

MULTIMEDIA GAMES INC  
Form 10-Q  
February 09, 2006  
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**UNITED STATES**  
**SECURITIES AND EXCHANGE COMMISSION**

Washington, D.C. 20549

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**Form 10-Q**

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(Mark One)

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

For the quarterly period ended: **December 31, 2005**

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

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

Commission File Number: **001-14551**

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**Multimedia Games, Inc.**

(Exact name of registrant as specified in its charter)

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Texas

74-2611034

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(State or other jurisdiction of  
incorporation or organization)

(I.R.S. Employer  
Identification No.)

206 Wild Basin Road, Building B, Fourth Floor

Austin, Texas  
(Address of principal executive offices)

78746  
(Zip Code)

Registrant's telephone number, including area code: (512) 334-7500

Registrant's website: [www.multimedialogames.com](http://www.multimedialogames.com)

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

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

Large accelerated filer

Accelerated filer

Non-accelerated filer

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

As of February 6, 2006, there were 26,976,521 shares of the Registrant's common stock, par value \$0.01 per share, outstanding.

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**Table of Contents****MULTIMEDIA GAMES, INC.****CONSOLIDATED BALANCE SHEETS****As of December 31, 2005 and September 30, 2005**

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

(Unaudited)

|  | <b>December 31,<br/>2005</b> | <b>September 30,<br/>2005</b> |
|--|------------------------------|-------------------------------|
| <b>ASSETS</b>  |                              |                               |
| <b>CURRENT ASSETS:</b>   |                              |                               |
| Cash and cash equivalents  | \$ 5,664                     | \$ 118                        |
| Accounts receivable, net of allowance for doubtful accounts of \$270 and \$229, respectively | 12,709                       | 18,807                        |
| Inventory  | 334                          | 414                           |
| Contract costs in excess of billing  | 1,182                        | 789                           |
| Prepaid expenses and other   | 3,064                        | 3,177                         |
| Notes receivable, net  | 9,362                        | 9,362                         |
| Deferred income taxes  | 2,005                        | 2,075                         |
| <b>Total current assets</b>  | <b>34,320</b>                | <b>34,742</b>                 |
| Restricted cash and long-term investments  | 1,033                        | 1,068                         |
| Leased gaming equipment, net   | 30,918                       | 37,391                        |
| Property and equipment, net  | 96,676                       | 93,894                        |
| Notes receivable noncurrent  | 31,076                       | 31,964                        |
| Intangible assets, net   | 56,336                       | 53,674                        |
| Other assets   | 1,717                        | 1,959                         |
| <b>Total assets</b>  | <b>\$ 252,076</b>            | <b>\$ 254,692</b>             |
| <b>LIABILITIES AND STOCKHOLDERS EQUITY</b>   |                              |                               |
| <b>CURRENT LIABILITIES:</b>  |                              |                               |
| Current portion of revolving lines of credit   | \$ 9,275                     | \$                            |
| Current portion of long-term debt and capital leases   | 11,655                       | 13,401                        |
| Accounts payable and accrued expenses  | 29,337                       | 35,349                        |
| Federal and state income tax payable   | 3,368                        | 3,312                         |
| Deferred revenue   | 2,081                        | 2,081                         |
| <b>Total current liabilities</b>   | <b>55,716</b>                | <b>54,143</b>                 |
| Revolving lines of credit  | 27,452                       | 27,770                        |
| Long-term debts and capital leases, less current portion                                     | 4,491                        | 6,498                         |
| Other long-term liabilities  | 2,826                        | 3,049                         |
| Deferred revenue noncurrent  | 846                          | 1,057                         |
| Deferred income taxes  | 457                          | 3,258                         |
| <b>Total liabilities</b>   | <b>91,788</b>                | <b>95,775</b>                 |
| Commitments and contingencies  |                              |                               |

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Stockholders' equity:

Preferred stock:

Series A, \$0.01 par value, 1,800,000 shares authorized, no shares issued and test outstanding

Series B, \$0.01 par value, 200,000 shares authorized, no shares issued and outstanding

Common stock, \$0.01 par value, 75,000,000 shares authorized, 30,852,499 and 30,802,524 shares issued, and 26,979,414 and 27,050,285 shares outstanding, respectively

|  |          |          |
|--|----------|----------|
|  | 309      | 308      |
| Additional paid-in capital   | 68,132   | 67,184   |
| Treasury stock, 3,873,085 and 3,752,239 shares at cost, respectively | (24,392) | (23,285) |
| Retained earnings  | 116,239  | 114,710  |

|                                   |                |                |
|-----------------------------------|----------------|----------------|
| <b>Total stockholders' equity</b> | <b>160,288</b> | <b>158,917</b> |
|-----------------------------------|----------------|----------------|

|   |                   |                   |
|---|-------------------|-------------------|
| <b>Total liabilities and stockholders' equity</b> | <b>\$ 252,076</b> | <b>\$ 254,692</b> |
|---|-------------------|-------------------|

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

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## MULTIMEDIA GAMES, INC.

## CONSOLIDATED STATEMENTS OF INCOME

For the Three Months Ended December 31, 2005 and 2004

(In thousands, except per-share amounts)

(Unaudited)

|   | <u>2005</u>       | <u>2004</u>       |
|---|-------------------|-------------------|
| <b>REVENUES:</b>  |                   |                   |
| Gaming revenue:   |                   |                   |
| Class II  | \$ 24,404         | \$ 27,669         |
| Charity   | 4,668             | 4,600             |
| All other   | 3,633             | 5,300             |
| Gaming equipment, system sale and lease revenue                 | 625               | 994               |
| Other   | 708               | 603               |
|   | <u>          </u> | <u>          </u> |
| <b>Total revenues</b>   | <b>34,038</b>     | <b>39,166</b>     |
|   | <u>          </u> | <u>          </u> |
| <b>OPERATING COSTS AND EXPENSES:</b>                            |                   |                   |
| Cost of gaming equipment and systems sold and royalty fees paid | 597               | 841               |
| Selling, general and administrative expenses                    | 15,958            | 16,825            |
| Amortization and depreciation                                   | 14,343            | 13,281            |
|   | <u>          </u> | <u>          </u> |
| <b>Total operating costs and expenses</b>                       | <b>30,898</b>     | <b>30,947</b>     |
|   | <u>          </u> | <u>          </u> |
| <b>Operating income</b>   | <b>3,140</b>      | <b>8,219</b>      |
| <b>OTHER INCOME (EXPENSE):</b>                                  |                   |                   |
| Interest income   | 481               | 432               |
| Interest expense  | (966)             | (554)             |
|   | <u>          </u> | <u>          </u> |
| <b>Income before income taxes</b>                               | <b>2,655</b>      | <b>8,097</b>      |
| Income tax expense  | 1,126             | 3,074             |
|   | <u>          </u> | <u>          </u> |
| <b>Net income</b>   | <b>\$ 1,529</b>   | <b>\$ 5,023</b>   |
|   | <u>          </u> | <u>          </u> |
| Basic earnings per share  | \$ 0.06           | \$ 0.18           |
|   | <u>          </u> | <u>          </u> |
| Diluted earnings per share                                      | \$ 0.05           | \$ 0.17           |
|   | <u>          </u> | <u>          </u> |

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



**Table of Contents****MULTIMEDIA GAMES, INC.****CONSOLIDATED STATEMENTS OF CASH FLOWS****For the Three Months Ended December 31, 2005 and 2004**

(In thousands)

(Unaudited)

|  | <u>2005</u>     | <u>2004</u>     |
|--|-----------------|-----------------|
| <b>CASH FLOWS FROM OPERATING ACTIVITIES:</b>   |                 |                 |
| Net income   | \$ 1,529        | \$ 5,023        |
| Adjustments to reconcile net income to cash and cash equivalents provided by operating activities: |                 |                 |
| Amortization   | 1,700           | 811             |
| Depreciation   | 12,643          | 12,470          |
| Accretion of contract rights   | 982             | 326             |
| Write-off of and loss on disposal of long-lived assets   |                 | 35              |
| Deferred income taxes  | (2,731)         | 1,080           |
| Share-based compensation   | 678             |                 |
| Options issued to consultants  | 4               | 67              |
| Provision for doubtful accounts  | 41              | 96              |
| (Increase) decrease in:  |                 |                 |
| Accounts receivable  | 6,063           | (4,102)         |
| Inventory  | 80              | 199             |
| Contract costs in excess of billing  | (393)           |                 |
| Prepaid expenses and other   | 355             | (336)           |
| Federal and state income tax payable   | 56              | 1,734           |
| Other long-term liabilities  | (188)           | (279)           |
| Notes receivable   | 111             | 1,871           |
| Increase (decrease) in:  |                 |                 |
| Accounts payable and accrued expenses  | (6,018)         | (6,429)         |
| Deferred revenue   | (211)           | (211)           |
|  | <u>14,701</u>   | <u>12,355</u>   |
| <b>NET CASH PROVIDED BY OPERATING ACTIVITIES</b>   |                 |                 |
| <b>CASH FLOWS FROM INVESTING ACTIVITIES:</b>   |                 |                 |
| Acquisition of property and equipment and leased gaming equipment                                  | (8,952)         | (23,370)        |
| Acquisition of intangible assets   | (1,416)         | (837)           |
| Advances under development agreements  | (5,914)         | (10,493)        |
| Repayments under development agreements  | 2,763           | 4,588           |
|  | <u>(13,519)</u> | <u>(30,112)</u> |
| <b>NET CASH USED IN INVESTING ACTIVITIES</b>   |                 |                 |
| <b>CASH FLOWS FROM FINANCING ACTIVITIES:</b>   |                 |                 |
| Proceeds from exercise of stock options, warrants,<br>and related tax benefit                      | 267             | 900             |
| Proceeds from long-term debt   |                 | 10,000          |
| Principal payments of long-term debt and capital leases  | (3,753)         | (2,385)         |



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|  |                   |                   |
|--|-------------------|-------------------|
| Proceeds from revolving lines of credit          | 17,400            | 10,436            |
| Payments on revolving lines of credit            | (8,443)           |                   |
| Purchase of treasury stock                       | (1,107)           |                   |
|  | <u>          </u> | <u>          </u> |
| <b>NET CASH PROVIDED BY FINANCING ACTIVITIES</b> | <b>4,364</b>      | <b>18,951</b>     |
|  | <u>          </u> | <u>          </u> |
| Net increase in cash and cash equivalents        | 5,546             | 1,194             |
| Cash and cash equivalents, beginning of period   | 118               | 4,768             |
|  | <u>          </u> | <u>          </u> |
| Cash and cash equivalents, end of period         | \$ 5,664          | \$ 5,962          |
|  | <u>          </u> | <u>          </u> |

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**MULTIMEDIA GAMES, INC.**

**CONSOLIDATED STATEMENTS OF CASH FLOWS (Continued)**

**For the Three Months Ended December 31, 2005 and 2004**

(In thousands)

(Unaudited)

|   | <u>2005</u> | <u>2004</u> |
|---|-------------|-------------|
| <b>SUPPLEMENTAL CASH FLOW DATA:</b>                       |             |             |
| Interest paid   | \$ 909      | \$ 462      |
| Income tax paid   | \$ 3,688    | \$ 5        |
| <b>NON-CASH TRANSACTIONS:</b>                             |             |             |
| Property and equipment and other assets acquired through: |             |             |
| Long-term debt  |             | 410         |

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

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**MULTIMEDIA GAMES, INC.**

**NOTES TO CONSOLIDATED FINANCIAL STATEMENTS**

(Unaudited)

**1. SIGNIFICANT ACCOUNTING POLICIES**

The accompanying consolidated financial statements should be read in conjunction with the Company's consolidated financial statements and footnotes contained within the Company's Annual Report on Form 10-K for the year ended September 30, 2005.

