methods and assumptions, not previously presented, used to estimate fair values are described as follows:

Cash and cash equivalents: The carrying amounts of cash and short-term instruments approximate fair values and are classified as either Level 1 or Level 2. Cash and due from banks is classified as Level 1. Certificates of deposit are classified as Level 2.

FHLB and FRB stock: It is not practicable to determine the fair value of FHLB or FRB stock due to restrictions placed on its transferability.

Loans held for sale, at lower of cost or fair value: The fair value of loans held for sale is determined using quoted prices for similar assets, adjusted for specific attributes of that loan or other observable market data, such as outstanding commitments from third party investors. Loans held for sale are classified as Level 2.

Loans: For variable rate loans that reprice frequently and with no significant change in credit risk, fair values are based on carrying values resulting in a Level 3 classification. Fair values for other loans are estimated using discounted cash flow analyses, using interest rates currently being offered for loans with similar terms to borrowers of similar credit quality resulting in a Level 3 classification. Impaired loans are valued at the lower of cost or fair value as described previously. The methods utilized to estimate the fair value of loans do not necessarily represent an exit price.

Deposits: The fair values disclosed for demand deposits (e.g., interest and noninterest checking, savings and money market accounts) are, by definition, equal to the amount payable on demand at the reporting date, (i.e., the carrying amount) resulting in a Level 1 classification. The carrying amounts of certificates of deposit approximate the fair values at the reporting date resulting in Level 2 classification. Fair values for fixed rate certificates of deposit are estimated using a discounted cash flow calculation that applies interest rates currently being offered on certificates to a schedule of aggregated expected monthly maturities on time deposits resulting in a Level 2 classification.

Overnight borrowings: The carrying amounts of overnight borrowings approximate fair values and are classified as Level 2.

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Federal Home Loan Bank advances: The fair values of the Corporation's long-term borrowings are estimated using discounted cash flow analyses based on the current borrowing rates for similar types of borrowing arrangements resulting in a Level 2 classification.

Accrued interest receivable/payable: The carrying amounts of accrued interest approximate fair value resulting in a Level 2 or Level 3 classification. Accrued interest on deposits and securities are included in Level 2. Accrued interest on loans is included in Level 3.

Off-balance sheet instruments: Fair values for off-balance sheet, credit-related financial instruments are based on fees currently charged to enter into similar agreements, taking into account the remaining terms of the agreements and the counterparties' credit standing. The fair value of commitments is not material.

8. OTHER OPERATING EXPENSES

The following table presents the major components of other operating expenses for the periods indicated:

	Three Months Ended March 31,	
(In thousands)	2016	2015
FDIC assessment	$ 1,559	$ 482
Wealth management division other expense	622	621
Professional and legal fees	986	768
Other operating expenses	2,267	1,856
Total other operating expenses	$ 5,434	$ 3,727

9. ACCUMULATED OTHER COMPREHENSIVE (LOSS)/INCOME

The following is a summary of the accumulated other comprehensive (loss)/income balances, net of tax, for the three months ended March 31, 2016 and 2015:

(In thousands)	Balance at January 1, 2016	Other Comprehensive Income/(Loss) Before Reclassifications	Amount Reclassified From Accumulated Other Comprehensive (Income)	Other Comprehensive Income/(Loss) Three Months Ended March 31, 2016	Balance at March 31, 2016
Net unrealized holding gain					

on securities available for sale, net of tax	$ 408	$ 688	$ (63)	$ 625	$ 1,033
Losses on cash flow hedges	(787)	(2,260)	—	(2,260)	(3,047)
Accumulated other comprehensive income/(loss), net of tax	$ (379)	$ (1,572)	$ (63)	$ (1,635)	$ (2,014)

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(In thousands)	Balance at January 1, 2015	Other Comprehensive Income/(Loss) Before Reclassifications	Amount Reclassified From Accumulated Other Comprehensive (Income)	Other Comprehensive Income/(Loss) Three Months Ended March 31, 2015	Balance at March 31, 2015
Net unrealized holding gain on securities available for sale, net of tax	$ 1,321	$ 779	$ (174)	$ 605	$ 1,926
Losses on cash flow hedges	(100)	(587)	—	(587)	(687)
Accumulated other comprehensive income, net of tax	$ 1,221	$ 192	$ (174)	$ 18	$ 1,239

The following represents the reclassifications out of accumulated other comprehensive income for the three months ended March 31, 2016 and 2015:

(In thousands)	Three Months Ended March 31, 2016	2015	Affected Line Item in Income
Unrealized gains on securities available for sale:			
Realized net gain on securities sales	$ 101	$ 268	Securities gains, net
Income tax expense	(38)	(94)	Income tax expense
Total reclassifications, net of tax	$ 63	$ 174	

10. DERIVATIVES

The Company utilizes interest rate swap agreements as part of its asset liability management strategy to help manage its interest rate risk position. The notional amount of the interest rate swaps does not represent amounts exchanged by the parties. The amount exchanged is determined by reference to the notional amount and the other terms of the individual interest rate swap agreements.

Interest Rate Swaps Designated as Cash Flow Hedges: Interest rate swaps with a notional amount of $180 million as of March 31, 2016 and December 31, 2015, were designated as cash flow hedges of certain interest-bearing demand brokered deposits and were determined to be fully effective during the quarter ended March 31, 2016. As such, no amount of ineffectiveness has been included in net income. Therefore, the aggregate fair value of the swaps is recorded in other assets/liabilities with changes in fair value recorded in other comprehensive income. The amount included in accumulated other comprehensive income would be reclassified to current earnings should the hedges no longer be considered effective. The Company expects the hedges to remain fully effective during the remaining terms of the swaps.

The following information about the interest rate swaps designated as cash flow hedges as of March 31, 2016 and December 31, 2015 is presented in the following table:

(Dollars in thousands)	March 31, 2016	December 31, 2015
Notional amount	$ 180,000	$ 180,000
Weighted average pay rate	1.64 %	1.64 %
Weighted average receive rate	0.51 %	0.29 %
Weighted average maturity	4.00 years	4.25 years
Unrealized loss	$ (5,151)	$ (1,331)
Number of contracts	9	9

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Net interest expense recorded on these swap transactions totaled $504 thousand and $95 thousand for the three months ended March 31, 2016 and 2015, respectively, and is reported as a component of interest expense.

Cash Flow Hedges

The following table presents the net losses recorded in accumulated other comprehensive (loss)/income and the consolidated financial statements relating to the cash flow derivative instruments for the three months ended March 31, 2016 (after tax):

(In thousands)	Amount of Gain/(Loss) Recognized In OCI (Effective Portion)	Amount of Gain/(Loss) Reclassified From OCI to Interest Expense	Amount of Gain/(Loss) Recognized in Other Non-Interest Expense (Ineffective Portion)
Interest rate contracts	$ (2,260)	$ —	$ —

The following table presents the net losses recorded in accumulated other comprehensive (loss)/income and the consolidated financial statements relating to the cash flow derivative instruments for the three months ended March 31, 2015:

(In thousands)	Amount of Gain/(Loss) Recognized In OCI (Effective Portion)	Amount of Gain/(Loss) Reclassified From OCI to Interest Expense	Amount of Gain/(Loss) Recognized in Other Non-Interest Expense (Ineffective Portion)
Interest rate contracts	$ (587)	$ —	$ —

The following tables reflect the cash flow hedges included in the financial statements as of March 31, 2016 and December 31, 2015:

	March 31, 2016	
(In thousands)	Notional Amount	Fair Value
Interest rate swaps related to interest-bearing demand brokered deposits	$180,000	$(5,151)
Total included in other assets	$—	$—
Total included in other liabilities	$180,000	$(5,151)

	December 31, 2015	
	Notional	Fair

(In thousands)	Amount	Value
Interest rate swaps related to interest-bearing demand brokered deposits	$ 180,000	$ (1,330)
Total included in other assets	$ 15,000	$ 104
Total included in other liabilities	$ 165,000	$ (1,434)

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Derivatives Not Designated as Accounting Hedges: Beginning in 2015, the Company offered facility specific/loan level swaps to its customers and offsets its exposure from such contracts by entering into mirror image swaps with a financial institution / swap counterparty (loan level / back to back swap program). The customer accommodations and any offsetting swaps are treated as non-hedging derivative instruments which do not qualify for hedge accounting (“standalone derivatives”). The notional amount of the swaps does not represent amounts exchanged by the parties. The amount exchanged is determined by reference to the notional amount and the other terms of the individual contracts. The fair value of the swaps is recorded as both an asset and a liability, in other assets and other liabilities, respectively, in equal amounts for these transactions.

