SCIENTIFIC GAMES CORP Form 10-K March 01, 2007

## UNITED STATES SECURITIES AND EXCHANGE COMMISSION

WASHINGTON, D.C. 20549

## **FORM 10-K**

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

For the fiscal year ended: December 31, 2006

Or

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

For the transition period from

Commission file number: 0-13063

## SCIENTIFIC GAMES CORPORATION

to

(Exact name of registrant as specified in its charter)

**Delaware** (State or other jurisdiction of incorporation or organization) **81-0422894** (I.R.S. Employer Identification No.)

750 Lexington Avenue, 25th Floor

New York, New York 10022

(Address of principal executive offices)

Registrant s telephone number, including area code: (212) 754-2233

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

Title of each class Class A Common Stock, \$.01 par value Name of each exchange on which registered Nasdaq Global Select Market

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

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

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

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

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

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 x Accelerated filer o Non-accelerated filer o

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

As of June 30, 2006 the market value of voting and non-voting common equity held by non-affiliates of the registrant was approximately \$2,363,205,516(1).

Common shares outstanding as of February 26, 2007 were 91,920,029.

#### DOCUMENTS INCORPORATED BY REFERENCE

The following document is incorporated herein by reference:

Document

Proxy Statement for the Company s 2007 Annual Meeting of Stockholders Parts Into Which Incorporated

Part III

(1) For this purpose only, non-affiliates excludes directors and executive officers.

**EXHIBIT INDEX APPEARS ON PAGE 138** 

#### PART I FORWARD-LOOKING STATEMENTS

Certain statements contained in this Form 10-K constitute forward-looking statements within the meaning of the United States Private Securities Litigation Reform Act of 1995. In some cases, forward-looking statements can be identified by the use of forward-looking terminology such as may, will, estimate, intend, continue, believe, expect, anticipate, could or the negatives thereof, variations thereon or similar terr forward-looking statements contained in this Form 10-K are generally located in the material set forth under the headings Management s Discussion and Analysis of Financial Condition and Results of Operations and Business, but may be found in other locations as well. These forward-looking statements are based upon management s current expectations, assumptions and estimates and are not guarantees of future results or performance. Actual outcomes may differ from those projected in forward-looking statements due to a variety of risks and uncertainties and other factors, including relating to the following:

• the availability and adequacy of our cash flow to satisfy our obligations, including our debt service obligations and our need for additional funds required to support capital improvements, development and acquisitions;

• economic, competitive, demographic, business and other conditions in our local, regional and international markets;

• changes or developments in the laws, regulations or taxes in the gaming, racing and lottery industries;

• actions taken or omitted to be taken by third parties, including customers, suppliers, competitors and shareholders, as well as legislative, regulatory, judicial and other governmental authorities;

• changes in business strategy, capital improvements, development plans, including those due to environmental remediation concerns, or changes in personnel or their compensation, including federal, state and local minimum wage requirements;

- an inability to enter into new contracts, renew existing contracts or the early termination of our existing contracts;
- an inability to engage in or complete future acquisitions;

• the loss of any license or permit, including the failure to obtain an unconditional renewal of a required gaming license on a timely basis; and

• resolution of any pending or future litigation in a manner adverse to us.

You should read this Form 10-K completely and with the understanding that actual future results may be materially different from what we expect. All subsequent written and oral forward-looking statements attributable to us or to persons acting on our behalf are expressly qualified in their entirety by the foregoing factors. These forward-looking statements speak only as of the date of the document in which they are made. We disclaim any obligation or undertaking to provide any updates or revisions to any forward-looking statement to reflect any change in our expectations or any change in events, conditions or circumstances in which the forward-looking statement is based.

As you read this Form 10-K, you should also note the following: This Form 10-K contains various references to industry market data and certain industry forecasts. The industry market data and industry forecasts were obtained from publicly available information and industry publications. Industry publications generally state that the information contained therein has been obtained from sources believed to be reliable, but that the accuracy and completeness of that information is not guaranteed. Similarly, industry forecasts, while we believe them to be accurate, have not been independently verified by us and we do not make any representation as to the accuracy of that information.

#### ITEM 1. BUSINESS

Unless the context indicates otherwise, all references to the words Scientific Games, we, our, ours, us and the Company refer to Scientific Games Corporation and its consolidated subsidiaries. International refers to non-United States jurisdictions. United States (U.S.) jurisdictions refers to all fifty states plus the District of Columbia and Puerto Rico. Online lottery refers to a computerized system in which lottery terminals in retail outlets are continuously connected to a central computer system for the sale and validation of lottery tickets and related functions. OTB refers to off-track betting facilities, including those owned and operated by our subsidiaries Autotote Enterprises, Inc. (in Connecticut and Maine) and Autotote Nederland B.V. (in the Netherlands). Handle is a racing industry term for dollars wagered. The wide area gaming market refers to a collection of video lottery and other markets in which gaming terminals are distributed across a large number of venues, with relatively few terminals per venue.

#### Overview

Scientific Games Corporation was incorporated in the state of Delaware on July 2, 1984. We are a leading supplier of technology-based products, systems and services to gaming markets worldwide. We offer our customers the widest array of technologically advanced products and services in each market we serve. We report our operations in three business segments: Printed Products Group, Lottery Systems Group, and Diversified Gaming Group.

#### **Printed Products Group**

Our Printed Products Group is composed of our instant lottery ticket business and our prepaid phone card business.

We believe we are the leading provider of instant lottery tickets in the world. Our instant ticket customers include 34 of the 42 U.S. jurisdictions that currently sell instant lottery tickets, and we have sold instant tickets and related services to lotteries in over 50 other countries. We believe that our innovative products and services allow lotteries to increase their retail sales of instant tickets.

Instant ticket and related services includes ticket design and manufacturing, as well as value-added services including game design, sales and marketing support, specialty games and promotions, inventory management and warehousing and fulfillment services. We provide lotteries with access to some of the world s most popular entertainment brands, including Major League Baseball®, NASCAR®, National Basketball Association, Harley-Davidson®, Wheel-of-Fortune®, Monopoly , Corvette®, World Poker Tour® and The World Series of Poker®. We also provide lotteries with customized partnerships, or cooperative service programs, to help lotteries efficiently and effectively manage and support their operations to achieve greater retail sales and lower operating costs.

We believe we are one of the largest suppliers of paper-based prepaid phone cards in the world. Prepaid phone cards utilize the secure process employed by us in the production of instant lottery tickets which helps ensure the integrity and reliability of the product. Prepaid phone cards offer consumers in more than 50 countries worldwide a cost-effective way to purchase cellular airtime, without requiring wireless service providers to extend credit or consumers to commit to contracts.

#### Lottery Systems Group

We believe we are a leading provider of sophisticated, customized computer software, equipment and data communication services to government-sponsored and privately-operated lotteries in the U.S. and internationally. This business includes the provision of transaction processing software for the accounting and validation of both instant and online lottery games, point-of-sale terminals, central site computers, communications technology, and ongoing support and maintenance for these products. Central computer

systems, terminals and associated software are typically provided in the U.S. through facilities management contracts and internationally through outright sales. We have contracts to operate online lottery systems for 16 of the 44 U.S. jurisdictions that operate online lotteries and we believe we are the second largest online lottery provider in Europe.

#### **Diversified Gaming Group**

Our Diversified Gaming Group provides services and systems to private and public operators in the wide area gaming markets and in the pari-mutuel wagering industry. Our product offerings includes fixed odds betting terminals (FOBTs), video lottery terminals (VLTs), monitor games, wagering systems for the pari-mutuel racing industry, sports betting systems and services, and Amusement With Prize (AWP) and Skill With Prize (SWP) terminals. Business units within the Diversified Gaming Group include The Global Draw Limited (Global Draw), a leading supplier of FOBTs and monitor games to licensed bookmakers, primarily in the United Kingdom (U.K.) and Austria; Scientific Games Racing LLC, a leading worldwide supplier of computerized systems for pari-mutuel wagering; Games Media Limited (Games Media), our AWP and SWP terminal supplier to the U.K. pub market, and our venue management gaming operations in Connecticut, Maine and the Netherlands.

#### **Industry Overview**

#### Lottery Market

Lotteries are operated by domestic and foreign governmental authorities and their licensees in approximately 200 jurisdictions throughout the world. Currently, 44 U.S. jurisdictions have operating lotteries. Two of those jurisdictions, North Dakota and Puerto Rico, do not offer instant lottery games. Governments typically authorize lotteries as a means of generating revenues without the imposition of additional taxes. Net lottery proceeds are frequently set aside for particular public purposes, such as education, aid to the elderly, conservation, transportation and economic development. As proceeds derived from lottery ticket sales have become a significant source of funding for such programs, many jurisdictions have come to rely on such proceeds to support some of those public purposes.

Although there are many types of lottery games worldwide, governmentally authorized lotteries may generally be categorized into three principal groups: instant ticket, online and traditional draw-type lotteries. An instant ticket lottery is typically played by removing a latex coating from a preprinted ticket to determine whether it is a winner. Online lottery games, such as Powerball®, are based on a random selection of a series of numbers. Online lottery prizes are generally based on the number of winners who share the prize pool, although set prizes are also offered. Online lotteries are conducted through a computerized system in which lottery terminals in retail outlets are continuously connected to a central computer system. Online lottery systems may also be used to validate instant tickets to confirm large prize levels and prevent duplicate payments, or separate instant ticket validation systems may be installed. In addition, lotteries may offer quick draw keno ( keno ), video lottery, sports and other lottery systems. Video lotteries are played on VLTs, featuring line-up and card games, typically targeted to locations such as horse and greyhound racetracks, bars, nightclubs and similar establishments. Video lotteries generally use a distinct system from an online lottery system for accounting, security and control purposes. In addition, in Oregon, several provinces in Canada and several countries outside the U.S., lotteries offer pari-mutuel or fixed odds wagers on various sports.

During the U.S. lottery industry s fiscal year-end 2006 (June 30, 2006 for all states except for three), U.S. online lottery retail sales totaled approximately \$23.0 billion, and U.S. instant ticket lottery sales totaled approximately \$28.9 billion. Based on international industry information, through December 31, 2005, we estimate that international online lottery retail sales totaled approximately \$99.3 billion and that

international instant ticket lottery sales totaled approximately \$37.8 billion. Industry data indicates that in the U.S. instant ticket retail sales have generally been growing faster than online games because of instant rewards rather than the delayed rewards of online games with periodic or weekly drawings, and also due to increased payouts and more frequent game introductions.

#### Wide Area Gaming Market

The wide area gaming market is a collection of video lottery and other markets in which gaming terminals are distributed across a large number of venues, with relatively few terminals per venue. This contrasts with casino-type venues, where hundreds or even thousands of gaming machines are housed in a single venue. The wide area gaming market is large and complements our wide area technology and service expertise. One of the key benefits of wide area gaming is the downloadable, centrally determined technology that allows for easy reconfiguration of game content on each terminal. Wide area gaming includes a number of regulatory categories including VLTs, FOBTs, AWP and SWP terminals and other gaming devices that are converging as networked video gaming terminals.

Historically video lottery has included gaming terminals monitored by a central system, often accepting currency but only dispensing vouchers. In the U.S., these gaming terminals were originally deployed by lotteries in bars and restaurants and more recently in horse and greyhound racetracks (racinos). Video lottery has expanded in Europe and other markets to include gaming machines networked to central systems, often with game results being centrally determined. The Global Draw system is highly adaptable to these regulations and markets, and can be used in either publicly owned or privately operated video lottery venues.

In the U.K., licensed bookmakers provide up to four self service gaming terminals per shop on which their customers can place bets on fixed odds events, such as roulette and other games. The outcome of each bet is determined randomly by a centrally determined system. There are approximately 25,000 FOBTs currently installed in the U.K. In September 2007, when the substantive provisions of Great Britain s Gambling Act of 2005 (the Gambling Act ) are scheduled to come into effect, bookmakers will be able to deploy up to four machines of two defined categories known as B2 machines (which is the new regulatory category for FOBTs) and new B3 machines which are a new classification of short play cycle machines with predominantly similar content to reel based slots and a £500 maximum win (otherwise referred to as jackpot machines). In addition to FOBTs, bookmakers in the U.K. and Austria also provide customers with the ability to wager on a variety of monitor games (including keno style content).

The U.K. wide area gaming market also includes approximately 120,000 AWP terminals and 30,000 SWP terminals. Nearly all of these AWP terminals are standalone, single game, analog mechanical spinning reel gaming devices. Because of the arcane nature of the analog AWP terminals, income from these machines has been declining an estimated 6-8% per year, however, in 2007, this market is expected to expand as the analog terminals are replaced with digital AWP terminals. The Gambling Act provides for AWPs to be provided by suppliers on the basis of participation agreements from September 2007 and is expected to be an additional catalyst for this change. These new digital terminals will provide content management through downloadable, centrally determined games, thereby attracting new players into the market. The majority of AWP terminals in Europe are expected to convert to digital terminals over the next few years.

#### Pari-mutuel Market

In pari-mutuel wagering, individuals bet against each other on horse races, greyhound races, jai alai matches and other events. Pari-mutuel wagering patrons place specific types of wagers (e.g., on a specified horse to win) and a patron s winnings are determined by dividing the total amount wagered, less a set commission, amongst the winners. Wagering is generally conducted at horse and greyhound racetracks, jai

alai frontons, OTBs and casino racebooks or through licensed telephone and Internet account wagering operators. Licenses to conduct races and/or offer pari-mutuel wagering are granted by governments to private enterprises, non-profit racing associations and occasionally government organizations, including lotteries.

Pari-mutuel wagering is currently authorized in 43 states in the U.S., Puerto Rico, all provinces in Canada and approximately 65 other countries around the world. Based on industry information, we estimate that the North American market for all forms of pari-mutuel wagering was approximately \$19 billion in 2006, down from approximately \$20 billion in 2000. We believe the decline in North American pari-mutuel wagering during this period is primarily due to competition from other gaming activities such as casinos, lotteries and on-line gambling and competition from other forms of individual and family entertainment such as movies, restaurants and the Internet.

Remote wagering, in which customers bet on races held at another location, has caused substantial changes in the distribution channels for pari-mutuel wagering and consolidation of live racing. Wagering within the pari-mutuel industry has evolved from wagering only at a racetrack where the race is held, to wagering at a racetrack on races simulcast from other racetracks, to wagering at an OTB or other off-track venue, and now, in some jurisdictions, to wagering via the telephone and the Internet.

In addition to favorable changes in the applicable statutes and regulations, a number of technological advances have facilitated remote wagering, including the simulcasting of live races via private satellite video networks, public broadcasting and Internet video streaming. Remote wagering has also increased Handle by enabling wagering on most racing events year-round. Increases in remote Handle have helped to offset the decline in live Handle (i.e., Handle at the race or event itself). Remote wagering increased its share of the total U.S. thoroughbred pari-mutuel racing industry Handle from 15% in 1986 to 88% in 2006.

#### Prepaid Phone Cards Market

Prepaid phone cards, which entitle cellular phone users to a defined value of airtime, offer consumers a convenient way to purchase cellular airtime. While less common in the U.S., prepaid phone cards offer consumers worldwide a cost-effective way to purchase cellular airtime without requiring phone companies to extend credit or consumers to commit to contracts. Because card access number theft is common, the security of the card is critical; our phone cards incorporate proprietary security technology originally developed for our instant lottery ticket operations.

#### **Operational Overview**

#### **Printed Products Group**

*InstantTicket and Related Services.* In 1974, we introduced the first secure instant game ticket. Today, we believe we remain a leading designer, manufacturer and distributor of instant tickets worldwide. We market instant tickets and related services to domestic and foreign lottery jurisdictions and commercial (non-lottery) customers. We presently have contracts with 34 of the 42 U.S. jurisdictions that sell instant lottery tickets. In addition, we have sold instant lottery tickets to customers in over 50 countries. Our instant ticket contracts typically have an initial term of three years and frequently include multiple renewal options which our customers generally exercise for additional periods ranging from one to five years. We typically sell our instant tickets for a per unit price or are paid a fee equal to a percentage of the retail value of the instant tickets sold. In 2005 and 2006, we sold approximately 18.4 billion and 24.5 billion, respectively, 2 x 4 inch equivalent-size instant tickets, of which approximately 21% and 31%, respectively, were sold outside the U.S. Some international customers purchase instant tickets as needed rather than through multi-game supply contracts.

The instant tickets we manufacture are typically printed on recyclable ticket stock by a series of computer-controlled presses and ink-jet imagers, which we believe incorporate the most advanced technology and security currently available in the industry. Instant tickets generally range in size from 2 inches by 3 inches to ticket sizes as large as some calendars; instant tickets are normally played by removing a latex coating to determine if they are winning tickets.

The increased application of computer-based and communications technologies to the manufacturing and servicing of instant tickets continues to separate the printing of instant tickets from conventional forms of printing. We are generally recognized within the lottery industry as the leader in applying these technologies to the manufacturing and sale of instant tickets. In order to maintain our position as a leading innovator within the lottery industry, we intend to continue to explore and develop new technologies and their applications to instant lottery tickets and systems.

We provide lotteries with access to some of the world s most popular entertainment brands, which help increase their instant ticket sales. Our entertainment brands include themed instant games such as Betty Boop , The Pink Panther , I Love Lucy®, Harley-Davidson®, Monopoly and Wheel of Fortune® to name a few. We also provide branded merchandise prizes, advertising, promotional support, turn-key drawing management and prize fulfillment programs. Popular brands offered as non-cash prizes for lottery players are Major League Baseball®, National Basketball Association, NASCAR®, Corvette®, Jeopardy!®, Popeye® and Dick Tracy , as well as World Poker Tour®, World Series of Poker® and The Apprentice .

We pioneered the concept of providing lotteries with customized partnership programs, our cooperative services program, whereby we manage a lottery s instant ticket operations as a means of reducing operating costs to the lottery, while increasing the lottery s retail sales. Cooperative services contracts bundle instant tickets, systems, facilities management and/or other services, including the design and installation of game management software, telemarketing, field sales, accounting, instant ticket game design, inventory and distribution, sales staff training, managing staff and advising with respect to security, maintenance, communication network and sales agent hot-line service for lottery jurisdictions.

We have contracts for cooperative services with the U.S. jurisdictions of Arizona, Delaware, District of Columbia, Florida, Georgia, Maine, Ohio, Oklahoma, Pennsylvania, South Carolina and Tennessee. Under such contracts, we are typically paid a percentage of the lottery authority s total instant ticket revenues. Customers designate the services they want us to perform from a menu of cooperative services offered. Beginning in 2005, we expanded our cooperative service style offerings in Germany, with two contracts with Toto-Lotto Niedersachsen GmbH and one contract with Lotterie-Treuhandgesellschaft GmbH, the state lottery of Hessen, Germany, to supply instant lottery tickets and the other lottery services.

We also applied our cooperative service programs in Italy as a member of Consorzio Lotterie Nazionali, a consortium consisting principally of ourselves, Lottomatica S.p.A, and Arianna 2001, a company owned by the Federation of Italian Tobacconists. The consortium has a signed contract with the Italian Monopoli di Stato to be the exclusive operator of the Italian Gratta e Vinci instant lottery. The contract has an initial term of six years with a six year-extension option. Under our contract with the consortium, we will supply instant lottery tickets, will participate in the profits or losses of the consortium as a 20% equity owner, and will assist Lottomatica S.p.A in the lottery operations. The consortium s contract commenced in mid-2004 and sales have continued to improve from approximately 4 million tickets per week at the start to approximately 354 million per week currently, an overall improvement of 8,750%.

*Phone Cards.* We are a manufacturer of prepaid phone cards in Europe, which entitle cellular phone users to a defined value of airtime. Prepaid phone cards offer consumers worldwide a cost-effective way to purchase cellular airtime, without requiring phone companies to extend credit or consumers to commit to contracts. To deter fraud, our phone cards incorporate proprietary security technology originally

developed for our lottery ticket operations. We sell our prepaid phone cards to phone companies for a per unit price.

#### Lottery Systems Group

We believe we are a leading provider of sophisticated, customized computer software, equipment and data communication services to government-sponsored and privately-operated lotteries in the U.S. and internationally. In the U.S., we typically provide the necessary equipment, software and maintenance services pursuant to long-term facilities management contracts that typically have a minimum initial term of five years, under which we are generally paid a fee equal to a percentage of the lottery s total retail sales of lottery tickets. Our U.S. contracts typically contain multiple renewal options that generally have been exercised by our customers. Internationally, we typically sell point-of-sale terminals and/or computer software to lottery authorities and may provide ongoing fee-based support services under long-term contracts.

Our lottery systems utilize proprietary technology that facilitates high speed processing of online wagers as well as validation of winning online and instant play tickets. Our lottery business includes the supply of transaction-processing software that accommodates instant ticket accounting and validation, and online lottery games, point-of-sale terminals, central site computers and communication platforms, and on-going operational support and maintenance services. We also provide software, hardware and support for sports betting systems, video lottery systems and the operation of credit card processing systems for non-lottery customers.

We have contracts to operate online lottery systems for 16 of the 44 U.S. jurisdictions that operate online lotteries and we believe we are the second largest online lottery provider in Europe. Internationally, we have lottery systems operating in Australia, Austria, Canada, China, Dominican Republic, France, Germany, Iceland, Italy, Mexico, the Netherlands, Peru, Philippines, Spain, South Korea, and Switzerland.

#### **Diversified Gaming Group**

*Wide Area Gaming.* We believe we are a leading supplier of wide area gaming systems and terminals to licensed bookmakers in the U.K. and Austria. We provide bookmakers with a facilities management offering which includes remote management of the game content and management information, wagering terminals, central computer system, data communications, and field support service. We develop game content through our own staff in Austria and Australia, and we contract with other gaming suppliers for additional content. Our contracts are for an initial period of one to four years duration under which we are typically paid a fee equal to a percentage of our customer s revenues generated from wagers on each terminal. Global Draw operates approximately 9,300 terminals in the U.K. and we believe it is one of the three largest suppliers in the U.K. market. We believe Global Draw s FOBTs achieve higher revenue levels for its customers than those provided by the competition. Global Draw is currently testing a new generation terminal that provides the operator the flexibility of switching from B2 to B3 use and has regulatory agreement for this mode of operation.

As currently conducted, in the U.K. AWP market, we develop our own game content and contract with third-party game developers. This game content is then programmed into an analog gaming terminal which is manufactured for us by a third party, and then the completed terminal is sold to gaming machine operators. In the U.K. SWP market, we offer gaming content both on terminals that we procure from third parties and on terminals offered by other manufacturers. In 2007, we expect to transition this business and begin offering full facilities management contracts to the U.K. pub market.

*Pari-mutuel Wagering.* We believe we are a leading worldwide provider of high volume, real-time transaction processing pari-mutuel wagering systems to licensed pari-mutuel operators. We provide our systems and services to horse and greyhound racetracks, OTBs, casinos, jai alai frontons, telephone and

Internet account wagering operators and other establishments where pari-mutuel wagering is permitted. In addition, we are a leading provider of ancillary services to the pari-mutuel industry, such as simulcasting of races and telecommunications services.