The financial statements included herein as of December 31, 2005, and for each of the three months ended December 31, 2005 and 2004, have been prepared by the Company without an audit, pursuant to accounting principles generally accepted in the United States of America, or U.S., and the rules and regulations of the Securities and Exchange Commission. They do not include all of the information and footnotes required by accounting principles generally accepted in the U.S. for complete financial statements. The information presented reflects all adjustments consisting solely of normal adjustments which are, in the opinion of management, considered necessary to present fairly the financial position, results of operations, and cash flows for the periods. Operating results for the three months ended December 31, 2005 are not necessarily indicative of the results which will be realized for the year ending September 30, 2006.

**Operations.** The Company is a leading supplier of interactive systems, electronic games, and gaming terminals for the Native American gaming market, as well as the growing racetrack casino, charity and commercial bingo, and video lottery markets. The Company designs and develops networks, software and content that provide its customers with, among other things, comprehensive gaming systems delivered through a telecommunications network linking its gaming terminals with one another, both within and among gaming facilities, thereby enabling players to simultaneously participate in the same game and to compete against one another to win common pooled prizes. The Company's ongoing development and marketing efforts focus on Class II and Class III gaming systems and products for use by Native American tribes throughout the United States, or U.S., video lottery systems and other products for domestic and international lotteries, and products for domestic and international charity and commercial bingo facilities. The Company's gaming systems are typically provided to customers under revenue sharing arrangements, except for video lottery terminals in the Class III market in Washington State, which are typically sold for an up-front purchase price. The Company offers content for its gaming systems that has been designed and developed by the Company, as well as game themes it has licensed from others.

**Consolidation Principles.** The Company's financial statements include the activities of Multimedia Games, Inc. and its wholly-owned subsidiaries: Megabingo, Inc., MGAM Systems, Inc., Innovative Sweepstakes Systems, Inc., and MGAM Services, LLC. Intercompany balances and transactions have been eliminated.

**Accounting Estimates.** The preparation of financial statements in conformity with accounting principles generally accepted in the U.S. requires management to make estimates and assumptions that affect the reported amounts of assets and liabilities, the disclosure of contingent assets and liabilities at the date of the financial statements, and the reported amounts of revenues and expenses during the reporting period. Examples include provisions for bad debts and contract losses, useful lives of property and equipment and intangible assets, impairment of property and equipment and intangible assets, deferred taxes, and the provision for and disclosure of litigation and loss contingencies. Actual results may differ materially from these estimates in the future.

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

**Revenue Recognition.** The majority of the Company's gaming revenue is of a recurring nature, and is generated under participation arrangements by providing its customers with gaming terminals, gaming terminal content licenses and back-office equipment, collectively referred to as gaming equipment. Under these arrangements, the Company retains ownership of the gaming equipment installed at customer facilities, and receives revenue based on a percentage of the hold per day generated by the gaming equipment. Certain of the Company's arrangements require a portion of the facilities' hold per day to be set aside to be used to fund facility-specific marketing, advertising, promotions, and service. These amounts are offset against revenue, and deferred in a liability account until expended. Participation revenue generated from the Company's Native American Class II product is reported in its results of operations as Gaming revenue - Class II, revenue from its charity bingo product is included in Gaming revenue - Charity, and participation revenue from the Company's Tribal Instant Lottery Game, or TILG, and its Native American Class III products, including games played under the Oklahoma Compact, are included in Gaming revenue - All other.

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**MULTIMEDIA GAMES, INC.**

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

(Unaudited)

The Company also generates revenues from the sale or lease of Class III gaming equipment in Washington State and from related back-office fees based on a share of the hold per day of the installed equipment. Back-office fees cover the service and maintenance costs for back-office servers installed in each gaming facility to run its gaming equipment, as well as the cost of related software updates. These back-office fees are reported in the Company's results of operations as a part of Gaming revenue - All other. For those gaming terminals sold to its customers, the back-office fees are based on a considerably smaller percentage of the hold per day than the revenue share received from terminals being rented under participation agreements.

Revenue from participation arrangements and back-office fees is generally considered both realizable and earned at the end of each gaming day.

The Company provides gaming solutions to domestic and international lottery organizations through a combination of gaming equipment and gaming systems utilizing central determinant system technology. The equipment and systems are either sold outright for a one-time fee, or are provided on a participation basis, whereby the Company receives a small portion of the network-wide hold, which is reported in its financial results of operations as a part of Gaming revenue - All other.

The Company also markets a modular suite of software gaming support products, such as player tracking, which enables operators to monitor, manage and track player activity, and slot accounting systems, slot management systems, and slot monitoring systems, collectively referred to as the MGAMe System. The MGAMe system is either sold to customers as a complete system or on a module-by-module basis for a one-time license fee and a recurring fee for post-customer support, or is provided under a participation arrangement.

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

Revenue from the sale of software is accounted for under Statement of Position 97-2, Software Revenue Recognition, or SOP 97-2. If vendor-specific objective evidence of fair value does not exist, the revenue is deferred until such time that all elements have been delivered or services have been performed. If any element is determined to be essential to the function of the other, revenues are generally recognized utilizing the subscription method of accounting over the term of the services that are rendered.

In accordance with the provisions of Emerging Issues Task Force, or EITF, Issue 00-21, Revenue Arrangements with Multiple Deliverables, or EITF 00-21, sales that are considered to contain multiple deliverables are bifurcated into accounting units based on their relative fair market value, provided each component is not essential to the function of the other. The majority of its multiple element contracts are for some combination of gaming terminals, content, system software, license fees and maintenance.

Revenues from the stand-alone product sales or separate accounting units are recorded when: a) persuasive evidence of an arrangement exists and the sales price is fixed and determinable; b) delivery has occurred and services have been rendered; and c) collectibility is reasonably

assured.

***Costs and Billings on Uncompleted Contract*** During fiscal 2005, the Company entered into a fixed-price contract with a customer, pursuant to which it will deliver an electronic instant lottery system. Revenues from this fixed-price contract will be recognized on the completed-contract method.

Contract costs include all direct material and labor costs, and those indirect costs related to contract performance, such as indirect labor, supplies and tools. General and administrative costs are charged to expense as incurred. Provisions for estimated losses on uncompleted contracts are made in the period in which such losses are determined.

Costs in excess of amounts billed are classified as Current assets under costs in excess of billings. Billings in excess of costs are classified under current liabilities as Billings in excess of costs on uncompleted contracts.

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## MULTIMEDIA GAMES, INC.

## NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)

(Unaudited)

At December 31, 2005 and September 30, 2005, the following amounts were recorded in the Company's financial statements:

|   | December 31,<br>2005 | September 30,<br>2005 |
|---|----------------------|-----------------------|
|   | <u>          </u>    | <u>          </u>     |
|   | (in thousands)       |                       |
| Costs incurred on uncompleted contracts                               | \$ 7,201             | \$ 6,808              |
| Billings on uncompleted contracts                                     | (6,019)              | (6,019)               |
|   | <u>          </u>    | <u>          </u>     |
|   | \$ 1,182             | \$ 789                |
|   | <u>          </u>    | <u>          </u>     |
| Included in accompanying balance sheets under the following captions: |                      |                       |
| Contract costs in excess of billings                                  | \$ 1,182             | \$ 789                |
|   | <u>          </u>    | <u>          </u>     |

**Cash and Cash Equivalents.** The Company considers all highly liquid investments (i.e., investments which, when purchased, have original maturities of three months or less) to be cash equivalents.

**Allowance for Doubtful Accounts.** The Company maintains an allowance for doubtful accounts related to its accounts receivable and notes receivable that have been deemed to have a high risk of collectibility. Management reviews its accounts receivable and notes receivable on a monthly basis to determine if any receivables will potentially be uncollectible. Management analyzes historical collection trends and changes in its customer payment patterns, customer concentration, and creditworthiness when evaluating the adequacy of its allowance for doubtful accounts. In its overall allowance for doubtful accounts, the Company includes any receivable balances that are determined to be uncollectible. Based on the information available, management believes the allowance for doubtful accounts is adequate; however, actual write-offs might exceed the recorded allowance.

**Inventory.** The Company's inventory consists primarily of completed gaming terminals, related component parts and back-office computer equipment expected to be sold within the Company's next fiscal year. Inventories are stated at the lower of cost (first in, first out) or market.

**Development Agreements.** The Company enters into development agreements to provide financing for new gaming facilities or for the expansion of existing facilities. In return, the facility dedicates a percentage of its floor space to exclusive placement of the Company's gaming terminals, and the Company receives a fixed percentage of those gaming terminals' hold per day over the term of the agreement. Certain of the agreements contain performance standards for its gaming terminals that could allow the facility to reduce a portion of the Company's guaranteed floor space. The agreements typically provide for a portion of the amounts retained by the gaming facility for their share of the hold to be used for repayment of some or all of the advances. Amounts advanced in excess of those to be reimbursed by the customer for real property and land improvements are allocated to intangible assets and are generally amortized over the life of the contract, which is recorded as a reduction of revenue generated from the gaming facility. Amounts related to personal property owned by the Company and located at the tribal gaming facility are carried in the Company's property and equipment, and depreciated over the estimated useful life of the related asset.

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Management reviews intangible assets for impairment whenever events or changes in circumstances indicate that the carrying amount of an asset may not be recoverable. An analysis of intangible assets at December 31, 2005, indicated there was no impairment to these assets carrying values.

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

|  | <b>December 31,</b>   | <b>September 30,</b> |
|--|-----------------------|----------------------|
|  | <b>2005</b>           | <b>2005</b>          |
|  | <u>          </u>     | <u>          </u>    |
|  | <b>(In thousands)</b> |                      |
| Included in:   |                       |                      |
| Notes receivable   | \$ 38,241             | \$ 38,421            |
| Property and equipment, net of accumulated depreciation            | 8,968                 | 9,381                |
| Intangible assets contract rights, net of accumulated amortization | 42,653                | 39,705               |



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## MULTIMEDIA GAMES, INC.

## NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)

(Unaudited)

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

|  | December 31,      | September 30,     |
|--|-------------------|-------------------|
|  | 2005              | 2005              |
|  | <u>          </u> | <u>          </u> |
|  | (In thousands)    |                   |
| Notes receivable from development agreements | \$ 38,241         | \$ 38,421         |
| Notes receivable from equipment sales        | 1,443             | 2,042             |
| Other notes receivable                       | 754               | 863               |
|  | <u>          </u> | <u>          </u> |
| Notes receivable, net                        | 40,438            | 41,326            |
| Less current portion                         | (9,362)           | (9,362)           |
|  | <u>          </u> | <u>          </u> |
| Notes receivable non-current                 | \$ 31,076         | \$ 31,964         |
|  | <u>          </u> | <u>          </u> |

Notes receivable from development agreements are generated from reimbursable amounts advanced under development agreements, and generally bear interest at prevailing interest rates. These notes are typically collateralized by all the personal property not owned by the Company and contained within the respective tribal gaming facility, although the value of such property, if repossessed, may be less than the note receivable outstanding. As of December 31, 2005, the average interest rate on notes receivable from development agreements was 6.20%, and the expected term of such notes ranged from one to three years; however, the timing of required payments may vary, as certain of the note repayment terms are based on the hold per day per gaming terminal retained by the facilities.

Notes receivable from equipment sales consist of financial instruments issued by customers for the purchase of gaming terminals and licenses, and generally bear interest at prevailing interest rates. All of the Company's notes receivable from equipment sales are collateralized by the related equipment sold, although the value of such equipment, if repossessed, may be less than the note receivable outstanding. As of December 31, 2005, the average interest rate on notes receivable from equipment sales was 5.25%, and the term of such notes ranged from one to two years.