Information about these swaps is as follows:

(Dollars in thousands)	March 31, 2016		December 31, 2015	
Notional amount	$ 34,696		$ 27,259	
Fair value	$ 2,185		$ 1,106	
Weighted average pay rates	3.25	%	3.06	%
Weighted average receive rates	1.84	%	1.44	%
Weighted average maturity	14.4	years	15.8	years

11. RECENT ACCOUNTING PRONOUNCEMENTS

Accounting Standards Update (“ASU”) 2014-09, “Revenue from Contracts with Customers (Topic 606)” implements a common revenue standard that clarifies the principles for recognizing revenue. The core principle of ASU 2014-09 is that an entity should recognize revenue to depict the transfer of promised goods or services to customers in an amount that reflects the consideration to which the entity expects to be entitled in exchange for those goods or services. To achieve that core principle, an entity should apply the following steps: (is) identify the contract(s) with a customer, (ii) identify the performance obligations in the contract, (iii) determine the transaction price, (iv) allocate the transaction price to the performance obligations in the contract and (v) recognize revenue when (or as) the entity satisfies a performance obligation. In July 2015, FASB deferred the effective date of the ASU by one year which means ASU 2014-09 will be effective for the Company on January 1, 2018. In March 2016, FASB issued ASU 2016-08 which amended illustrative examples to clarify how to apply the implementation guidance on principal versus agent considerations. The Company is currently evaluating the potential impact of ASU 2014-09, and subsequent amendments, on its consolidated financial statements.

In January 2016, the FASB amended existing guidance to improve accounting standards for financial instruments including clarification and simplification of accounting and disclosure requirements and the requirement for public business entities to use the exit price notion when measuring the fair value of financial instruments for disclosure purposes. These amendments are effective for public business entities for annual periods and interim periods within those annual periods beginning after December 15, 2017. The Company is evaluating the impact of these amendments on its consolidated financial statements.

In February 2016, the FASB amended existing guidance to increase transparency and comparability among organizations by recognizing lease assets and lease liabilities on the balance sheet and disclosing key information about leasing arrangements. These amendments are effective for public business entities for annual periods and interim periods within those annual periods beginning after December 15, 2018. The Company is evaluating the impact of these amendments on its consolidated financial statements.

In March 2016, the FASB amended existing guidance to simplify aspects of the accounting for share-based payment transactions, including the income tax consequences, classification of awards as either equity or liabilities, and classification on the statement of cash flows. These amendments are effective for public business entities for annual periods and interim periods within those annual periods beginning after December 15, 2016. The Company is evaluating the impact of these amendments on its consolidated financial statements.

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Item 2

MANAGEMENT'S DISCUSSION AND ANALYSIS OF FINANCIAL CONDITION

AND RESULTS OF OPERATIONS

GENERAL: This Quarterly Report on Form 10-Q, both in the following discussion and analysis and elsewhere contains forward-looking statements within the meaning of the Private Securities Litigation Reform Act of 1995. Such statements are not historical facts and include expressions about Management's view of future interest income and net loans, Management's confidence and strategies and Management's expectations about new and existing programs and products, relationships, opportunities and market conditions. These statements may be identified by such forward-looking terminology as "expect", "look", "believe", "anticipate", "may", "will", or similar statements or variations of s terms. Actual results may differ materially from such forward-looking statements. Factors that may cause actual results to differ materially from those contemplated by such forward-looking statements include, among others, those risk factors identified in the Company's Form 10-K for the year ended December 31, 2015, in addition to/which include the following:

- inability to successfully grow our business and implement our strategic plan, including an inability to generate revenues to offset the increased personnel and other costs related to the strategic plan;
- the impact of anticipated higher operating expenses in 2016 and beyond;
- inability to manage our growth;
- inability to successfully integrate our expanded employee base;
- a continued or unexpected decline in the economy, in particular in our New Jersey and New York market areas;
- declines in our net interest margin caused by the low interest rate environment and highly competitive market;
- declines in value in our investment portfolio;
- higher than expected increases in our allowance for loan losses;
- higher than expected increases in loan losses or in the level of nonperforming loans;
- unexpected changes in interest rates;
- a continued or unexpected decline in real estate values within our market areas;
- legislative and regulatory actions (including the impact of the Dodd-Frank Wall Street Reform and Consumer Protection Act, Basel III and related regulations) subject us to additional regulatory oversight which may result in increased compliance costs;
- successful cyberattacks against our IT infrastructure and that of our IT providers;
- higher than expected FDIC insurance premiums;
- adverse weather conditions;
- inability to successfully generate new business in new geographic markets;
- inability to execute upon new business initiatives;
- lack of liquidity to fund our various cash obligations;
- reduction in our lower-cost funding sources;
- our inability to adapt to technological changes;
- claims and litigation pertaining to fiduciary responsibility, environmental laws and other matters; and
- other unexpected material adverse changes in our operations or earnings.

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The Company assumes no responsibility to update such forward-looking statements in the future even if experience shows that the indicated results or events will not be realized. Although we believe that the expectations reflected in the forward-looking statements are reasonable, the Company cannot guarantee future results, levels of activity, performance, or achievements.

CRITICAL ACCOUNTING POLICIES AND ESTIMATES: Management's Discussion and Analysis of Financial Condition and Results of Operations is based upon the Company's consolidated financial statements, which have been prepared in accordance with U.S. generally accepted accounting principles. The preparation of these financial statements requires the Company to make estimates and judgments that affect the reported amounts of assets, liabilities, revenues and expenses. Note 1 to the Company's Audited Consolidated Financial Statements for the year ended December 31, 2015, contains a summary of the Company's significant accounting policies.

Management believes that the Company's policy with respect to the methodology for the determination of the allowance for loan losses involves a higher degree of complexity and requires Management to make difficult and subjective judgments, which often require assumptions or estimates about highly uncertain matters. Changes in these judgments, assumptions or estimates could materially impact results of operations. This critical policy and its application are periodically reviewed with the Audit Committee and the Board of Directors.

The provision for loan losses is based upon Management's evaluation of the adequacy of the allowance, including an assessment of known and inherent risks in the portfolio, giving consideration to the size and composition of the loan portfolio, actual loan loss experience, level of delinquencies, detailed analysis of individual loans for which full collectability may not be assured, the existence and estimated fair value of any underlying collateral and guarantees securing the loans, and current economic and market conditions. Although Management uses the best information available, the level of the allowance for loan losses remains an estimate, which is subject to significant judgment and short-term change. Various regulatory agencies, as an integral part of their examination process, periodically review the Company's allowance for loan losses. Such agencies may require the Company to make additional provisions for loan losses based upon information available to them at the time of their examination. Furthermore, the majority of the Company's loans are secured by real estate in the State of New Jersey and to a lesser extent New York City. Accordingly, the collectability of a substantial portion of the carrying value of the Company's loan portfolio is susceptible to changes in local market conditions and any adverse economic conditions. Future adjustments to the provision for loan losses and allowance for loan losses may be necessary due to economic, operating, regulatory and other conditions beyond the Company's control.