In 2006, we believe that our systems processed approximately 45% of the estimated \$19 billion in pari-mutuel wagering conducted on racing in North America. Internationally, we have pari-mutuel wagering systems operating in more than 20 countries.

In the United States, Germany and Ireland, we typically provide the necessary equipment, software and maintenance services pursuant to long-term facilities management contracts that typically have a minimum term of five years, under which we are generally paid a fee equal to a percentage of the amount wagered on a particular event. These fees generally have a weighted-average of approximately 0.31% of the amounts wagered. In addition, fees may be charged for extra equipment and services, particularly for new terminal models and equipment levels or services which exceed those originally contracted. We have generally been successful in renewing these contracts. Internationally, we typically sell pari-mutuel wagering systems to licensed pari-mutuel operators and may provide ongoing fee-based support services under long-term contracts. Each of these systems is customized to meet the unique needs of our customers, including game designs, regulatory requirements, language preferences, network communication standards and other key system requirements.

Our pari-mutuel systems utilize proprietary technology that facilitates high speed processing of wagers made on a particular event over secure, high speed communication channels and the calculation and display of betting odds on a particular event. Our systems link multiple racetracks and OTBs to one another which enable operators to increase their revenues. Our pari-mutuel wagering business includes the supply of transaction-processing software, wagering terminals, central site computers and communication hardware, and on-going operational support and maintenance services. Our central site computers have historically been located in regional hubs or, in some cases, at the racetrack itself, depending on regulatory requirements. In 2006, we began migrating these systems into two new special purpose, enterprise-level computing data centers. One data center is located in Sacramento, CA and another in Mount Laurel, NJ. By the end of the migration process, pending certain regulatory approval, all U.S.-based systems will operate from these two data centers while separate systems will remain in Canada and Puerto Rico.

*Simulcasting.* We are one of the leading providers of simulcasts of live horse and greyhound racing and jai alai matches to racetracks, OTBs, jai alai frontons and casinos in North America and Europe. We simulcast racing events from over 56 racetracks and jai alai frontons to more than 185 racetracks and almost 915 OTBs throughout North America. We provide similar services in Europe, particularly in the Netherlands and Germany, where we service more than 50 racetracks and more than 200 OTBs and bookmaker shops.

Simulcasting of races entails the encryption and transmission of the audio/video signal from a race or jai alai event to a satellite transponder and the retransmission of this signal to other racetracks, OTBs and casinos, where the signal is received and decoded for viewing. In general, we receive a daily event fee from the racetracks for uplinking the video and audio signals and a monthly fee from end users (racetracks, OTBs and casinos) for the signal received on our decoders.

*NASRIN*<sup>®</sup>. In conjunction with our 70% interest in a joint venture with Churchill Downs, Inc., we operate a national voice/data telecommunications network, known as NASRIN<sup>®</sup>, that securely transmits wagering data from almost 225 racetracks and OTBs in North America. The system is designed to link all wagering locations in North America and to serve as a platform for future technology developments. In exchange for our services, we are paid certain fees based on bandwidth and level of service.

*Venue Management.* We own and have the right to operate in perpetuity substantially all off-track pari-mutuel wagering in Connecticut, subject to our compliance with certain licensing requirements. Our

Connecticut operations, with total wagers of approximately \$230 million in 2006, consist of 11 OTB facilities, including video simulcasting at two teletheaters and four other branches, and telephone account wagering for customers in 11 states. We hold one of five OTB licenses within the state of Maine. We are also the exclusive licensed operator for all pari-mutuel wagering in the Netherlands, which totaled approximately \$42.6 million in 2006, originating from four racetracks and 29 OTBs under a contract through June 2008. Our revenues are based on a percentage of the amounts wagered at or through our facilities, which ranges from 21% in Connecticut to 29% in the Netherlands, depending on the location of the wagering event and the type of wager made. We also provide facilities management services to the five licensed wagering operators under five year contracts.

For additional information concerning our business and geographic segments, see Note 16 to the Consolidated Financial Statements.

#### **Contract Procurement**

#### Lottery Market

Government authorized lotteries in the U.S. typically operate under state-mandated public procurement regulations. See Government Regulation. Lotteries select an instant ticket or online supplier by issuing a Request for Proposal, or RFP, which outlines contractual obligations as well as products and services to be delivered. An evaluation committee frequently comprised of key lottery staff evaluates responses based on various criteria. These criteria usually include quality of product and/or technical solutions, security plan and features, experience in the industry, quality of personnel and services to be delivered and price. We believe that our product functionality, game content, the quality of our personnel, our technical expertise and our demonstrated ability to help the lotteries increase their revenues may give us an advantage relative to the competition when responding to state lottery RFPs. However, many lotteries still award the contract to the qualified vendor with the lowest price, regardless of factors other than price. Contract awards by lottery authorities are sometimes challenged by unsuccessful competitors, which can result in protracted legal proceedings. Internationally, lottery authorities do not always utilize such a formal bidding process, but rather negotiate with one or more potential vendors.

U.S. instant ticket lottery contracts typically have an initial term of three years and frequently include multiple renewal options, which our customers have generally exercised for additional periods ranging from one to five years. Our U.S. online lottery contracts typically have a minimum initial term of five years, with additional renewal options that may extend up to ten years. The length of these lottery contracts, together with their renewal options, limits the number of contracts available for bidding in any given year.

The table below lists the U.S. lottery contracts for which we had executed agreements as of January 15, 2007 and certain information with respect thereto. We are the exclusive provider of systems in all online and video lottery contracts and the primary supplier of instant tickets unless otherwise noted. The commencement date of the current contract is the date we began generating revenues under such contract, which for our online contracts is typically the start-up date. The table also includes instant ticket or online retail sales, as applicable, for each state or district.

State/District	Fiscal 2006 * State Instant Ticket or Online Retail Sales (in millions)	Type of Contract <b>*</b> *	Commencement Date of Current Contract	Expiration Date of Current Contract (before exercise of remaining renewal options)	Current Renewal Options Remaining
Arizona	(in minons) \$ 249.8	ITRS	January 2003	January 2008	2 one-year
California	1,929.6	ITRS	July 2005	June 2009	4 one-year
Colorado	293.8	ITRS	January 2005	November 2007	3 one-year
Colorado	175.0	Online	April 2005	October 2012	
Connecticut	587.6	ITRS	1		2 one-year None
Connecticut	382.8	Online	August 2002	August 2007	None
			May 1998	May 2008	
Delaware	31.4	ITRS	November 2005	November 2008	3 one-year
Delaware	93.1	Online & Video	September 2001	February 2010	5 one-year
District of Columbia	39.0	ITRS	August 2005	August 2010	2 one-year
Florida	2,200.9	ITRS	April 1997	September 2008	None
Georgia	2,054.6	ITRS	September 2003	September 2010	None
Illinois	999.5	ITRS	December 2005	December 2008	2 one-year
Indiana (2)	506.0	ITRS	January 2002	January 2009	None
Indiana	294.8	Online	January 1999	August 2009	None
Iowa	93.96	Online	July 2001	June 2010	1 one-year
Iowa (2)	124.54	ITRS	January 2005	December 2007	2 one-year
Kentucky (2)	424.9	ITRS	September 2002	September 2009	None
Louisiana	118.9	ITRS	February 2005	October 2007	3 one-year
Maine	64.3	Online	July 2001	June 2011	None
Maine	164.9	ITRS	July 2001	June 2011	None
Maine	N/A	Video	February 2005	February 2010	1 five-year
Maryland	1,145.6	Online	October 2005	June 2011	1 five-year
Maryland (1) (3)	415.9	ITRS	July 2006	June 2010	1 three-year
Massachusetts (2)	3,125.9	ITRS	August 2004	August 2007	2 one-year
Minnesota (1)	267.8	ITRS	March 2005	February 2007	3 one-year
Missouri (2)	571.1	ITRS	April 2001	June 2007	4 one-year
New Hampshire	85.8	Online	June 2006	June 2010	None
New Hampshire (3)	176.5	ITRS	July 2006	June 2008	2 two-year
New Jersey (1)	1,141.7	ITRS	November 2001	October 2007	1 one-year
New Mexico	89.4	ITRS	March 2003	March 2007	3 one-year
New Mexico	NA	Video	December 2005	December 2013	None
New York	3,197.7	ITRS	July 2006	July 2009	2 one-year
North Dakota	22.4	Online	February 2004	March 2012	2 one-year
Ohio	1,272.6	ITRS	July 2003	June 2007	2 one-year
Oklahoma .	126.4	ITRS	August 2005	August 2007	5 one-year
Oklahoma	80.9	Online	August 2005	August 2007	5 one-year
Oregon (1) (2)	127.3	ITRS	May 2005	May 2008	3 one-year
Pennsylvania	1,587.8	ITRS	April 1997	April 2007	None
Pennsylvania (4)	1,587.8	ITRS	April 2007	April 2012	5 one-year
Pennsylvania	1,480.4	Online	February 1998	December 2008	None
Puerto Rico	334.5	Online	September 2004	June 2012	None
South Carolina	696.5	ITRS	October 2006	September 2008	5 one-year
South Carolina	448.1	Online	January 2002	November 2008	None
10			2002	1.0.011001 2000	1.0.10

South Dakota	18.2	ITRS	August 2005	August 2007	3 one-year
South Dakota	20.9	Online & Video	March 1999	August 2009	None
Tennessee	696.2	ITRS	January 2004	April 2011	None
Texas	2,866.6	ITRS	September 2004	August 2007	5 one-year
Vermont	25.7	Online	July 2000	June 2010	None
Vermont	79.7	ITRS	February 2006	January 2008	2 one-year
Washington	305.5	ITRS	March 2006	March 2010	4 one-year
West Virginia	119.1	ITRS	February 2006	January 2009	2 one-year
West Virginia	98.8	Online	November 1999	July 2008	None
West Virginia	N/A	Video	March 2006	February 2008	4 one-year
Wisconsin (2)	285.6	ITRS	July 2004	June 2007	2 one-year

#### (1) Secondary instant ticket supplier.

- (2) Pull-tab sales are included within instant ticket sales.
- (3) New contract commenced in 2006.
- (4) New contract commencing in 2007.

\* Fiscal 2006 is the year ended June 30, 2006, except for New York which is March 31, 2006; Texas which is August 31, 2006 and Michigan which is September 30, 2006.

- \*\* ITRS = Instant ticket and related services.
- \*\* Video = Video lottery service contract.

#### Wide Area Gaming Market

Contract awards by the major bookmakers in the U.K. often involve a competitive bid process. Major bookmakers have typically awarded the majority of their terminal installations to a single vendor. Contracts with major bookmakers are typically for a term of four years.

In the U.K. AWP and SWP market, machine operators purchase AWPs and SWPs based on the relative performance of competing products, and the desires of pub operators. As this market migrates to digital technology and begins to take on the characteristics of the U.K. bookmaker market, we expect the contract award process will be similar to that in the U.K. bookmaker market.

#### Pari-mutuel Market

Contract awards by owners of horse and greyhound racetracks, OTBs and casinos and jai alai frontons, and from state and foreign governments, often involve a lengthy competitive bid process, spanning from specification development to contract negotiation and award. Our contracts for the provision of pari-mutuel systems services in North America are typically for terms of five years. In addition, our ancillary pari-mutuel services, such as simulcasting, are typically provided under one-year contracts.

Our license to provide on-track and off-track services in the Netherlands extends through June 2008. New venue management opportunities generally occur via the privatization of existing government operated OTBs, as in the cases of Connecticut and the Netherlands, the acquisition or outsourcing of an existing private racetrack or OTB operation, as with our 2005 acquisition of the OTB in Maine and the Shoreline simulcast facility in Connecticut, or new legislation or regulation enabling new distribution

channels. These opportunities occur infrequently and may be subject to public procurement bidding requirements.

#### Prepaid Phone Cards Market

All telecommunications products customers issue purchase orders with agreed upon terms and conditions. In addition, certain customer purchase orders contain multiple delivery dates.

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

We believe our ability to attract new lottery, wide area gaming and pari-mutuel wagering customers and retain existing customers depends in part on our ability to continue to incorporate technological advances into, and to improve, our products, systems and related equipment. We maintain a development program directed toward systems development as well as toward the improvement and refinement of our present products and the expansion of their uses and applications. Many of our product developments and innovations have quickly become industry standards, including games for Printed Products, and multiplier games for Lottery Systems.

#### **Intellectual Property**

We have a number of U.S. and foreign patents that we consider, in the aggregate, to be of material importance to our business. Patents extend for varying periods of time according to the date of patent filing or grant and the legal term of patents in the various countries where patent protection is obtained. In the U.S., the term of a patent generally expires 20 years from the date of filing. The actual protection afforded by a patent, which can vary from country to country, depends upon the type of patent, the scope of its coverage and the availability of legal remedies in the country.

Certain technology material to our lottery and pari-mutuel wagering products, processes and systems is the subject of patents issued, and patent applications currently pending, in the U.S. and certain other countries. In our lottery business, we utilize our patented and patent-pending technology for the production, secure printing, validation and distribution of instant lottery tickets. In our pari-mutuel and diversified gaming business, our patent-pending systems and methods provide racing and wagering data and related information. In addition, our MDI Entertainment, Inc. (MDI), Global Draw and Games Media businesses patent and license game content as part of our businesses. Most of our material patents are not scheduled to expire until 2013 or later. We also have a number of U.S. and foreign registered trademarks and other common law trademark rights for certain of our products, including Winner s Choice®, Play Central®, SciScan Technology®, Aegis®, PROBE®, EXTREMA®, SGI-NET, NASRIN®, QUANTUM, SAM®, STAN®, MAX®, TINY TIM®, On the Wire®, Autotote® and others. Trademark protection continues in some countries, including the U.S., for as long as the mark is used and in other countries for as long as it is registered. Registrations generally are for fixed, but renewable, terms.

From time to time we become aware of potential infringement of our intellectual property by competitors and other third parties and consider what action, if any, to take in that regard, including, where appropriate, litigation. Historically, others have threatened and even brought litigation against us. As of December 31, 2006, we have settled all known intellectual property claims made by and against us.

#### Seasonality

The first and fourth quarters of the calendar year traditionally comprise the weakest season for our Diversified Gaming segment. As a result of inclement weather during the winter months, a number of racetracks do not operate and those that do operate often experience missed racing days. This adversely affects the amounts wagered and our corresponding service revenues. Wagering and lottery equipment sales and software license revenues usually reflect a limited number of large transactions, which do not recur on an annual basis. Additionally, the fourth quarter is the weakest quarter for Global Draw due to reduced wagering during the holiday season. Revenues and operating results of our Lottery Systems Group can vary substantially from period to period as a result of the timing of revenue recognition for major equipment sales and software licensing transactions. In addition, Printed Products sales may vary depending on the season and timing of contract awards, changes in customer budgets, inventory ticket levels, lottery retail sales and general economic conditions.

Operating results may also vary significantly from period to period depending on the addition or disposition of business units in each period.

#### Production Processes, Sources and Availability of Components

Our dedicated computer-controlled printing process is specifically designed to produce secure instant lottery game tickets for governmentally sanctioned lotteries and promotional games as well as prepaid phone cards. Our facilities are designed for efficient, secure production of instant game tickets and support high-speed variable image printing, packaging and storage of instant game tickets. Instant ticket games are delivered finished and ready for distribution by the lottery authority, or by us in the jurisdictions which are part of an instant ticket contract with cooperative services. Paper and ink are the principal raw materials consumed in our ticket manufacturing operations. We have a variety of sources for both paper and ink and therefore, should not be dependent on any particular supplier.

Production of our lottery, wide area gaming and pari-mutuel wagering terminals and related component products primarily involves the assembly of electronic components into more complex systems and products. We produce our lottery and pari-mutuel terminals at our manufacturing facility in Ballymahon, Ireland, or at our Georgia manufacturing facility. Wide area gaming terminals and certain lottery terminals are purchased from third-party vendors, as needed.

We normally have sufficient lead time between reaching an agreement to provide the required system and the commencement of operations so that we are able to provide the customer with a fully functioning system, customized to meet their requirements. In the event that current suppliers of central processing units were no longer available, we believe we would be able to adapt our application software to run on the then-available hardware in time to allow us to meet new contractual obligations, although the price competitiveness of our products might change. The lead time for obtaining most of the electronic components we use is approximately 90 days. We believe that this is consistent with our competitors lead times and is also consistent with the needs of our customers.

#### Competition

#### Printed Products Group

We currently have three principal instant lottery ticket competitors in the U.S.: Pollard Banknote Limited, Oberthur Gaming Technologies, a subsidiary of Group Francois-Charles Oberthur of France, and Creative Games International, Inc., a subsidiary of Gtech Corporation. We estimate that the retail sales value of our U.S. customer base was approximately 73% of total U.S. instant ticket retail sales in 2006. Except as permitted by the applicable provisions of the North American Free Trade Agreement with respect to Canada and Mexico, it is currently illegal to import lottery tickets into the U.S. from a foreign

country. Our business could be adversely affected should additional foreign competitors in Canada or Mexico export their lottery products to the U.S. or should other foreign competitors establish printing facilities in the U.S., Canada or Mexico to supply the U.S. market. Internationally, a few lottery instant ticket vendors compete with us including the competitors noted above.

The market for prepaid phone cards is highly fragmented, but competition comes from other instant ticket lottery printers, as well as alternative printing and non-printing technologies. There are alternative technologies such as smart cards or other alternative means to provide the funding of telephone services. We have invested in new higher speed and higher capacity printing and packaging technologies that we believe, in combination with our lottery security and logistics expertise, will continue to provide us a competitive advantage in this market.

#### Lottery Systems Group

The online lottery business is highly competitive and continues to operate in a period of intense price-based competition.

Our principal competitors in the U.S. online lottery systems market are Gtech Corporation (with approximately 70% of the U.S. market based on retail sales) and Intralot Technologies, Inc.( Intralot ). Gtech Corporation is also our major competitor in the international online market along with Intralot, and International Lottery and Totalizator Systems, Inc.

#### Diversified Gaming Group

Our wide area gaming business competes with a variety of suppliers in the U.K. and internationally. Principal direct competitors in the FOBT business include Inspired Gaming Group and Cyberview Technology, Inc. In the U.K. AWP/SWP market, we compete directly with other suppliers of gaming machines, including Barcrest USA, a division of International Game Technology (IGT); Bell-Fruit Games, Ltd., a division of Gamestec Leisure Limited; Inspired Gaming Group, plc; and Games Warehouse Limited, a division of Merit Industries, Inc. As the pub business transitions from analog to digital, we expect to compete with both the current competitors, as well as new compete with video lottery and other gaming terminal suppliers. Our competitors in these markets include IGT International, Gtech, Inspired Gaming Group, Cyberview Technology, Aristocrat Leisure Ltd, Novomatic Industries, AG., Octavian International and Multimedia Games, Inc. The expected change in the gaming rules in Great Britain in 2007 may expose our businesses to additional competition.

Our two principal competitors in the North American pari-mutuel wagering systems business are AmTote International, Inc., principally owned by Magna Entertainment Corporation, and United Tote Company, a subsidiary of Youbet.com, Inc. Our competition outside of North America is more fragmented, with competition being provided by several international and regional companies. In addition, we believe we are one of the leading providers in North America of video and data simulcasting services to the racing industry. Simulcasting competition includes many satellite communication companies and uplink providers and alternative communication technologies. Current and future competitors in Internet-based wagering include Youbet.com, Inc. and Gemstar-TV Guide, Inc. (TVG).

Our venue management business competes with other pari-mutuel operators, as well as with casinos, lotteries and other forms of legal and illegal gambling, and other forms of entertainment within our licensed markets.

#### Employees

As of December 31, 2006, we employed approximately 5,500 persons. Many of our U.S. pari-mutuel employees involved in field operations are represented by the International Brotherhood of Electrical Workers under contract, extending through October 2009. Most of our Canadian pari-mutuel employees are represented by the Service Employees International Union, which contract also extends through October 2009. The majority of our lottery employee groups are not represented by labor unions; however, our employees in Austria are represented by a Worker's Council, which is typical of many European companies; and at the United Kingdom facility, approximately 220 employees are members of the Graphic Paper and Media Union, while our printed products facility in Chile has approximately 80 employees who belong to a local labor union.

#### **Government Regulation**

#### General

Lotteries, pari-mutuel wagering, sports wagering, and wide area gaming may be lawfully conducted only in jurisdictions that have enacted enabling legislation. In jurisdictions that currently permit various wagering activities, regulation is extensive and evolving but customarily includes some form of licensing of an applicant and its subsidiaries, if any. Regulators in those jurisdictions review many facets of an applicant or holder of a license including, among other items, financial stability, integrity and business experience. We believe we are currently in substantial compliance with all regulatory requirements in the jurisdictions where we operate and where appropriate maintain obligations in our supply agreements to customers to allow us to monitor and ensure ongoing compliance. Any failure to receive a material license or the loss of a material license that we currently hold could have a material adverse effect on our overall operations and financial condition.

While we believe that our current and planned business activities comply with all applicable laws, law enforcement authorities in certain jurisdictions have opposed the expansion of wagering via telephone and the Internet. There can be no assurance that our activities or the activities of our customers will not become the subject of any law enforcement proceeding or that such proceeding, if any, would not have a material adverse impact on us or our business plans.

We have developed and implemented an internal compliance program in an effort to ensure that we comply with legal requirements imposed in connection with our wagering-related activities, as well as legal requirements generally applicable to all publicly traded corporations. The compliance program is run on a day-to-day basis by our Chief Compliance Officer with legal advice provided by our General Counsel and outside experts. The compliance program is overseen by the Compliance Committee of our Board of Directors, consisting of three outside directors. While we are firmly committed to full compliance with all applicable laws, there can be no assurance that such steps will prevent the violation of one or more laws or regulations, or that a violation by us or an employee will not result in the imposition of a monetary fine or suspension or revocation of one or more of our licenses.

In the last two years, new legislation was passed or has come into effect in the United States and Great Britain that may impact various aspects of our business. In Great Britain, the Gambling Act of 2005 is being brought into force gradually, with most of the substantive provisions scheduled to come into effect in September 2007. Among other things, the Gambling Act requires specific licenses be obtained for operations conducted in pubs, licensed betting offices and other adult gaming centers and for remote gambling, such as the transport of data from a central system to a gaming device via satellite transmission. The Gambling Act also provides for regulation of the technical specifications and standards of gaming machines and systems, and technical standards which are the outcome of discussions between the Gambling Commission and the industry are set to be published in March 2007. While we are confident that The Global Draw, Games Media and our sports wagering and pari-mutuel businesses are in compliance

with the requirements of the Gambling Act, we are unable to predict the impact of new regulations or how enforcement or gaming regulatory authorities will interpret same. Moreover, in addition to the risk of enforcement action, we are also at risk of loss from business reputation in the event of any potential legal or regulatory investigation, whether or not the Company is ultimately accused of or found to have committed any violations.