**Property and Equipment and Leased Gaming Equipment.** Property and equipment and leased gaming equipment is stated at cost. The cost of property and equipment and leased gaming equipment is depreciated over their estimated useful lives, generally using the straight-line method for financial reporting, and accelerated methods for tax reporting purposes. Gaming terminals placed with customers under participation arrangements are included in leased gaming equipment. Leased gaming equipment includes a pool of rental terminals, i.e., the rental pool. Rental pool units are those units that have previously been placed in the field under participation arrangements, but are currently back at the Company being refurbished and/or awaiting redeployment. Routine maintenance of property and equipment and leased gaming equipment is expensed in the period incurred, while major component upgrades are capitalized and depreciated over the estimated useful life of the component. Sales and retirements of depreciable property are recorded by removing the related cost and accumulated depreciation from the accounts. Gains or losses on sales and retirements of property are reflected in the Company's results of operations.

Management reviews long-lived assets for impairment whenever events or changes in circumstances indicate that the carrying amount of an asset may not be recoverable. Recoverability of assets to be held and used is measured by a comparison of the carrying amount of an asset to its fair value, which considers the future undiscounted cash flows expected to be generated by the asset. If such assets are considered to be impaired, the impairment recognized is measured by the amount by which the carrying amount of the assets exceeds their fair value. Assets to be disposed of are reported at the lower of the carrying amount or the fair value less costs of disposal. An analysis of the long-lived assets at December 31, 2005 indicated there was no impairment to these assets' carrying values.

***Equipment under Capital Lease.*** Equipment under capital leases is recorded at the lower of the present value of the minimum lease payments or the fair value of the assets. The cost of leased property and equipment is amortized using the Company's normal depreciation policy, described under Property and Equipment and Leased Gaming Equipment.

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

(Unaudited)

**Credit Facility, Long-Term Debt and Capital Leases.** At December 31, 2005 and September 30, 2005, the Company's Credit Facility, long-term debt and capital leases consisted of the following:

|   | December 31,      | September 30,     |
|---|-------------------|-------------------|
|   | 2005              | 2005              |
|   | <u>          </u> | <u>          </u> |
|   | (In thousands)    |                   |
| Revolving lines of credit                               | \$ 36,727         | \$ 27,770         |
| Less current portion                                    | (9,275)           |                   |
|   | <u>          </u> | <u>          </u> |
| Long-term revolving lines of credit                     | \$ 27,452         | \$ 27,770         |
|   | <u>          </u> | <u>          </u> |
| Term Loan facility                                      | \$ 9,785          | \$ 12,014         |
| Other long-term debt                                    | 2,834             | 3,320             |
| Capital lease obligations                               | 3,527             | 4,565             |
|   | <u>          </u> | <u>          </u> |
| Long-term debt and capital leases                       | 16,146            | 19,899            |
| Less current portion                                    | (11,655)          | (13,401)          |
|   | <u>          </u> | <u>          </u> |
| Long-term debt and capital leases, less current portion | \$ 4,491          | \$ 6,498          |
|   | <u>          </u> | <u>          </u> |

The Company's debt structure consists of a Credit Facility, which provides the Company with a \$20.0 million term loan facility, or the Term Loan, a \$15.0 million revolving line of credit, or the Revolver, and a \$35.0 million reducing line of credit, or the Reducing Revolver. Two of the three tranches of the Term Loan mature in June 2006 and bear interest at a rate of Prime (or 7.25% as of December 31, 2005). The third tranche of the Term Loan matures in June 2007, and also bears interest at a rate of Prime. As of December 31, 2005, the Company had drawn \$20.2 million under the available tranches of the Term Loan. Equal installments of principal and interest are payable over the term of the first two tranches, which are 36 and 30 months, respectively. On the third tranche, installments based on a 24-month term began in July 2005, with a balloon payment due in June 2007.

The Revolver provides the Company with up to \$15.0 million for working capital needs. The Revolver bears interest, payable monthly, at a rate of Prime and has a commitment fee based on the daily average unborrowed commitment. The Revolver matures in November 2006. As of December 31, 2005, \$7.0 million was outstanding under the Revolver, leaving \$8.0 million available, which was reduced by \$1.0 million, reflecting outstanding letters of credit.

The Reducing Revolver provides the Company with up to \$35.0 million, which is advanceable based on the Company's unfinanced capital expenditures. After the first 12 months, the availability under the Reducing Revolver is reduced quarterly, based on a 36-month straight-line amortization. The Reducing Revolver bears interest, payable monthly, at a rate of Prime and has a commitment fee based on the daily average

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unborrowed commitment. Interest payments are due monthly, and principal plus unpaid interest is due when the Reducing Revolver matures in June 2009. As of December 31, 2005, \$29.8 million was outstanding under the Reducing Revolver, leaving \$4.6 million available.

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

The Credit Facility is collateralized by substantially all of the Company's assets, and contains financial covenants as defined in the agreement, that include a maximum indebtedness to EBITDA ratio of 1.50:1.00, a maximum total liabilities to tangible net worth ratio of 1.25:1.00, a minimum trailing twelve-month EBITDA of \$60.0 million and a maximum rolling four-quarter capital expenditures rate, including amounts advanced under development agreements, of \$175.0 million. The Company was in compliance with these covenants as of December 31, 2005.

Other long-term debt at December 31, 2005 represents a five-year loan related to financing the Company's corporate aircraft, and various three-to five-year loans for the purchase of automobiles and property and equipment.

***Fair Value of Financial Instruments.*** The fair value of a financial instrument is the amount at which the instrument could be exchanged in a current transaction between willing parties, other than in a forced sale or liquidation. At December 31, 2005 and September 30, 2005, the carrying amounts for the Company's financial instruments, which include accounts and notes receivable, accounts payable, the Credit Facility, and long-term debt and capital leases, approximate fair value.

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## MULTIMEDIA GAMES, INC.

## NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)

(Unaudited)

**Related Party Transactions.** During the three months ended December 31, 2005, in connection with executing a content license agreement, the Company paid \$25,000 to a family member of the Chairman of the Board.

**Income Taxes.** The Company applies the provisions of Statement of Financial Accounting Standards, or SFAS, No. 109, Accounting for Income Taxes. Under SFAS No. 109, deferred tax liabilities or assets arise from differences between the tax basis of liabilities or assets and their bases for financial reporting, and are subject to tests of recoverability in the case of deferred tax assets. Deferred tax assets and liabilities are measured using enacted tax rates expected to apply to taxable income in the years in which those temporary differences are expected to be recovered or settled. A valuation allowance is provided for deferred tax assets to the extent realization is not judged to be more likely than not.

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

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

|   | Three Months Ended           |            |
|---|------------------------------|------------|
|   | December 31,                 |            |
|   | 2005                         | 2004       |
|   | (In thousands, except shares |            |
|   | and per-share amounts)       |            |
| Income available to common stockholders basic and diluted | \$ 1,529                     | \$ 5,023   |
| Weighted average common shares outstanding                | 27,014,114                   | 27,954,564 |
| Effect of dilutive securities:                            |                              |            |
| Options   | 1,839,889                    | 2,307,330  |
| Weighted average common and potential shares outstanding  | 28,854,003                   | 30,261,894 |
| Basic earnings per share                                  | \$ 0.06                      | \$ 0.18    |
| Diluted earnings per share                                | \$ 0.05                      | \$ 0.17    |

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At December 31, 2005 and 2004, options to purchase 2,135,380 and 399,500 shares, respectively, of Common Stock at exercise prices ranging from \$7.61 to \$21.53 per share, and \$13.76 to \$21.53 per share, respectively, were outstanding, but were not included in the computation of diluted earnings per share due to their antidilutive effect.

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

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

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

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## MULTIMEDIA GAMES, INC.

## NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)

(Unaudited)

The assumptions used for the three-month periods ended December 31, 2005 and 2004 and the resulting estimates of weighted-average fair value per share of options granted during those periods are as follows:

|  | Three Months Ended |            |
|--|--------------------|------------|
|  | December 31,       |            |
|  | 2005               | 2004       |
| Weighted average expected life                                   | 4.50 years         | 4.57 years |
| Risk free interest rate  | 4.10%              | 4.12%      |
| Expected volatility  | 62.0%              | 62.0%      |
| Expected dividend yields   |                    |            |
| Weighted average fair value of options granted during the period | \$ 5.35            | \$ 7.59    |

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

The following table presents a comparison of the actual three months ended December 31, 2005 reported net income, net income per share and compensation cost of stock options granted to employees, to the pro forma amounts that would have been reported if compensation expense had been determined using the fair value method required by SFAS No. 123 for the three months ended December 31, 2004:

|  | Three Months Ended    |          |
|--|-----------------------|----------|
|  | December 31,          |          |
|  | 2005                  | 2004     |
|  | (In thousands, except |          |
|  | per-share amounts)    |          |
| Net income:                                    |                       |          |
| As reported                                    | \$ 1,529              | \$ 5,023 |
| Reported share-based compensation, net of tax  | 533                   |          |
| Pro forma share-based compensation, net of tax |                       | (858)    |
| Pro forma                                      | \$ 2,062              | \$ 4,165 |

|   |                |                |
|---|----------------|----------------|
| <b>Basic earnings per common share:</b>   |                |                |
| As reported                               | \$ 0.06        | \$ 0.18        |
| <b>Pro forma</b>                          | <b>\$ 0.08</b> | <b>\$ 0.15</b> |
| <b>Diluted earnings per common share:</b> |                |                |
| As reported                               | \$ 0.05        | \$ 0.17        |
| <b>Pro forma</b>                          | <b>\$ 0.07</b> | <b>\$ 0.14</b> |

## 2. COMMITMENTS AND CONTINGENCIES

### *Litigation*

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

On November 30, 2004, the Company received letters from the Acting General Counsel of the NIGC advising the Company that, based on the fee it receives under its agreements with other tribes, (collectively, the tribes), those



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**MULTIMEDIA GAMES, INC.**

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

(Unaudited)

agreements may evince a proprietary interest by the Company in the tribes' gaming activities in violation of IGRA and the tribes' gaming ordinances. The NIGC invited the Company and the tribes to submit any explanation or information that would establish that the agreement terms do not violate the requirement that the tribes maintain the sole proprietary interest in the gaming operation. The NIGC letters also advised that some of the agreements may also constitute management contracts, thereby requiring the approval of the NIGC Chairman.

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

If certain of the Company's development agreements are finally determined to be management contracts or to create a proprietary interest of the Company in tribal gaming operations, there could be material adverse consequences to the Company. In that event, the Company may be required, among other things, to modify the terms of such agreements. Such modification may adversely affect the terms on which the Company conducts business, and have a significant impact on its financial condition and results of operations from such agreement and from other development agreements that may be similarly interpreted by the NIGC.

The Company's contracts could be subject to further review at any time. Any further review of these agreements by the NIGC, or alternative interpretations of applicable laws and regulations could require substantial modifications to those agreements or result in their designation as management contracts, which could materially and adversely affect the terms on which it conducts business.

***Diamond Games.*** The Company is a defendant, along with others, in a lawsuit filed on November 16, 2004, in the State Court in Oklahoma City, Oklahoma, alleging five causes of action: 1) Deceptive Trade Practices, 2) Unfair Competition, 3) Wrongful Interference with Diamond Games, Inc.'s Business; 4) Malicious Wrong / Prima Facie Tort; and, 5) Restraint of Trade. The Company filed a motion to dismiss the case, challenging subject matter jurisdiction of the Oklahoma state courts. The motion was denied. A motion to reconsider was likewise denied. Relief was sought from the Supreme Court of Oklahoma by an Application for a Writ of Prohibition. The application for a writ was denied on October 10, 2005. The case asserts that the Company offered allegedly illegal Class III games on the MegaNanza® and Reel Time Bingo® gaming systems to Native American tribes in Oklahoma. Diamond Games claims that the offer of these games negatively affected the market for its pull-tab game, Lucky Tab II. Diamond Games also alleges that the Company's development agreements with Native American tribes unfairly interfere with the ability of Diamond Games to successfully conduct its business. Diamond Games is seeking unspecified damages and injunctive relief; however, the Company believes the claims of Diamond Games are without merit and intends to defend the case vigorously. The Company's defense will include a continued challenge to the jurisdiction of the Oklahoma state courts over matters directly involving the self-governance of Native American tribes involved in Indian gaming, which has been recognized as a governmental enterprise. At the present time, the case is in the preliminary stages of discovery which entails responding to the adverse parties' requests for production of documents.