The Company accounts for its securities in accordance with "Accounting for Certain Investments in Debt and Equity Securities," which was codified into Accounting Standards Codification ("ASC") 320. All securities are classified as available for sale and are carried at fair value, with unrealized holding gains and losses reported in other comprehensive income, net of tax.

Management evaluates securities for other-than-temporary impairment on at least a quarterly basis, and more frequently when economic or market conditions warrant such an evaluation. For securities in an unrealized loss position, Management considers the extent and duration of the unrealized loss and the financial condition and near-term prospects of the issuer. Management also assesses whether it intends to sell, or it is more likely than not that it will be required to sell, a security in an unrealized loss position before recovery of its amortized cost basis. If either of the criteria regarding intent or requirement to sell is met, the entire difference between amortized cost and fair value is recognized as impairment through earnings. For debt securities that do not meet the aforementioned criteria, the amount of impairment is split into two components as follows: 1) other-than-temporary impairment related to credit loss, which must be recognized in the income statement and 2) other-than-temporary impairment related to other factors, which is recognized in other comprehensive income. The credit loss is defined as the difference between the present value of the cash flows expected to be collected and the amortized cost basis. No impairment charges were recognized in the three months ended March 31, 2016 and 2015. For equity securities, the entire amount of impairment is recognized through earnings.

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EXECUTIVE SUMMARY: The following table presents certain key aspects of our performance for the three months ended March 31, 2016 and 2015.

	Three Months Ended March 31,		Change
(Dollars in thousands, except per share data)	2016(A)	2015	2016 vs 2015
Results of Operations:			
Net interest income	$ 23,410	$ 19,583	$ 3,827
Provision for loan losses	1,700	1,350	350
Net interest income after provision for loan losses	21,710	18,233	3,477
Other income	6,263	5,882	381
Operating expense	19,206	15,768	3,438
Income before income tax expense	8,767	8,347	420
Income tax expense	3,278	3,339	(61)
Net income	$ 5,489	$ 5,008	$ 481
Total revenue (Net interest income plus other income)	$ 29,673	$ 25,465	$ 4,208
Diluted earnings per share	$ 0.34	$ 0.33	$ 0.01
Diluted average shares outstanding	16,016,972	15,070,352	946,620
Return on average assets annualized (ROAA)	0.64 %	0.71 %	(0.07)
Return on average equity annualized (ROAE)	7.83	8.13	(0.30)

(A) The quarter ended March 31, 2016 included $1.30 million of pre-tax charges related to increased FDIC premiums and increased investment in risk management related analytics and practices. These charges reduced pretax income by $1.30 million, net income by $814 thousand, diluted earnings per share by $0.05 per share, ROAA by 0.09%, and ROAE by 1.16%.

	March 31, 2016	December 31, 2015	Change 2016 vs 2015
Selected Balance Sheet Ratios:			
Total capital (Tier I + II) to risk-weighted assets	11.57 %	11.40 %	0.17 %
Tier I leverage ratio	8.19	8.10	0.09
Loans to deposits	99.48	99.24	0.24
Allowance for loan losses to total loans	0.90	0.86	0.04
Allowance for loan losses to nonperforming loans	375.39	383.22	(7.83)

Nonperforming loans to total loans	0.24	0.23	0.01

For the first quarter of 2016, the Company recorded net income of $5.5 million compared to $5.0 million for the same quarter of 2015. For the three months ended March 31, 2016 and 2015, diluted earnings per share were $0.34 and $0.33, respectively. Annualized return on average assets was 0.64 percent and annualized return on average equity was 7.83 percent for the first quarter of 2016, compared to 0.71 percent and 8.13 percent, respectively, for the first quarter of 2015.

CONTRACTUAL OBLIGATIONS: For a discussion of our contractual obligations, see the information set forth in the Corporation’s Annual Report on Form 10-K for the year ended December 31, 2015 under the heading “Management’s Discussion and Analysis of Financial Condition and Results of Operations – Contractual Obligations” which is incorporated herein by reference.

OFF-BALANCE SHEET ARRANGEMENTS: For a discussion of our off-balance sheet arrangements, see the information set forth in the Corporation’s Annual Report on Form 10-K for the year ended December 31, 2015 under the heading “Management’s Discussion and Analysis of Financial Condition and Results of Operations – Off-Balance Sheet Arrangements” which is incorporated herein by reference.

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EARNINGS ANALYSIS

NET INTEREST INCOME/AVERAGE BALANCE SHEET:

The primary source of the Company's operating income is net interest income, which is the difference between interest and dividends earned on earning assets and fees earned on loans, and interest paid on interest-bearing liabilities. Earning assets include loans to individuals and businesses, investment securities, interest-earning deposits and federal funds sold. Interest-bearing liabilities include interest-bearing checking, savings and time deposits, Federal Home Loan Bank advances and other borrowings. Net interest income is determined by the difference between the yields earned on earning assets and the rates paid on interest-bearing liabilities ("Net Interest Spread") and the relative amounts of earning assets and interest-bearing liabilities. The Company's Net Interest Spread is affected by regulatory, economic and competitive factors that influence interest rates, loan demand and deposit flows and general levels of nonperforming assets.

The following table summarizes the Company's net interest income and related spread and margin, on a fully tax-equivalent basis, for the periods indicated:

	Three Months Ended March 31,			
(Dollars in thousands)	2016		2015	
Net interest income	$ 23,410		$ 19,583	
Interest rate spread	2.69	%	2.78	%
Net interest margin	2.82		2.88	

Net interest income, on a fully tax-equivalent basis, for the three months ended March 31, 2016, grew $3.9 million, or 20 percent from the three months ended March 31, 2015, due to increased earning assets. Net interest spread and margin for the three months ended March 31, 2016 declined when compared to the same 2015 periods partially due to the continuing effect of low market yields, as well as competitive pressures in attracting new loans and deposits. Net interest income for the three months ended March 31, 2016 was benefitted by significant loan growth during 2015. The Company expects continued loan growth in this lower market rate and competitive environment.

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The following table summarizes the Company's loans closed for the periods indicated:

(In thousands)	For the Three Months Ended March 31, 2016	March 31, 2015
Residential mortgage loans retained	$ 17,747	$ 16,986
Residential mortgage loans sold	8,062	8,938
Total residential mortgage loans	25,809	25,924
Commercial real estate loans	9,339	57,787
Multifamily properties	108,035	209,034
Commercial loans (A)	67,488	40,696
SBA	1,055	—
Wealth Lines of Credit (A)	1,800	10,260
Total commercial loans	187,717	317,777
Installment loans	486	344
Home equity lines of credit (A)	3,604	3,377
Total loans closed	$ 217,616	$ 347,442

(A) Includes lines of credit that closed in the period, but not necessarily funded.

As the Company explained over the last several quarters, the Company anticipated multifamily loan originations (and growth) would be less than past quarters, as it manages its balance sheet such that multifamily loans decline as a percentage of the overall loan portfolio and commercial loans become a larger percentage of the overall loan portfolio. This balance sheet management, however, will likely not be linear each quarter, but will rather be apparent over periods of time.