Similarly, in the United States, Congress passed the Unlawful Internet Gambling Enforcement Act of 2006 (the Unlawful Internet Gambling Enforcement Act ). Among other things, the Unlawful Internet Gambling Enforcement Act prohibits the transmission of any wager, at least in part, by means of the Internet, where such wager is prohibited by any applicable law where initiated, received or otherwise made. It imposes potentially severe criminal and civil sanctions on the owners and operators of such systems and on financial institutions processing wagering transactions. The law does contain a safe harbor for wagers placed within a single state (disregarding intermediate routing of the transmission) where the method of placing the bet and receiving the bet is authorized by that state s law, provided the underlying regulations establish appropriate age and location verification. The U.S. Treasury Department has not yet adopted implementing regulations for financial institutions.

In France, Germany and elsewhere in the European Union, enforcement actions and pronouncements, statutory enactments and court decisions have raised questions about the ability of European national governments to grant monopolies to lotteries or to limit extra-jurisdictional gaming where gaming is allowed in that country.

Currently, account wagering operations, through which pari-mutuel customers place wagers by phone or via the Internet on thoroughbred, harness or greyhound racing, may be conducted only from certain jurisdictions and only through licensed wagering operators in certain jurisdictions. While we believe that the activities of our pari-mutuel and gaming businesses comply with all applicable laws, law enforcement authorities in certain jurisdictions have opposed the expansion of wagering via telephone and the Internet. Where state or other regulators have expressed concerns to us regarding such wagering by their citizens through our account wagering systems and the racetracks serviced by our pari-mutuel wagering systems, we have ceased operations in those jurisdictions in a manner that anticipated the safe harbor principles later adopted in the Unlawful Internet Gambling Enforcement Act. There can be no assurance that our activities or the activities of our customers will not become the subject of law enforcement proceedings or that any such proceedings would not have a material adverse impact on us or our business plans.

While we believe that we have developed the proper procedures and policies to comply with the requirements of these evolving laws and legal pronouncements, we cannot assure our investors that law enforcement or gaming regulatory authorities will not seek to restrict our business in their jurisdictions or even institute enforcement proceedings.

#### Lottery Operations

At the present time, 44 U.S. jurisdictions, all the Canadian provinces, Mexico and many other foreign countries authorize lotteries. Lottery contracts and ongoing operations of lotteries both domestically and abroad are subject to extensive regulation. Although certain of the features of a lottery, such as the percentage of gross revenues that must be paid back to players in prize money, are usually set by legislation, the various lottery regulatory authorities generally exercise significant discretion, including the determination of the types of games played, the price of each wager, the manner in which the lottery is marketed and the selection of vendors for equipment, technology and services, and retailers of lottery products. Furthermore, laws and regulations applicable to lotteries in the U.S. and foreign jurisdictions are subject to change, and the effect of such changes on our ongoing and potential operations cannot be predicted with certainty.

To ensure the integrity of the contract award and wagering process, most jurisdictions require detailed background disclosure on a continuous basis from, and conduct background investigations of, the vendor, its officers and directors, its subsidiaries and affiliates and its principal shareholders. Background investigations of the vendor s employees who will be directly responsible for the operation of the system are also generally conducted, and most states reserve the right to require the removal of employees whom they deem to be unsuitable or whose presence they believe may adversely affect the operational security or integrity of the lottery. Certain jurisdictions also require extensive personal and financial disclosure and background checks from persons and entities beneficially owning a specified percentage (typically five percent or more) of a vendor s securities. The failure of beneficial owners of our securities to submit to background checks and provide such disclosure could result in the imposition of penalties upon these beneficial owners and could jeopardize the award of a lottery contract to us or provide grounds for termination of an existing lottery contract.

From time to time we retain governmental affairs representatives in various states of the U.S. to advise legislators and the public concerning our views on lottery legislation, to monitor such legislation and to advise us in our relations with lottery authorities. We also make political contributions to various state political parties and state political candidates.

The award of lottery contracts and ongoing operations of lotteries in international jurisdictions are also extensively regulated, although this regulation usually varies from that prevailing in the U.S. Restrictions are frequently imposed on foreign corporations seeking to do business in such jurisdictions and, as a consequence, we have, in a number of instances, allied ourselves with local companies when seeking foreign lottery contracts. Laws and regulations applicable to lotteries in the U.S. and foreign jurisdictions are subject to change, and the effect of such changes on our ongoing and potential operations cannot be predicted with certainty.

#### Wide Area Gaming

The existing and emerging wide area gaming markets are governed by gaming regulations. Coin or voucher operated gambling devices offering electronic, video versions of spinning reels, poker, blackjack and similar games include VLTs, FOBTs, AWPs, and SWPs. Fifteen U.S. states authorize wagering on VLTs at state regulated and licensed facilities. Although some states currently restrict VLTs to already existing wagering facilities, others permit these devices to be placed at bars, restaurants, and specific licensed gaming facilities. In addition, all of the Canadian provinces and various other foreign countries have authorized their use.

Companies that manufacture, sell or distribute VLTs or provide the central computer systems that monitor these devices are subject to various provincial, state, county and municipal laws and regulations. The primary purposes of these rules are (i) to ensure the responsibility, financial stability and character of companies involved and their officers and directors and stockholders through licensing requirements, (ii) to ensure the integrity and randomness of the machines, and (iii) to prohibit the use of VLTs at unauthorized locations or for the benefit of undesirable individuals or entities.

In the U.K., the regulation of gaming activity is undergoing significant change. The major provisions of the Gambling Act are to take effect in September 2007. Among other provisions, the Gambling Act deals with the licensing of the various types of venues allowed to carry out gambling activities, the types of gaming activities, the categories and number of gaming machines allowed in each type of venue and the licensing and regulation of the supply and operation of those machines and other gaming activities. These regulations allow for some expansion of gaming in controlled environments (including the establishment of additional national and local casinos) and limits on the type of activities and number of gaming machines and gaming activities allowed in other venues. Under the Gambling Act each category of gaming machine

and individual operators will be subject to regulation and require specific licensing which will also cover the minimum technical specification of machines.

In September 2007, when the substantive provisions of the Gambling Act become effective, bookmakers will be able to deploy up to four machines expected to be from two defined categories known as B2 machines and new B3 machines. Global Draw is testing a new generation of terminals that provide the operator the flexibility of offering either B2 or B3 increasing capabilities, including the ability to switch from one designation to the other depending on customer demand. Global Draw will also continue to offer its monitor game products (which offer fixed odds bets on virtual random number based events) under the general betting provisions of the Gambling Act.

Also, when the Gambling Act provisions come into effect, pubs will be limited to category C gaming machines (the category into which AWPs fall, although for the first time AWPs will be able to be supplied under participation agreements). The Gambling Act also provides some scope for other soft gaming activities to be conducted in pubs including some pool betting and social lotteries. Pubs will also continue to operate SWPs which continue to fall outside of the scope of the Gambling Act.

#### Pari-mutuel Wagering

At present, 44 U.S. jurisdictions, all of the Canadian provinces, Mexico and many other foreign countries have authorized pari-mutuel wagering on horse races, and 16 states and many foreign countries, including Mexico, conduct pari-mutuel wagering on greyhound races. In addition, Connecticut, Rhode Island, Florida and Mexico also allow pari-mutuel wagering on jai alai matches.

Companies that manufacture, distribute and/or operate pari-mutuel wagering systems in these jurisdictions are subject to the regulations of the applicable regulatory authorities there. These authorities generally require a company, as well as its directors, officers, certain employees and holders of five percent or more of our common stock, to obtain various licenses, permits and approvals. Regulatory authorities may also conduct background investigations of us and our key personnel and stockholders in order to ensure the integrity of the wagering system. These authorities have the power to refuse, revoke or restrict a license for any cause they deem reasonable. The loss of a license in one jurisdiction may cause our licensing status to come under review in other jurisdictions as well.

In order for any of our subsidiaries to provide pari-mutuel wagering equipment and/or services to casinos in Atlantic City, New Jersey, the subsidiary must be licensed by the New Jersey Casino Control Commission, or the Casino Commission, as a gaming related casino service industry in accordance with the New Jersey Casino Control Act, or the Casino Control Act, and by the New Jersey Racing Commission. An applicant for a gaming related casino service industry license is required to establish, by clear and convincing evidence, financial stability, integrity and responsibility, good character, honesty and integrity, and sufficient business ability and experience to conduct a successful operation. We must also qualify under the standards of the Casino Control Act. We and any of our applicant subsidiaries may also be required to produce such information, documentation and assurances as required by the regulators to establish the integrity of all our directors, officers and financial backers, who may be required to seek qualification or waiver of qualification. For affiliates of New Jersey casinos, the Casino Commission traditionally has waived the qualification requirement for investors holding less than 15% of a debt issue. For institutional investors, the Casino Commission has traditionally waived the qualification requirement for holders if their positions are not more than 20% of the issuer s overall debt and not more than 50% of the specific debt issue. There can be no assurance, however, that the Casino Commission will waive any qualification requirement for any holder.

The Casino Commission has broad discretion in licensing matters and may at any time condition a license or suspend or revoke a license or impose fines upon a finding of disqualification or non-compliance. The Casino Commission may require that persons holding five percent or more of our Class A common stock or instruments convertible into Class A common stock qualify under the Casino Control Act. Under the Casino Control Act, a security holder is presumed to control a publicly traded corporation if the holder owns at least five percent of the corporation s equity securities; however, for passive institutional investors, qualification is generally not required for a position of less than 10%, and upon a showing of good cause, qualification may be excused for a position of 10% or more. Failure to qualify could jeopardize our license. In addition, the New Jersey Racing Commission also licenses our subsidiary and retains concurrent regulatory oversight over this subsidiary with the Casino Commission.

Our rights to operate the Connecticut OTB system are conditioned on our continuing to hold all licenses required for the operation of the system. In addition, our officers and directors and certain other employees must be licensed. Licensees are generally required to submit to background investigations and provide required disclosures. The Division of Special Revenue of the State of Connecticut, or the Division, may revoke the license to operate the system under certain circumstances, including a false statement in the licensing disclosure materials, a transfer of ownership of the licensed entity without Division approval and failure to meet financial obligations. The approval of the Connecticut regulatory authorities is required before any off-track betting facility is closed or relocated or any new branch or simulcast facility is established. Our telephone wagering operations, based in Connecticut, are subject to the Division s regulation. We have expanded the market for our business-to-consumer On the Wire® account wagering business through our Connecticut OTB to 11 states.

While in the past we have been the subject of enforcement proceedings instituted by one or more regulatory bodies, we have been able to consensually resolve any such proceedings upon the implementation of remedial measures and/or the payment of settlements or monetary fines to such bodies. However, there can be no assurance that similar proceedings in the future will be similarly resolved, or that such proceedings will not have a material adverse impact on our ability to retain and renew existing licenses or to obtain new licenses in other jurisdictions.

#### Simulcasting

The Federal Communications Commission regulates the use and transfer of earth station licenses used to operate our domestic simulcasting operations.

At present, 43 U.S. states, Puerto Rico, all of the Canadian provinces, Mexico and many other foreign countries authorize interstate and/or intrastate pari-mutuel wagering, which may involve the simulcasting of the races in question. Licensing and other regulatory requirements associated with such simulcasting activities are similar to those governing pari-mutuel wagering and are generally enforced by pari-mutuel regulators. In addition, contracts with host tracks whose races are simulcast by us to other facilities within or outside the jurisdictions in which such races are held may be subject to approval by regulatory authorities in the jurisdictions from and/or to which the races are simulcast. We believe that we are in substantial compliance with applicable regulations and that we, and/or the appropriate third parties, have entered into contracts and obtained the necessary regulatory approvals to conduct current simulcast operations lawfully.

#### Nevada Regulatory Matters

We and certain of our 100%-owned subsidiaries are applicants or will be applicants for certain registrations, approvals, findings of suitability and licenses in the State of Nevada. Accordingly, set forth below is certain information required by Nevada law to be included herein.

The manufacture, sale and distribution of gaming devices for use or play in Nevada or for distribution outside of Nevada, the manufacture and distribution of associated equipment for use in Nevada, the operation of an off-track pari-mutuel wagering system in Nevada, the operation of an off-track pari-mutuel sports wagering system in Nevada and the operation of slot machine routes in Nevada are subject to: (i) the Nevada Gaming Control Act and the regulations promulgated thereunder, or the Nevada Act; and (ii) various local ordinances and regulations (collectively Nevada gaming laws). Such activities are subject to the licensing and regulatory control of the Nevada Gaming Commission, the Nevada State Gaming Control Board, and various local, city and county regulatory agencies, collectively the Nevada gaming authorities.

The laws, regulations and supervisory procedures of the Nevada gaming authorities are based upon declarations of public policy which are concerned with, among other things: (i) the prevention of unsavory or unsuitable persons from having a direct or indirect involvement with gaming, or manufacturing or distribution of gaming devices at any time or in any capacity; (ii) the strict regulation of all persons, locations, practices, associations and activities related to the operation of licensed gaming establishments and the manufacture or distribution of gaming devices and equipment; (iii) the establishment and maintenance of responsible accounting practices and procedures; (iv) the maintenance of effective controls over the financial practices of licensees, including the establishment of minimum procedures for internal fiscal affairs and the safeguarding of assets and revenues, providing reliable record keeping and requiring the filing of periodic reports with the Nevada gaming authorities; (v) the prevention of cheating and fraudulent practices; and (vi) to provide a source of state and local revenues through taxation and licensing fees. Changes in such laws, regulations and procedures could have an adverse effect on our various applications in the event they are granted. The grant or denial of the applications is within the discretion of the Nevada gaming authorities. There can be no assurances that the pending applications by us and our subsidiaries operating in Nevada will be approved or that, if approved, they will be approved on a timely basis or without conditions or limitations.

We are an applicant for registration by the Nevada Gaming Commission as a publicly traded corporation and are or will be an applicant to be found suitable to own the stock, both directly and indirectly of various 100%-owned subsidiaries which are or will be applicants for approvals and licensing as a manufacturer, distributor and operator of a slot machine route, an operator of an off-track pari-mutuel wagering system and an operator of an off-track pari-mutuel sports wagering system. Our officers, directors and key employees who are actively and directly involved in the licensed activities of our subsidiaries operating in Nevada may be required to be licensed or found suitable by the Nevada gaming authorities. In addition, certain of our shareholders may have to be found suitable. Any beneficial holder of our voting securities, regardless of the number of shares owned, may be required to file an application, be investigated, and have his suitability determined as a beneficial holder of our voting securities if the Nevada Gaming Commission has reason to believe that such ownership would otherwise be inconsistent with the declared policies of the state of Nevada. The applicant must pay all costs of investigation incurred by the Nevada gaming authorities in conducting any such investigation. The Nevada Act requires any person who acquires beneficial ownership of more than 5% of a registered corporation s voting securities to report the acquisition to the Nevada Gaming Commission for a finding of suitability within thirty days after the Chairman of the Nevada Gaming Control Board mails the written notice requiring such filing. Under certain circumstances, an institutional investor, as defined in the Nevada Act, which acquires more than 10%, but not more than 15%, of the registered corporation s voting

institutional investor, as defined in the Nevada Act, which acquires more than 10%, but not more than 15%, of the registered corporation's voting securities may apply to the Nevada Gaming Commission for a waiver of such finding of suitability if such institutional investor holds the voting securities for investment purposes only. An institutional investor shall not be deemed to hold voting securities for investment purposes unless the voting securities were acquired and are held in the ordinary course of business as an institutional investor and not for the purpose of causing, directly or indirectly, the election of a majority of the members

of the board of directors of the registered corporation, any change in the registered corporation s corporate charter, bylaws, management, policies or operations of the registered corporation, or any of its gaming affiliates, or any other action which the Nevada Gaming Commission finds to be inconsistent with holding the registered corporation s voting securities for investment purposes only. Activities which are not deemed to be inconsistent with holding voting securities for investment purposes only include: (i) voting on all matters voted on by stockholders; (ii) making financial and other inquiries of management of the type normally made by securities analysts for informational purposes and not to cause a change in its management, policies or operations; and (iii) such other activities as the Nevada Gaming Commission may determine to be consistent with such investment intent.

We and our subsidiaries operating in Nevada will be required to maintain a current stock ledger in Nevada, which may be examined by the Nevada gaming authorities at any time. If any securities are held in trust by an agent or by a nominee, the record holder may be required to disclose the identity of the beneficial owner to the Nevada gaming authorities. A failure to make such disclosure may be grounds for finding the record holder unsuitable. We are also required to render maximum assistance in determining the identity of the beneficial owner. The Nevada Gaming Commission has the power to require our stock certificates to bear a legend indicating that the securities are subject to the Nevada Act.

If the beneficial holder of voting securities who must be licensed or found suitable is a corporation, partnership or trust, it must submit detailed business and financial information including a list of beneficial owners. The applicant is required to pay all costs of investigation.

Also under the Nevada Act and under certain circumstances, an institutional investor as defined in the Nevada Act, which intends to acquire not more than 15% of any class of nonvoting securities of a privately-held corporation, limited partnership or limited liability company that is also a registered holding or intermediary company or the holder of a gaming license, may apply to the Nevada Gaming Commission for a waiver of the usual prior licensing or finding of suitability requirements if such institutional investor holds such nonvoting securities for investment purposes only. An institutional investor shall not be deemed to hold nonvoting securities for investment purposes unless the nonvoting securities were acquired and are held in the ordinary course of business as an institutional investor, do not give the institutional investor management authority, and do not, directly or indirectly, allow the institutional investor to vote for the election or appointment of members of the board of directors, a general partner or manager, cause any change in the articles of organization, operating agreement, other organic document, management, policies or operations, or cause any other action that the Nevada Gaming Commission finds to be inconsistent with holding nonvoting securities for investment purposes only. Activities that are not deemed to be inconsistent with holding nonvoting securities for investment purposes only include: (i) nominating any candidate for election or appointment to the entity s board of directors or equivalent in connection with a debt restructuring; (ii) making financial and other inquiries of management of the type normally made by securities analysts for informational purposes and not to cause a change in the entity s management, policies or operations; and (iii) such other activities as the Nevada Gaming Commission may determine to be consistent with such investment intent. If the beneficial holder of nonvoting securities who must be licensed or found suitable is a corporation, partnership or trust, it must submit detailed business and financial information including a list of beneficial owners. The applicant is required to pay all costs of investigation.

Any person who fails or refuses to apply for a finding of suitability or a license within thirty days after being ordered to do so by the Nevada Gaming Commission or the Chairman of the Nevada Gaming Control Board, may be found unsuitable. The same restrictions apply to a record owner if the record owner, after request, fails to identify the beneficial owner. Any stockholder found unsuitable and who holds, directly or indirectly, any beneficial ownership of the common stock beyond such period of time as may be prescribed by the Nevada Gaming Commission may be guilty of a criminal offense. We will be subject to disciplinary action if, after we receive notice that a person is unsuitable to be a stockholder or to

have any other relationship with us, our subsidiaries operating in Nevada or we (i) pay that person any dividend or interest upon our voting securities, (ii) allow that person to exercise, directly or indirectly, any voting right conferred through securities held by that person, (iii) pay remuneration in any form to that person for services rendered or otherwise, or (iv) fail to pursue all lawful efforts to require such unsuitable person to relinquish his voting securities including, if necessary, the immediate purchase of said voting securities for cash at fair market value.

The Nevada Gaming Commission may, in its discretion, require the holder of any debt security of a registered corporation to file applications, be investigated and be found suitable to own the debt security of a registered corporation if the Nevada Gaming Commission has reason to believe that his acquisition of such debt security would otherwise be inconsistent with the declared policy of the State of Nevada. If the Nevada Gaming Commission determines that a person is unsuitable to own such security, then pursuant to the Nevada Act, the registered corporation can be sanctioned, including the loss of its approvals, if without the prior approval of the Nevada Gaming Commission, it: (i) pays to the unsuitable person any dividend, interest, or any distribution whatsoever; (ii) recognizes any voting right by such unsuitable person in connection with such securities; (iii) pays the unsuitable person remuneration in any form; or (iv) makes any payment to the unsuitable person by way of principal, redemption, conversion, exchange, liquidation, or similar transaction.

The Nevada gaming authorities may deny an application for licensing for any cause that they deem reasonable. A finding of suitability is comparable to licensing, and both require submission of detailed personal and financial information followed by a thorough investigation. The applicant or the entity with which the applicant is employed or for which the applicant serves must pay all the costs of the investigation. Changes in licensed positions must be reported to the Nevada gaming authorities and in addition to their authority to deny an application for a finding of suitability or licensure, the Nevada gaming authorities have jurisdiction to disapprove a change in a corporate position.

As a registered corporation, we will be required periodically to submit detailed financial and operating reports to the Nevada Gaming Commission and furnish any other information that the Nevada Gaming Commission may require. No person may become a stockholder of, or receive any percentage of profits from, our subsidiaries operating in Nevada without first obtaining licenses and approvals from the Nevada gaming authorities. We and our subsidiaries operating in Nevada have or will apply to the Nevada gaming authorities for the various registrations, approvals, permits, findings of suitability and licenses to engage in manufacturing, distribution, slot route activities, and off-track pari-mutuel wagering systems operations in Nevada.

The following regulatory requirements may apply to us and our subsidiaries operating in Nevada if we and our subsidiaries are approved and licensed. All gaming devices and cashless wagering systems that are manufactured, sold or distributed for use or play in Nevada, or for distribution outside of Nevada, must be manufactured by licensed manufacturers and distributed or sold by licensed distributors. The Nevada Gaming Commission must approve all gaming devices manufactured for use or play in Nevada before distribution or exposure for play. The approval process for gaming devices includes rigorous testing by the Nevada Gaming Control Board, a field trial and a determination as to whether the gaming device meets strict technical standards that are set forth in the regulations of the Nevada Gaming Commission. Associated equipment must be administratively approved by the Chairman of the Nevada Gaming Control Board before distribution or use in Nevada.

The Nevada gaming authorities may investigate any individual who has a material relationship to, or material involvement with, us or our subsidiaries operating in Nevada to determine whether such individual is suitable or should be licensed as a business associate of a gaming licensee. Officers, directors and certain key employees of our subsidiaries operating in Nevada must file applications with the Nevada gaming authorities and may be required to be licensed or found suitable by the Nevada gaming authorities.

If the Nevada gaming authorities were to find an officer, director or key employee unsuitable for licensing or unsuitable to continue having a relationship with us or our subsidiaries operating in Nevada, the companies involved would have to sever all relationships with such person. In addition, the Nevada Gaming Commission may require us and our subsidiaries operating in Nevada to terminate the employment of any person who refuses to file appropriate applications. Determinations of suitability or of questions pertaining to licensing are not subject to judicial review in Nevada.

We and our subsidiaries operating in Nevada will be required to submit detailed financial and operating reports to the Nevada Gaming Commission. Substantially all material loans, leases, sales of securities and similar financing transactions by our subsidiaries operating in Nevada will be required to be reported to or approved by the Nevada Gaming Commission. If we are licensed by the Nevada gaming authorities, any (i) guarantees issued by our subsidiaries operating in Nevada in connection with any public financing; (ii) hypothecation of the assets of our subsidiaries operating in Nevada as security in connection with any public financing; and/or (iii) pledges of the equity securities of our subsidiaries operating in Nevada as security in connection with any financing will require the approval of the Nevada Gaming Commission to remain effective. If it were determined that the Nevada Act was violated by us or any of our subsidiaries operating in Nevada, the licenses we or they hold could be limited, conditioned, suspended or revoked, subject to compliance with certain statutory and regulatory procedures. In addition, any of our subsidiaries operating in Nevada, we and the persons involved could be subject to substantial fines for each separate violation of the Nevada Act at the discretion of the Nevada Gaming Commission. Limitation, conditioning or suspension of the licenses held by us and our subsidiaries operating in Nevada.