***International Gamco, Inc.*** International Gamco, Inc., or Gamco, claiming certain rights in United States Patent No. 5,324,035, (the '035 Patent), brought suit on May 25, 2004 against the Company in the United States District Court for the Southern District of California. The suit claims that the central determinant system, as operated in the New York State Lottery, infringes the '035 Patent. Gamco claimed to have acquired ownership of the '035 Patent from Oasis Technologies, Inc., or Oasis, a previous owner of the '035 Patent. In February 2003, Oasis assigned the '035 Patent to International Game Technology, or IGT. Gamco claimed to have received a license back from IGT for the New York State

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Lottery. The lawsuit claimed that the Company infringed the 035 Patent after the date on which Gamco assigned the 035 Patent to IGT.

Pursuant to an agreement between the Company and Alliance Gaming, Inc., or Alliance, the Company currently sublicenses the right to practice the technology stated in the 035 Patent in Native American gaming jurisdictions in the United States. Alliance obtained from Oasis the right to sublicense those rights to the Company. That sublicense remains in effect today. Under the sublicense from Alliance, in the event that the Company desires to expand its

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**MULTIMEDIA GAMES, INC.**

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

(Unaudited)

rights beyond Native American gaming jurisdictions, the agreement provides the Company the following options: 1) to pursue legal remedies to establish its rights independent of the '035 Patent; or 2) to negotiate directly and enter into a separate agreement with Oasis for such rights, paying either a one-time license fee per jurisdiction or a unit fee per gaming machine.

Prior to deployment of the Company's central determinant system in New York, MGAM undertook an analysis of the patent issues to determine whether or not its central determinant system infringed the claims of the '035 Patent. The Company determined that it did not infringe. Although continuing to assert noninfringement, the Company offered to enter into a license agreement with Gamco, who refused the offer and filed its complaint seeking injunctive relief, unspecified damages, and attorneys' fees.

Upon the Company's motion to dismiss, on September 27, 2005, the court dismissed Gamco's lawsuit for lack of standing. The court granted Gamco leave to file an amended complaint for infringement, if any, that might have occurred during the time Gamco owned the patent. Gamco amended its complaint on November 14, 2005, alleging that the Company sold or offered to sell master processing units as part of the service to be provided to the New York State Lottery. On December 7, 2005, the Company filed a motion to dismiss the amended complaint, asserting that no equipment, including any master processing units, were sold or offered for sale to the New York State Lottery, and that no alleged infringing equipment was used in the New York State Lottery during the time that Gamco owned the '035 Patent. To the extent an amended complaint may survive the Company's motion to dismiss, the Company intends to vigorously defend the matter. Given the inherent uncertainties in any litigation, the Company is unable to make any prediction as to the outcome.

***Aristocrat Technologies, Inc.*** On January 27, 2005, Aristocrat Technologies, Inc. filed suit in the United States District Court for the Central District of California, alleging that deployment of the Company's networked central-determinant instant lottery system infringes U.S. Letters Patent No. 4,817,951, entitled "Player Operable Lottery Machine Having Display Means Displaying Combination of Game Result Indicia," (the '951 Patent). Aristocrat is seeking an injunction, damages, and a trebling of damages for willful infringement. Preliminary research indicates that the Company has not infringed the '951 Patent. Trial is set for December 5, 2006. The Company intends to vigorously defend this matter. Given the inherent uncertainties in any litigation, the Company is unable to make any prediction as to the outcome.

***HomeBingo Network, Inc.*** On May 16, 2005, HomeBingo Network filed suit in the United States District Court for the Northern District of New York, against the Company and the gaming entity of the Miami Tribe of Oklahoma, alleging that deployment of Reel Time Bingo and other bingo games infringes U.S. Letters Patent No. 6,186,892, entitled "Bingo Game for use on the Interactive Communication Network which Relies upon Probabilities for Winning." HomeBingo seeks an injunction, damages in the amount of a reasonable royalty, and a trebling of damages for willful infringement. The Company received no demand or prior indication that this suit was going to be filed. The Miami Tribe of Oklahoma has been dismissed from the lawsuit on the basis of tribal immunity, and as such, a lack of jurisdiction. The litigation is in the discovery phase. The Company intends to vigorously defend this matter. Given the inherent uncertainties in any litigation, the Company is unable to make any prediction as to the outcome.

***Other Litigation.*** In addition to the threat of litigation relating to the Class II or Class III status of the Company's games and equipment, the Company is the subject of various pending and threatened claims arising out of the ordinary course of business. The Company believes that any liability resulting from these claims will not have a material adverse effect on its results of operations or financial condition.

***Development Agreements***

As of December 31, 2005, the Company had entered into development agreements to provide up to \$159.0 million towards the construction and/or remodeling of tribal gaming facilities, and had advanced \$112.9 million under these agreements. In exchange for a certain amount of the funds advanced under the development agreement, the Company receives a guarantee of floor space for its gaming terminals. A portion of the hold per day generated by these gaming terminals is used to repay the construction advance. Consequently, the payback period is dependent on the hold per day generated by the Company's gaming terminals located on the guaranteed floor space. The Company is in various stages of discussion with new and existing customers to provide funding for similar opportunities under joint development agreements.

***Off Balance Sheet Arrangements***

As of December 31, 2005, the Company had \$1.0 million in outstanding letters of credit issued under the Revolver to guarantee its performance under certain contracts.

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

**Overview**

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

We derive the majority of our gaming revenues from the placement of gaming terminals, gaming terminal content licenses, and back-office equipment, which we collectively refer to as gaming equipment, under participation arrangements. To a lesser degree, we derive revenue from the placement of gaming equipment in the Washington State Class III market under lease-purchase or participation arrangements, and from the back-office fees generated by those video lottery systems. We also generate gaming revenues in return for providing the central determinant system for a network of gaming terminals operated by the New York State Division of the Lottery. A significantly smaller portion of our revenues is generated from the sale of gaming equipment in the Class III market in Washington State, except for a relatively few periods during which market conditions result in a temporary increase in the number of gaming terminals sold during the period (e.g., the opening of a new casino, or a change in the law that allows existing casinos to increase the number of gaming terminals permitted under prior law).

***Class II Market***

We derive our Class II gaming revenues from participation arrangements with our Native American customers. Under participation arrangements, we retain ownership of the gaming equipment installed at our customers' tribal gaming facilities, and receive revenue based on a percentage of the hold per day generated by each gaming system. Our portion of the hold per day is reported by us as Gaming revenue - Class II and represents the total amount that end users wager, less the total amount paid to end users for prizes, and the amounts retained by the facilities for their share of the hold. Our New Generation gaming system operates at a speed considerably faster than our Legacy system, generally resulting in end users playing a greater number of games on our New Generation system in the same amount of time. As a result of the faster speed of play and higher payout ratios, we believe that end users derive a higher level of satisfaction from playing our New Generation games. We believe that this enhanced satisfaction results in end users playing more games and for longer periods of time than on our Legacy system, resulting in higher play on our New Generation system. In July 2005, we introduced and began deploying our Gen5 gaming system to our Class II markets. The product is gradually replacing the Gen IV back-office system that we introduced in late 2003, and which enabled enhancements to prior systems to allow us to add bonus round games and wide-area progressive jackpots to our extensive library of game titles. The new Gen5 product features a more robust database for accounting, player tracking and database marketing, enhanced hardware and software redundancy, the ability to provide customers with currency accounting and player tracking support for third-party vendor games, and the ability to offer Class II and Class III compacted games on a single integrated system.

As the market has grown, we have seen new competitors with significant gaming experience and financial resources enter the Class II market. As the rules and regulations governing Class II gaming are clarified by court decisions and by new rule-making procedures, we expect there to be even more competition. New tribal-state compacts, such as the Oklahoma gaming legislation passed by referendum in 2004, has also led to increased competition from such competitors. In addition, we continue to experience an extended period of uncertainty relative to enforcement of existing restrictions on non-Class II devices, which is forcing us to continue competing against games that do not appear to comply with the published regulatory restrictions on Class II games. As a result of this increased competition in Oklahoma, and conversion to games played under the compact, we have and may continue to experience pressure on our pricing model and hold per day, with the result that gaming

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providers are competing on the basis of price as well as the entertainment value and technological superiority of their products. While we will continue to compete by regularly introducing new and more entertaining games with technological enhancements that we believe will appeal to end users, we believe that the level of revenue retained by our customers from their installed base of gaming terminals will become a more significant competitive factor, one that may require us to change the terms of our participation arrangements with customers. Consequently, we believe that a simple business model based upon the average hold per gaming terminal per day will become less relevant in predicting our performance, as our participation arrangements with customers become less standardized and more complex.

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

The majority of our Class III gaming equipment in Washington State have been sold to customers outright, for a one-time purchase price, and are reported in our results of operations as Gaming equipment, system sale and lease revenue. Certain game themes we use in the Class III market have been licensed from third parties and are resold to customers along with our Class III gaming terminals. Revenues from the sale of Class III gaming equipment are recognized when the units are delivered to the customer, and the licensed games installed. To a considerably lesser extent, we also enter into either participation arrangements or lease-purchase arrangements for our Class III gaming terminals, on terms similar to those used for our gaming terminals in the Class II market.

We also receive back-office fees based on a share of the hold per day from both leased and sold gaming equipment in Washington State. Back-office fees cover the service and maintenance costs for back-office servers installed in each facility to run our Class III games, as well as the cost of related software updates.

In December 2003, we installed the first gaming terminals for TILG in California. TILG is a one-touch game based on a simulated scratch-off lottery ticket, and employs our central determinant system technology. In January 2005, we removed all of the deployed TILG terminals, and redeployed a significant number of these original placements as Reel Time Bingo.

In May 2004, the Oklahoma Legislature passed legislation authorizing certain forms of gaming at racetracks, and additional types of games at tribal gaming facilities, pursuant to a tribal-state compact. This legislation was subject to approval in a statewide referendum, which was subsequently obtained in the November 2004 elections. The Oklahoma gaming legislation allows the tribes to sign a compact with the State of Oklahoma to operate an unlimited number of electronic instant bingo games, electronic bonanza-style bingo games, electronic amusement games, and non-house-banked tournament card games. In addition, certain horse tracks in Oklahoma will be allowed to operate a limited number of instant and bonanza-style bingo games and electronic amusement games. On March 30, 2005, our bonanza-style bingo games became the first such games played in the state. As of December 31, 2005, we had placed 1,229 gaming terminals at thirteen facilities that are operating under the Oklahoma compact.

### ***Charity and Commercial Bingo Market***

In December 2003, we began installing a high speed, standard bingo game for the charity market in Alabama, and as of December 31, 2005, we had 2,419 gaming terminals installed in three facilities. Charity bingo and other forms of charity gaming are operated by or for the benefit of nonprofit organizations for charitable, educational and other lawful purposes. These games are typically only interconnected within the gaming facility where the terminals are located. Regulation of charity gaming is vested with each individual state, and in some states, regulatory authority is delegated to county or municipal governmental units. We typically place gaming terminals under participation arrangements in the charity market and receive a percentage of the hold per day generated by each of the gaming terminals. In addition, during July 2004, we began installing a limited number of charity gaming units in the state of Louisiana.