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The following table reflects the components of the average balance sheet and of net interest income for the periods indicated:

Average Balance Sheet

Unaudited

Three Months Ended

	March 31, 2016			March 31, 2015		
(Dollars in thousands)	Average Balance	Income/ Expense	Yield	Average Balance	Income/ Expense	Yield
ASSETS:						
Interest-earning assets:						
Investments:						
Taxable (1)	$199,579	$926	1.86 %	$273,946	$1,182	1.73 %
Tax-exempt (1) (2)	24,044	200	3.33	37,631	231	2.46
Loans held for sale	1,042	11	4.22	774	10	5.10
Loans (2) (3):						
Mortgages	465,860	3,807	3.27	465,722	3,785	3.25
Commercial mortgages	1,959,721	17,170	3.50	1,459,872	13,589	3.72
Commercial	525,896	5,100	3.88	316,109	2,897	3.67
Commercial construction	1,395	14	4.01	5,930	62	4.18
Installment	44,906	335	2.98	27,791	252	3.63
Home equity	53,056	440	3.32	50,660	405	3.20
Other	486	12	9.88	530	12	9.06
Total loans	3,051,320	26,878	3.52	2,326,614	21,002	3.61
Federal funds sold	101	—	0.23	101	—	0.10
Interest-earning deposits	77,903	87	0.45	91,657	43	0.18
Total interest-earning assets	3,353,989	28,102	3.35 %	2,730,723	22,468	3.29 %
Noninterest-earning assets:						
Cash and due from banks	15,603			6,804		
Allowance for loan losses	(26,582)			(20,056)		
Premises and equipment	30,000			32,256		
Other assets	83,632			63,868		
Total noninterest-earning assets	102,653			82,872		
Total assets	$3,456,642			$2,813,595		
LIABILITIES:						
Interest-bearing deposits:						
Checking	$882,497	$571	0.26 %	$630,557	$314	0.20 %
Money markets	819,818	573	0.28	710,590	463	0.26
Savings	116,560	16	0.05	113,435	14	0.05
Certificates of deposit - retail	442,563	1,489	1.35	247,860	663	1.07
Subtotal interest-bearing deposits	2,261,438	2,649	0.47	1,702,442	1,454	0.34
Interest-bearing demand - brokered	200,000	741	1.48	240,500	280	0.47
Certificates of deposit - brokered	93,674	497	2.12	126,404	524	1.66
Total interest-bearing deposits	2,555,112	3,887	0.61	2,069,346	2,258	0.44

Borrowings	155,274	479	1.23	109,639	392	1.43
Capital lease obligation	10,140	122	4.81	10,635	128	4.81
Total interest-bearing liabilities	2,720,526	4,488	0.66 %	2,189,620	2,778	0.51 %
Noninterest-bearing liabilities:						
Demand deposits	435,770			366,919		
Accrued expenses and other liabilities	19,898			10,752		
Total noninterest-bearing liabilities	455,668			377,671		
Shareholders' equity	280,448			246,304		
Total liabilities and shareholders' equity	$3,456,642			$2,813,595		
Net interest income (tax-equivalent basis)		23,614			19,690	
Net interest spread			2.69 %			2.78 %
Net interest margin (4)			2.82 %			2.88 %
Tax equivalent adjustment		(204)			(107)	
Net interest income		$23,410			$19,583	

(1) Average balances for available for sale securities are based on amortized cost.
(2) Interest income is presented on a tax-equivalent basis using a 35 percent federal tax rate.
(3) Loans are stated net of unearned income and include nonaccrual loans.
(4) Net interest income on a tax-equivalent basis as a percentage of total average interest-earning assets.

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The effect of volume and rate changes on net interest income (on a tax-equivalent basis) for the periods indicated are shown below:

(In Thousands):	Three Months Ended March 31, 2016 Difference due to Change In: Volume	Rate	Three Months Ended March 31, 2015 Change In Income/ Expense
ASSETS:			
Investments	$ (386)	$ 99	$ (287)
Loans	6,560	(684)	5,876
Loans held for sale	3	(2)	1
Federal funds sold	—	—	—
Interest-earning deposits	(7)	51	44
Total interest income	$ 6,170	$ (536)	$ 5,634
LIABILITIES:			
Interest-bearing checking	$ 174	$ (12)	$ 162
Money market	89	21	110
Savings	—	2	2
Certificates of deposit - retail	627	199	826
Certificates of deposit - brokered	(154)	127	(27)
Interest bearing demand brokered	(31)	587	556
Borrowed funds	67	20	87
Capital lease obligation	(6)	—	(6)
Total interest expense	$ 766	$ 944	$ 1,710
Net interest income	$ 5,404	$ (1,480)	$ 3,924

Interest income on earning assets, on a fully tax-equivalent basis, totaled $28.1 million for the first quarter of 2016 compared to $22.5 million for the same quarter of 2015, reflecting an increase of $5.6 million or 25 percent from the first quarter in 2015. Average earning assets totaled $3.35 billion for the first quarter of 2016, an increase of $623.3 million or 23 percent from the same period of 2015. The average commercial loan portfolio increased $209.8 million or 66 percent from the first quarter of 2015, averaging $525.9 million for the first quarter of 2016. The average commercial mortgage portfolio (which includes multifamily mortgage loans) increased $499.8 million to $1.96 billion for the first quarter of 2016 when compared to the same period in 2015. The increase was attributable to the addition of seasoned banking professionals over the course of 2015; a more concerted focus on the client service aspect of the lending process; and more of a focus on New York City markets. The increase was also due to demand from borrowers looking to refinance multifamily mortgages held by other institutions. Multifamily lending will remain a focus of the Company, however, it is anticipated that multifamily loan growth will be less robust than in 2015.

For the quarters ended March 31, 2016 and 2015, the average rates earned on earning assets was 3.35 percent and 3.29 percent, respectively, an increase of 6 basis points. The increased overall yield was due to growth in commercial loans at higher yields than the existing portfolio, as well as certain cash flows from the investment portfolio and interest-earning deposits being invested in higher yielding loans.

For the first quarter of 2016, total interest-bearing deposits averaged $2.56 billion, increasing $486 million or 23 percent from the average balance for the same period of 2015. The growth in customer deposits (excluding brokered CDs and brokered interest-bearing demand, but including reciprocal funds discussed in Footnote 4 and below) has come from the addition of seasoned banking professionals over the course of 2015 and into 2016; an intense focus on providing high-touch client service; and a full array of treasury management products that support core deposit growth.

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Average rates paid on total interest-bearing deposits were 61 basis points and 44 basis points for the first quarters of 2016 and 2015, respectively. The increase in the average rate paid on deposits was principally due to growth in higher costing certificates of deposit partially to help manage the Company's interest rate risk position, as well as competitive pressures in attracting new deposits in volumes sufficient to appropriately fund asset growth.

For the first quarters of 2016 and 2015, average borrowings totaled $155.3 million and $109.6 million, respectively, increasing $45.6 million when compared to the same period of 2015. The increase was due to periodic increased short-term borrowings to fund loan growth ahead of deposit growth.

The Company is a participant in the Reich & Tang Demand Deposit Marketplace ("DDM") program. The Company uses these deposit sweep services to place customer funds into interest-bearing demand (checking) accounts issued by other participating banks. Customer funds are placed at one or more participating banks to ensure that each deposit customer is eligible for the full amount of FDIC insurance. As a program participant, the Company receives reciprocal amounts of deposits from other participating banks. The DDM program is considered to be a source of brokered deposits for bank regulatory purposes. However, the Company considers these reciprocal deposit balances to be in-market customer deposits as distinguished from traditional out-of-market brokered deposits. Such reciprocal deposit balances are included in the Company's interest-bearing checking balances. Reciprocal balances averaged $441.3 million for the March 31, 2016 quarter and $220.3 million for March 31, 2015 quarter.