After becoming a registered corporation, we may not make a public offering of our securities without the prior approval of the Nevada Gaming Commission if the securities or proceeds from that sale are intended to be used to construct, acquire or finance gaming facilities in Nevada, or to retire or extend obligations incurred for such purposes. Such approval, if given, does not constitute a finding, recommendation or approval by the Nevada Gaming Commission or the Nevada Gaming Control Board as to the accuracy or adequacy of the prospectus or the investment merits of the securities offered. Any representation to the contrary is unlawful. While we are not yet subject to the provisions of the Nevada Act or the regulations of the Nevada Gaming Commission, such regulations also provide that any entity that is not an affiliated company, as such term is defined in the Nevada Act, or which is not otherwise subject to the Nevada Act or such regulations, which plans to make a public offering of securities intending to use such securities, or the proceeds from the sale thereof, for the construction or operation of gaming facilities in Nevada, or to retire or extend obligations incurred for such purposes, may apply to the Nevada Gaming Commission for prior approval of such offering. The Nevada Gaming Commission may find an applicant unsuitable based solely on the fact that it did not submit such an application, unless upon a written request for a ruling, the Nevada Gaming Control Board Chairman has ruled that it is not necessary to submit an application.

Changes in control of a registered corporation through merger, consolidation, stock or asset acquisitions, management or consulting agreements, or any act or conduct by a person whereby he obtains control, may not occur without the prior approval of the Nevada Gaming Commission. Entities seeking to acquire control of a registered corporation must satisfy the Nevada Gaming Control Board and the Nevada Gaming Commission in a variety of stringent standards prior to assuming control of such Registered Corporation. The Nevada Gaming Commission may also require controlling stockholders, officers, directors and other persons having a material relationship or involvement with the entity proposing to acquire control, to be investigated and licensed as part of the approval process relating to the transaction.

The Nevada Legislature has declared that some corporate acquisitions opposed by management, repurchases of voting securities and corporate defense tactics affecting Nevada corporate gaming licensees,

and registered corporations that are affiliated with those operations, may be injurious to stable and productive corporate gaming. The Nevada Gaming Commission has established a regulatory scheme to ameliorate the potentially adverse effects of these business practices upon Nevada s gaming industry and to further Nevada s policy to: (i) assure the financial stability of corporate gaming licensees and their affiliates; (ii) preserve the beneficial aspects of conducting business in the corporate form; and (iii) promote a neutral environment for the orderly governance of corporate affairs. Approvals are, in certain circumstances, required from the Nevada Gaming Commission before the registered corporation can make exceptional repurchases of voting securities above the current market price thereof and before a corporate acquisition opposed by management can be consummated. The Nevada Act also requires prior approval of a plan of recapitalization proposed by the registered corporation s Board of Directors in response to a tender offer made directly to the registered corporation s stockholders for the purposes of acquiring control of the registered corporation.

Any person who is licensed, required to be licensed, registered, required to be registered, or is under common control with such persons, collectively licensees, and who proposes to become involved in a gaming venture outside of Nevada, is required to deposit with the Nevada Gaming Control Board, and thereafter maintain, a revolving fund in the amount of \$10,000 to pay the expenses of investigation by the Nevada Gaming Control Board of their participation in such foreign gaming. The revolving fund is subject to increase or decrease at the discretion of the Nevada Gaming Commission. Thereafter, licensees are required to comply with certain reporting requirements imposed by the Nevada Act. A licensee is also subject to disciplinary action by the Nevada Gaming Commission if it knowingly violates any laws of the foreign jurisdiction pertaining to the foreign gaming operations, engages in activities that are harmful to the state of Nevada or its ability to collect gaming taxes and fees, or employs a person in the foreign operation who has been denied a license or finding of suitability in Nevada on the ground of personal unsuitability.

#### Application of Additional or Future Regulatory Requirements

In the future, we intend to seek the necessary licenses, approvals and findings of suitability for us, our personnel and products in other jurisdictions throughout the world wherever significant sales are anticipated to be made. There can be no assurance, however, that such licenses, approvals or findings of suitability will be obtained or, if obtained, will not be conditioned, suspended or revoked or that we will be able to obtain the necessary approvals for any future products as they are developed. If a license, approval or a finding of suitability is required by a regulatory authority and we fail to obtain the necessary license, approval or finding, we may be prohibited from selling our products for use in the respective jurisdiction or may be required to sell our products through other licensed entities at a reduced profit.

#### **Executive Officers of the Company**

Our executive officers are elected each year at the annual meeting of the Board of Directors, which follows the annual meeting of stockholders, to hold office for a one-year term and until their successors have been elected and qualified or until their earlier death, resignation or removal.

Certain information regarding each of our executive officers is set forth below.

Name	Age	Position
A. Lorne Weil	61	Chairman of the Board and Chief Executive Officer
Michael R. Chambrello	49	President and Chief Operating Officer
DeWayne E. Laird	59	Vice President, Chief Financial Officer and Corporate Controller
Ira H. Raphaelson	53	Vice President, General Counsel and Secretary
Larry A. Potts	59	Vice President, Chief Compliance Officer and Director of Security
Sally L. Conkright	54	Vice President of Administration and Chief Human Resources Officer
William J. Huntley	57	Vice President and President of Racing, Sports and Gaming Technology
Steven M. Saferin	58	Vice President and President of Properties
Robert C. Becker	48	Vice President and Treasurer
Stephen L. Gibbs	34	Vice President and Chief Accounting Officer

A. Lorne Weil has been Chairman of the Board of Directors since October 1991 and Chief Executive Officer since April 1992. Mr. Weil also served as President of the Company from August 1997 to June 2005. Mr. Weil was President of Lorne Weil, Inc., a firm providing strategic planning and corporate development services to high technology industries, from 1979 to November 1992. Previously, Mr. Weil was Vice President of Corporate Development at General Instrument Corporation, working with wagering and cable systems.

*Michael R. Chambrello* has served as President and Chief Operating Officer since July 2005. From November 2000 to June 2005, Mr. Chambrello was President and CEO of Environmental Systems Products Holdings, Inc. (ESP), which provides vehicle emissions testing systems and services to government agencies and prior to ESP he was CEO of Transmedia Asia Pacific, Inc. and Transmedia Europe Inc., which provide membership-based consumer and business services. Mr. Chambrello has approximately 20 years of lottery industry experience, having served as President of Gtech Corporation and Executive Vice President of Gtech Holdings Corporation.

*DeWayne E. Laird* has served as Vice President and Chief Financial Officer since November 1998 and Corporate Controller since April 1996. From January 1992 to March 1996, Mr. Laird was President of Laird Associates, PC, a CPA firm providing financial consulting services to a variety of industries. From April 1984 to December 1991, he held various senior positions with Philadelphia Suburban Corporation, including Chief Financial Officer and Treasurer.

*Ira H. Raphaelson* has served as Vice President and General Counsel since February 2006 and as Secretary since June 2006. Mr. Raphaelson is the chief legal officer of the Company. Prior to joining the Company, Mr. Raphaelson was a partner in the Washington D.C. office of the law firm of O Melveny & Myers LLP where he was a member of the firm s global enforcement defense practice and litigator for 10 years.

*Larry A. Potts* has served as Vice President, Chief Compliance Officer and Director of Security since February 2006. Mr. Potts joined the Company in September 2004 as Vice President, Security and Compliance. Previously, he was the Chief Operating Officer of an international consulting and investigative company in Washington, D.C. Prior to that, he served as a Special Agent of the Federal Bureau of Investigation for over 23 years, where he served in a number of management positions, including Deputy Director.

*Sally L. Conkright* has served as Vice President of Administration and Chief Human Resources Officer since 2005. Ms Conkright previously served as Vice President of Organizational Development for the Company. Prior to joining the Company in 2002, Ms. Conkright served as Director of Compensation and Benefits for Xerox Corporation from 1999 to 2000 and as Vice President of Human Resources and Public Relations for Xerox New Enterprises from 1997 to 1999.

*William J. Huntley* has served as Vice President and President of Racing, Sports and Gaming Technology since March 2006. Mr. Huntley previously served as Vice President of Lottery Systems and as President of the Systems Division of Scientific Games International, Inc. from September 2000 to February 2006. Mr. Huntley has also served as President of Scientific Games Racing, LLC since January 2005. Previously, Mr. Huntley served as President of Autotote Lottery Corporation from November 1997 until its merger into Scientific Games International, Inc. in September 2000. He served as Vice President of Autotote Systems, Inc. (now known as Scientific Games Racing, LLC) from June 1989 to November 1997 and as Vice President of Operations of the Company from 1991 to 1994.

*Steven M. Saferin* has served as Vice President of Properties since June 2005 and as President of the Properties Division of Scientific Games International, Inc. since September 2003. Mr. Saferin has been with the Company since the acquisition of MDI in January 2003. Mr. Saferin founded MDI in 1986, an industry leader in licensed lottery games and promotions, where Mr. Saferin served as President and Chief Executive Officer. Prior to founding MDI, Mr. Saferin was the Director of Program Acquisitions at ESPN. In addition, Mr. Saferin held the positions of Vice President with Viacom Communications and Warner Amex Cable and was an Attorney-Advisor to the Cable Television Bureau of the Federal Communications Commission.

*Robert C. Becker* has served as Treasurer since October 1996 and as Vice President and Treasurer since April 2001. Prior to joining the Company, Mr. Becker served as Assistant Treasurer for the Fuller Company from 1990 to 1994.

*Stephen L. Gibbs* has served as Vice President and Chief Accounting Officer since April 2006. Mr. Gibbs joined Scientific Games Racing, LLC, a subsidiary of the Company, in April 2005, as Vice President of Finance. Prior to joining the Company, Mr. Gibbs served as Manager of Accounting Research for The Coca-Cola Company from September 2004 to March 2005 and as Controller for TRX, Inc. from May 2004 to August 2004. Prior to that time, Mr. Gibbs served nine years in public accounting with the firms of Arthur Andersen and Deloitte & Touche.

#### Access to Public Filings

We file annual reports, quarterly reports, current reports, proxy statements and other documents with the Securities and Exchange Commission (SEC) under the Securities Exchange Act of 1934, as amended. The SEC maintains an Internet website that contains reports, proxy and information statements, and other information regarding issuers, including us, that file electronically with the SEC. The public can obtain any documents that we file with the SEC at http://www.sec.gov.

We make the following information available free of charge through the Investor Relations link on our website at www.scientificgames.com:

• Our annual reports on Form 10-K, quarterly reports on Form 10-Q, current reports on Form 8-K and amendments to those reports as soon as reasonably practicable after they are filed electronically with the SEC;

• The Section 16 ownership reports filed by our officers, directors and 10% stockholders on Forms 3, 4 and 5 and amendments to those reports as soon as reasonably practicable after they are filed electronically with the SEC; and

• Our code of business conduct and ethics, which applies to all of our officers, directors and employees.

#### ITEM 1A. RISK FACTORS

You should carefully consider the following information with the other information contained or incorporated by reference in this annual report on Form 10-K.

# We operate in highly competitive industries and our success depends on our ability to effectively compete with numerous domestic and foreign businesses.

We face competition from a number of domestic and foreign businesses, some of which have substantially greater financial resources than we do, which could impact our ability to win new contracts and renew existing contracts. We continue to operate in a period of intense price-based competition, which could affect the profitability of the contracts we do win. Contract awards by lottery authorities are sometimes challenged by unsuccessful bidders, which can result in protracted legal proceedings that can result in delayed implementation or cancellation of the award. In addition, the domestic lottery market has matured such that the number of states conducting lotteries is unlikely to increase in the near-term. Our domestic U.S. instant ticket business could be adversely affected should additional foreign competitors in Canada or Mexico export their lottery products to the U.S. or should other foreign competitors establish printing facilities in the U.S., Canada or Mexico to supply the U.S. market.

We also compete in the international instant ticket lottery market with low-price, low-quality printers in a regulated environment where competition laws are being reinterpreted so as to create competition from non-traditional lottery vendors and products.

Pricing pressures and potential privatization of some lotteries may also change the manner in which online and instant ticket contracts are awarded and the profitability of those contracts. Any future success of our lottery business will also depend, in part, on the success of the lottery industry in attracting and retaining players in the face of increased competition for these players entertainment dollars, as well as our own success in developing innovative products and systems to achieve this goal. Our failure to achieve this goal could reduce revenues from our lottery operations.

We also operate in competitive markets in other parts of our business. Our pari-mutuel business faces competition from other operators, other gaming venues such as casinos and state-sponsored lotteries and other forms of legal and illegal gaming. The market for pari-mutuel wagering has seen declines over a period of years and the continuing popularity of horse and dog racing is important to the operating results of our pari-mutuel business. Our other gaming related businesses face competition from other vendors and illegal operators, as well as changes in law and regulation that can affect our future profitability. In our prepaid phone card business, we face competition from other instant lottery ticket printers utilizing similar lottery security and printing technologies, as well as alternative printing and non-printing technologies, such as smart cards, with which our products compete. Moreover, the cellular telephone industry is undergoing technology changes such that other technologies, including electronic commerce, could impact our growth opportunities and our customer relationships. Further, increasing price competition in the prepaid phone card business may continue to negatively affect our operating margins.

#### Our business is subject to evolving technology.

The markets for all of our products and services are affected by changing technology, new legislation and evolving industry standards. Our ability to anticipate or respond to such changes and to develop and introduce new and enhanced products and services on a timely basis will be a significant factor in our ability to expand, remain competitive, attract new customers and retain existing contracts.

We can give no assurance that we will achieve the necessary technological advances, have the financial resources, introduce new products or services on a timely basis or otherwise have the ability to compete effectively in the markets we serve.

## We are heavily dependent on our ability to renew our long-term contracts with our customers and we could lose substantial revenue if we are unable to renew certain of our contracts.

Generally, our contracts are for initial terms of one to seven years, with optional renewal periods. Upon the expiration of a contract, including any extensions thereof, new contracts may be awarded through a competitive bidding process. Contracts representing a substantial majority of our annual revenues from lottery contracts are scheduled to expire or reach optional extension dates during the next three years. Contracts accounting for a majority of our current annual pari-mutuel revenues are scheduled to expire during the next three years. Contracts accounting for a majority of our wide area gaming revenues are scheduled to expire beginning in 2010.

We are also required by certain of our lottery customers to provide surety, or performance, bonds. There can be no assurance that we will continue to be able to obtain performance bonds on commercially reasonable terms or at all. Our inability to provide such bonds would materially and adversely affect our ability to renew existing, or obtain new, lottery contracts.

Our contracts for the broadcast of signals are usually one year contracts. Because of competitive and other factors, we cannot provide assurance that these broadcast contracts will be renewed. Elimination of our access to racing broadcast signals could have a material adverse affect on racing revenue as well as our ability to expand the business into new markets.

There can be no assurance that our current contracts will be extended or that we will be awarded new contracts as a result of competitive bidding processes in the future. The termination, expiration or failure to renew one or more of our contracts could cause us to lose substantial revenue.

# Our ability to bid on new contracts is dependent upon our ability to fund required up-front capital expenditures through our cash from operations or through financings.

Our online lottery, wide area gaming and pari-mutuel contracts generally require significant up-front capital expenditures for terminal assembly, software customization and implementation, systems and equipment installation and telecommunications configuration. Historically, we have funded these up-front costs through cash flows generated from operations, available cash on hand and borrowings under our credit facilities. Our ability to continue to procure new contracts will depend on, among other things, our then present liquidity levels or our ability to obtain additional financing at commercially acceptable terms to finance the initial up-front costs. If we do not have adequate liquidity or are unable to obtain financing for these up-front costs on favorable terms or at all, we may not be able to bid on certain contracts, which could restrict our ability to grow and have a material adverse effect on our future profitability.

#### Our business depends on the protection of our intellectual property and proprietary information.

We believe that our success depends, in part, on protecting our intellectual property in the United States and in foreign countries. Our intellectual property includes certain patents and trademarks relating to our instant ticket games and wagering systems, as well as proprietary or confidential information that is not subject to patent or similar protection. Our intellectual property protects the integrity of our games, systems, products and services, which is a core value of the industries in which we operate. For example, our intellectual property is designed to ensure the security of the printing of our instant lottery tickets and prepaid phone cards and provide simple and secure validation of our lottery tickets. Competitors may independently develop similar or superior products, software, systems or business models. In cases where our intellectual property is not protected by an enforceable patent, such independent development may result in a significant diminution in the value of our intellectual property.

There can be no assurance that we will be able to protect our intellectual property. We enter into confidentiality or license agreements with our employees, vendors, consultants, and, to the extent legally

permissible, our customers, and generally control access to, and the distribution of, our game designs, systems and other software documentation and other proprietary information, as well as the designs, systems and other software documentation and other information we license from others. Despite our efforts to protect these proprietary rights, unauthorized parties may try to copy our gaming products, business models or systems, use certain of our confidential information to develop competing products, or develop independently or otherwise obtain and use our gaming products or technology, any of which could have a material adverse effect on our business. Policing unauthorized use of our technology is difficult and expensive, particularly because of the global nature of our operations. The laws of other countries may not adequately protect our intellectual property.

There can be no assurance that our business activities, games, products and systems will not infringe upon the proprietary rights of others, or that other parties will not assert infringement claims against us. Any such claim and any resulting litigation, should it occur, could subject us to significant liability for damages and could result in invalidation of our proprietary rights, distract management, and/or require us to enter into costly and burdensome royalty and licensing agreements. Such royalty and licensing agreements, if required, may not be available on terms acceptable to us, or may not be available at all. In the future, we may also need to file lawsuits to defend the validity of our intellectual property rights and trade secrets, or to determine the validity and scope of the proprietary rights of others. Such litigation, whether successful or unsuccessful, could result in substantial costs and diversion of resources.

We rely on products and technologies that we license from third parties. There can be no assurance that these third-party licenses, or the support for such licenses, will continue to be available to us on commercially reasonable terms.

#### Our business competes on the basis of the security and integrity of our systems and products.

We believe that our success depends, in part, on providing secure products and systems to our vendors and customers. Attempts to penetrate security measures may come from various combinations of customers, retailers, vendors, employees and others. Our ability to monitor and ensure quality of our products is periodically reviewed and enhanced. Similarly, we constantly assess the adequacy of our security systems to protect against any material loss to any of our customers and the integrity of the product to end-users. There can be no assurance that our business might not be affected by a security breach or lapse which could have a material adverse impact on our business.

# Our industry is subject to strict government regulations that may limit our existing operations and have a negative impact on our ability to grow.

In the United States and many other countries, lotteries, pari-mutuel and other forms of wagering must be expressly authorized by law. Once authorized, such activities are subject to extensive and evolving governmental regulation. Moreover, such gaming regulatory requirements vary from jurisdiction to jurisdiction. Therefore, we are subject to a wide range of complex gaming laws and regulations in the jurisdictions in which we are licensed. Most jurisdictions require that we be licensed, that our key personnel and certain of our security holders be found suitable or be licensed, and that our products be reviewed and approved before placement. If a license, approval or finding of suitability is required by a regulatory authority and we fail to seek or do not receive the necessary approval, license or finding of suitability, then we may be prohibited from distributing our products for use in the respective jurisdiction.

The regulatory environment in any particular jurisdiction may change in the future, and any such change could have a material adverse effect on our results of operations. Moreover, there can be no assurance that the operation of lotteries, pari-mutuel wagering facilities, video gaming industry machines, Internet gaming or other forms of lottery or wagering systems will be approved by additional jurisdictions or that those jurisdictions in which these activities are currently permitted will continue to permit such

activities. While we believe that we have developed procedures and policies designed to comply with the requirements of evolving laws, there can be no assurance that law enforcement or gaming regulatory authorities will not seek to restrict our business in their jurisdictions or even institute enforcement proceedings. Moreover, in addition to the risk of enforcement action, we are also at risk from loss of business reputation in the event of any potential legal or regulatory investigation whether or not the Company is ultimately accused of or found to have committed any violations.

We are required to obtain and maintain licenses from various state and local jurisdictions in order to operate certain aspects of our pari-mutuel business and we are subject to extensive background investigations and suitability standards in our lottery business. We also will become subject to regulation in any other jurisdiction where our customers operate in the future. There can be no assurance that we will be able to obtain new licenses or renew any of our licenses, and the loss, denial or non-renewal of any of our licenses could have a material adverse effect on our business. Lottery authorities generally conduct background investigations of the winning vendor and its employees prior to and after the award of a lottery contract. Generally, regulatory authorities have broad discretion when granting, renewing or revoking these approvals and licenses. Lottery authorities with which we do business may require the removal of any of our employees deemed to be unsuitable and are generally empowered to disqualify us from receiving a lottery contract or operating a lottery system as a result of any such investigation. Our failure, or the failure of any of our key personnel, systems or machines, in obtaining or retaining a required license or approval in one jurisdiction could negatively impact our ability (or the ability of any of our key personnel, systems or gaming machines) to obtain or retain required licenses and approvals in other jurisdictions. The failure to obtain or retain a required license or approval in any jurisdiction would decrease the geographic areas where we may operate and generate revenues, decrease our share in the gaming marketplace and put us at a disadvantage compared with our competitors.

Some jurisdictions also require extensive personal and financial disclosure and background checks from persons and entities beneficially owning a specified percentage (typically 5% or more) of our equity securities. The failure of these beneficial owners to submit to such background checks and provide required disclosure could jeopardize the award of a lottery contract to us or provide grounds for termination of an existing lottery contract. Additional restrictions are often imposed by international jurisdictions in which we market our lottery systems on foreign corporations, such as us, seeking to do business in such jurisdictions. In light of these regulations and the potential impact on our business, the Board of Directors adopted a proposed amendment to our restated certificate of incorporation in January 2007, subject to a vote of the stockholders at our next stockholders meeting, which amendment would allow for the restriction of stock ownership by persons or entities who fail to comply with informational or other regulatory requirements under applicable gaming law, who are found unsuitable to hold our stock by gaming authorities or whose stock ownership adversely affect our ability to obtain, maintain, renew or qualify for a license, contract, franchise or other regulatory approval from a gaming authority. The licensing procedures and background investigations of the authorities that regulate our businesses and the proposed amendment may inhibit potential investors from becoming significant stockholders or inhibit existing shareholders from retaining or increasing their ownership.

We have developed and implemented an internal compliance program in an effort to ensure that we comply with legal requirements imposed in connection with our wagering-related activities, as well as legal requirements generally applicable to all publicly traded corporations. The compliance program is run on a day-to-day basis by our Chief Compliance Officer with legal advice provided by our General Counsel and outside experts. The compliance program is overseen by the Compliance Committee of our Board of Directors, consisting of three outside directors. While we are firmly committed to full compliance with all applicable laws, there can be no assurance that such steps will prevent the violation of one or more laws or regulations, or that a violation by us or an employee will not result in the imposition of a monetary fine or suspension or revocation of one or more of our licenses.