### ***State Video Lottery Market***

Beginning in January 2004, we began the first operation of our central determinant system for the video lottery terminal network that the New York Lottery operates at licensed New York State racetrack casinos. As payment for providing and maintaining the central determinant system,

we receive a small portion of the network-wide hold per day.

***Promotional Sweepstakes System***

On December 15, 2005, we leased a promotional sweepstakes system to the Birmingham Race Course, a greyhound race course in Birmingham, Alabama. A promotional sweepstakes game allows a patron to obtain sweepstakes entries when purchasing products or services. There are a number of methods that allow a patron to redeem their sweepstakes entries, including having the predetermined outcome displayed by video card readers. On December 22, 2005, the local sheriff served a search warrant, issued by an Alabama state judge, on the Birmingham Race Course. Pursuant to a search warrant, the local sheriff shut down the promotional sweepstakes system that was operating at the facility. On January 31, 2006, the Alabama Circuit Court issued a Declaratory Judgment and Injunction that declared that the Promotional Sweepstakes game is legal under Alabama law (see Recent Developments ). We provide the promotional sweepstakes system, including the video card readers to the facility under a lease arrangement.



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### ***Development Agreements***

As we seek to continue the growth in our customer base and to expand our installed base of linked gaming terminals, a key element of our strategy has become entering into joint development agreements with various Native American tribes to help fund new or expand existing tribal gaming facilities. Pursuant to these agreements, we advance funds to the tribes for the construction of new tribal gaming facilities or for the expansion of existing facilities. The agreements typically provide that a portion of the amounts retained by the gaming facility for their share of the hold per day be used to repay some or all of the advances.

Amounts advanced that are in excess of those to be reimbursed by such tribes for real property and land improvements are allocated to an other asset and are generally amortized over the life of the contract. Amounts advanced that relate to personal property owned by us and located at the tribal gaming facility are carried in our property and equipment, and depreciated over the estimated useful life of the asset.

In return for the amounts advanced by us, we received a commitment for a fixed number of gaming terminal placements in the facility, and a fixed percentage of the hold per day from those units over the term of the agreement. Certain of the agreements contain performance standards for our gaming terminals that could allow the facility to reduce a portion of our gaming terminals. To date, we have entered into development agreements for an aggregate commitment to advance approximately \$159.0 million. As of December 31, 2005, we had advanced a total of \$112.9 million under such agreements and expect to advance the remaining \$46.1 million over the next twelve to twenty-four months.

We are in various stages of discussion with new and existing tribal customers to provide funding for similar opportunities under additional development agreements.

### ***Research and Development***

Research and development activities primarily relate to the development of new gaming systems, gaming engines, player tracking systems, casino data management systems, central video lottery systems, gaming platforms and content, and enhancements to our existing product lines. Research and development costs consist primarily of salaries and benefits, consulting fees, and an allocation of corporate facilities costs related to these activities. Once the technological feasibility of a project has been established, the project is transferred from research to development, and capitalization begins.

Research and development expenses increased by 15.0% to \$4.8 million for the three months ended December 31, 2005, from \$4.1 million for the comparable period in the prior fiscal year. This increase primarily resulted from an increased headcount in our development group as we have focused our internal efforts on developing new gaming systems and game themes.

### **Recent Developments**

#### ***Promotional Sweepstakes System***

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

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

That same day, the Circuit Court in Jefferson County, Alabama, or the Alabama Circuit Court, issued a temporary restraining order preventing the Jefferson County Sheriff from removing additional units, and essentially freezing matters until the January 3, 2006 hearing. In fact, the judge had issued a preliminary injunction, which had the same effect as the temporary restraining order noted above until further notice of the court.

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On January 4, 2006, the Alabama Circuit Court issued an order in the case of Jefferson County Racing Association v. Hale, Civil Action No. CV 2005-07684, granting plaintiffs' motions that, (a) commencing on January 5, 2006, the law enforcement officials return all equipment, information and information media seized from the Birmingham Race Course on December 22, 2005, and (b) plaintiffs may begin immediate repairs and reinstallation of the equipment at the Birmingham Race Course. The court order prohibited operation of the games at the Birmingham Race Course without further order of the court. The parties were required to work with a mediator to develop and submit a stipulated version of the facts in the case, and to file briefs with the court by January 13, 2006, in connection with a January 17, 2006 hearing. Innovative filed a motion to intervene in the case. The Alabama Circuit Court allowed the intervention and aligned Innovative with the plaintiff.

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

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

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

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

This decision can be appealed within 42 days from the date of the Order and can be extended under certain circumstances

***Johnson Act***

Recently, the DOJ made available to the public proposed legislation the agency has drafted amending the Johnson Act. The proposed legislation, if enacted, could materially and adversely affect our Class II gaming market. The proposed legislation would classify electronic technological aids used by Native American tribes in Class II games, such as bingo, as gambling devices, and would authorize the use of such Class II devices by Native American tribes only if such devices are certified by the National Indian Gaming Commission, or NIGC, as Class II technological aids. The proposed legislation establishes criteria that must be met in order for the NIGC to certify the gambling devices as a Class II technological aid. The criteria would restrict the speed of the Class II games, as well as the depictions and graphics used in the games, thereby rendering the game potentially less appealing to the customers.

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

The following tables outline our end-of-period and average installed base of gaming terminals for the three months ended December 31, 2005 and 2004:

|   | <b>At December 31,</b> |             |
|---|------------------------|-------------|
|   | <b>2005</b>            | <b>2004</b> |
| <b>End-of-period installed gaming terminal base</b> |                        |             |
| Class II gaming terminals                           |                        |             |
| Reel Time Bingo                                     | 8,915                  | 9,857       |
| Legacy system                                       | 390                    | 705         |
| Oklahoma compacted games                            | 1,229                  |             |
| Other gaming terminals                              | 2,589                  | 5,617       |

|  | <b>Three Months Ended<br/>December 31,</b> |             |
|--|--|-------------|
|  | <b>2005</b>                                | <b>2004</b> |
| <b>Average installed gaming terminal base:</b> |  |             |
| Class II gaming terminals                      |  |             |
| Reel Time Bingo                                | 9,283                                      | 10,061      |
| Legacy system                                  | 436  | 798         |
| Oklahoma compacted games                       | 1,105                                      |             |
| Other gaming terminals                         | 2,572                                      | 4,232       |

**Three Months Ended December 31, 2005, Compared to Three Months Ended December 31, 2004**

Total revenues for the three months ended December 31, 2005 were \$34.0 million, compared to \$39.2 million for the same period of 2004. The revenue decrease was primarily driven by the decline of Class II gaming and TILG revenues discussed below.

***Gaming Revenue Class II***

Class II gaming revenues decreased by \$3.3 million, or 12%, from \$27.7 million in the three months ended December 31, 2004, to \$24.4 million in the three months ended December 31, 2005.

Legacy revenue decreased \$700,000, or 48%, to \$753,000 in the three months ended December 31, 2005, from \$1.5 million in the three months ended December 31, 2004. The average installed base of Legacy gaming terminals decreased 45%, which was partially offset by a 6% increase in hold per day.

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Reel Time Bingo revenue was \$23.7 million for the quarter ended December 31, 2005, compared to \$26.2 million in the quarter ended December 31, 2004, a \$2.6 million, or 10% decrease. The average installed base of gaming terminals decreased 8%, but was partially offset by a 7% higher average hold per day. During fiscal 2005 and the first quarter of fiscal 2006, 1,294 Reel Time Bingo gaming terminals were converted to games played under the compact, and generated \$1.8 million in first quarter 2006 revenues, which are included in all other gaming revenues.

Accretion of contract rights related to development agreements, which is recorded as a reduction of revenue, increased \$656,000, to \$982,000 in the three months ended December 31, 2005, compared to \$326,000 in the three months ended December 31, 2004.

### *Gaming Revenue*   *Charity*

Charity gaming revenues increased 1%, to \$4.7 million for the December 2005 quarter, compared to \$4.6 million for the same quarter of 2004. The average installed gaming terminal base increased 15% in the three months ended December 31, 2005, compared to the same period in 2004, but was partially offset by a 13% decrease in the average hold per day, resulting from facilities increasing their install base to maximize earnings.

As of December 31, 2005, we had an installed player terminal base of 2,589 units in the charity market, compared to 2,237 units in the prior year.

**Table of Contents****Gaming Revenue All Other**

Class III rental and back-office fees decreased 2%, to \$1.3 million in the three months ended December 31, 2005, from \$1.3 million during the same period of 2004.

In March 2005, we began converting Reel Time Bingo gaming terminals to games that could be played under the Oklahoma compact. These games generated revenue of \$1.8 million in the three months ended December 31, 2005, compared to no revenue during the same period of 2004.

Other recurring gaming revenue generated from TILG decreased to no revenue for the quarter ended December 31, 2005, compared to \$3.5 million in same quarter of 2004. The decrease relates to the fiscal 2005 second-quarter conversion of the remaining TILG POSTS to Reel Time Bingo

Revenues from the New York Lottery system increased \$127,000 in the three months ended December 31, 2005, from \$430,000 in the three months ended December 31, 2004. Currently, five of the eight planned racetrack casinos are operating, with approximately 5,600 total terminals. To date, we have realized substantially less revenue than anticipated from our New York Lottery operations, in significant part due to delays in the opening of planned racetrack casino operations at several racetracks. We are nevertheless required to incur ongoing expenses associated with development and maintenance of the New York video lottery system, and we do not currently expect to have profitable operations there until one or more of the larger racetrack casinos open.

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

|   | Three Months ended |        |      |      |
|---|--------------------|--------|------|------|
|   | December 31,       |        |      |      |
|   | 2005               |        |      | 2004 |
|   | 2005               | 2004   | 2005 | 2004 |
| Gaming equipment and system revenue       | \$ 336             | \$ 644 |      |      |
| Cost of gaming equipment and systems sold | (104)              | (416)  |      |      |
|   | 232                | 69%    | 228  | 35%  |
| License revenue                           | \$ 289             | \$ 350 |      |      |
| Cost of licenses sold                     | (179)              | (88)   |      |      |
|   | 110                | 38%    | 262  | 75%  |
| Cost of royalty fees                      | 312                |        | 337  |      |

Gaming terminal and system revenue reflected no sales of gaming terminals in the three months ending December 31, 2005, compared to 43 gaming terminals in the three months ending December 31, 2004. In the periods ending December 31, 2005 and 2004, gaming equipment sale revenue included revenues of \$281,000 for both quarters and cost of sales of \$70,000 and \$159,000, respectively, related to a certain equipment sale being recognized ratably over the term of the agreement. Margins on licenses sold decreased as a licensed third-party participation game introduced in the second quarter of fiscal 2004 has a lower margin than the outright sale of the license. Royalty fees decreased due to lower

revenue on some licensed game themes in play.

Selling, general and administrative expenses decreased to \$16.0 million for the three months ended December 31, 2005, from \$16.8 million in the same period of 2004. Stock-based compensation expense of \$678,000 was included in SG&A expense for the three months ended December 31, 2005, while no stock-based compensation expense was recorded in the same period of 2004. Consulting and contract labor decreased \$1.2 million, due to decreased commissions in the California TILG market. Repairs and maintenance, transportation, and related cost decreased by \$498,000 due to deployment costs incurred in the first quarter of fiscal 2005 for the launch of TILG. The decrease was offset by the continued higher salaries and wages and the related employee benefits and taxes, which increased approximately \$67,000 due to the additional personnel hired to develop our gaming systems and content, and to monitor and develop proposals to address opportunities in both domestic and international markets. At December 31, 2005, we employed 476 full-time and part-time employees, compared to 460 at December 31, 2004. Legal, professional and lobbying fees increased approximately \$195,000, primarily as a result of increased legal and professional services related to our research of new products, entry into new markets and Sarbanes-Oxley consulting costs.