OTHER INCOME: The following table presents the major components of other income, excluding income from wealth management, which is summarized and discussed subsequently:

	Three Months Ended March 31,		Change
(In thousands)	2016	2015	2016 vs 2015
Service charges and fees	$ 807	$ 805	$ 2
Gain on sale of loans (mortgage banking)	121	148	(27)
Gain on sale of loans, at lower of cost or fair value	124	—	124
Bank owned life insurance	342	537	(195)
Securities gains	101	268	(167)
Other income	473	93	380
Total other income	$ 1,968	$ 1,851	$ 117

Service charges and fees for the three months ended March 31, 2016 were basically flat compared to the same period last year, partially due to increases in income from debit card usage, as well as account analysis fees, offset by declines in overdraft/NSF.

For the three months ended March 31, 2016, income from the sale of newly originated residential mortgage loans was $121 thousand compared to $148 thousand the same prior year period. The volume of loans originated for sale in the first quarter of 2016 was lower compared to the same period in 2015.

For the three months ended March 31, 2016, the Company recorded $342 thousand of bank owned life insurance (BOLI) income as compared to $537 thousand for the same three months in 2015. The three months ended March 31, 2015 included $285 thousand additional income related to a net life insurance death benefit under its BOLI policies. BOLI income in the first quarter of 2016 benefitted from the increase of the BOLI policy by $10 million which occurred in the fourth quarter of 2015.

Securities gains were $101 thousand for the March 2016 quarter compared to $268 thousand for the same 2015 quarter. Sales of securities have been generally employed to benefit interest rate risk, prepayment risk, and/or liquidity risk. Given the shorter duration of our investment portfolio and the interest rate environment, such sales will continue to be a very small component of the Company's operations.

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Gain on sale of multifamily loans held for sale at lower of cost or fair value was $124 thousand. During the first quarter of 2016, the Company began selling whole multifamily loans. The Company will continue to employ this strategy to manage the Company's balance sheet.

Other income was $473 thousand for the March 2016 quarter compared to $93 thousand for the March 2015 quarter. The three months ended March 2016 included $94 thousand of fee income related to the Company's loan level / back-to-back swap program, which was implemented during mid-2015. The program utilizes mirror interest rate swaps, one directly with the commercial loan customer and one directly with a well-established counterparty. This enables a commercial loan customer to benefit from a fixed rate loan, while the Company records a floating rate loan. The program provides enhanced interest rate risk management, as well as the potential for fee income for the Company. While the Company cannot predict the amount of fee income that may be recognized each period, these programs are a part of ongoing operations. Other improvements in other income in the March 2016 quarter included greater loan servicing fees due principally to continued multifamily loan participations, and higher unused line of credit fees associated with the Commercial & Industrial lending business.

OPERATING EXPENSES: The following table presents the components of operating expenses for the periods indicated:

	Three Months Ended March 31,		Change
(In thousands)	2016	2015	2016 vs 2015
Salaries and employee benefits	$ 10,908	$ 9,425	$ 1,483
Premises and equipment	2,864	2,616	248
Other Operating Expenses:			
FDIC assessment	1,559	482	1,077
Wealth management division other expense	622	621	1
Professional and legal fees	986	768	218
Loan expense	112	113	(1)
Telephone	238	223	15
Advertising	144	148	(4)
Postage	107	104	3
Amortization of intangibles	31	—	31
Other	1,635	1,268	367
Total operating expenses	$ 19,206	$ 15,768	$ 3,438

The Company's total operating expenses were $19.2 million for the quarter ended March 31, 2016 compared to $15.8 million in the same 2015 quarter, reflecting a net increase of $3.4 million or 22 percent. Salary and benefits expense increased to $10.9 million in the first quarter of 2016 from $9.4 million in the same period in 2015, an increase of $1.5 million or 16 percent. Strategic hiring that was in line with the Company's Plan, the acquisition of Wealth Management Consultants in the second quarter of 2015, normal salary increases and increased bonus/incentive accruals associated with the Company's growth, all contributed to the increase from the March 2015 quarter to the March 2016 quarter.

Premises and equipment expense totaled $2.9 million for the quarter ended March 31, 2016 compared to $2.6 million in the same quarter of 2015, increasing $248 million or 10 percent. The increases were consistent with the Company's continued growth, as well as certain investment in risk management related analytics and practices.

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During the first quarter of 2016, other operating expenses included increased FDIC premiums and increased investment in risk management related analytics and practices, as was expected and previously disclosed. For the three months ended March 31, 2016, FDIC insurance expense was $1.56 million compared to $482 thousand for the three months ended March 31, 2015, increasing $1.1 million. The Company incurred an increased FDIC premium accrual of approximately $950 thousand in the first quarter of 2016. The quarter ended March 31, 2016 included approximately $675 thousand of additional risk management related expenses, of which approximately $350 thousand are one time charges.

Expense increases were generally planned and expected. Last quarter the Company disclosed that given its significant growth and high concentration in multifamily lending, Management had decided to accelerate approximately $2.0 million of costs over 2016 to ensure it adhered to best in class risk management practices. The Company had originally planned for such expenditures over the next 24 to 30 months, but felt it prudent to pull them forward. The Company had also previously disclosed the additional FDIC premiums. The first quarter of 2016 expenses related to these were in line with that guidance.

PRIVATE WEALTH MANAGEMENT DIVISION: This division has served in the roles of executor and trustee while providing investment management, custodial, tax, retirement and financial services to its growing client base. Officers from the Private Wealth Management Division are available to provide trust and investment services at the Bank’s corporate headquarters in Bedminster, at private banking locations in Bedminster, Morristown, Princeton and Teaneck, New Jersey and at the Bank’s subsidiary, PGB Trust & Investments of Delaware, in Greenville, Delaware.

The following table presents certain key aspects of the Bank’s Private Wealth Management Division performance for the quarters ended March 31, 2016 and 2015.

	Three Months Ended March 31,		Change
(In thousands)	2016 (2)	2015	2016 v 2015
Total fee income	$ 4,295	$ 4,031	$ 264
Salaries and benefits (1)	2,095	1,885	210
Other operating expense (1)	1,744	1,463	281
Assets under administration (market value)	$ 3,307,799	$ 3,053,110	$ 254,689

(1) Expenses are included in the Operating Expenses discussion above.

(2) 2016 results include the income and expenses of the Wealth Management Consultants Division, which was acquired in May 2015.

In the March 2016 quarter, the Private Wealth Management Division generated $4.3 million in fee income compared to $4.0 million for the March 2015 quarter, reflecting a 7 percent increase. The market value of the assets under administration (AUA) of the wealth management division was $3.31 billion at March 31, 2016, up approximately 8 percent from $3.05 billion at March 31, 2015. The growth in fee income and AUA was due to the combination of the acquisition of a wealth management company in early May 2015, continued healthy new business results, higher yields on new business as compared to lost/closed business and the conversion of lower fee custody relationships to higher fee advisory relationships. These increases were partially offset by the effect of the broader market declines in the second half of 2015, as well as the first quarter of 2016, which negatively impacted investment fee revenue.

The Company continues to incorporate wealth into every conversation it has with all of the Company’s clients, across all business lines. The Company has expanded its wealth management team and will continue to grow its team and expand its products, services, and advice delivered to clients.

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While the “Operating Expenses” section above offers an overall discussion of the Corporation’s expenses including the Private Wealth Management Division, operating expenses relative to the Private Wealth Management Division totaled $3.8 million and $3.3 million for the first quarters of 2016 and 2015, respectively, an increase of $491 thousand, or 15 percent. Increased expenses in 2016 include the expenses of the Wealth Management Consultants Division, which was acquired in May 2015. Remaining expenses are in line with the Company’s Strategic Plan, particularly the hiring of key management and revenue-producing personnel. Revenue and profitability related to the new personnel will generally lag expenses by several quarters.