## Gaming opponents persist in their efforts to curtail the expansion of legalized gaming, which, if successful, could limit our existing operations.

Legalized gaming is subject to opposition from gaming opponents. There can be no assurance that this opposition will not succeed in preventing the legalization of gaming in jurisdictions where these activities are presently prohibited or prohibiting or limiting the expansion of gaming where it is currently permitted, in either case to the detriment of our business, financial condition, results and prospects.

# Our ability to complete future acquisitions of gaming and related businesses and integrate those businesses successfully could limit our future growth.

Part of our corporate strategy is to continue to pursue expansion and acquisition opportunities in gaming and related businesses, such as our acquisition of certain assets of EssNet AB, and our acquisitions of The Global Draw Ltd, and Games Media which all occurred in 2006, and we could face significant challenges in managing and integrating the expanded or combined operations including acquired assets, operations and personnel. There can be no assurance that acquisition opportunities will be available on acceptable terms or at all or that we will be able to obtain necessary financing or regulatory approvals to complete potential acquisitions. Our ability to succeed in implementing our strategy will depend to some degree upon the ability of our management to identify, complete and successfully integrate commercially viable acquisitions. Acquisition transactions may disrupt our ongoing business and distract management from other responsibilities. Any future acquisition transactions involving the use of company stock have the potential of dilution to our existing shareholders and earnings per share.

## Our revenues fluctuate due to seasonal, weather and other variations and you should not rely upon our periodic operating results as indications of future performance.

Our pari-mutuel service revenues are subject to seasonal and weather variations. The first and fourth quarters of the calendar year traditionally comprise the weakest period for our pari-mutuel wagering service revenue. As a result of inclement weather during the winter months, a number of racetracks do not operate and those that do operate often experience missed racing days. Additionally, the fourth quarter is the weakest quarter for Global Draw due to reduced wagering during the holiday season. This adversely affects the amounts wagered and our corresponding service revenues. Wagering equipment sales and software license revenues usually reflect a limited number of large transactions, which may not recur on an annual basis. Consequently, revenues and operating results can vary substantially from period to period as a result of the timing of revenue recognition for major equipment sales and software license revenue. In addition, instant ticket and prepaid phone card sales may vary depending on the season and timing of contract awards, changes in customer budgets, ticket inventory levels, lottery retail sales and general economic conditions.

Our business could also be impacted by natural or man-made disasters such as Hurricane Katrina or the terrorist attack in New York on September 11, 2001. We have taken steps to have disaster recovery plans in place but there can be no assurance that such an event would not have a significant impact on our business.

## We are dependent on our suppliers and contract manufacturers, and any failure of these parties to meet our performance and quality standards or requirements could cause us to incur additional costs or lose customers.

Our production of instant lottery tickets and prepaid phone cards, in particular, depends upon a continuous supply of raw materials, supplies, power and natural resources. Our operating results could be adversely affected by an interruption or cessation in the supply of these items or a serious quality assurance lapse.

We transmit certain wagering data and broadcast live racing events utilizing satellite transponders, generally pursuant to long-term contracts. The technical failure of any of these satellites would require us to obtain other communication services, including other satellite access. Although we maintain insurance and, in some cases, employ backup systems to limit our exposure in the event of such a failure, we have no assurance of access to such other satellites or, if available, whether the use of such other satellites could be obtained on favorable terms or in a timely manner. While satellite failures are infrequent, the operation of satellites is outside of our control.

In addition, our Global Draw business has signed a number of significant contracts whose performance depends on our third party suppliers delivering equipment on schedule for Global Draw to meet its contract commitments. Failure of the suppliers to meet their delivery commitments could result in Global Draw being in breach of and subsequently losing those contracts, which loss could have a material adverse affect on the revenue.

#### We have foreign operations, which subjects us to additional risks.

Our business in foreign markets subjects us to risks customarily associated with such operations, including:

• foreign withholding taxes on our subsidiaries earnings that could reduce cash flow available to meet our required debt service and our other obligations;

- the complexity of foreign laws, regulations and markets;
- the impact of foreign labor laws and disputes;
- other economic, tax and regulatory policies of local governments; and
- the ability to attract and retain key personnel in foreign jurisdictions.

Our consolidated financial results are significantly affected by foreign currency exchange rate fluctuations. Foreign currency exchange rate exposures arise from current transactions and anticipated transactions denominated in currencies other than U.S. dollars and from the translation of foreign currency balance sheet accounts into U.S. dollar-denominated balance sheet accounts. We are exposed to currency exchange rate fluctuations because a significant portion of our revenues is denominated in currencies other than the U.S. dollar, particularly the British pound sterling and the Euro. Exchange rate fluctuations have in the past adversely affected our operating results and cash flows and may continue to adversely affect our results of operations and cash flows and the value of our assets outside the United States.

There can be no assurance that we will be able to operate successfully in any foreign market.

# Certain holders of our common stock exert significant influence over the Company and make decisions with which other stockholders may disagree.

In August 2004, MacAndrews & Forbes Holdings Inc. was issued approximately 25% of our outstanding common stock in connection with its conversion of our then outstanding Series A Convertible Preferred Stock. Such holder is entitled to appoint up to four of the ten members of our Board of Directors under a stockholders agreement with us, as supplemented, which we originally entered into with holders of the Series A Convertible Preferred Stock, and certain actions of the Company require the approval of such holder. As a result, this holder has the ability to exert significant influence over our business and may make decisions with which other stockholders may disagree, including, among other things, to delay, discourage or prevent a change of control of the Company or a potential merger, consolidation, tender offer, takeover or other business combination.

#### If certain of our key personnel leave us, our business will be significantly adversely affected.

We depend on the continued performance of A. Lorne Weil, our Chairman and Chief Executive Officer, and the members of our senior management team. Mr. Weil has extensive experience in the lottery and pari-mutuel businesses and has contributed significantly to the growth of our business. If we lose the services of Mr. Weil or any of our other senior officers and cannot find suitable replacements for such persons in a timely manner, it could have a material adverse effect on our business. Mr. Weil has an employment contract with us through 2009.

#### We could incur costs in the event of violations of or liabilities under environmental laws.

Our operations and real properties are subject to U.S. and foreign environmental laws and regulations, including those relating to air emissions, the management and disposal of hazardous substances and wastes, and the cleanup of contaminated sites. We could incur costs, including cleanup costs, fines or penalties, and third-party claims as a result of violations of or liabilities under environmental laws. Some of our operations require environmental permits and controls to prevent or reduce environmental pollution, and these permits are subject to review, renewal and modification by issuing authorities. We believe that our operations are currently in substantial compliance with all environmental laws, regulations and permits and have not historically incurred material costs for noncompliance with, or liabilities under, these requirements.

## Failure to perform under our lottery contracts may result in litigation, substantial monetary liquidated damages, as well as contract termination.

Our business subjects us to contract penalties and risks of litigation, including due to potential allegations that we have not fully performed under our contracts or that goods or services we supply are defective in some respect. Litigation is pending in Colombia arising out of the termination of certain Colombian lottery contracts in 1993. An agency of the Colombian government has asserted claims against certain parties, including our subsidiary Scientific Games International, Inc., or SGI, which owned a minority interest in the former operator of the Colombian national lottery. The claims are for, among other things, contract penalties, interest and the costs of a bond issued by a Colombian surety. See Item 3 Legal Proceedings for additional information regarding this litigation. Although we believe that any potential losses arising from this litigation will not result in a material adverse effect on our consolidated financial position or results of operations, we cannot predict the final outcome, and there can be no assurance that this litigation might not be finally resolved adversely to us or result in material liability.

In addition, our lottery contracts typically permit a lottery authority to terminate the contract at any time for material failure to perform, other specified reasons and, in many cases, for no reason at all. Lottery contracts to which we are a party also frequently contain exacting implementation schedules and performance requirements and the failure to meet these schedules and requirements may result in substantial monetary liquidated damages, as well as possible contract termination. We are also required by certain of our lottery customers to provide surety, or performance, bonds. We have paid or incurred liquidated damages under our lottery contracts and material amounts of liquidated damages could be imposed on us in the future, which could, if imposed, have a material adverse effect on our business.

#### Labor disputes may have an adverse effect on our pari-mutuel operations.

Though we have increasingly automated our pari-mutuel field operations and created two hub centers, we have union employees in our pari-mutuel field operations in the United States and Canada. We collectively bargain with the labor unions that represent these employees. The current collective bargaining agreement representing the majority of our union employees in the United States expires October 20,

2009. Another collective bargaining agreement relating to our Canadian racing operations has been extended through October 20, 2009. Notwithstanding these contracts, if we were to experience a union strike or work stoppage, it would be difficult to find sufficient replacement employees with the proper skills. There can be no assurance that we will not encounter any conflicts or strikes with the labor union, which could have an adverse effect on our business or results of operations, could cause us to lose customers or could cause our customers or perations to be affected and might have permanent effects on our business.

## We have a significant amount of indebtedness and failure to generate sufficient cash as our debt comes due or to renew credit lines prior to expiration may adversely affect our business.

As of December 31, 2006, we had approximately \$916 million of debt outstanding, consisting of convertible senior subordinated debentures, senior subordinated notes and a senior secured credit facility. We expect that existing cash, cash equivalents, short term investments, cash provided from operations and our bank credit facilities will be sufficient to meet ongoing cash requirements. However, failure to generate adequate cash as our debt becomes due or to renew credit lines prior to their expiration may adversely affect our business.

#### The price of our common stock may be volatile.

Our stock price may fluctuate in response to a number of events and factors, such as, variations in operating results, actions by various regulatory agencies, litigation, market perceptions of our financial reporting, financial estimates and recommendation by securities analysts, rating agency reports, performance of other companies that investors or security analysts deem comparable to us, news reports relating to our business, our markets or general market conditions.

## ITEM 1B. UNRESOLVED STAFF MATTERS

No disclosure required pursuant to this Item.

### ITEM 2. PROPERTIES

The following is a list of facilities that we use in the operation of our business.

Location	Square Feet	Owned/leased	Purposes	Business
New York, NY	21,700	Leased	Corporate Headquarters	1
Essen, Germany	15,900	Leased	Administration and operations	2
Alpharetta, GA	44,800	Leased	Manufacturing and warehouse	2
Ballymahon, Ireland	14,500	Leased	Manufacturing and warehouse	2
Various cities, Germany	9.063	Leased	Warehouse	2
Various cities, CT	47,200	Leased	OTB facilities	2
New Haven, CT	1.700	Leased	Administration and operations	2
Windsor Locks, CT*	39.000	Owned	OTB facility	2
New Haven, CT*	55,000	Owned	OTB facility, administration and operations	2
Waterville, ME*	30,100	Owned	OTB facility	2
Den Haag, Netherlands	5.000	Leased	Administration and operations	2
Various cities, Netherlands	25,700	Leased	OTB facilities	2
Rocky Hill, CT	13,000	Leased	Administration, operations and warehouse	3,4
South Barre, VT	3,100	Leased	Administration, operations and watchouse	3,4
Concord, NH	5,400	Leased	Administration and operations	3,4
Urbandale, IA	7,300	Leased	Administration and operations	3, 4
Gardner, ME	10,000	Leased	Administration and operations	3,4
Blythewood, SC	30,000	Leased	Administration and operations	3,4
Vienna, Austria	47,400	Leased	Administration and operations	3,4
Various U.S. Cities	62,300	Leased	Warehouse space and operations	3,4
Mexico City, Mexico	29.235	Leased	Warehouse	3,4
5	29,233	Leased	Administration and operations	3
San Andres Cholula, Mexico	/		•	3
Col Espartaco, Del. Coyoacan, Mexico	13,519	Leased	Administration and operations	
Barcelona, Spain	16,146	Leased	Administration and operations	3, 4
Alpharetta, GA*	185,000	Owned	Administration and operations	1, 2, 3, 4
Duluth, GA	48,300	Leased	Warehouse	3
Baltimore, MD	35,600	Leased	Administration and operations	
Harrisburg, PA	40,700	Leased	Administration, operations and warehouse	3, 4
Middletown, PA	35,200	Leased	Warehouse	3, 4
Indianapolis, IN	20,000	Leased	Administration and operations	3, 4
Oklahoma City, OK	42,600	Leased	Administration and operations	3, 4
Sharon Hills, PA	12,000	Leased	Administration and operations	3, 4
Hato Rey, PR	34,700	Leased	Administration and operations	3
Leeds, England	150,000	Owned	Manufacturing	4
Alpharetta, GA*	170,000	Owned	Manufacturing and warehouse	4
Central Islip, NY	40,000	Leased	Manufacturing and warehouse	4
Santiago, Chile	16,700	Owned	Administration and manufacturing	4
Santiago, Chile	32,200	Leased	Operations and warehouse	4
Phoenix, AZ	22,700	Leased	Administration and warehouse	4
Orlando, FL	50,000	Leased	Administration and operations	4
Twinsburg, OH	41,100	Leased	Warehouse	4
La Vergne, TN	23,600	Leased	Administration and warehouse	4
Bielefeld, Germany	79,000	Owned	Administration, operations, warehouse and manufacturing	4
Sacramento, CA	9,000	Leased	Administration and operations	4
Pueblo, CO	8,000	Leased	Administration and operations	3, 4
Washington, DC	9,600	Leased	Administration and operations	4

1. Property use relates to Corporate functions.

2. Property use relates to functions concerning the Diversified Gaming Group.

3. Property use relates to functions concerning the Lottery Systems Group.

4. Property use relates to functions concerning the Printed Products Group.

\* Property is subject to a mortgage encumbrance.

#### ITEM 3. LEGAL PROCEEDINGS

Although we are a party to various claims and legal actions arising in the ordinary course of business, we believe, on the basis of information presently available to us, that the ultimate disposition of these matters will not likely have a material adverse effect on our consolidated financial position or results of operations.

Our subsidiary, Scientific Games International, Inc. (SGI), owned a minority interest in Wintech de Colombia S.A., or Wintech (now liquidated), which formerly operated the Colombian national lottery under contract with Empresa Colombiana de Recursos para la Salud, S.A. (Ecosalud), an agency of the Colombian government. The contract projected that certain levels of lottery ticket sales would be attained and provided a penalty against Wintech, SGI and the other shareholders of Wintech of up to \$5.0 million if such performance levels were not achieved. In addition, with respect to a further guarantee of performance under the contract with Ecosalud, SGI delivered to Ecosalud a \$4.0 million bond issued by a Colombian surety, Seguros del Estado (Seguros). Wintech started the instant lottery in Colombia, but, due to difficulties beyond its control, including, among other factors, social and political unrest in Colombia which we believe was in violation of Wintech s exclusive license from Ecosalud, the projected sales level was not met for the year ended June 30, 1993. On July 1, 1993, Ecosalud adopted resolutions declaring, among other things, that the contract was in default and asserted various claims for compensation and penalties against Wintech, SGI and other shareholders of Wintech. Litigation is pending and/or threatened in Colombia concerning various claims among Ecosalud, Wintech and SGI, relating to the termination of the contracts with Ecosalud. Ecosalud s claims are for, among other things, realization of the full amount of the penalty, plus interest and costs of the bond. In 2002 the Colombian Government enacted new gaming and lottery legislation which included the dissolution of Ecosalud. A new company, Empresa Territorial para la Salud (Etesa), was incorporated replacing Ecosalud. Etesa is the legal successor to Ecosalud with respect to the pending litigation.

On June 4, 1999, Ecosalud filed a collection proceeding against SGI before the Third Section of the Tribunal Contencioso of Cundinamarca in Colombia, which served notice on SGI in May 2002. In July 2002, the Tribunal Contencioso of Cundinamarca denied SGI s preliminary motion to dismiss the lawsuit and the decision was upheld by the Council of State, the highest appellate court with jurisdiction over this matter, in August 2003, of which SGI received notice in January 2004. As a result of these decisions, this lawsuit, which is in its early stages, will be heard in due course on its merits by the Tribunal Contencioso of Cundinamarca. Likewise, an appeal stage will be available before the Council of State of Colombia.

SGI has various defenses on the merits as well as procedural defenses, which were timely filed against Ecosalud s claims. We intend to vigorously pursue these defenses as appropriate. On August 31, 2005, the procedural defense motion filed against this lawsuit was denied by the Tribunal Contencioso of Cundinamarca, while the appeal motion before the Council of State remains pending. Currently, the case file is at the chambers of the justice in charge and we expect that a decision on the matter will be made during 2007. Following final decision of the procedural motions, defenses on the merits will be heard. Parallel factual proceedings may also occur during the appeal this year before any final determination can be made. SGI also has certain cross indemnities and undertakings from the two other privately held shareholders of Wintech for their respective shares of any liability to Ecosalud. No assurance can be given that the other shareholders of Wintech will, or have sufficient assets to, honor their indemnity undertakings to SGI when the claims by Ecosalud against SGI and Wintech are finally resolved, in the event such claims result in any final liability. Although we believe that any potential losses arising from these claims will not result in a material adverse effect on our consolidated financial position or results of operations, it is not feasible to predict the final outcome, and there can be no assurance that these claims might not be finally resolved adversely to us or result in material liability.

In December 2006, we agreed to settle the three previously reported litigations with Gtech Corporation, consisting of an action that we filed in May 2005 in the U.S. District Court for the District of Delaware alleging Gtech infringed our group participation multiplier patents which relate to certain online lottery games, an action that Gtech filed in March 2004 in U.S. District Court for the District of Delaware alleging we infringed certain of its patents relating to instant lottery ticket vending and dispensing machines and methods and a defamation action that Gtech filed in December 2004 against us and others in state court in Texas. As part of the settlement agreement, under which the parties agreed to dismiss the litigations with prejudice, (i) we granted Gtech a license for any new games covered by our group participation patents with respect to which Gtech will pay royalty fees during the first three years consistent with fees charged to our customers subject to certain annual caps; (ii) we paid to acquire certain patent rights from Gtech, and granted back to Gtech a royalty-free license to those patents; and (iii) we granted Gtech a royalty-free license for all existing games covered by our group participations that had not signed a license agreement with another organization or with us. The litigations were dismissed in January 2007.

On March 9, 2006, we received a request for information relating to the licensing of our operation of several earth stations in our racing communications business from the enforcement bureau of the Federal Communications Commission (FCC). We conducted an internal review which determined that our racing subsidiary was not in full compliance with FCC licensing requirements. We engaged special FCC counsel to assist us in ensuring that we are in compliance with all applicable licensing requirements and responding to the FCC s inquiry. We believe we are currently in compliance. While it is not possible to predict the outcome of this inquiry at this time, we believe an administrative settlement will be achieved.

### ITEM 4. SUBMISSION OF MATTERS TO A VOTE OF SECURITY HOLDERS

No matters were submitted to a vote of our security holders during the fourth quarter of fiscal year 2006.

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

Our outstanding common stock has been listed for trading on the Nasdaq Global Select Market under the symbol SGMS. The following table sets forth, for the periods indicated, the range of high and low closing prices of our Class A common stock.

	Market P Scientific Common	Games
	High	Low
Fiscal 2005 (January 1, 2005-December 31, 2005)		
First Quarter	26.48	21.72
Second Quarter	27.49	21.34
Third Quarter	31.54	27.00
Fourth Quarter	31.38	26.51
Fiscal 2006 (January 1, 2006-December 31, 2006)		
First Quarter	35.13	27.45
Second Quarter	40.41	32.86
Third Quarter	35.90	28.03
Fourth Quarter	32.34	27.09
Fiscal 2007		
First Quarter through February 26, 2007	34.60	29.00

On February 26, 2007, the last reported sale price for our common stock on the Nasdaq Global Select Market was \$33.70 per share. There were approximately 1,215 holders of record of our common stock as of February 26, 2007.

We have never paid any cash dividends on our Class A common stock. The Board presently intends to retain all earnings, if any, for use in the business. Any future determination as to payment of dividends will depend upon our financial condition and results of operations and such other factors as are deemed relevant by the Board. Further, under the terms of certain of our debt agreements, we are limited in our ability to pay cash dividends or make certain other restricted payments (other than stock dividends) on our Class A common stock.

On November 2, 2006, our Board of Directors approved a stock repurchase program under which we are authorized to repurchase, from time to time in the open market through December 31, 2007, shares of our outstanding common stock in an aggregate amount up to \$200 million. Purchases are expected to be funded by cash flows from operations, borrowings, or a combination thereof. The timing and amount of purchases will be determined by our management based on its evaluation of market conditions, share price and other factors. The stock repurchase program may be discontinued at any time. The repurchases for the fourth quarter ended December 31, 2006 are reflected on the following table:

Period	Total Number of Shares Purchased(2)	Average Price Paid per Share	Total Number of Shares Purchased as Part of Publicly Announced Plans or Programs	Approximate Dol of Shares that Ma Purchased Under or Programs	ay Yet Be
10/1/06 - 10/31/06				\$ million	200.0
11/1/2006 - 11/30/2006	100,541	\$ 29.08	100,000	\$ million	197.1
12/1/2006 - 12/31/2006 (1)	251,636	\$ 31.24	221,548	\$ million	190.2
Total	352,177	\$ 30.62	321,548	\$ million	190.2

(1) The date of the last repurchase as part of the publicly announced repurchase program was December 12, 2006.

(2) In addition to the open market purchases made under the stock repurchase program during the fourth quarter of 2006, this column reflects approximately 30,629 shares acquired from employees to satisfy the exercise price of employee stock options and the withholding taxes associated with the vesting of restricted stock awards.

#### **Shareholder Return Performance Graph**

The following graph compares the cumulative total stockholder return over the five-year period ended December 31, 2006 of our common stock, the Nasdaq Global Select Market (Nasdaq), on which our shares of common stock are traded, and a peer group index of companies that provide services similar to ours (New Peer Group) and a peer group index of companies that was used in our proxy statement for our 2005 annual meeting of the stockholders (Old Peer Group). Our New Peer Group consists of Bally Technologies Inc., Progressive Gaming International Corporation, International Game Technology, Shuffle Master, Inc., WMS Industries Inc., and Youbet.com, Inc. Our Old Peer Group consists of International Lottery and Totalisator Systems, Inc., Churchill Downs, Inc. and Gtech Corporation. We selected the New Peer Group for this year s Shareholder Return Performance Graph because Gtech Corporation became a private subsidiary of another company and because we believe that the companies included in our New Peer Group index, taken together, are comparable to our businesses. Both peer group companies have been weighted based upon their relative market capitalization each year. The graph assumes that \$100 was invested in our common stock, the Nasdaq, the New Peer Group index and the Old Peer Group index at the beginning of the five-year period and that all dividends were reinvested.

#### **Comparison of 5-year Cumulative Total Return**

\* \$100 invested on 12/31/01 in stock or index-including reinvestment of dividends. Fiscal year ending December 31.