Effective September 30, 2005, we accelerated the vesting for certain out-of-the-money unvested stock options previously awarded to employees and directors under our stock option plans. We made the decision to immediately vest these options to avoid future compensation expense related to those options upon adoption of Financial Accounting Standards Board's, or FASB's issuance of Statement of Financial Accounting Standards, or

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SFAS No. 123 (R). With this action, options to purchase 311,625 shares of our common stock, at prices ranging from \$10.15 to \$21.53, that would otherwise have vested at various times over the next four years, became fully vested. Absent the acceleration of these options, upon adoption of SFAS No. 123 (R) on October 1, 2005, we would have been required to recognize approximately \$1.5 million in compensation expense from these options over their remaining vesting terms, which will, as a result, only be reflected in our footnote disclosures.

Depreciation expense increased 1%, to \$12.6 million for the three months ended December 31, 2005, from \$12.5 million in 2004, primarily as a result of a the increase in the number of gaming terminals in our rental pool. Amortization expense increased to \$1.7 million for the quarter ended December 2005, compared to \$810,000 for the same quarter of 2004. The majority of the increase was related to amortization of license agreements for gaming content and internally developed software.

Interest income increased to \$481,000 for the three months ended December 31, 2005, from \$433,000 in the same period of 2004, due to the higher balance of notes receivable bearing variable interest rates.

Interest expense increased 74%, to \$966,000 for the first fiscal quarter of 2006, from \$554,000 for the same quarter of fiscal 2004, due primarily to an increase in amounts outstanding under our Credit Facility. As we continue to fund our capital commitments pursuant to our development agreements and otherwise, we will likely be required to borrow more money under our Credit Facility. As a result, our interest expense will likely continue to increase in the future.

Income tax expense decreased \$1.9 million to \$1.1 million for the three months ended December 31, 2005, from \$3.1 million in the same period of 2004. These figures represent effective tax rates of 42.4% and 38.0% for the three months ended December 31, 2005 and 2004, respectively. SFAS No. 123 (R) includes several modifications to the way that income taxes are recorded in the financial statements. The expense for certain types of option grants is only deductible for tax purposes at the time that the taxable event takes place, which could cause variability in our effective tax rates recorded throughout our fiscal year. The higher effective tax rate for the three months ended December 31, 2005, was primarily a result of the timing of such deductibility of stock options.

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

## **RECENT ACCOUNTING PRONOUNCEMENTS ISSUE**

In December 2004, the Financial Accounting Standards Board, or FASB, issued Statement of Financial Accounting Standards, or SFAS No. 123(R), Share-Based Payment. SFAS 123(R) will provide investors and other users of financial statements with more complete and neutral financial information by requiring that the compensation cost relating to share-based payment transactions be recognized in financial statements. That cost will be measured based on the fair value of the equity or liability instruments issued. SFAS 123(R) covers a wide range of share-based compensation arrangements, including share options, restricted share plans, performance-based awards, share appreciation rights, and employee share purchase plans. SFAS 123(R) replaces FASB SFAS 123, Accounting for Stock-Based Compensation, and supersedes APB Opinion No. 25, Accounting for Stock Issued to Employees.



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SFAS 123, as originally issued in 1995, established as preferable a fair-value-based method of accounting for share-based payment transactions with employees. However, that Statement permitted entities the option of continuing to apply the guidance in Opinion 25, as long as the footnotes to financial statements disclosed what net income would have been had the preferable fair-value-based method been used. Public entities (other than those filing as small business issuers) are required to apply SFAS 123(R) as of the first interim or annual reporting period that begins after June 15, 2005. In April 2005, the Securities and Exchange Commission adopted a rule that amended the required application date of 123(R) from interim or annual reporting periods beginning after June 15, 2005, to the beginning of the entity's next fiscal year. We adopted SFAS 123(R) on October 1, 2005, the effects of which are discussed under Results of Operations.

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

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In May 2005, the FASB issued SFAS No. 154, Accounting Changes and Error Corrections, a replacement of APB Opinion No. 20 and FASB SFAS No. 3, which changes the requirements for the accounting for and reporting of a change in accounting principle. SFAS No. 154 applies to all voluntary changes in accounting principles and also to changes required by an accounting pronouncement that does not contain specific transition provisions. SFAS No. 154 carries forward without change the guidance contained in APB Opinion No. 20, Accounting Changes, for reporting the correction of an error in previously issued financial statements and a change in accounting estimate. SFAS No. 154 is effective for accounting changes and corrections of errors made in fiscal years beginning after December 15, 2005. We will be adopting SFAS No. 154, effective October 1, 2006, and do not expect the adoption to have a material impact on our financial position and results of operations. SFAS No. 154 does not change the transition provisions of any existing accounting pronouncements.

## **CRITICAL ACCOUNTING POLICIES**

We prepare our consolidated financial statements in conformity with accounting principles generally accepted in the United States of America. As such, we are required to make certain estimates, judgments and assumptions that we believe are reasonable based on the information available. These estimates and assumptions affect the reported amounts of assets and liabilities at the date of the financial statements, and the reported amounts of revenues and expenses during the periods presented. There can be no assurance that actual results will not differ from those estimates. We believe the following represent our most critical accounting policies.

**Revenue Recognition.** The majority of our gaming revenue is of a recurring nature and is generated by providing customers with gaming terminals, gaming terminal content licenses and back-office equipment, which are collectively referred to as gaming equipment, under participation arrangements. Under these arrangements, we retain ownership of the gaming equipment installed at customer facilities, and receive revenue based on a percentage of the hold per day generated by the gaming equipment. Certain of our arrangements require a portion of the facilities' hold per day to be set aside to be used to fund facility-specific marketing, advertising, promotions, and service. These amounts are offset against revenue, and are deferred in a liability account until expended.

We also generate revenues from the sale or lease of Class III gaming equipment in Washington State and from related back-office fees based on a share of the hold per day of the installed equipment. Back-office fees cover the service and maintenance costs for back-office servers installed in each gaming facility to run its gaming equipment, as well as the cost of related software updates. For those gaming terminals sold to our customers, the back-office fees are based on a considerably smaller percentage of the hold per day than the revenue share received from terminals being rented under participation agreements.

Revenue from participation arrangements and back-office fees are generally considered both realizable and earned at the end of each gaming day.

We provide gaming solutions to domestic and international lottery organizations through a combination of gaming equipment and gaming systems that utilize central determinant system technology. The equipment and systems are either sold outright for a one-time fee, or are provided on a participation basis, whereby we receive a small portion of the network-wide hold.

We also market a modular suite of software gaming support products, such as player tracking, which enables operators to monitor, manage and track player activity, and slot accounting systems, slot management systems, and slot monitoring systems, collectively referred to as the MGAMe System. The MGAMe system is either sold to customers as a complete system or on a module-by-module basis for a one-time license fee and a recurring fee for post-customer support, or is provided under a participation arrangement.

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Revenue from the sale of software is accounted for under Statement of Position 97-2, Software Revenue Recognition, or SOP 97-2. If vendor-specific objective evidence of fair value does not exist, the revenue is deferred until such time that all elements have been delivered or services have been performed. If any element is determined to be essential to the function of the other, revenues are generally recognized utilizing the subscription method of accounting over the term of the services that are rendered.

In accordance with the provisions of Emerging Issues Task Force, or EITF, Issue 00-21, Revenue Arrangements with Multiple Deliverables, or EITF 00-21, sales that are considered to contain multiple deliverables are bifurcated into accounting units based on their relative fair market value, provided each component is not essential to the function of the other. The majority of our multiple-element contracts are for some combination of gaming terminals, content, system software, license fees and maintenance.

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Revenues from the stand-alone product sales or separate accounting units are recorded when: a) persuasive evidence of an arrangement exists and the sales price is fixed and determinable; b) delivery has occurred and services have been rendered; and c) collectibility is reasonably assured.

The application of revenue recognition policies is critical, due to the nature of the product sale or license contracts we execute. Revenue recognition for the sale or license of our gaming systems is complex and involves judgment in: a) identifying multiple deliverables, since each system contract is generally unique; b) determining the interoperability of certain elements of our hardware and software; and c) assessing the creditworthiness of our customers. While we believe our assumptions are reasonable, these factors significantly influence our decision to recognize or defer revenue from each gaming system, and if different, could materially affect the timing of our revenues.

***Property and Equipment and Leased Gaming Equipment.*** The cost of property and equipment and leased gaming equipment is depreciated over their estimated useful lives, generally using the straight-line method for financial reporting, and accelerated methods for tax reporting purposes. A majority of our assets are susceptible to changes in technology and changes in the competitive marketplace, influencing customer preferences in such things as cabinet styles or game titles. These factors could cause us to evaluate and change the estimated lives used to depreciate assets.

Furthermore, we review our property and equipment and leased gaming equipment for impairment whenever events or changes in circumstances, such as technological obsolescence or customer preferences, indicate we may not recover the carrying amount of an asset. We measure recoverability of assets to be held and used by comparing the carrying amount of an asset to future cash flows expected to be generated by the asset. While we believe that our estimates and assumptions used in evaluating the carrying amount of these assets are reasonable, different assumptions could materially affect either the carrying amount or the estimated useful lives of the assets.

***Development Agreements.*** We enter into development agreements to provide financing for new tribal gaming facilities, or for the expansion of existing facilities. In return, the customer commits to a fixed number of gaming terminal placements in the facility, and we receive a fixed percentage of those gaming terminals hold per day over the term of the agreement. Certain of the agreements contain performance standards for our gaming terminals that could allow the facility to reduce a portion of our guaranteed floor space. The agreements typically provide for a portion of the amounts retained by the gaming facility for their share of the hold to be used for repayment of some or all of the advances. Amounts advanced in excess of those reimbursed by the customer for real property and land improvements are allocated to intangible assets and amortized over the life of the contract. Amounts related to personal property owned by us and located at the tribal gaming facility are carried in our property and equipment and depreciated over the estimated useful life of the related asset or the contract life, whichever is shorter.

Generally, we utilize the term of a contract to amortize the intangible assets associated with development agreements. We review the carrying value of these contract rights at least annually, or whenever changes in circumstances indicate the carrying value of these assets may not be recoverable. While we believe that our estimates and assumptions used in evaluating the carrying value of these assets are reasonable, different assumptions could materially affect either the carrying value or the estimated useful lives of the contract rights.

***Allowance for Doubtful Accounts.*** We maintain an allowance for doubtful accounts related to our accounts receivable and notes receivable that have been deemed to have a high risk of collectibility. We review our accounts receivable and notes receivable on a monthly basis to determine if any receivables will potentially be uncollectible. We analyze historical collection trends and changes in our customers' payment patterns, customer concentration, and creditworthiness when evaluating the adequacy of our allowance for doubtful accounts. A large percentage of receivables are with Native American tribes that have their reservations and gaming operations in the state of Oklahoma, and we have concentrations of credit risk with several tribes. Despite the industry, geographic and customer concentrations related to our receivables, due to our historical experience with receivable collections, management considers credit risk to be minimal with respect to accounts receivable. We include any receivable balances that are determined to be uncollectible in our overall allowance for doubtful accounts. Changes in our

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assumptions or estimates reflecting the collectibility of certain accounts could materially affect our allowance for both trade and notes receivable.

At December 31, 2005 and 2004, our allowance for doubtful trade accounts and notes receivable was \$270,000 and \$679,000, respectively.

**Income Taxes.** We apply the provisions of SFAS No. 109 Accounting for Income Taxes. Under SFAS No. 109, deferred tax liabilities or assets arise from differences between the tax basis of liabilities or assets and their basis for

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financial reporting, and are subject to tests of recoverability in the case of deferred tax assets. Deferred tax assets and liabilities are recognized for the future tax consequences attributable to differences between the financial statements carrying amounts of assets and liabilities and their respective tax basis. Deferred tax assets and liabilities are measured using enacted tax rates expected to apply to taxable income in the years in which those temporary differences are expected to be recovered or settled. The effect on deferred tax assets and liabilities of a change in tax rates is recognized in the period that includes the enactment date.