The Private Wealth Management Division currently generates adequate revenue to support the salaries, benefits and other expenses of the Division; however, Management believes that the Bank generates adequate liquidity to support the expenses of the Division should it be necessary.

NONPERFORMING ASSETS: OREO, loans past due in excess of 90 days and still accruing, and nonaccrual loans are considered nonperforming assets.

The following table sets forth asset quality data on the dates indicated (in thousands):

	As of March 31, 2016	December 31, 2015	September 30, 2015	June 30, 2015	March 31, 2015
Loans past due over 90 days and still accruing	$—	$ —	$ —	$—	$ —
Nonaccrual loans	7,278	6,747	7,615	7,111	6,335
Other real estate owned	861	563	330	956	1,103
Total nonperforming assets	$8,139	$ 7,310	$ 7,945	$8,067	$ 7,438
Performing TDRs	$16,033	$ 16,045	$ 14,609	$13,695	$ 13,561
Loans past due 30 through 89 days and still accruing	$1,393	$ 2,143	$ 2,748	$1,744	$ 2,481
Classified loans	$48,817	$ 42,777	$ 41,985	$38,676	$ 38,450
Impaired loans	$23,335	$ 23,107	$ 22,224	$20,806	$ 19,896
Nonperforming loans as a % of total loans	0.24 %	0.23 %	0.27 %	0.26 %	0.26 %
Nonperforming assets as a % of total assets	0.23 %	0.22 %	0.24 %	0.26 %	0.26 %
Nonperforming assets as a % of total loans plus other real estate owned	0.27 %	0.25 %	0.28 %	0.29 %	0.30 %

The Company does not hold and has not made or invested in subprime loans or “Alt-A” type mortgages.

PROVISION FOR LOAN LOSSES: The provision for loan losses was $1.7 million for the first quarter of 2016 and $1.35 million for the same quarter of 2015. The amount of the loan loss provision and the level of the allowance for loan losses are based upon a number of factors including Management’s evaluation of probable losses inherent in the portfolio, after consideration of appraised collateral values, financial condition and past credit history of the borrowers as well as prevailing economic conditions. Commercial credits carry a higher risk profile, which is reflected in Management’s determination of the proper level of the allowance for loan losses.

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The provision for loan losses of $1.7 million in the first quarter of 2016 was primarily related to loan growth experienced by the Company, as well as greater qualitative factor allocations of the allowance to commercial and commercial real estate loans. Originations of commercial and commercial real estate loans have increased and these loans have historically carried a higher general reserve allocation than multifamily loans. In the first quarter of 2016, Management reevaluated the qualitative factors for these loan types and as a result of the evaluation, increased the allocations. In addition, the multifamily portfolio is more seasoned and the Company has reduced concentration risk by participating out more multifamily loans.

The overall allowance for loan losses was $27.3 million as of March 31, 2016 compared to $25.9 million at December 31, 2015. As a percentage of loans, the allowance for loan losses was 0.90 percent as of March 31, 2016 and 0.89 percent as of December 31, 2015. The specific reserves on impaired loans have increased very slightly to $491 thousand at March 31, 2016 compared to $489 thousand as of December 31, 2015. Total impaired loans were $23.3 million and $23.1 million as of March 31, 2016 and December 31, 2015, respectively. The general component of the allowance increased from $25.4 million at December 31, 2015 to $26.8 million at March 31, 2016, due principally to the loan growth and the greater qualitative factor allocations referenced previously.

A summary of the allowance for loan losses for the quarterly periods indicated follows:

(In thousands)	March 31, 2016	December 31, 2015	September 30, 2015	June 30, 2015	March 31, 2015
Allowance for loan losses:					
Beginning of period	$ 25,856	$ 24,374	$ 22,969	$ 20,816	$ 19,480
Provision for loan losses	1,700	1,950	1,600	2,200	1,350
Charge-offs, net	(235)	(468)	(195)	(47)	(14)
End of period	$ 27,321	$ 25,856	$ 24,374	$ 22,969	$ 20,816
Allowance for loan losses as a % of total loans	0.90 %	0.89 %	0.85 %	0.84 %	0.85 %
Allowance for loan losses as a % of nonperforming loans	375.39 %	383.22 %	320.08 %	323.01 %	328.59 %

INCOME TAXES: For the first quarter of 2016 and 2015 income tax expense as a percentage of pre-tax income was 37.4 and 40.0 percent, respectively. The lower effective tax for the quarter ended March 31, 2016 was a result of higher tax exempt income along with the Company implementing a state tax planning strategy during the fourth quarter of 2015.

CAPITAL RESOURCES: A solid capital base provides the Company with the ability to support future growth and financial strength and is essential to executing the Company's Strategic Plan – "Expanding Our Reach." The Company's capital strategy is intended to provide stability to expand its businesses, even in stressed environments. The Company strives to maintain capital levels in excess of those considered to be well capitalized under regulatory guidelines applicable to banks. Maintaining an adequate capital position supports the Company’s goal of providing shareholders an attractive and stable long-term return on investment.

Capital for the quarter ended March 31, 2016 was benefitted by net income of $5.5 million and by $4.4 million of voluntary share purchases by our shareholder under the Dividend Reinvestment Plan.

Quantitative measures established by regulation to ensure capital adequacy require the Bank to maintain minimum amounts and ratios of Total, Common Equity Tier 1 and Tier 1 capital (each as defined in the regulations) to risk-weighted assets (as defined), and of Tier I capital (as defined) to average assets (as defined). At March 31, 2016 and 2015, all of the Bank’s capital ratios remain above the levels required to be considered “well capitalized” and the Company’s capital ratios remain above regulatory requirements.

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To be categorized as well capitalized, the Bank must maintain minimum total risk-based, Tier I risk-based, common equity Tier I and Tier I leverage ratios as set forth in the table.

The Bank's actual capital amounts and ratios are presented in the following table:

	Actual		To Be Well Capitalized Under Prompt Corrective Action Provisions		For Capital Adequacy Purposes		For Capital Adequacy Purposes Including Capital Conservation Buffer (A)	
(Dollars in thousands)	Amount	Ratio	Amount	Ratio	Amount	Ratio	Amount	Ratio
As of March 31, 2016:								
Total capital (to risk-weighted assets)	$308,292	11.50%	$267,988	10.00%	$214,391	8.00%	$ 231,140	8.625 %
Tier I capital (to risk-weighted assets)	280,971	10.48	214,391	8.00	160,793	6.00	177,542	6.625
Common equity tier I (to risk-weighted assets)	280,968	10.48	174,192	6.50	120,595	4.50	137,344	5.125
Tier I capital (to average assets)	280,971	8.14	172,682	5.00	138,146	4.00	138,146	4.000
As of December 31, 2015:								
Total capital (to risk-weighted assets)	$297,497	11.32%	$262,719	10.00%	$210,176	8.00%	N/A	N/A
Tier I capital (to risk-weighted assets)	271,641	10.34	210,176	8.00	157,632	6.00	N/A	N/A
Common equity tier I (to risk-weighted assets)	271,641	10.34	170,768	6.50	118,224	4.50	N/A	N/A
Tier I capital (to average assets)	271,641	8.04	169,027	5.00	135,221	4.00	N/A	N/A

The Company's actual capital amounts and ratios are presented in the following table:

	Actual		To Be Well Capitalized Under Prompt Corrective Action Provisions		For Capital Adequacy Purposes		For Capital Adequacy Purposes Including Capital Conservation Buffer (A)	
(Dollars in thousands)	Amount	Ratio	Amount	Ratio	Amount	Ratio	Amount	Ratio