	12/01	12/02	12/03	12/04	12/05	12/06
Scientific Games Corporation	\$ 100.00	\$ 82.97	\$ 193.94	\$ 272.46	\$ 311.77	\$ 345.49
NASDAQ Composite	\$ 100.00	\$ 71.97	\$ 107.18	\$ 117.07	\$ 120.50	\$ 137.02
New Peer Group	\$ 100.00	\$ 107.62	\$ 198.48	\$ 200.56	\$ 179.38	\$ 260.28
Old Peer Group	\$ 100.00	\$ 104.26	\$ 100.25	\$ 123.87	\$ 103.46	\$ 123.84

#### ITEM 6. SELECTED FINANCIAL DATA

Selected historical financial data presented below as of and for the year ended December 31, 2002 has been derived from our audited consolidated financial statements which have been audited by KPMG LLP, independent registered public accounting firm. Selected financial data presented below as of and for the years ended December 31, 2003, 2004, 2005 and 2006 have been derived from our audited consolidated financial statements which have been audited by Deloitte & Touche LLP, independent registered public accounting firm. The following financial information reflects the acquisitions of certain businesses during the period 2002 through 2006, including the acquisition of 65% of the equity of Serigrafica Chilena S.A. (SERCHI) since June 5, 2002, the acquisition of the remaining 35% minority interest of SERCHI since April 2005, the acquisition of MDI Entertainment, Inc. since January 10, 2003, the acquisition of IGT OnLine Entertainment Systems, Inc. (OES) since November 6, 2003, the acquisition of Honsel on December 31, 2004, the acquisition of Games Media on December 22, 2006 and the acquisition of International Lotto Corp., SRL (ILC) on December 28, 2006. The following summary presents selected financial data for the years ended December 31, 2002, 2003, 2004, 2005 and 2006. These data should be read in conjunction with Item 7, Management s Discussion and Analysis of Financial Condition and Results of Operations, and the Consolidated Financial Statements and the Notes thereto, included in Item 8 of this Form 10-K.

#### FIVE YEAR SUMMARY OF SELECTED FINANCIAL DATA

#### (in thousands, except per share amounts)

	Year 2002	Ended De	cembe	r 31, 2003		2004 (d)		2005 (g)		2006 (h)	
Selected Statement of Operations Data:											
Operating Revenues:											
Services	\$	382,818		452,564		590,984		639,327		799,227	
Sales	72,43	35		108,347		134,511		142,356		98,003	
	455,2	253		560,911		725,495		781,683		897,230	
Costs and Expenses:											
Cost of services (exclusive of depreciation and											
amortization)	221,0	)38		247,730		318,989		351,430		437,147	
Cost of sales (exclusive of depreciation and											
amortization)	47,41	2		76,082		92,231		100,621		72,800	
Amortization of service contract software	4,930	)		5,312		5,799		7,007		7,236	
Selling, general and											
administrative	63,13	32		80,074		105,274		131,844		155,727	
Depreciation and amortization	37,90	)5		42,373		55,478		59,787		98,770	(i)
Interest expense	44,84	42	(a)	26,397		30,952		26,548		43,393	
Other (income) expense	636			1,184		(748	)	(1,700	)	(767	)
Equity in (income) loss of joint ventures (e)						6,060		2,064		(7,900	)
Early extinguishment of debt	22,50	)1	(b)	293		16,868	(f)	478			
Total costs and expenses	442,3	396		479,445		630,903		678,079		806,406	
Income before income tax expense (benefit)	12,85	57		81,466		94,592		103,604		90,824	
Income tax expense (benefit)	(26,8	75	) (c)	29,319		28,850		28,285		24,063	
Net income	39,73	32		52,147		65,742		75,319		66,761	
Convertible preferred paid-in-kind dividend	7,484	ļ.		7,661		4,721					
Net income available to common stockholders	\$	32,248		44,486		61,021		75,319		66,761	
Basic and diluted income per share:											
Basic net income available to common stockholders	\$	0.64		0.74		0.84		0.84		0.73	
Diluted net income available to common stockholders	\$	0.50		0.59		0.72		0.81		0.70	
Weighted average number of shares used in per share calculation:											
Basic shares	50,22	21		60,010		73,014		89,327		91,066	
Diluted shares	80,15	51		88,143		90,710		92,484		94,979	
Selected Balance Sheet Data (End of Period):											
Total assets	\$	636,789		962,989		1,093,225		1,172,513		1,759,610	i i
Total long-term debt, including current installments	\$	360,529		532,163		610,878		580,735		916,401	
Stockholders equity	\$	168,770		237,152		300,564		386,833		528,078	
Ratio of earnings to fixed charges	1.3		х	3.6	х	3.8	х	4.4	х	2.7	х

The following notes are an integral part of these selected historical consolidated financial data.

(a) Includes \$3,300 in debt restructuring charges related to interest rate swaps that were settled in connection with the refinancing of our 2000 senior secured credit facility (the 2000 Facility ).

(b) Reflects early extinguishment of debt costs of \$10,226 incurred in connection with the write-off of deferred financing fees related to our refinancing of the 2000 Facility, the payment of \$11,172 of redemption premium

1	of a portion of our 12 1/2% Senior Subordinated Notes and the payment of \$1,103 in bank fees to permit us to use a majority of the net by 2002 public offering and sale of 14,375 shares of our Class A Common Stock at a price of \$7.25 per share to redeem subordinated debt.
(c)	Includes an income tax benefit of \$32,900 from the recognition of net operating loss carryforwards ( NOL ) at December 31, 2002.
(d)	Includes approximately \$3,100 of items identified during the initial adoption of Sarbanes-Oxley.
(e) earnings of the Italian	Reflects losses of \$6,060 and \$1,713 in 2004 and 2005, respectively, and income of approximately \$8,300 in 2006, for our share of the a joint venture that began selling instant tickets in 2004.
(f) refinancing of the 200	Includes early extinguishment of debt costs of \$16,868 incurred in connection with the write-off deferred financing fees related to our 03 Facility and the payment of \$6,862 of redemption premium for the purchase of most of our 12 $V2\%$ Senior Subordinated Notes.
	Includes a charge of \$12,363 related to the discontinuance of the Supplemental Executive Retirement Plan, a non-tax deductible charge of with the earn-out on the Honsel acquisition, a \$2,230 charge in the Lottery segment related to defective tickets and \$5,291 for restructuring e Diversified Gaming Segment.
(h)	Includes approximately \$18,100 in share-based compensation expense and approximately \$14,900 in employee termination costs.
(i)	Includes approximately \$9,700 related to pari-mutuel asset impairment charges.
44	

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

#### Summary

To present a better understanding of the overall business of Scientific Games Corporation and its consolidated subsidiaries (together, we), we begin Management s Discussion and Analysis of Financial Condition and Results of Operations (MD&A) with an overview of our business and major operating segments, including any significant events that have occurred in the periods presented. We then provide a discussion of our Critical Accounting Policies, including revenue recognition policies requiring critical judgment, our policies for accounting for share-based payment, our valuation of long-lived and intangible assets and goodwill, our income tax methodology and the use of estimates and assumptions throughout our financial results. Next, we discuss our Results of Operations, presenting first an overall view of the financial results of the business as a whole, followed by additional discussion of our operating segments. We then review our financial condition, explaining changes in our balance sheet and cash flows, along with our outstanding debt, contractual obligations and commitments. Next we discuss the existence of any New Accounting Pronouncements and Related Party Transactions, and clarify their impact on our financial statements.

Our results may vary significantly from period to period depending on the addition or disposition of business units in each period. The acquisition of Printpool Honsel GmbH (Honsel) in December 2004, the acquisition of the remaining 35% minority interest in Scientific Games Latin America S.A. (SGLA) in April 2005, the acquisition of most of the online lottery assets of EssNet AB (EssNet) in March 2006, the acquisitions of The Shoreline Star Greyhound Park and Simulcast Facility (Shoreline) and The Global Draw Limited and certain related companies (Global Draw) in April 2006, and the acquisitions of Games Media Limited (Games Media) and International Lotto Corp., SRL (ILC) in December 2006, affect the comparability of operations from period to period (see Note 3 to the Consolidated Financial Statements). In addition, the adoption of Statement of Financial Accounting Standards (SFAS) No. 123(revised 2004), *Share-Based Payment* (SFAS 123(R)) in 2006 affects the comparability of operations from period.

The first and fourth quarters of the calendar year traditionally comprise the weakest season for our Diversified Gaming segment. As a result of inclement weather during the winter months, a number of racetracks do not operate and those that do operate often experience missed racing days. This adversely affects the amounts wagered and our corresponding service revenues. Additionally, the fourth quarter is the weakest quarter for Global Draw due to reduced wagering during the holiday season. Wagering and lottery equipment sales and software license revenues usually reflect a limited number of large transactions, which do not recur on an annual basis. Consequently, revenues and operating results of our Lottery Systems Group can vary substantially from period to period as a result of the timing of revenue recognition for major equipment sales and software licensing transactions. In addition, Printed Products sales may vary depending on the season and timing of contract awards, changes in customer budgets, inventory ticket levels, lottery retail sales and general economic conditions.

#### Background

We operate primarily in three business segments: Printed Products Group, Lottery Systems Group and Diversified Gaming Group. Our revenues consist of two major components: services revenues and sales revenues.

#### Printed Products Group

We provide instant tickets and related services. Instant ticket and related services includes ticket design and manufacturing as well as value-added services, including game design, sales and marketing

support, inventory management and warehousing and fulfillment services. Additionally, this division provides lotteries with over 80 licensed brand products, including Major League Baseball®, NASCAR®, Mandalay Bay®, National Basketball Association, Harley-Davidson®, Wheel-of-Fortune®, Monopoly , Corvette®, World Poker Tour® and The World Series of Poker®. This division also includes promotional instant tickets and pull-tab tickets that we sell to both lottery and non-lottery customers.

We are a worldwide manufacturer of prepaid phone cards, which entitle cellular phone users to a defined value of airtime. Prepaid phone cards offer consumers a cost-effective way to purchase cellular airtime, without requiring phone companies to extend credit or consumers to commit to contracts.

Prepaid phone cards utilize the secure process that we employ in the production of instant lottery tickets. This helps to ensure integrity and reliability of the product, thus providing consumers in more than 50 countries with access to prepaid cellular phone service.

On December 28, 2006, we acquired 80% of the common stock of ILC. ILC is a member of a consortium agreement with certain charities in Peru which gives them the right to participate in the operation of a lottery in Peru. We expect that our acquisition of ILC will enable us to further expand into the Latin American market. As consideration for the acquisition, we exchanged our approximately \$16.0 million receivable due from ILC and contributed approximately \$3.9 million in assets The carrying value of our receivable from ILC and assets, totaling approximately \$20.0 million, at December 31, 2006, was treated as the purchase price for accounting purposes.

#### Lottery Systems Group

Our lottery systems business includes the supply of transaction processing software for the accounting and validation of instant ticket and online lottery games, point-of-sale terminal hardware sales, central site computers and communication hardware sales, and ongoing support and maintenance services for these products. This business also includes software and hardware and support services for sports betting and operation of credit card processing systems.

On March 22, 2006, we acquired substantially all of the online lottery assets of Swedish firm EssNet which specializes in online lottery systems and terminals to run online lotteries, sports betting, instant tickets and mobile games on a national level. EssNet s lottery customers include seven states in Germany, the national lottery of Norway, Golden Casket and Tattersall s Lottery in Australia, and other national lotteries. We expect that the acquisition of EssNet will enable us to further expand into the European lottery market. The purchase price was approximately \$60 million in cash.

In conjunction with the purchase of EssNet, we have a plan to integrate certain operating locations as part of the integration of EssNet. At the time of acquisition, we recorded approximately \$27 million in liabilities, primarily related to involuntary employee terminations, termination of leases and termination of service contracts that will result from the integration.

#### Diversified Gaming Group

Our Diversified Gaming Group provides services and systems to private and public operators in the wide area gaming markets and in the pari-mutuel wagering industry. Our product offering includes fixed odds betting terminals (FOBTs), video lottery terminals (VLTs), monitor games, wagering systems for the pari-mutuel racing industry, sports betting systems and services, and Amusement With Prize (AWP) and Skill With Prize (SWP) terminals. Business units within the Diversified Gaming Group include Global Draw, a leading supplier of FOBTs and monitor games to licensed bookmakers, primarily in the United Kingdom (U.K.) and Austria; Scientific Games Racing LLC, a leading worldwide supplier of computerized systems for pari-mutuel wagering; Games Media, our AWP and SWP terminal supplier in the U.K. pub market, and our pari-mutuel gaming operations in Connecticut, Maine and the Netherlands.

On December 22, 2006, we acquired Games Media. We expect the acquisition of Games Media to allow us to strengthen our role in the U.K. video lottery business. The purchase price was approximately \$25 million (subject to adjustment), plus an earn-out based on the future performance of the business.

On April 20, 2006, we acquired Global Draw, a leading U.K. supplier of fixed odds betting terminals and systems, and interactive sports betting systems and terminals and betting systems in Austria and the U.K. We expect that the acquisition of Global Draw will strengthen our role in the worldwide sports betting and video lottery business. The purchase price was approximately \$183 million, plus an earn-out to the selling shareholders, as well as contingent bonuses to certain members of the management team, which are based on the future financial performance of the business.

On April 5, 2006, we acquired certain assets of Shoreline located in Bridgeport, Connecticut. We expect that the acquisition of Shoreline will allow us to maximize the potential of our Connecticut operations. Additionally, the acquisition eliminates existing restrictions on our ability to simulcast live racing in certain portions of the state. The purchase price was approximately \$12 million, plus an earn-out, based on the future financial performance of the business.

#### **Critical Accounting Policies**

The SEC defines critical accounting policies as those that require application of management s most difficult, subjective or complex judgments, often as a result of the need to make estimates about the effect of matters that are inherently uncertain and may change in subsequent periods.

The following is not intended to be a comprehensive list of all of our accounting policies. Our significant accounting policies are more fully described in Note 1 to the Consolidated Financial Statements. In many cases, the accounting treatment of a particular transaction is specifically dictated by accounting principles generally accepted in the United States of America, with no need for management s judgment in their application. There are also areas in which management s judgment in selecting an available alternative would not produce a materially different result.

#### Revenue recognition

We recognize revenue when it is realized or realizable and earned. As described below, the determination of when to recognize revenue for certain revenue transactions requires judgment. Revenue from licensed branded property coupled with a service component whereby we purchase and distribute merchandise prized on behalf of the lottery authorities to identified winners is recognized on a proportional performance method as this method best reflects the pattern in which the obligations to customer are fulfilled. A performance measure is used based on total estimated cost allocated to a specific contract. By accumulating costs for services as they are incurred, and dividing such costs by the total contract costs which is estimated based on a budget prior to contract inception, a percentage is determined. The percentage determined is applied to the total fixed price of the contract and that proportionate amount of revenue is recognized on a monthly basis.

Revenue from the sale of lottery and pari-mutuel systems which require the production and delivery of terminals and customized software is recognized using cost-to-cost measure of the percentage-of-completion method of accounting. The percentage-of-completion method recognizes income as work on a contract progresses. The use of the percentage-of-completion method depends on our ability to make reasonably dependable cost estimates for the design, manufacture, and delivery of its products. Estimation of these costs requires the use of judgment. Revenues under percentage-of-completion contracts are recorded as costs are incurred.

#### Share-based payment

We measure compensation cost for stock awards at fair value and recognize compensation over the service period for awards expected to vest. The fair value of restricted stock units is determined based on the number of shares granted and the quoted price of our common stock, and the fair value of stock options is determined using the Black-Scholes valuation model. The estimation of stock awards that will ultimately vest requires judgment, and to the extent actual results or updated estimates differ from our current estimates, such amounts will be recorded as a cumulative adjustment in the period estimates are revised. We consider many factors when estimating expected forfeitures, including types of awards, employee class, and historical experience. Actual results, and future changes in estimates, may differ substantially from our current estimates.

#### Business combinations

In accounting for business combinations, we apply the accounting requirements of SFAS No. 141, *Business Combinations* (SFAS 141), which requires us to record the net assets of acquired businesses at fair value. In developing estimates of fair value of acquired assets and assumed liabilities, we analyze a variety of factors including market data, estimated future cash flows of the acquired operations, industry growth rates, current replacement cost for fixed assets, and market rate assumptions for contractual obligations. We engage third party valuation specialists to assist in the determination of fair value estimates. Changes to the assumptions used to estimate fair value could materially affect the recorded amounts for acquired assets and assumed liabilities, including but not limited to, property, plant and equipment, customer lists, goodwill, and deferred income taxes. Significant changes to the recorded amounts could have a material impact on our future operating results, including changes in depreciation and amortization expense resulting from higher or lower fair values assigned to property, plant and equipment and finite-lived intangible assets.

#### Valuation of long-lived and intangible assets and goodwill

We assess the recoverability of long-lived assets and intangible assets whenever events or changes in circumstances indicate that the carrying value of the asset may not be recoverable. We assess the impairment of goodwill annually or more frequently if events or changes in circumstances indicate the carrying value of goodwill may not be recoverable. Factors we consider important which could trigger an impairment review include:

- significant underperformance relative to expected historical performance or projected future operating results;
- significant changes in the manner of or use of the acquired assets or the strategy of our overall business;
- significant adverse change in the legality of our business ventures or the business climate in which we operate; and
- loss of a significant customer.

We evaluate goodwill for impairment by comparing the carrying value of each reporting unit to its fair value using a two-step impairment test. If the carrying amount of reporting unit goodwill exceeds the implied fair value of that goodwill, an impairment loss is recognized in an amount equal to that excess. When we determine that the carrying value of the long-lived assets, intangible assets and goodwill may not be recoverable based upon the existence of one or more of the above indicators of impairment, we measure any impairment based on the projected discounted cash flow, using a discount rate equal to our weighted average cost of capital, or by a comparison to third party indications of fair market value. The estimate of a reporting unit s fair value requires the use of assumptions and estimates regarding the

reporting unit s future cash flows, growth rates and weighted average cost of capital. Any significant adverse changes in key assumptions about these businesses and their prospects or an adverse change in market conditions may cause a change in the estimation of fair value and could result in an impairment charge. Given the significance of goodwill, an adverse change to the estimated fair value could result in an impairment charge that could be material to our financial statements.

Significant judgment is required in the forecasting of future operating results, which are used in the preparation of projected cash flows. Due to uncertain market conditions and potential changes in our strategy and products, it is possible that forecasts used to support our goodwill and trademark may change in the future which could result in significant non-cash charges that would adversely affect our results of operations

#### Income Taxes and Deferred Income Taxes

We account for income taxes in accordance with SFAS No. 109, *Accounting for Income Taxes* (SFAS 109). Under SFAS 109, deferred tax assets and liabilities are determined based on the difference between the book and tax bases of assets and liabilities, using enacted tax rates in effect for the year in which the differences are expected to reverse. Deferred tax assets are recognized if it is more likely than not that the assets will be realized in future years. We establish a valuation allowance for deferred tax assets for which realization is unlikely. We have also established a valuation allowance for foreign loss carryforwards, as we believe that it is more likely than not that the tax benefits of these items will not be realized. When we establish or reduce the valuation allowance, against our deferred tax assets, our income tax expense will increase or decrease, respectively, in the period such determination is made.

We account for income tax contingencies in accordance with the SFAS No. 5, Accounting for Contingencies (SFAS 5).

We are subject to periodic audits of our income tax returns by federal, state and local agencies. In evaluating the exposures associated with our various tax filing positions, including state and local taxes, we record reserves for what we identify as probable exposures. A number of years may elapse before a particular matter for which we have established a reserve is audited and fully resolved. The estimate of our tax contingencies reserve contains uncertainty because management must use judgment to estimate the exposures associated with various tax filing positions. Based on information about other tax settlements, we estimate amounts that we may agree to settle with taxing authorities in order to conclude audits. To the extent we prevail in matters for which reserves have been established, or are required to pay amounts in excess of our reserves, our effective tax rate in a given financial statement period could be materially affected. An unfavorable tax settlement would require use of our cash and result in an increase in our effective tax rate in the year of resolution. A favorable tax settlement would be recognized as a reduction in our effective tax rate in the year of resolution.

#### **Results of Operations**

#### Year Ended December 31, 2006 Compared to Year Ended December 31, 2005

The following analysis compares our results of operations for the year ended December 31, 2006 to the results for the year ended December 31, 2005.

#### Overview

#### **Revenue** Analysis

For the year ended December 31, 2006, total revenue was \$897.2 million compared to \$781.7 million for the year ended December 31, 2005, an increase of \$115.5 million or 15%. Our service revenue for the year ended December 31, 2006 was \$799.2 million compared to \$639.3 million for the year ended

December 31, 2005, an increase of \$159.9 million, or 25%. The increase was primarily attributable to the acquisitions of EssNet (\$18.7 million) and Global Draw (\$61.7 million), strong sales of instant lottery tickets, the addition of new instant ticket contracts during 2006, and the realization of a full year of revenue on Lottery Systems contracts that commenced in 2005. Our sales revenue for the year ended December 31, 2006 was \$98.0 million compared to \$142.4 million in the year ended December 31, 2005, a decrease of \$44.4 million, or 31%. The decrease was primarily due to the absence of a one-time sale of Instant Ticket Vending Machines to Pennsylvania that accounted for \$29.8 million of revenue in 2005, a decline in phone card sales of \$12.1 million, and a decrease of \$9.5 million for German instant ticket sales now being classified as service revenue because of the expansion of the services being offered in the German markets, partially offset by an increase in equipment sales in the European market.

#### Expense Analysis

Cost of services of \$437.1 million for the year ended December 31, 2006 were \$85.7 million or 24% higher than for the year ended December 31, 2005. This increase is primarily related to the acquisitions of EssNet and Global Draw, the addition of new instant ticket contracts during 2006, \$1.9 million of employee termination costs in 2006, and the realization of a full year of cost on Lottery Systems contracts that commenced in 2005. Cost of sales of \$72.8 million for the year ended December 31, 2006 were \$27.8 million or 28% lower than for the year ended December 31, 2005 due to lower sales revenues in Lottery Systems and Printed Products.

Selling, general and administrative expenses of \$155.7 million for the year ended December 31, 2006 were \$23.9 million or 18% higher than for the year ended December 31, 2005. This increase was primarily related to a \$17.9 million non-cash charge for share-based compensation expense in 2006, and charges of \$13.0 million related to employee termination costs during 2006.

Depreciation and amortization expense of \$106.0 million for the year ended December 31, 2006 increased \$39.2 million or 59% from the year ended December 31, 2005, primarily due to the acquisition of Global Draw (\$8.1 million), a full year of costs of Lottery Systems contracts that commenced in 2005, and a \$9.7 million charge during the third quarter of 2006 related to the impairment of certain hardware and software assets in the pari-mutuel business as a result of the roll-out of our new terminal, the two new Quantum Data Centers and the write-off of hardware on certain under-performing pari-mutuel contracts.

Interest expense of \$43.4 million for the year ended December 31, 2006 increased \$16.9 million or 64% from the year ended December 31, 2005, primarily attributable to higher market rates on our floating rate debt and increased borrowings to fund our 2006 acquisitions.

Equity in net income of joint ventures primarily reflects our share of the net income of the Italian joint venture in connection with the operations of the Italian Gratta e Vinci instant lottery. For the year ended December 31, 2006, our share of net income totaled \$8.3 million compared to a loss of \$1.7 million in the year ended December 31, 2005. The income in 2006 reflects the growth of instant ticket sales in Italy.