The accounting for income taxes involves significant judgments and estimates, and deals with complex tax regulations. The recoverability of certain deferred tax assets is based in part on estimates of future income and the timing of temporary differences, and the failure to fully realize such deferred tax assets could result in a higher tax provision in future periods.

At December 31, 2005 and September 30, 2005 our net deferred tax asset (liability) totaled \$1.5 million and \$(1.2) million, respectively.

**LIQUIDITY AND CAPITAL RESOURCES**

At December 31, 2005, we had unrestricted cash and cash equivalents of \$5.7 million, compared to \$118,000 at September 30, 2005. Our working capital deficit at December 31, 2005 increased to a working capital deficit of \$21.4 million, compared to \$19.4 million at September 30, 2005. The working capital deficit as of December 31, 2005 was the result of our repurchases of treasury stock, our continued investment in development agreements, and acquisition of property and equipment and leased gaming equipment. During 2005, we used \$1.1 million to purchase treasury stock, \$9.0 million for capital expenditures of property and equipment, and advanced \$3.2 million, net of amounts reimbursed, under development agreements. At September 30, 2005, none of the lines of credit were current and at December 31, 2005, \$9.3 million was due within twelve months.

As of December 31, 2005, our total contractual cash obligations were as follows (in thousands):

|   | Less than        |                  | More than       |                 | Total             |
|---|------------------|------------------|-----------------|-----------------|-------------------|
|   | 1 year           | 1-3 years        | 3-5 years       | 5 years         |                   |
| Revolving lines of credit <sup>(1)</sup>                    | \$ 9,985         | \$ 28,192        | \$ 5,123        | \$              | \$ 43,300         |
| Long-term debt <sup>(2)</sup>                               | 9,558            | 4,555            | 75              |                 | 14,188            |
| Capital leases <sup>(3)</sup>                               | 3,330            | 357              |                 |                 | 3,687             |
| Operating leases <sup>(4)</sup>                             | 1,537            | 2,842            | 2,321           |                 | 6,700             |
| Purchase commitments <sup>(5)</sup>                         | 1,894            | 2,038            | 288             | 1,524           | 5,744             |
| Payments due under employment agreement <sup>(6)</sup>      | 250              | 500              | 500             | 2,021           | 3,271             |
| Gaming facility joint development agreements <sup>(7)</sup> | 33,462           | 12,609           |                 |                 | 46,071            |
| <b>Total</b>  | <b>\$ 60,016</b> | <b>\$ 51,093</b> | <b>\$ 8,307</b> | <b>\$ 3,545</b> | <b>\$ 122,961</b> |

(1) The revolving credit lines bear interest at a rate of Prime (7.25% as of December 31, 2005).

(2) Consists of various three-to-five-year loans for the purchase of automobiles and property and equipment at an overall average annual interest rate of 7.49%, a five-year loan related to financing our corporate aircraft at an annual interest rate of LIBOR plus 2.75% (7.57% as of December 31, 2005), and amounts borrowed under our Credit Facility at annual interest rate of Prime (7.25% as of December 31, 2005).

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- (3) Consists of various three-year capital leases for property and equipment at an overall average annual interest rate of 7.39%.
- (4) Consists of operating leases for our facilities and office equipment that expire at various times through 2010.
- (5) Consists of commitments to order third-party license agreements and for the purchase of gaming terminals.
- (6) Represents the expected future payments due, based on life expectancy tables, to Gordon Graves for his noncompete agreement entered into under his Employment Agreement.
- (7) Represents commitments for payments toward development and construction and/or expansion of tribal gaming facilities. For purposes of this table, cash obligations under development agreements are considered payable over the next twelve to twenty-four months, although the actual timing of payments may extend beyond twenty-four months, depending on the number and schedule of development projects ongoing at any given time.

During the quarter ended December 31, 2005, we generated \$14.7 million in cash from our operations, compared to \$12.4 million during the same period of 2004. This \$2.3 million increase in cash generated from operations over the prior period was primarily due to the timing of collections, including \$4.0 million collected on our Israel lottery contract.

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Cash used in investing activities decreased to \$13.5 million in the quarter ended December 31, 2005, from \$30.1 million in the same period of 2004. The decrease was primarily the result of a \$14.4 million decrease in acquisitions of property and equipment. During the quarter ended December 31, 2005, additions to property and equipment consisted of:

|   | Cash              | Financed          |                   |
|---|-------------------|-------------------|-------------------|
|   | Capital           | Capital           |                   |
|   | Expenditures      | Expenditures      | Total             |
|   | <u>          </u> | <u>          </u> | <u>          </u> |
| Gaming equipment                                | \$ 7,680          | \$                | \$ 7,680          |
| Third-party gaming content licenses             | 1,223             |                   | 1,223             |
| Tribal gaming facilities and portable buildings | 47                |                   | 47                |
| Other   | 2                 |                   | 2                 |
|   | <u>          </u> | <u>          </u> | <u>          </u> |
| <b>Total</b>                                    | <b>\$ 8,952</b>   | <b>\$</b>         | <b>\$ 8,952</b>   |
|   | <u>          </u> | <u>          </u> | <u>          </u> |

Cash provided by financing activities for the quarter ended December 31, 2005 was \$4.4 million, compared to \$19.0 million in the same period of 2004. During the first quarter of fiscal 2005, we received \$10.0 million from the proceeds of long-term debt. During the first quarter of fiscal 2006, we drew a net of \$9.0 million under our revolving lines of credit compared to \$10.4 million in the same period of fiscal 2005. During the quarter ended December 31, 2005, we repurchased 120,846 shares of treasury stock for a total cash consideration of \$1.1 million, and we expect to continue repurchasing shares during the remainder of fiscal 2006, as discussed under Stock Repurchase Authorizations.

Our projected capital expenditures for the next year will consist of gaming terminals and related gaming equipment that are placed with our customers under participation arrangements, to which we have committed \$1.9 million under purchase arrangements with certain vendors, substantial capital outlays of approximately \$33.5 million in connection with the joint development of new and expanded tribal gaming facilities, increased costs of maintaining and/or upgrading our rental pool of gaming terminals, and may include substantial capital expenditures in connection with potential acquisitions. In our strategy to partner with current and prospective customers to jointly develop tribal gaming facilities that will house our gaming terminals, and in pursuing any potential acquisitions, we may make expenditures that could significantly affect our cash flow and liquidity, and use a significant portion of both our cash flow from operations and any proceeds we receive from debt or equity financing we might undertake. Our total capital expenditures will depend upon the number of gaming terminals that we are able to place in service during the year, as well as the number and size of tribal gaming facilities we develop under existing or future agreements. Additional capital expenditures will be required for gaming terminals if we are successful in introducing our games into new markets, such as additional charity bingo markets. In addition to manufacturing our own, we also purchase gaming terminals from Alliance Gaming, Inc., or Alliance, and WMS Gaming Inc., or WMS, and licenses from Alliance, WMS, and Progressive Gaming International Corporation, or Progressive (formerly Mikohn Gaming Corporation).

To date, we have entered into development agreements with our customers to provide up to \$159.0 million towards the construction of tribal gaming facilities. The development agreements typically require that some or all of the construction advances be repaid to us. As of December 31, 2005, we had advanced a total of \$112.9 million under such agreements, and expect to advance the remaining \$46.1 million over the next twelve to twenty-four months.

At December 31, 2005, our debt structure consisted of a Credit Facility, which provided us with a \$20.0 million term loan facility, or the Term Loan, a \$15.0 million revolving line of credit, and a \$35.0 million reducing revolving line of credit. As of December 31, 2005, we had drawn \$20.2 million under the Term Loan and had \$36.7 million outstanding under the revolving lines of credit.



The Credit Facility contains financial covenants, as defined in the agreement, that include a maximum indebtedness to EBITDA ratio of 1.50:1.00, a maximum total liabilities to tangible net worth ratio of 1.25:1.00, a minimum trailing twelve month EBITDA of \$60.0 million and a maximum rolling four-quarter capital expenditures rate, including advances made under development agreements, of \$175.0 million. We were in compliance with these covenants as of December 31, 2005.

We believe that our existing cash and cash equivalents, cash provided from our operations, and amounts available under our Credit Facility can sustain our current operations, which will include a portion of the financing required from us in connection with our development agreements, depending upon the timing and mix of those projects.

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

### ***Stock Repurchase Authorizations***

Our Board of Directors authorized us to repurchase 900,000 shares of our common stock, effective April 2000, an additional 3,000,000 shares of our common stock, effective September 2001, and an additional 748,690 shares of our common stock, effective July 2004. The timing and total number of shares repurchased will depend upon prevailing market conditions and other investment opportunities. At December 31, 2005, there were approximately 925,000 shares authorized for repurchase.

During the fiscal year ending September 2005, we repurchased 1,216,591 shares of our common stock with cash, at an average cost of \$8.96. We repurchased an additional 120,846 shares of our common stock with cash, at an average cost of \$9.16, during the quarter ended December 31, 2005.

At December 31, 2005, we had approximately 5.7 million options outstanding, with exercise prices ranging from \$1.00 to \$21.53 per share. At December 31, 2005, approximately 4.5 million of the outstanding options were exercisable.

### **SEASONALITY**

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

### **CONTINGENCIES**

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

### **INFLATION AND OTHER COST FACTORS**

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

### **FUTURE EXPECTATIONS AND FORWARD-LOOKING STATEMENTS**

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

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

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

In June 2003, we entered into a Credit Facility to provide us with additional liquidity to meet our short-term financing needs, as further described under PART I Item 1. Financial Statements Significant Accounting Policies Credit Facility, Long-Term Debt and Capital Leases. Pursuant to the Credit Facility, we may currently borrow up to a total of \$49.4 million under a \$15.0 million revolving line of credit and a \$35.0 million reducing revolving line of credit. The entire Credit Facility bears an adjustable interest rate of Prime.

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

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

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

We estimate that a hypothetical increase of 100 basis points in interest rates would increase our interest expense by approximately \$481,000, based on our variable debt outstanding of \$47.8 million as of December 31, 2005. We do not currently manage this exposure with derivative financial instruments.

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

***Evaluation of Disclosure Controls and Procedures.*** As of the end of the period covered by this report an evaluation was carried out under the supervision and with the participation of the Company's management, including its Chief Executive Officer and Chief Financial Officer, of the effectiveness of the design and operation of its disclosure controls and procedures (as defined in rules 13a-15(e) and 15d-15(e) under the Securities Exchange Act of 1934) to ensure information required to be disclosed in our filings under the Securities Exchange Act of 1934, is (i) recorded, processed, summarized and reported within the time periods specified in the Commission rules and forms and (ii) accumulated and communicated to our management, including our Chief Executive Officer and Chief Financial Officer, as appropriate to allow timely decisions regarding required disclosure. Management recognizes that any controls and procedures, no matter how well designed and operated, can only provide reasonable assurance of achieving desired control objectives and management is necessarily required to apply its judgment when evaluating the cost-benefit relationship of potential controls and procedures. Based upon the evaluation, the Chief Executive Officer and Chief Financial Officer concluded that the design and operation of these disclosure controls and procedures were effective as of December 31, 2005.

