

SCIENTIFIC GAMES CORP  
Form 10-Q  
May 10, 2007

**UNITED STATES**  
**SECURITIES AND EXCHANGE COMMISSION**

Washington, D. C. 20549

**Form 10-Q**

{Mark One}

**x QUARTERLY REPORT PURSUANT TO SECTION 13 OR 15(d) OF THE SECURITIES EXCHANGE ACT OF 1934**

For the quarterly period ended March 31, 2007

OR

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

For the transition period from to

Commission file number: 0-13063

**SCIENTIFIC GAMES CORPORATION**

(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, New York, New York 10022**

(Address of principal executive offices)

(Zip Code)

**(212) 754-2233**

(Registrant's telephone number, including area code)

Indicate by check mark whether the registrant (1) has filed all reports 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**

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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 Exchange Act).

Yes ☐ o No ☒ x

### APPLICABLE ONLY TO CORPORATE ISSUERS:

Indicate the number of shares outstanding of each of the issuer's classes of common stock as of May 7, 2007:

Class A Common Stock: 92,536,365

Class B Common Stock: None

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SCIENTIFIC GAMES CORPORATION AND SUBSIDIARIES

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THREE MONTHS ENDED MARCH 31, 2007

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### Forward-Looking Statements

Throughout this Quarterly Report on Form 10-Q we make 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 terms. Forward-looking statements contained in this Quarterly Report on Form 10-Q are generally located in the material set forth under the headings Management's Discussion and Analysis of Financial Condition and Results of Operations 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 related to the following:

- 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, members 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;
- 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;
- 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 and integrate those businesses successfully;
- 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.

Actual future results may be materially different from what we expect. We will not update forward-looking statements even though our situation may change in the future.

## SCIENTIFIC GAMES CORPORATION AND SUBSIDIARIES

## CONSOLIDATED BALANCE SHEETS

As of December 31, 2006 and March 31, 2007

(Unaudited, in thousands, except per share amounts)

## PART 1. FINANCIAL INFORMATION

## Item 1. Financial Statements

|                                                                                                                                                                                           | December 31,<br>2006 | March 31,<br>2007 |
|-------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------|----------------------|-------------------|
| <b>ASSETS</b>                                                                                                                                                                             |                      |                   |
| Current assets:                                                                                                                                                                           |                      |                   |
| Cash and cash equivalents                                                                                                                                                                 | \$ 27,791            | \$ 33,231         |
| Accounts receivable, net of allowance for doubtful accounts of \$5,703 and \$6,209 as of December 31, 2006 and March 31, 2007, respectively                                               | 178,445              | 193,512           |
| Inventories                                                                                                                                                                               | 59,464               | 64,238            |
| Deferred income taxes, current portion                                                                                                                                                    | 8,960                | 9,992             |
| Prepaid expenses, deposits and other current assets                                                                                                                                       | 70,042               | 59,482            |
| Total current assets                                                                                                                                                                      | 344,702              | 360,455           |
| Property and equipment, at cost                                                                                                                                                           | 803,089              | 794,978           |
| Less accumulated depreciation                                                                                                                                                             | (352,429)            | (343,387)         |
| Net property and equipment                                                                                                                                                                | 450,660              | 451,591           |
| Goodwill, net                                                                                                                                                                             | 633,730              | 642,000           |
| Intangible assets, net                                                                                                                                                                    | 157,251              | 153,497           |
| Other assets and investments                                                                                                                                                              | 173,267              | 198,115           |
| Total assets                                                                                                                                                                              | \$ 1,759,610         | \$ 1,805,658      |
| <b>LIABILITIES AND STOCKHOLDERS' EQUITY</b>                                                                                                                                               |                      |                   |
| Current liabilities:                                                                                                                                                                      |                      |                   |
| Current installments of long-term debt                                                                                                                                                    | \$ 3,148             | \$ 5,049          |
| Accounts payable                                                                                                                                                                          | 60,566               | 46,767            |
| Accrued liabilities                                                                                                                                                                       | 130,309              | 143,528           |
| Total current liabilities                                                                                                                                                                 | 194,023              | 195,344           |
| Deferred income taxes                                                                                                                                                                     | 43,143               | 43,684            |
| Other long-term liabilities                                                                                                                                                               | 81,113               | 78,926            |
| Long-term debt, excluding current installments                                                                                                                                            | 913,253              | 919,021           |
| Total liabilities                                                                                                                                                                         | 1,231,532            | 1,236,975         |
| Commitments and contingencies                                                                                                                                                             |                      |                   |
| Stockholders' equity:                                                                                                                                                                     |                      |                   |
| Class A common stock, par value \$0.01 per share, 199,300 shares authorized, and 91,628 and 92,510 shares issued and outstanding as of December 31, 2006 and March 31, 2007, respectively | 916                  | 925               |
| Class B non-voting common stock, par value \$0.01 per share, 700 shares authorized, none outstanding                                                                                      |                      |                   |
| Additional paid-in capital                                                                                                                                                                | 477,261              | 492,760           |
| Accumulated earnings                                                                                                                                                                      | 33,452               | 56,715            |
| Treasury stock, at cost, 1,140 shares held as of December 31, 2006 and March 31, 2007                                                                                                     | (19,442)             | (19,442)          |
| Accumulated other comprehensive income                                                                                                                                                    | 35,891               | 37,725            |
| Total stockholders' equity                                                                                                                                                                | 528,078              | 568,683           |
| Total liabilities and stockholders' equity                                                                                                                                                | \$ 1,759,610         | \$ 1,805,658      |