Income tax expense was \$24.1 million for the year ended December 31, 2006 and \$28.3 million for the year ended December 31, 2005. The effective income tax rate for the year ended December 31, 2006 and 2005 was 26.5% and 27.3% respectively. The rate decreased in 2006 primarily from having a greater proportion of the Company s foreign earnings taxed at rates lower than the U.S. statutory rate and from the federal tax benefit related to the amortization of original issue discount related to the issuance in 2004 of long-term debt.

#### Segment Overview

	Year Ended Decc (in thousands) Printed Products Group	ember 31, 2006 Lottery Systems Group	Diversified Gaming Group	Totals
Service revenues	\$ 388,841	213,144	197,242	799,227
Sales revenues	50,769	42,300	4,934	98,003
Total revenues	439,610	255,444	202,176	897,230
Cost of services (exclusive of depreciation and amortization)	199,006	119,835	118,306	437,147
Cost of sales (exclusive of depreciation and amortization)	40,027	28,363	4,410	72,800
Selling, general and administrative expenses	51,425	34,571	17,615	103,611
Depreciation and amortization	25,203	48,423	31,410	105,036
Segment operating income	\$ 123,949	24,252	30,435	178,636
Unallocated corporate selling, general and administrative costs and				
depreciation and amortization expense				53,086
Consolidated operating income				\$ 125,550
Interest expense				\$ 43,393

	Year Ended Dece (in thousands) Printed Products	mber 31, 2005 Lottery Systems	<b>Diversified</b> Gaming	
	Group	Group	Group	Totals
Service revenues	\$ 331,087	175,843	132,397	639,327
Sales revenues	72,214	59,829	10,313	142,356
Total revenues	403,301	235,672	142,710	781,683
Cost of services (exclusive of depreciation and amortization)	170,097	87,290	94,043	351,430
Cost of sales (exclusive of depreciation and amortization)	52,193	41,387	7,041	100,621
Selling, general and administrative expenses	43,969	29,684	15,528	89,181
Depreciation and amortization	18,250	33,522	13,843	65,615
Segment operating income	\$ 118,792	43,789	12,255	174,836
Unallocated corporate selling, general and administrative costs and				
depreciation and amortization expense				43,842
Consolidated operating income				\$ 130,994
Interest expense				\$ 26,548

#### Printed Products

For the year ended December 31, 2006, total revenue for Printed Products was \$439.6 million compared to \$403.3 million for the year ended December 31, 2005, an increase of \$36.3 million, or 9%. For the year ended December 31, 2006, service revenue for Printed Products was \$388.8 million compared to \$331.1 million in the year ended December 31, 2005, an increase of \$57.7 million, or 17%. The increase was attributable to new contracts, strong sales of instant lottery tickets, the launch of the Major League Baseball licensed games in 2006, and German instant tickets now being classified as service revenue because of the expansion of the services being offered in the German markets.

Printed Products sales revenue for the year ended December 31, 2006 was \$50.8 million compared to \$72.2 million for the year ended December 31, 2005, a decrease of \$21.4 million, or 30%. The decrease was

primarily the result of a \$12.1 million decline in phone card sales reflecting a continuing market driven shift to lower priced products, German instant ticket sales now being classified as service revenue because of the expansion of the services being offered in the German markets, and a decrease in the sales of non-lottery printed products in Germany.

Cost of services of \$199.0 million for the year ended December 31, 2006 were \$28.9 million or 17% higher than in the year ended December 31, 2005. This increase is due to higher operating costs as a result of the addition of new customers and higher revenue in 2006. Cost of sales of \$40.0 million for the year ended December 31, 2006 were \$12.2 million or 23% lower than in 2005 due to a decrease in sales revenues as discussed above.

Selling, general and administrative expenses of \$51.4 million for the year ended December 31, 2006 were \$7.4 million or 17% higher than in the year ended December 31, 2005. This increase is primarily the result of \$2.9 million of employee termination costs and start-up costs for the German cooperative services business.

Depreciation and amortization expense of \$25.2 million for the year ended December 31, 2006 increased \$6.9 million or 38%, as compared to the year ended December 31, 2005, primarily due to depreciation of a new printing press in the U.K. and amortization of acquired licensed properties.

#### Lottery Systems

For the year ended December 31, 2006, total revenue for Lottery Systems was \$255.4 million compared to \$235.7 million in the year ended December 31, 2005, an increase of \$19.7 million, or 8%. Lottery Systems service revenue for the year ended December 31, 2006 was \$213.1 million compared to \$175.8 million for the year ended December 31, 2005, an increase of \$37.3 million, or 21%. The increase was primarily due to the acquisition of EssNet and the realization of a full year of revenue from Lottery Systems contracts that commenced during 2005, partially offset by the loss of approximately \$2.2 million of revenue from the Montana online lottery contract, which ended in March 2006.

Lottery Systems sales revenue for the year ended December 31, 2006, was \$42.3 million compared to \$59.8 million for the year ended December 31, 2005, a decrease of \$17.5 million, or 29%. The decrease was primarily due to the absence of a one-time sale of Instant Ticket Vending Machines to Pennsylvania that accounted for \$29.8 million of revenue during 2005, partially offset by increased lottery systems sales in Europe and an increase in sales due to the acquisition of EssNet.

Cost of services of \$119.8 million for the year ended December 31, 2006 were \$32.5 million or 37% higher than in the corresponding period in the prior year. The increase was due to higher operating costs of \$12.8 million as a result of the acquisition of EssNet, and the addition of new customers and higher revenue during 2006, partially offset by reduced operating costs on the Montana online lottery contract. Cost of sales of \$28.4 million for the year ended December 31, 2006 were \$13.0 million or 31% lower than in the year ended December 31, 2005 due primarily to the absence of the one-time sale of Instant Ticket Vending Machines to Pennsylvania during 2005, partially offset by an increase in costs associated with increased lottery systems sales in Europe and sales from the acquisition of EssNet.

Selling, general and administrative expenses of \$34.6 million for the year ended December 31, 2006 were \$4.9 million or 16% higher than in the year ended December 31, 2005. This increase is primarily the result of \$3.9 million of employee termination costs during 2006.

Depreciation and amortization expense of \$48.4 million for the year ended December 31, 2006 increased \$14.9 million or 44%, as compared to the year ended December 31, 2005, primarily due to a full year of costs on the Lottery Systems contracts that commenced in 2005.

#### Diversified Gaming

For the year ended December 31, 2006, total revenue for Diversified Gaming was \$202.2 million compared to \$142.7 million for the year ended December 31, 2005, an increase of \$59.5 million, or 42%. Diversified Gaming service revenue for the year ended December 31, 2006 was \$197.2 million compared to \$132.4 million from the year ended December 31, 2005, an increase of \$64.8 million, or 49%. The increase in service revenues primarily reflects the acquisitions of Global Draw and Shoreline, partially offset by lower Handle in the domestic and foreign pari-mutuel businesses. We believe the trend in reduced pari-mutuel wagering may continue.

The Diversified Gaming sales revenue for the year ended December 31, 2006 was \$4.9 million compared to \$10.3 million in the year ended December 31, 2005, a decrease of \$5.4 million. The decrease was due to reduced system sales in Europe in the year ended December 31, 2006.

Cost of services of \$118.3 million for the year ended December 31, 2006 were \$24.3 million or 26% higher than in the year ended December 31, 2005. This increase is due to the acquisitions of Global Draw and Shoreline, \$0.5 million of loss accruals on underperforming pari-mutuel contracts, and \$0.8 million of employee termination costs, partially offset by reduced costs in the U.S. pari-mutuel business. Costs of sales of \$4.4 million for the year ended December 31, 2006 were \$2.6 million lower than in the year ended December 31, 2005 due to decreased sales revenue in Europe during 2006.

Selling, general and administrative expenses of \$17.6 million for the year ended December 31, 2006 were \$2.1 million or 14% higher than the year ended December 31, 2005 due to the addition of Global Draw, start-up costs at the sports wagering operation, and \$0.8 million in employee termination costs, partially offset by cost savings initiatives initiated in the second half of 2005.

Depreciation and amortization expense, including amortization of service contract software, of \$31.4 million for the year ended December 31, 2006 increased \$17.6 million as compared to the year ended December 31, 2005, primarily due to the increased depreciation resulting from the acquisition of Global Draw and a \$9.7 million charge during the year related to the impairment of certain hardware and software assets in the pari-mutuel business as a result of the roll-out of our new terminal, and the two new Quantum Data Centers and the write-off of hardware on certain under-performing pari-mutuel contracts.

#### Year Ended December 31, 2005 Compared to Year Ended December 31, 2004

The following analysis compares our results of operations for the year ended December 31, 2005 to the results for the year ended December 31, 2004.

#### Overview

#### Revenue Analysis

For the year ended December 31, 2005, total revenue was \$781.7 million compared to \$725.5 million, an improvement of \$56.2 million or 8% overall as compared to the prior year. Our service revenue was \$639.3 million compared to \$591.0 million in fiscal year 2004, an increase of \$48.3 million, or 8%. Our sales revenue was \$142.4 million compared to \$134.5 million in the prior year, an increase of \$7.9 million, or 6%.

#### **Expense** Analysis

Cost of services of \$351.4 million for the year ended December 31, 2005 were \$32.4 million or 10% higher than in 2004. This increase is due to higher operating costs in each segment. Cost of sales of \$100.6 million for the year ended December 31, 2005 were \$8.4 million or 9% higher than in 2004 due to higher sales revenues in the Printed Products Group and the Diversified Gaming Group.

Selling, general and administrative expenses of \$131.8 million for the year ended December 31, 2005 were \$26.5 million or 25% higher than for 2004. This increase is due to a charge relating to the curtailment of our Supplemental Executive Retirement Plan (the SERP) for approximately \$12.4 million (see Note 14 to the Consolidated Financial Statements). Also contributing to the increase is a non tax-deductible charge of \$1.7 million in connection with the earn-out on the Honsel acquisition, \$3.0 million of unanticipated legal and related consulting and severance expenses, incurred charges of \$2.4 million for restructuring costs and to discontinue certain unprofitable racing-related businesses and the compensation and recruitment expenses of newly appointed key personnel such as the Chief Operating Officer.

Depreciation and amortization expense, including amortization of service contract software, of \$66.8 million for the year ended December 31, 2005 increased \$5.5 million or 9% from 2004, primarily due to the addition of new lottery contracts, including Colorado, Puerto Rico and Oklahoma.

Interest expense of \$26.5 million for the year ended December 31, 2005 decreased \$4.5 million or 15% from 2004, primarily as a result of the lower interest rates associated with our December 2004 debt structure.

Equity in loss of joint ventures reflects our share of the losses of the Italian joint venture in connection with the operation of the Italian Gratta e Vinci instant lottery. In 2005, our share of the consortium s losses totaled \$1.7 million compared to \$6.1 million in 2004. In 2004 the joint venture experienced costs in excess of revenues relating to the re-launch of the lottery. The loss in 2005 was less than in 2004 because of increased sales of instant tickets. Also included in equity loss in joint ventures is our 50% share of the losses of our joint venture with Electronic Game Card, Inc. (EGC) in connection with our efforts to jointly market and promote electronic lottery game cards. In 2005, our share of the EGC joint venture s losses totaled approximately \$0.4 million compared to \$0 in 2004.

The effective tax rate decreased to 27.3% in 2005 from 30.5% in 2004. In 2005, we recorded a federal tax benefit of 5.8% related to the realization of research and development credits, of which 4.5% will not recur. In 2005, we also recorded a federal benefit of 3.7% from the amortization of original issue discount related to the issuance of long term debt in 2004. Our tax rate will continue to reflect a benefit from this amortization through 2010. The effect of these tax benefits were partially offset by a 4.2% reduction in the federal tax benefit for extraterritorial income exclusion and a smaller release of the valuation allowance in 2005 of 1.7%.

#### Segment Overview

	Year Ended Dece (in thousands) Printed Products Group	ember 31, 2005 Lottery Systems Group	Diversified Gaming Group	Totals
Service revenues	\$ 331,087	175,843	132,397	639,327
Sales revenues	72,214	59,829	10,313	142,356
Total revenues	403,301	235,672	142,710	781,683
Cost of services (exclusive of depreciation and amortization)	170,097	87,290	94,043	351,430
Cost of sales (exclusive of depreciation and amortization)	52,193	41,387	7,041	100,621
Selling, general and administrative expenses	43,969	29,684	15,528	89,181
Depreciation and amortization	18,250	33,522	13,843	65,615
Segment operating income	\$ 118,792	43,789	12,255	174,836
Unallocated corporate selling, general and administrative costs and				
depreciation and amortization expense				43,842
Consolidated operating income				\$ 130,994
Interest expense				\$ 26,548

	Year Ended Dece (in thousands)			
	Printed Products			
	Group	Group	Group	Totals
Service revenues	\$ 261,737	189,319	139,928	590,984
Sales revenues	67,865	62,506	4,140	134,511
Total revenues	329,602	251,825	144,068	725,495
Cost of services (exclusive of depreciation and amortization)	136,819	92,683	89,487	318,989
Cost of sales (exclusive of depreciation and				
amortization)	49,809	40,041	2,381	92,231
Selling, general and administrative expenses	34,774	30,169	13,579	78,522
Depreciation and amortization	14,196	30,917	15,220	60,333
Segment operating income	\$ 94,004	58,015	23,401	175,420
Unallocated corporate selling, general and administrative costs and				
depreciation and amortization expense				27,696
Consolidated operating income				\$ 147,724
Interest expense				\$ 30,952

#### Printed Products

For the year ended December 31, 2005, total revenue for Printed Products was \$403.3 million compared to \$329.6 million in the year ended December 31, 2004, an increase of \$73.7 million, or 22%. For the year ended December 31, 2005, service revenue for Printed Products was \$331.1 million compared to \$261.7 million in the corresponding prior year, an increase of \$69.4 million, or 27%. The increase was attributable to the strong demand for our branded and licensed property lottery contracts and strong sales of instant lottery tickets, partially offset by a \$1.4 million defective ticket charge.

Printed Products sales revenue for the year ended December 31, 2005, was \$72.2 million compared to \$67.9 million for the year ended December 31, 2004, an increase of \$4.3 million, or 6%. The increase was due to the addition of Honsel from the beginning of fiscal year 2005, partially offset by an \$11.3 million

decrease in phone card sales primarily due to a large sale in 2004 to a customer in Africa that did not recur in 2005 and to a lesser extent the change in mix of sheet and web based products and continued phone industry pricing pressures.

Cost of services of \$170.1 million for the year ended December 31, 2005 were \$33.3 million or 24% higher than in 2004. This increase is due to higher operating costs as a result of the higher revenue for the year along with a \$2.2 million defective ticket charge. Cost of sales of \$52.2 million for the year ended December 31, 2005 were \$2.4 million or 5% higher than in 2004 due to a 6% increase in sales revenues.

Selling, general and administrative expenses of \$44.0 million for the year ended December 31, 2005 were \$9.2 million or 26% higher than in the year ended December 31, 2004. This increase is primarily due to incremental selling, general and administrative expenses from the addition of Honsel for the full year, a non tax-deductible charge of \$1.7 million in connection with the earn-out on the Honsel acquisition and unanticipated legal and related consulting and severance expenses of \$1.3 million.

Depreciation and amortization expense, including amortization of service contract software, of \$18.3 million for the year ended December 31, 2005 increased \$4.1 million or 29%, as compared to the year ended December 31, 2004, primarily due to a full year of operations of Honsel and increased amortization costs because of the addition of new properties for our licensed product offerings.

#### Lottery Systems

For the year ended December 31, 2005 total revenue for Lottery Systems was \$235.7 million compared to \$251.8 million in the year ended December 31, 2004, a decrease of \$16.1 million, or 6%. Lottery Systems service revenue for the year ended December 31, 2005 was \$175.8 million compared to \$189.3 million for the year ended December 31, 2004, a decrease of \$13.5 million, or 7%. The decrease was primarily due the loss of approximately \$30.0 million of revenues on the Florida online lottery contract, which ended in January 2005, partially offset by the addition of new contracts which began in 2005.

Lottery Systems sales revenue for the year ended December 31, 2005, was \$59.8 million compared to \$62.5 million for the year ended December 31, 2004, a decrease of \$2.7 million, or 4%. The decrease was due to lower sales of lottery systems and terminals.

Cost of services of \$87.3 million for the year ended December 31, 2005 were \$5.4 million or 6% lower than in 2004. This decrease is due to reduced operating costs associated with the Florida online lottery contract, partially offset by higher operating costs as a result of the addition of new customers. Cost of sales of \$41.4 million for the year ended December 31, 2005 were \$1.4 million or 4% higher than in 2004 due to a sales mix that yielded slightly less margins in 2005.

Selling, general and administrative expenses of \$29.7 million for the year ended December 31, 2005 were \$0.5 million or 2% lower than in the year ended December 31, 2004. This decrease is primarily the result of the lower revenues for 2005.

Depreciation and amortization expense, including amortization of service contract software, of \$33.5 million for the year ended December 31, 2005 increased \$2.6 million or 8%, as compared to the year ended December 31, 2004, primarily due to the amortization of deferred installation costs of new contracts.

#### Diversified Gaming

For the year ended December 31, 2005, total revenue for Diversified Gaming was \$142.7 million compared to \$144.1 million in the year ended December 31, 2004, a decrease of \$1.4 million, or 1%. Diversified Gaming service revenue for the year ended 2005 was \$132.4 million compared to \$139.9 million from the year ended 2004, a decrease of \$7.5 million, or 5%. The decrease in service revenues reflects lower Handle in the domestic and foreign pari-mutuel and venue management businesses, the loss of the New York Racing Association (NYRA) contract, and a smoking ban in Connecticut that became

effective at the beginning of the second quarter of 2004, partially offset by the addition of the Maine OTB operation and higher non-wagering services. We believe the trend in reduced wagering may continue.

Diversified Gaming sales revenue for the year ended December 31, 2005 was \$10.3 million compared to \$4.1 million in the prior fiscal year, an increase of \$6.2 million. The increase was due to increased system sales in Europe in 2005. Pari-mutuel system sales usually reflect a limited number of large transactions, which do not recur on an annual basis.

Cost of services of \$94.0 million for the year ended December 31, 2005 were \$4.5 million or 5% higher than in 2004. This increase is due to higher operating costs as a result of weather related losses due to hurricanes, the integration of four European racing operations into our European racing center in Essen, Germany, costs associated with the termination of certain unprofitable racing contracts, increased communications and \$0.4 million of restructuring costs in the Netherlands. Cost of sales of \$7.0 million for the year ended December 31, 2005 were \$4.6 million higher than in 2004 due to an increase in sales revenues.

Selling, general and administrative expenses of \$15.5 million for the year ended December 31, 2005 were \$1.9 million or 14% higher than in the year ended December 31, 2004. This increase is primarily due to charges of \$2.4 million relating to restructuring costs in Europe and the discontinuance of certain unprofitable racing contracts along with higher compensation, professional fees and marketing costs.

Depreciation and amortization expense, including amortization of service contract software, of \$13.8 million for the year ended December 31, 2005 decreased \$1.4 million or 9%, as compared to the year ended December 31, 2004, primarily due to fixed assets that are now fully depreciated.

#### **Overview of Financial Position**

Our consolidated balance sheet as of December 31, 2006, compared to our consolidated balance sheet as of December 31, 2005, was impacted by the following:

• Goodwill increased significantly to \$633.7 million as of December 31, 2006 from \$339.2 million as of December 31, 2005 primarily as a result of the completion of our acquisitions of EssNet (\$84 million), Global Draw (\$157 million), Games Media (\$20 million), and ILC (\$10 million).

• Long-term debt increased to \$913.3 million as of December 31, 2006 from \$574.7 million as of December 31, 2005. The increase is primarily the result of additional borrowings to fund the 2006 acquisitions.

#### Liquidity, Capital Resources and Working Capital

In December 2004, we entered into a series of financial transactions structured to create additional borrowing capacity, loosen certain financial covenants, extend the average maturity of our debt, lower our average cost of borrowing, and reduce our exposure to rising interest rates. We sold \$275 million of 0.75% convertible senior subordinated debentures due 2024 (the Convertible Debentures ), sold \$200 million of 6.25% senior subordinated notes due 2012 (the 2004 Notes ), and entered into a new senior secured credit facility (the 2004 Facility ) which consists of a \$250 million revolving credit facility due December 2009 (the Revolver ) and a \$100 million term loan due December 2009 (the Term Loan B ), (together, the Convertible Debentures, the 2004 Notes and the 2004 Facility, the 2004 Securities ).

On March 31, 2006, we amended (the March Amendment ) the credit agreement dated December 23, 2004 for the 2004 Facility (the 2004 Credit Agreement ) to provide for a new \$100 million senior secured term loan (the Term Loan C ), to increase the Revolver from \$250 million to \$300 million and to make certain other changes to the 2004 Credit Agreement (the 2004 Credit Agreement together with the March Amendment are collectively referred to as the March 2006 Amended and Restated Credit Agreement ). The proceeds from the Term Loan C were used to partially finance the acquisition of Global

Draw, a supplier of FOBTs and interactive betting systems, and certain related companies. We paid approximately \$0.4 million to certain financial institutions for the March Amendment plus legal and other fees and costs.

On July 7, 2006, we amended (the July Amendment ) the March 2006 Amended and Restated Credit Agreement to provide for a new \$150 million senior secured term loan (the Term Loan D ) and to make certain other changes to the March 2006 Amended and Restated Credit Agreement (the March 2006 Amended and Restated Credit Agreement and the July Amendment are collectively referred to as the July 2006 Amended and Restated Credit Agreement ). The proceeds from the Term Loan D were used to repay, in full, the remaining \$98.5 million of existing Term Loan B and to pay down approximately \$51 million of borrowings under our Revolver. We paid approximately \$0.3 million to certain financial institutions for the July Amendment plus legal and other fees and costs.

During January 2007, we amended (the January Amendment ) the July 2006 Amended and Restated Credit Agreement to provide for a new \$200 million senior secured term loan (the Term Loan E ) and to make certain other changes to the July 2006 Amended and Restated Credit Agreement (the July 2006 Amended and Restated Credit Agreement and the January Amendment are collectively referred to as the January 2007 Amended and Restated Credit Agreement ). The proceeds from the Term Loan E were used to pay down approximately \$188 million of borrowings under our Revolver. We paid approximately \$0.6 million to certain financial institutions for the January Amendment plus legal and other fees and costs. The January 2007 Amended and Restated Credit Agreement will terminate on December 23, 2009.

Under our January 2007 Amended and Restated Credit Agreement, the interest rate with respect to the borrowings under our Revolver will vary, depending upon our consolidated leverage ratio, from 125 basis points to 225 basis points above LIBOR for Eurocurrency loans and from 25 basis points to 125 basis points above the higher of (i) the prime rate or (ii) the Federal Funds Effective Rate plus 0.50%, for base rate loans. The interest rate with respect to Term Loan C, Term Loan D and Term Loan E will vary, depending upon our consolidated leverage ratio, from 75 basis points to 175 basis points above LIBOR for Eurocurrency loans and from zero basis points to 75 basis points above the higher of (i) the prime rate or (ii) the Federal Funds Effective Rate plus 0.50%, for base rate loans.