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

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**PART II**

**OTHER INFORMATION**

**ITEM 1. LEGAL PROCEEDINGS**

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

**ITEM 1A. RISK FACTORS**

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

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

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

The market for electronic Class II gaming terminals and systems is subject to continuing ambiguity due to the difficulty of reconciling the Johnson Act's broad definition of "gambling devices" with the provisions of IGRA that expressly make legal the play of bingo and tribes' use of "electronic, computer, or other technological aids" in the play of bingo. Issues surrounding the classification of our games as Class II games that may generally be offered by our tribal customers without a tribal-state compact, or as Class III games that can only be offered by the tribes pursuant to such a compact, have affected our business in the past, and continue to do so. Government enforcement, regulatory action, judicial

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decisions, or the prospects or rumors thereof have in the past and will continue to affect our business, operating results and prospects. Although some of our games have been reviewed and approved as legal Class II games by the NIGC, we have placed and continue to derive revenue from a significant number of gaming terminals running games that have not been so approved. Our business and operating results would likely be adversely affected, at least in the short term, by any significant regulatory enforcement action involving our games. The trading price of our common stock has in the past and may in the future be subject to significant fluctuations based upon market perceptions of the legal status of our products.

Native American gaming activities involving our games and systems are also subject to regulation by state and local authorities, to the extent such gaming activities constitute, or are perceived to constitute, Class III gaming. Class III gaming is illegal in most states unless conducted by a tribe pursuant to a compact between a tribe and the state in which the tribe is located. The Class III video lottery systems we offer, such as the systems and terminals operating in Washington State, are subject to regulation by authorities in that state and to the terms of the compacts between

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the tribes offering such games and the State of Washington. Gaming activities under the new tribal-state compact in Oklahoma will be subject to the terms of the compact between such tribes and the State of Oklahoma. Regulatory interpretations and enforcement actions by state regulators could have significant and immediate adverse impacts on our business and operating results.

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

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

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

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

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

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

The NIGC has recently determined that the magnetic stripe card system, employed by Native American gaming operations using the gaming system developed by us, is an account access card system as defined in the NIGC's Minimum Internal Control Standards regulation, thereby



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triggering certain recordkeeping requirements. An account access card is defined as an instrument to access customer accounts for wagering at a gaming machine. Account access cards are used in connection with a computerized database. Account access cards are not smart cards.

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

Currency fluctuations;

Higher operating costs due to local laws or regulations;

Unexpected changes in regulatory requirements;

Costs and risks of localizing products for foreign countries;

Difficulties in staffing and managing geographically disparate operations;

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

Challenges negotiating and enforcing contractual provisions;

Repatriation of earnings; and

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

Beginning in January 2004, we began the first operation of our central determinant system for the video lottery terminal network that the New York Lottery operates at licensed New York State racetrack casinos. As payment for providing and maintaining the central determinant system, we receive a small portion of the network-wide hold per day. To date, we have realized substantially less revenue than anticipated from our New York Lottery operations, in significant part due to delays in the opening of planned operations at several racetrack casinos. We are nevertheless required to incur ongoing expenses associated with the development and maintenance of the New York video lottery system, and we do not currently expect to have profitable operations there until one or more of the larger racetrack casinos are opened. Delays in the anticipated development of the New York video lottery system and other emerging market opportunities may continue to adversely affect our revenue and operating results.

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

project, and therefore the timing and possibility of actual revenue recognition may differ from our forecast.

We provide linked interactive electronic bingo systems and gaming terminals to charitable bingo operations in Alabama. During January 2004, we began placing gaming terminals in Alabama, and as of December 31, 2005, we had 2,419 gaming terminals at three facilities. The Attorney General of Alabama has recently completed a review of the gaming within the state. He concluded that the games that we were operating in Alabama were a legal form of bingo. He also concluded that two of the facilities are operating under a valid constitutional amendment authorizing the facilities the ability to play electronic bingo. The third facility is operating under a constitutional amendment that was flawed in its ratification. The Attorney General and his staff have indicated that they will file a declaratory judgment action asking the courts to invalidate this amendment as improperly ratified.

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

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

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

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

For the quarters ended December 31, 2005 and 2004, approximately 59% and 56%, respectively, of our gaming revenues were from Native American tribes located in Oklahoma, and approximately 40% and 33%, respectively, of our gaming revenues were from one tribe in that state. The significant concentration of our customers in Oklahoma means that local economic changes may adversely affect our customers, and therefore our business, disproportionately to changes in national economic conditions, including more sudden adverse economic declines or slower economic recovery from prior declines. The loss of any of our Oklahoma tribes as customers would have a material and adverse effect upon our financial condition and results of operations. In addition, the recent legislation allowing tribal-state compacts in Oklahoma could result in increased competition from other vendors, who we believe have avoided entry into the Class II market due to its uncertain and ambiguous legal environment. The new legislation allows for other types of gaming, both at tribal gaming facilities and at Oklahoma racetracks. The loss of significant market share to these new gaming opportunities or our competitors' products in Oklahoma could also have a material adverse effect upon our financial condition and results of operations.

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

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

In May 2004, the Oklahoma Legislature passed legislation authorizing certain forms of gaming at racetracks, and additional types of games at tribal gaming facilities, pursuant to a tribal-state compact. This legislation was subject to approval in a statewide referendum, which was subsequently obtained in the November 2004 elections. The Oklahoma gaming legislation allows the tribes to sign a compact with the State of Oklahoma to operate an unlimited number of electronic instant bingo games, electronic bonanza-style bingo games, electronic amusement games, and non-house-banked tournament card games. In addition, certain horse tracks in Oklahoma will be allowed to operate a limited number of instant and bonanza-style bingo games and electronic amusement games. On March 30, 2005, our bonanza-style bingo games became the first such games played in the state. As of September 30, we had placed more than 1,076 gaming terminals at thirteen facilities that are operating under the Oklahoma compact. All vendors placing games at any of the racetracks under the compact will ultimately be required to be licensed by the State of Oklahoma. Pursuant to the compacts, vendors placing games at tribal facilities will have to be licensed by each tribe. All electronic games placed under the compact will have to be certified by independent testing laboratories to meet technical specifications. These were published by the Oklahoma Horse Racing Commission and the individual tribal gaming authorities in the first calendar quarter of 2005.

We believe the recently adopted Oklahoma legislation significantly clarifies and expands the types of gaming permitted by Native American tribes in that state. We currently expect continued intensified competition from vendors currently operating in Oklahoma as well as from new market entrants. As a result, we anticipate further pressure on our market and revenue share percentages in Oklahoma. In addition, in the immediate future, we expect continued regulatory uncertainty in Oklahoma. In particular, although we and other vendors may not begin to offer games enabled by the new legislation until state and tribal regulations, and rules and specifications adopted pursuant to that legislation become final, certain other vendors and tribes may begin to offer new games prior to that time. It is unclear what, if any, regulatory enforcement action

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could or would be taken against tribes and vendors offering games not authorized by existing law but permitted under the newly adopted, but not yet effective, legislation. New opportunities in the Oklahoma market resulting from the recent legislation may not develop as we anticipate, or may take longer to develop than we expected. Further, we may offer games similar to those games that do not appear to comply with published regulatory restrictions on Class II games, in an effort to compete on an equal footing. These games may be the subject of enforcement actions against us.

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The new legislation requires Oklahoma tribes to develop their own vendor licensing procedures. Some of our Oklahoma tribal customers have developed these procedures, and others are in the process of defining the procedures. For that reason, deployment of games to be operated under a compact in Oklahoma is proceeding at an erratic pace and will continue to do so for many months. Moreover, tribal policies and procedures, as well as tribal selection of gaming vendors, are subject to the political and governance environment within the tribe. Changes in tribal leadership or tribal political pressure can affect our relationships with our customers. As a result of these and other considerations, it remains difficult to forecast the short-term impact on our business from the recent Oklahoma gaming legislation.

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

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

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

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

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

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

We compete with other vendors for customers, primarily on the basis of the amount of profit our gaming products generate for our customers in relation to other vendors gaming products. We believe that the most important factor influencing our customers product selection is the appeal of



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those products to end users. This appeal has a direct effect on the volume of play by end users, and drives the amount of revenues generated for and by our customers. Our ability to remain competitive depends primarily on our ability to continuously develop new game themes and systems that appeal to end users, and to introduce those game themes and systems in a timely manner. See Certain Risk Factors Our future performance will depend on our ability to develop and introduce new gaming systems and to enhance existing games that are widely accepted and played. We may not be able to continue to develop and introduce appealing new game themes and systems that meet the emerging requirements in a timely manner, or at all. In addition, others may independently develop games similar to our games, and competitors may introduce

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noncompliant games that unfairly compete in certain markets due to uneven regulatory enforcement policies. In addition, we have lost certain end users based upon our decision not to place pre-drawn games in the field that would be covered under the Oklahoma compact, but in advance of the effective date of the compact. After we are able to place the compacted games, it may take some time, if ever, to regain the players that we previously lost.

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

If certain of our development agreements are finally determined to be management contracts or to create a proprietary interest of ours in tribal gaming operations, there could be material adverse consequences to us. In that event, we may be required, among other things, to modify the terms of such agreements. Such modification may adversely affect the terms on which we conduct business, and have significant impact on our financial condition and results of operations from such agreements and from other development agreements that may be similarly interpreted by the NIGC.

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

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

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

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

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

governs.

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

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

Our contracts with Native American customers include a limited waiver of each tribe's sovereign immunity, and generally provide that any dispute regarding interpretation, performance or enforcement shall be submitted to, and resolved by, arbitration in accordance with the Commercial Arbitration Rules of the American Arbitration Association, and that any award, determination, order or relief resulting from such arbitration is binding and may be

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entered in any court having jurisdiction. In the event that such waiver of sovereign immunity is held to be ineffective, we could be precluded from judicially enforcing any rights or remedies against a tribe. These rights and remedies include, but are not limited to, our right to enter Native American lands to retrieve our property in the event of a breach of contract by the tribe party to that contract.

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

### **We may incur prize payouts in excess of game revenues.**

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

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

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

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

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



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

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

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

**Worsening economic conditions may adversely affect our business.**

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

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

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

**Summary of Stock Repurchases**

(Unaudited)

|                                       | <b>Total Number of<br/>Shares<br/>Purchased</b> | <b>Average Price<br/>Paid per Share</b> | <b>Total Number of<br/>Shares Purchased as<br/>Part of Publicly<br/>Announced Plans<br/>or Programs</b> | <b>Maximum Number of<br/>Shares that May yet<br/>be Purchased Under<br/>the Plans<br/>or Programs</b> |
|---------------------------------------|---|---|---|---|
| October 1, 2005 to October 31, 2005   | 58,500  | \$ 9.27                                 | 58,500  | 1,045,909   |
| November 1, 2005 to November 30, 2005 |   |   |   | 987,409   |
| December 1, 2005 to December 31, 2005 | 62,346  | \$ 9.06                                 | 62,346  | 925,063   |
| <b>Total</b>                          | <b>120,846</b>                                  | <b>\$ 9.16</b>                          | <b>120,846</b>  |   |

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

**ITEM 6. EXHIBITS**

(a) Exhibits

See Exhibit Index.

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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.

Date: February 9, 2006

Multimedia Games, Inc.

By: /s/ Craig S. Nous

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Craig S. Nous  
Chief Financial Officer

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

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

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

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- (9) Incorporated by reference to Appendix B of our Definitive Proxy Statement on Schedule 14A filed with the Securities and Exchange Commission on January 6, 2004.
- (10) Incorporated by reference to our Form 10-Q filed with the Securities and Exchange Commission for the quarter ended December 31, 2003.
- (11) Incorporated by reference to our Form 10-K filed with the Securities and Exchange Commission for the fiscal year ended September 30, 2004.
- (12) Incorporated by reference to our Registration Statement on Form S-8 filed with the Securities and Exchange Commission on October 18, 2002 (File No. 333-100612).
- (13) Incorporated by reference to our Form 10-K filed with the Securities and Exchange Commission for the fiscal year ended September 30, 2005.
- (\*) Filed herewith.