As of March 31, 2016:								
Total capital (to risk-weighted assets)	$310,236	11.57%	$ N/A	N/A %	$214,427	8.00%	$ 231,179	8.625 %
Tier I capital (to risk-weighted assets)	282,915	10.56	N/A	N/A	160,820	6.00	177,572	6.625
Common equity tier I (to risk-weighted assets)	282,912	10.56	N/A	N/A	120,615	4.50	137,367	5.125
Tier I capital (to average assets)	282,915	8.19	N/A	N/A	138,162	4.00	138,162	4.000
As of December 31, 2015:								
Total capital (to risk-weighted assets)	$299,593	11.40%	$ N/A	N/A %	$210,209	8.00%	$ N/A	N/A
Tier I capital (to risk-weighted assets)	273,738	10.42	N/A	N/A	157,657	6.00	N/A	N/A
Common equity tier I (to risk-weighted assets)	273,738	10.42	N/A	N/A	118,242	4.50	N/A	N/A
Tier I capital (to average assets)	273,738	8.10	N/A	N/A	135,237	4.00	N/A	N/A

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(A) When fully phased in on January 1, 2019, the Basel Rules will require the Company and the Bank to maintain a 2.5% “capital conservation buffer” on top of the minimum risk-weighted asset ratios. The capital conservation buffer is designed to absorb losses during periods of economic stress. Banking institutions with a ratio of (i) CET1 to risk-weighted assets, (ii) Tier 1 capital to risk-weighted assets or (iii) total capital to risk-weighted assets above the respective minimum but below the capital conservation buffer will face constraints on dividends, equity repurchases and discretionary bonus payments to executive officers based on the amount of the shortfall. The implementation of the capital conservation buffer began on January 1, 2016 at the 0.625% level and will increase by 0.625% on each subsequent January 1, until it reaches 2.5% on January 1, 2019.

The Dividend Reinvestment Plan of Peapack-Gladstone Financial Corporation, or the “Reinvestment Plan,” allows shareholders of the Company to purchase additional shares of common stock using cash dividends without payment of any brokerage commissions or other charges. Beginning with the August 19, 2015 dividend payment, shareholders may also make voluntary cash payments of up to $200 thousand per quarter to purchase additional shares of common stock. The Reinvestment Plan provided $4.4 million of capital to the Company in the first quarter of 2016. The Plan provides a continuing source of capital.

As previously announced, on April 21, 2016, the Board of Directors declared a regular cash dividend of $0.05 per share payable on May 16, 2016 to shareholders of record on May 5, 2015.

Management believes the Company’s capital position and capital ratios are adequate. Further, Management believes the Company has sufficient common equity to support its planned growth and expansion for the immediate future. The Company continues to assess other potential sources of capital, such as subordinated debt, to support future growth.

LIQUIDITY: Liquidity refers to an institution’s ability to meet short-term requirements including funding of loans, deposit withdrawals and maturing obligations, as well as long-term obligations, including potential capital expenditures. The Company’s liquidity risk management is intended to ensure the Company has adequate funding and liquidity to support its assets across a range of market environments and conditions, including stressed conditions. Principal sources of liquidity include cash, temporary investments, securities available for sale, customer deposit inflows, loan repayments and secured borrowings. Other liquidity sources include loan sales and loan participations.

Management actively monitors and manages the Company’s liquidity position and believes it is sufficient to meet future needs. Cash and cash equivalents, including federal funds sold and interest-earning deposits, totaled $77.9 million at March 31, 2016. In addition, the Company had $214.1 million in securities designated as available for sale at March 31, 2016. These securities can be sold, or used as collateral for borrowings, in response to liquidity concerns. In addition, the Company generates significant liquidity from scheduled and unscheduled principal repayments of loans and mortgage-backed securities.

A further source of liquidity is borrowing capacity. At March 31, 2016, unused borrowing commitments totaled $935.0 million from the FHLB, $112.2 million from the Federal Reserve Bank and $22.0 million from correspondent banks.

Asset growth of $101.3 million in the first three months of 2016 was funded by customer deposit growth of $108.2 million, capital growth of $7.8 million, and reduced other borrowings.

Brokered interest-bearing demand (“overnight”) deposits stayed flat at $200 million at March 31, 2016. The interest rate paid on these deposits allows the Bank to fund at attractive rates and engage in interest rate swaps to hedge its asset-liability interest rate risk. The Company ensures ample available collateralized liquidity as a backup to these short term brokered deposits.

From a liquidity/funding perspective, such brokered deposits, at a cost of approximately 50 to 60 basis points (excluding cost of hedging), are generally a more cost effective alternative than other borrowings and do not require use of pledged collateral, as secured wholesale borrowings do. From a balance sheet management perspective, the rate paid on these short term brokered deposits is used as the basis to transact longer term interest rate swaps, basically extending repricing generally to five years for asset matching / interest rate risk management purposes. As of March 31, 2016, the Company has transacted pay fixed, receive floating interest rate swaps totaling $180.0 million notional amount.

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The Company has a Board-approved Contingency Funding Plan in place. This plan provides a framework for managing adverse liquidity stress and contingent sources of liquidity. The Company conducts liquidity stress testing on a regular basis to ensure sufficient liquidity in a stressed environment.

Management believes the Company's liquidity position and sources are adequate.

ASSET/LIABILITY MANAGEMENT: The Company's Asset/Liability Committee (ALCO) is responsible for developing, implementing and monitoring asset/liability management strategies and reports and advising the Board of Directors on such, as well as the related level of interest rate risk. In this regard, interest rate risk simulation models are prepared on a quarterly basis. These models have the ability to demonstrate balance sheet gaps, and predict changes to net interest income and economic/market value of portfolio equity under various interest rate scenarios. In addition, these models, as well as ALCO processes and reporting, are subject to annual independent third-party review.

ALCO is generally authorized to manage interest rate risk through management of capital and management of cash flows and duration of assets and liabilities, including sales and purchases of assets, as well as additions of wholesale borrowings and other sources of medium/longer term funding. ALCO is authorized to engage in interest rate swaps as a means of extending the duration of shorter term liabilities.

The following strategies are among those used to manage interest rate risk:

- Actively market commercial and industrial (C&I) loan originations, which tend to have adjustable rate features, and which generate customer relationships that can result in higher core deposit accounts;
- Actively market commercial mortgage loan originations, which tend to have shorter terms and higher interest rates than residential mortgage loans, and which generate customer relationships that can result in higher core deposit accounts;
- Manage growth in the residential mortgage portfolio to adjustable-rate and/or shorter-term and/or "relationship" loans that result in core deposit relationships;
- Actively market core deposit relationships, which are generally longer duration liabilities;
- Utilize medium to longer term certificates of deposit and/or wholesale borrowings to extend liability duration;
- Utilize interest rate swaps to extend liability duration;
- Utilize a loan level / back to back interest rate swap program, which converts a borrower's fixed rate loan to adjustable rate for the Company;
- Closely monitor and actively manage the investment portfolio, including management of duration, prepayment and interest rate risk;
- Maintain adequate levels of capital; and
- Utilize loan sales and/or loan participations.

The swap program is administered by ALCO and follows procedures and documentation in accordance with regulatory guidance and standards as set forth in ASC 815 for cash flow hedges. The program incorporates pre-purchase analysis, liability designation, sensitivity analysis and correlation analysis, daily mark-to-market and collateral posting as required. The Board is advised of all swap activity. In all of these swaps, the Company is receiving floating and paying fixed interest rates.

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In addition, during the second quarter of 2015, the Company initiated a loan level / back-to-back swap program in support of its commercial lending business. Pursuant to this program, the Company extends a floating rate loan and executes a floating to fixed swap with the borrower. At the same time, the Company executes with a third party a swap, the terms of which fully offset the fixed exposure and result in a final floating rate exposure for the Company. As of March 31, 2016, $34.7 million of notional value in swaps were executed and outstanding with borrowers under this program.