Our January 2007 Amended and Restated Credit Agreement is secured by a first priority, perfected lien on: (i) substantially all the property and assets (real and personal, tangible and intangible) of our Company and 100%-owned domestic subsidiaries; (ii) 100% of the capital stock of all of the direct and indirect 100%-owned domestic subsidiaries and 65% of our interest in the capital stock of our first-tier foreign subsidiaries; and (iii) all inter-company indebtedness owing amongst our Company and our 100%-owned domestic subsidiaries. The January 2007 Amended and Restated Credit Agreement is supported by guarantees provided by all of our direct and indirect 100%-owned domestic subsidiaries.

In addition, the January 2007 Amended and Restated Credit Agreement is subject to the following mandatory prepayments, with certain customary exceptions: (i) 100% of the net cash proceeds from the sale or issuance of debt securities; and (ii) 100% of the net proceeds from the sale of assets and casualty insurance proceeds, subject to a reinvestment exclusion limited to \$80 million per annum.

The January 2007 Amended and Restated Credit Agreement contains certain covenants that, among other things, limit our ability, and the ability of certain of our subsidiaries, to incur additional indebtedness, pay dividends or make distributions or certain other restricted payments, purchase or redeem capital stock, make investments or extend credit, engage in certain transactions with affiliates, engage in sale-leaseback transactions, consummate certain asset sales, effect a consolidation or merger, sell, transfer, lease or otherwise dispose of all or substantially all assets, or create certain liens and other encumbrances on assets. Additionally, the January 2007 Amended and Restated Credit Agreement contains the following financial covenants that are computed quarterly on a rolling four-quarter basis as applicable:

#### • A maximum Consolidated Leverage Ratio as follows:

3.75 through December 31, 2006

4.30 from January 1, 2007 through March 31, 2007

4.25 from April 1, 2007 through September 30, 2007

4.00 from October 1, 2007 through September 30, 2008

3.85 from October 1, 2008 through September 30, 2009

3.75 from October 1, 2009 until December 23, 2009

Consolidated Leverage Ratio means the ratio of (x) the aggregate stated balance sheet amount of our indebtedness determined on a consolidated basis in accordance with Generally Accepted Accounting Principles (GAAP) as of the last day of the fiscal quarter for which such determination is being made to (y) Consolidated Earnings Before Interest, Taxes, Depreciation and Amortization (EBITDA) for the four consecutive fiscal quarters ended on the last day of the fiscal quarter for which such determination is being made.

• A maximum Consolidated Senior Debt Ratio as follows:

2.50 through December 31, 2006

2.60 from January 1, 2007 to March 31, 2007

2.50 from April 1, 2007 through December 23, 2009

Consolidated Senior Debt Ratio means the ratio of (x) the aggregate stated balance sheet amount of our indebtedness, the amount of our 2004 Notes and the Convertible Debentures determined on a consolidated basis in accordance with GAAP as of the last day of the fiscal quarter for which such determination is being made to (y) Consolidated EBITDA for the four consecutive fiscal quarters ended on the last day of the fiscal quarter for which such determination is being made.

• A minimum Consolidated Interest Coverage Ratio of 3.50 through December 23, 2009. Consolidated Interest Coverage Ratio means, as of any date of determination, the ratio computed for our four most recent fiscal quarters of (x) Consolidated EBITDA to (y) the total interest expense less non-cash amortization costs included in interest expense.

For purposes of the foregoing limitations, Consolidated EBITDA means the sum of (i) consolidated net income, (ii) consolidated interest expense with respect to all outstanding indebtedness, (iii) provisions for taxes based on income, (iv) total depreciation expense, (v) total amortization expense and (vi) certain other non-cash expenses and acquisition-related costs, in each case for the period being measured, all of the foregoing as determined on a consolidated basis for our Company and our subsidiaries in accordance with GAAP.

On December 31, 2006, we had approximately \$54.6 million available for additional borrowing or letter of credit issuance under our Revolver. There were \$191 million of borrowings and \$54.4 million in outstanding letters of credit under our Revolver as of December 31, 2006. Effective with the January 2007

Amended and Restated Agreement, we had approximately \$245.6 million available for additional borrowing or letter of credit issuance under our Revolver. Our ability to borrow under the January 2007 Amended and Restated Credit Agreement will depend on our remaining in compliance with the limitations imposed by our lenders, including the maintenance of the specified financial covenants.

We were in compliance with its covenants as of December 31, 2006 and for all of the quarters included in the fiscal year 2006.

Our contractual obligations and commercial commitments principally include obligations associated with our outstanding indebtedness and future minimum operating lease obligations, as set forth in the table below:

Cash Payments Due by Period								
			Within 1	1-3	3-5	After 5		
Contractual Obligations:	Tota	-	Year	Years	Years	Years		
	(in t	housands)						
Long-term debt, 6 1/4% notes	\$	200,000				200,000		
Long-term debt, 0.75% notes (1)	275,	,000				275,000		
Long-term debt, Term Loan C	99,2	50	1,000	98,250				
Long-term debt, Term Loan D	149,250		1,500	147,750				
Long-term debt, revolving credit facility	191,	,000		191,000				
Other long-term debt	1,90	1	648	723	27	503		
Interest expense (2)	200,	,742	44,646	87,581	29,186	39,329		
Purchase obligation (3)	55,0	00	55,000					
Operating leases	90,314		17,114	29,450	16,429	27,321		
Other long-term liabilities (4)	10,680		8,066	2,230	80	304		
Total contractual cash obligations	\$	1,273,137	127,974	556,984	45,722	542,457		

<sup>(1)</sup> The 0.75% Convertible Debentures are due 2024. However, these Convertible Debentures could require cash payment before that date if holders of these Convertible Debentures elect to convert the Convertible Debentures when the market price of our common stock equals or exceeds \$34.92, subject to certain conditions, if we call the Convertible Debentures for redemption, or upon certain corporate transactions.

(2) Based on rates in effect at December 31, 2006.

(3) We have a purchase order outstanding as of December 31, 2006 for approximately 9,000 fixed odds betting terminals with a total cost of approximately \$55.0 million. As of December 31, 2006, 10%, or approximately \$5.5 million has been paid as cash deposits on the purchase order.

(4) Because of the uncertainty as to the timing of such payments, we have excluded all but \$5.2 million of cash payments related to our contractual obligations for our pension plans and deferred compensation plans of approximately \$23.0 million at December 31, 2006.

In August 2005, we paid cash of \$8.1 million, including a \$0.5 million redemption premium, to redeem all of the remaining 12 ½% Senior Subordinated Notes due 2010.

Our pari-mutuel wagering and online lottery systems service contracts require us to, among other things, maintain the central computing system and related hardware in efficient working order, provide added software functionality upon request, provide on-site computer operators, and furnish necessary supplies. Our primary expenditures associated with these services are personnel and related costs, which are expensed as incurred and are included in Operating Expenses Services in the consolidated statements of income. Historically, the revenues we derive from our pari-mutuel wagering and lottery systems service contracts have exceeded the direct costs associated with fulfilling our obligations thereunder. We expect that we will continue to realize positive cash flow and operating income as we extend or renew existing

service contracts. We also expect that we will enter into new contracts that are accretive to our cash flow. In addition, through advancements in technology, we are continually deploying more efficient and cost effective methods for manufacturing and delivering our products and services to our customers. We expect that technological efficiencies will continue to positively impact our future cash flows and operating results. We are not party to any other material short-term or long-term obligations or commitments pursuant to these service contracts.

Periodically, we bid on new pari-mutuel and online lottery contracts. Once awarded, these contracts generally require significant up-front capital expenditures for terminal assembly, customization of software, software and equipment installation and telecommunications configuration. Historically we have funded these up-front costs through cash flows generated from operations, available cash on hand and borrowings under our credit facilities. Our ability to continue to procure new contracts will depend on, among other things, our then present liquidity levels and/or our ability to borrow at commercially acceptable rates to finance the initial up-front costs. Once operational, long-term service contracts have been accretive to our operating cash flow. The actual level of capital expenditures will ultimately largely depend on the extent to which we are successful in winning new contracts. Furthermore, our pari-mutuel wagering network consists of approximately 26,000 wagering terminals. Periodically, we elect to upgrade the technological capabilities of older terminals and replace terminals that have exhausted their useful lives. In the next year, we expect to replace approximately 6,000 and 9,000 existing pari-mutuel and fixed odds betting terminals, respectively, for a total cost of approximately \$60 million. As of December 31, 2006, we have paid cash deposits of approximately \$5.5 million related to the 9,000 fixed odds betting terminals. Servicing our installed terminal base requires that we maintain a supply of parts and accessories on hand. We are also required, contractually in some cases, to provide spare parts over an extended period of time, principally in connection with our systems and terminal sale transactions. To meet our contractual obligations and maintain sufficient levels of on-hand inventory to service our installed base, we purchase inventory on an as-needed basis. We presently have no inventory purchase obligations, other than in the ordinary course of business.

At December 31, 2006, our available cash, short-term investments and borrowing capacity totaled \$82.4 million compared to \$258.6 million at December 31, 2005. Effective with the January 2007 Amendment, we had approximately \$214.6 million available for additional borrowings or letter of credit issuance under our Revolver. The amount of our available cash and short-term investments fluctuates principally based on the timing of collections from our customers, cash expenditures associated with new and existing pari-mutuel wagering and lottery systems contracts, borrowings or repayments under our credit facilities and changes in our working capital position. The increase/decrease in our available cash from the December 31, 2005 level principally reflects the net cash provided by operating activities for the year ended December 31, 2006 of \$128.5 million plus long-term borrowings of \$441.3 million, offset by wagering and other capital expenditures and other investing activities totaling \$203.6 million, acquisition related payments of \$296.9 million and \$105.7 million of payments on long-term debt. The \$128.5 million of net cash provided by operating activities is derived from \$177.9 million of net cash provided by operations offset by \$49.4 million used in changes in working capital. The working capital changes occurred principally from increases in accounts receivable, inventories, other current assets and decreases in accounts payable, offset by increases in accrued liabilities. Capital expenditures of \$16.0 million in the year ended December 31, 2006 are less than expenditures totaling \$32.4 million in the corresponding period in 2005. Wagering system expenditures, including software expenditures, totaled \$142.2 million in the year ended December 31, 2006, compared to \$127.8 million in 2005. This increase is primarily due to the new lottery contracts in Shanghai, Mexico, Maryland and Oklahoma, coupled with gaming terminals related to Global Draw. Cash flow from financing activities principally reflects the repayme

At December 31, 2005, our available cash, short-term investments and borrowing capacity totaled \$258.6 million compared to \$318.6 million at December 31, 2004. Our available cash, short-term investments and borrowing capacities fluctuate principally based on the timing of collections from our customers, cash expenditures associated with new and existing pari-mutuel wagering and lottery systems contracts, repayment of our outstanding debt and changes in our working capital position. For the year ended December 31, 2005, net cash provided by operating activities of \$200.9 million exceeded cash used in investing activities of \$174.5 million, excluding funds used for acquisitions and debt financing fees. The \$200.9 million of net cash provided by operating activities is derived from net cash provided by operations of \$188.6 million coupled with \$12.3 million provided by changes in working capital. The working capital changes occurred principally from decreases in short-term investments, along with increases in accounts payable, offset by increases in accounts receivable, inventories, other current assets and decreases in accrued liabilities. Capital expenditures of \$32.4 million in 2005 increased \$5.1 million from the prior year primarily due to the build out of the Alpharetta, Georgia facility and the purchase of a short-run printing press. Wagering systems expenditures of \$127.8 million in 2005, increased \$60.6 million from the prior year primarily due to new online lottery contracts in Puerto Rico, Spain, Mexico, Oklahoma and Colorado. Cash flow from financing activities principally reflects the repayments of borrowings under the 2004 Facility.

We believe that our cash flow from operations, available cash and available borrowing capacity under the 2004 Facility, as amended, will be sufficient to meet our liquidity needs, including anticipated capital expenditures, for the foreseeable future; however, there can be no assurance that this will be the case. While we are not aware of any particular trends, our contracts periodically renew and there can be no assurance that we will be successful in sustaining our cash flow from operations through renewal of our existing contracts or through the addition of new contracts. In addition, lottery customers in the United States generally require service providers to provide performance bonds in connection with each state contract. Our ability to obtain performance bonds on commercially reasonable terms is subject to prevailing market conditions, which may be impacted by economic and political events. Although we have not experienced any difficulty obtaining such bonds, there can be no assurance that we will continue to be able to obtain performance bonds on commercially reasonable terms or at all. While we are not aware of any reason to do so, if we need to refinance all or part of our indebtedness, on or before maturity, or provide letters of credit or cash in lieu of performance bonds, there can be no assurance that we will be able to obtain new financing or to refinance any of our indebtedness, on commercially reasonable terms or at all.

Further, the terms of the indenture governing the Convertible Debentures give holders the right to convert the Convertible Debentures when the market price of our Class A Common Stock exceeds a defined target market price. The terms of such indenture require us to pay cash for the face amount of the Convertible Debentures which have been presented for conversion, with the value of the difference between the stated conversion price and the prevailing market price payable by our issuance of additional shares of our Class A Common Stock. We cannot offer any assurance that we will have sufficient available cash to pay for the Convertible Debentures presented to us for conversion nor can we offer any assurance that we will be able to refinance all or a portion of the converted Convertible Debentures at that time.

#### New Accounting Pronouncements

In July 2006, the Financial Accounting Standards Board (the FASB) issued FASB Interpretation No. 48 Accounting for Uncertainty in Income Taxes (FIN 48), which prescribes a recognition threshold and measurement process for recording in the financial statements uncertain tax positions taken or expected to be taken in a tax return. Additionally, FIN 48 provides guidance on the derecognition, classification, accounting in interim periods and disclosure requirements for uncertain tax positions. This

standard is required to be adopted by us on January 1, 2007. We do not believe the adoption of FIN 48 will have a material impact on our financial statements.

In September 2006, the FASB issued SFAS No. 157, *Fair Value Measurements* (SFAS 157). SFAS 157 establishes a standard definition for fair value, establishes a framework under generally accepted accounting principles for measuring fair value and expands disclosure requirements for fair value measurements. This standard is effective for financial statements issued for fiscal years beginning after November 15, 2007. We are currently evaluating the impact the adoption of SFAS 157 will have on our financial statements.

In September 2006, the FASB issued SFAS No. 158, *Employers Accounting for Defined Benefit Pension and Other Postretirement Plans an amendment of FASB Statements No. 87, 88, 106 and 132(R) (SFAS 158). SFAS 158 requires an employer to recognize the overfunded or underfunded status of a defined benefit postretirement plan as an asset or liability in its statement of financial position and to recognize changes in that funded status in the year in which the changes occur as a component of comprehensive income. The standard also requires an employer to measure the funded status of a plan as of the date of its year-end statement of financial position.* 

The requirement to recognize the funded status of a defined benefit postretirement plan became effective December 31, 2006, and we adopted the recognition requirements as of December 31, 2006. The requirement to measure plan assets and benefit obligations as of the date of an employer s fiscal year-end statement of financial position is not applicable to the Company.

In September 2006, the SEC staff added Section N to Staff Accounting Bulletin (SAB) Topic 1 through the issuance of *Financial Statements Considering the Effects of Prior Year Misstatements when Qualifying Misstatements in Current Year Financial Statements* (SAB) SAB 108 addresses how a registrant should evaluate whether an error in its financial statements is material. The guidance in SAB 108 is effective for fiscal years ending after November 15, 2006. The adoption of SAB 108 had no impact on our consolidated financial statements.

In February, 2007, the FASB issued SFAS No. 159, *The Fair Value Option for Financial Assets and Financial Liabilities Including an amendment of FASB Statement No. 115* (SFAS 159). SFAS 159 permits entities to choose to measure many financial assets and financial liabilities at fair value. Unrealized gains and losses on items for which the fair value option has been elected are reported in earnings. SFAS 159 is effective for fiscal years beginning after November 15, 2007. We are currently assessing the impact of SFAS 159 on our consolidated financial position and results of operations.

#### **Related Party Transactions**

SFAS No. 57, *Related Party Disclosures*, (SFAS 57) requires us to identify and describe material transactions involving related persons or entities and to disclose information necessary to understand the effects of such transactions on our consolidated financial statements. We are not a party to material transactions involving related persons or entities.

### ITEM 7A. QUANTITATIVE AND QUALITATIVE DISCLOSURES ABOUT MARKET RISK

Our products and services are sold to a diverse group of customers throughout the world. As such, we are subject to certain risks and uncertainties as a result of changes in general economic conditions, sources of supply, competition, foreign exchange rates, tax reform, litigation and regulatory developments. (See Item 1A Risk Factors for a more complete description of these risks and uncertainties.) The diversity and breadth of our products and geographic operations mitigate the risk that adverse changes from any single event would materially affect our financial position.

Additionally, as a result of the diversity of our customer base, we do not consider ourselves exposed to concentration of credit risks. These risks are further minimized by setting credit limits, ongoing monitoring of customer account balances, and assessment of the customers financial strengths.

Inflation has not had an abnormal or unanticipated effect on our operations. Inflationary pressures would be significant to our business if raw materials used for instant lottery ticket production, prepaid phone card production or terminal manufacturing are significantly affected. Available supply from the paper and electronics industries tends to fluctuate and prices may be affected by supply.

For fiscal 2006, inflation was not a significant factor in our results of operations, and we were not impacted by significant pricing changes in our costs, except for personnel related expenditures. We are unable to forecast the prices or supply of substrate, component parts or other raw materials in 2007, but we currently do not anticipate any substantial changes that will materially affect our operating results.

In certain limited cases, our lottery contracts with our customers contain provisions to adjust for inflation on an annual basis, but we cannot be assured that this adjustment would cover raw material price increases or other costs of services. While we have long-term and generally satisfactory relationships with most of our suppliers, we also believe alternative sources to meet our raw material and production needs are available.

In the normal course of business, we are exposed to fluctuations in interest rates and equity market risks as we seek debt and equity capital to sustain our operations. At December 31, 2006, approximately 52% of our debt was in fixed rate instruments. The following table provides information about our financial instruments that are sensitive to changes in interest rates. The table presents principal cash flows and related weighted-average interest rates by expected maturity dates. (See Management s Discussion and Analysis of Financial Condition and Results of Operations Liquidity, Capital Resources and Working Capital .)

## Principal Amount by Expected Maturity Average Interest Rate December 31, 2006

#### (Dollars in thousands)

	Twelve Months Ended December 31												
	2007		2008		2009		2010	2011	Thereafter	Total		FMV	
Debt at fixed interest rates	\$ 648		449		274		13	14	475,503	476,901		511,644	
Weighted-average interest rates	5.4	%	5.5	%	5.0	%	6.2 %	6.2 %	3.1 %	3.1	%		
Debt at variable interest rates	\$ 2,500	)	2,500		434,50	00				439,500		438,545	
Weighted-average interest rates	6.6	%	6.6	%	6.8	%	%	%	%	6.8	%		

We are also exposed to fluctuations in foreign currency exchange rates as the financial results of our foreign subsidiaries are translated into U.S. dollars in consolidation. Assets and liabilities outside the United States are primarily located in the United Kingdom, Germany, the Netherlands, Spain, Sweden, Mexico, Austria, Chile and Ireland. Our investments in foreign subsidiaries with a functional currency other than the U.S. dollar are generally considered long-term investments. Accordingly, we do not hedge

these net investments. During 2006, we made a material acquisition in the United Kingdom. This acquisition has increased our market risk associated with foreign currency movements. Our most significant transactional foreign currency exposures are the Euro and the Sterling in relation to the United States dollar. Fluctuations in the value of foreign currencies create exposures, which can adversely affect our results of operations. We manage our foreign currency exchange risks on a global basis by one or more of the following: (i) securing payment from our customers in U.S. dollars, when possible, (ii) entering into foreign currency exchange contracts and (iii) netting asset and liability exposures denominated in similar foreign currencies. to the extent possible. In addition, a significant portion of the cost attributable to our foreign operations is incurred in the local currencies. We may, from time to time, enter into foreign currency exchange or other contracts to hedge the risk associated with certain firm sales commitments, anticipated revenue streams and certain assets and liabilities denominated in foreign currencies. We believe that a hypothetical 10% upward or downward fluctuation in foreign currency exchange rates relative to the United States dollar would not have a material impact on future earnings, fair values, or cash flows.

Our cash and cash equivalents and investments are in high-quality securities placed with a wide array of institutions with high credit ratings. The investment policy limits our exposure to concentration of credit risks. We believe that the impact of a 10% increase or decrease in interest rates would not be material to our investment income and interest expense from bank loans.

## ITEM 8. FINANCIAL STATEMENTS AND SUPPLEMENTARY DATA

#### INDEX TO CONSOLIDATED FINANCIAL STATEMENTS AND FINANCIAL STATEMENT SCHEDULE SCIENTIFIC GAMES CORPORATION AND SUBSIDIARIES

	Form 10-K (Page)
Report of Independent Registered Public Accounting Firm on Internal Control Over Financial Reporting	67
Report of Independent Registered Public Accounting Firm	69
Consolidated Financial Statements:	
Balance Sheets as of December 31, 2005 and 2006	70
Statements of Operations for the years ended December 31, 2004, 2005 and 2006	71
Statements of Stockholders Equity and Comprehensive Income for the years ended December 31, 2004, 2005	
and 2006	72
Statements of Cash Flows for the years ended December 31, 2004, 2005 and 2006	73
Notes to Consolidated Financial Statements	75
Schedule:	
II. Valuation and Qualifying Accounts	128

All other schedules are omitted as the required information is inapplicable or the information is presented in the consolidated financial statements or related notes.

#### REPORT OF INDEPENDENT REGISTERED PUBLIC ACCOUNTING FIRM

To the Board of Directors and Stockholders of Scientific Games Corporation New York, New York

We have audited management s assessment, included in the accompanying Management Report on Internal Control over Financial Reporting, that Scientific Games Corporation and subsidiaries (the Company ) maintained effective internal control over financial reporting as of December 31, 2006, based on criteria established in Internal Control Integrated Framework issued by the Committee of Sponsoring Organizations of the Treadway Commission. As described in Management Report on Internal Control Over Financial Reporting, management excluded from its assessment the internal control over financial reporting at The Global Draw, which was acquired on April 20, 2006, EssNet, which was acquired on March 22, 2006, Games Media, which was acquired on December 22, 2006, and ILC, which was acquired on December 28, 2006 and whose financial statements collectively constitute 7 percent and 3 percent of net and total assets, respectively, 10 percent of revenues, and 35 percent of net income of the consolidated financial statement amounts as of and for the year ended December 31, 2006. Accordingly, our audit did not include the internal control over financial reporting at The Global Draw, EssNet, Games Media, and ILC. The Company s management is responsible for maintaining effective internal control over financial reporting and for its assessment of the effectiveness of internal control over financial reporting and for its assessment and an opinion on the effectiveness of the Company s internal control over financial reporting based on our audit.

We conducted our audit in accordance with the standards of the Public Company Accounting Oversight Board (United States). Those standards require that we plan and perform the audit to obtain reasonable assurance about whether effective internal control over financial reporting was maintained in all material respects. Our audit included obtaining an understanding of internal control over financia