As noted above, ALCO uses simulation modeling to analyze the Company's net interest income sensitivity, as well as the Company's economic value of portfolio equity under various interest rate scenarios. The model is based on the actual maturity and repricing characteristics of rate sensitive assets and liabilities. The model incorporates certain prepayment and interest rate assumptions, which management believes to be reasonable as of March 31, 2016. The model assumes changes in interest rates without any proactive change in the balance sheet by management. In the model, the forecasted shape of the yield curve remains static as of March 31, 2016.

In an immediate and sustained 200 basis point increase in market rates at March 31, 2016, net interest income for year 1 would increase approximately 3.1 percent, when compared to a flat interest rate scenario. In year 2 this sensitivity improves to an increase of 8.0 percent, when compared to a flat interest rate scenario.

In an immediate and sustained 100 basis point decrease in market rates at March 31, 2016, net interest income would decline approximately 4.1 percent for year 1 and 6.6 percent for year 2, compared to a flat interest rate scenario.

The table below shows the estimated changes in the Company's economic value of portfolio equity ("EVPE") that would result from an immediate parallel change in the market interest rates at March 31, 2016.

(Dollars in thousands)	Estimated Increase/ Decrease in EVPE			EVPE as a Percentage of Present Value of Assets (2)	
Change In Interest Rates (Basis Points)	Estimated EVPE (1)	Amount	Percent	EVPE Ratio (3)	Increase/(Decrease) (basis points)
+200	$372,543	$(5,429)	(1.44)%	11.33%	42
+100	381,027	3,055	0.81	11.29	38
Flat interest rates	377,972	—	—	10.91	—
-100	362,208	(15,764)	(4.17)	10.27	(64)

(1) EVPE is the discounted present value of expected cash flows from assets and liabilities.
(2) Present value of assets represents the discounted present value of incoming cash flows on interest-earning assets.
(3) EVPE ratio represents EVPE divided by the present value of assets.

Certain shortcomings are inherent in the methodologies used in determining interest rate risk. Simulation modeling requires making certain assumptions that may or may not reflect the manner in which actual yields and costs respond to changes in market interest rates. In this regard, the modeling assumes that the composition of our interest-sensitive assets and liabilities existing at the beginning of a period remains constant over the period being measured and assumes that a particular change in interest rates is reflected uniformly across the yield curve regardless of the duration or repricing of specific assets and liabilities. Accordingly, although the information provides an indication of our interest rate risk exposure at a particular point in time, such measurements are not intended to and do not provide a precise forecast of the effect of changes in market interest rates on our net interest income and will differ from actual results.

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Model simulation results indicate the Company is slightly asset sensitive, which indicates the Company's net interest income should improve slightly in a rising rate environment. Management believes the Company's interest rate risk position is reasonable.

ITEM 3. Quantitative and Qualitative Disclosures about Market Risk

There have been no material changes to information regarding quantitative and qualitative disclosures about market risk from the end of the preceding fiscal year to the date of the most recent interim financial statements (March 31, 2016).

ITEM 4. Controls and Procedures

The Corporation's Management, with the participation of its Chief Executive Officer and Chief Financial Officer, have evaluated the effectiveness of the Corporation's disclosure controls and procedures (as defined in Rule 13a-15(e) or Rule 15d-15(e) under the Securities Exchange Act of 1934, as amended) as of the end of the period covered by this Quarterly Report on Form 10-Q. Based on such evaluation, the Corporation's Chief Executive Officer and Chief Financial Officer have concluded that the Corporation's disclosure controls and procedures are effective as of the end of the period covered by this Quarterly Report on Form 10-Q.

The Corporation's Chief Executive Officer and Chief Financial Officer have also concluded that there have not been any changes in the Corporation's internal control over financial reporting during the quarter ended March 31, 2016 that have materially affected, or are reasonable likely to materially affect, the Corporation's internal control over financial reporting.

The Corporation's Management, including the CEO and CFO, does not expect that our disclosure controls and procedures of our internal controls will prevent all errors and all fraud. A control system, no matter how well conceived and operated, provides reasonable, not absolute, assurance that the objectives of the control system are met. The design of a control system reflects resource constraints; the benefits of controls must be considered relative to their costs. Because there are inherent limitations in all control systems, no evaluation of controls can provide absolute assurance that all control issues and instances of fraud, if any, within the Corporation have been or will be detected. These inherent limitations include the realities that judgments in decision-making can be faulty and that breakdowns occur because of simple error or mistake. Controls can be circumvented by the individual acts of some persons, by collusion of two or more people, or by Management override of the controls. The design of any system of controls is based in part upon certain assumptions about the likelihood of future events. There can be no assurance that any design will succeed in achieving its stated goals under all future conditions; over time, control may become inadequate because of changes in conditions or deterioration in the degree of compliance with the policies or procedures. Because of the inherent limitations in a cost-effective control system, misstatements due to error or fraud may occur and not be detected.

PART II. OTHER INFORMATION

ITEM 1. Legal Proceedings

In the normal course of its business, lawsuits and claims may be brought against the Company and its subsidiaries. There is no currently pending or threatened litigation or proceedings against the Company or its subsidiaries, which asset claims that if adversely decided, we believe would have a material adverse effect on the Company.

ITEM 1A. Risk Factors

There were no material changes in the Corporation's risk factors during the three months ended March 31, 2016 from the risk factors disclosed in Part I, Item 1A of the Corporation's Annual Report on Form 10-K for the year ended December 31, 2015.

ITEM 2. Unregistered Sales of Equity Securities and Use of Proceeds

There were no repurchases or unregistered sales of the Corporation's stock during the quarter.

ITEM 3. Defaults Upon Senior Securities

None.

ITEM 4. Mine Safety Disclosures

Not applicable.

ITEM 5. Other Information

None.

ITEM 6. Exhibits

3 Articles of Incorporation and By-Laws:

	A. Certificate of Incorporation of the Registrant, as amended, incorporated herein by reference to Exhibit 3 of the Registrant's Quarterly Report on Form 10-Q filed on November 9, 2009 (File No. 001-16197).
	B. By-Laws of the Registrant, incorporated herein by reference to Exhibit 3.1 of the Registrant's Current Report on Form 8-K filed on January 26, 2015 (File No. 001-16197).
10	Peapack-Gladstone Financial Corporation 2012 Long-Term Stock Incentive Plan, as amended, incorporated herein by reference to Exhibit 10.1of the Registrant's Form 8-K filed on April 29, 2016.
31.1	Certification of Douglas L. Kennedy, Chief Executive Officer of the Corporation, pursuant to Securities Exchange Act Rule 13a-14(a).
31.2	Certification of Jeffrey J. Carfora, Chief Financial Officer of the Corporation, pursuant to Securities Exchange Act Rule 13a-14(a).
32	Certification pursuant to 18 U.S.C. Section 1350, as adopted pursuant to Section 906 of the Sarbanes-Oxley Act of 2002, signed by Douglas L. Kennedy, Chief Executive Officer of the Corporation, and Jeffrey J. Carfora, Chief Financial Officer of the Corporation.
101	Interactive Data File

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SIGNATURES

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

PEAPACK-GLADSTONE FINANCIAL CORPORATION
(Registrant)

DATE: May 9, 2016 By: /s/ Douglas L. Kennedy
Douglas L. Kennedy
President and Chief Executive Officer

DATE: May 9, 2016 By: /s/ Jeffrey J. Carfora
Jeffrey J. Carfora
Senior Executive Vice President, Chief Financial Officer
and Chief Accounting Officer

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