See accompanying notes to consolidated financial statements.



## SCIENTIFIC GAMES CORPORATION AND SUBSIDIARIES

## CONSOLIDATED STATEMENTS OF INCOME

Three Months Ended March 31, 2006 and 2007

(Unaudited, in thousands, except per share amounts)

|                                                                   | Three Months Ended March 31, |            |
|-------------------------------------------------------------------|------------------------------|------------|
|                                                                   | 2006                         | 2007       |
| Operating revenues:                                               |                              |            |
| Services                                                          | \$ 176,960                   | \$ 210,993 |
| Sales                                                             | 31,169                       | 31,273     |
|                                                                   | 208,129                      | 242,266    |
| Operating expenses:                                               |                              |            |
| Cost of services (exclusive of depreciation and amortization)     | 94,948                       | 116,747    |
| Cost of sales (exclusive of depreciation and amortization)        | 24,544                       | 22,485     |
| Selling, general and administrative expenses                      | 32,392                       | 39,145     |
| Depreciation and amortization                                     | 19,292                       | 29,078     |
| Operating income                                                  | 36,953                       | 34,811     |
| Other (income) expense:                                           |                              |            |
| Interest expense                                                  | 7,202                        | 12,892     |
| Equity in net income of joint ventures                            | (1,576)                      | (11,878)   |
| Other income, net                                                 | (643)                        | (390)      |
|                                                                   | 4,983                        | 624        |
| Income before income tax expense                                  | 31,970                       | 34,187     |
| Income tax expense                                                | 9,600                        | 9,428      |
| Net income                                                        | \$ 22,370                    | \$ 24,759  |
| Basic and diluted net income per share:                           |                              |            |
| Basic net income per share                                        | \$ 0.25                      | \$ 0.27    |
| Diluted net income per share                                      | \$ 0.24                      | \$ 0.26    |
| Weighted-average number of shares used in per share calculations: |                              |            |
| Basic shares                                                      | 90,166                       | 91,993     |
| Diluted shares                                                    | 93,172                       | 95,288     |

See accompanying notes to consolidated financial statements.

**SCIENTIFIC GAMES CORPORATION AND SUBSIDIARIES**  
**CONDENSED CONSOLIDATED STATEMENTS OF CASH FLOWS**

**Three Months Ended March 31, 2006 and 2007**

(Unaudited, in thousands, except per share amounts)

|                                                              | <b>Three Months Ended March 31,</b> |             |
|--------------------------------------------------------------|-------------------------------------|-------------|
|                                                              | <b>2006</b>                         | <b>2007</b> |
| Net cash provided by operating activities                    | \$ 34,164                           | \$ 30,420   |
| Cash flows from investing activities:                        |                                     |             |
| Capital expenditures                                         | (4,239 )                            | (2,465 )    |
| Wagering system expenditures                                 | (31,248 )                           | (23,543 )   |
| Other intangible assets and software expenditures            | (17,320 )                           | (8,354 )    |
| Change in other assets and liabilities, net                  | (2,888 )                            | (6,447 )    |
| Business acquisitions, net of cash acquired                  | (57,564 )                           | (336 )      |
| Net cash used in investing activities                        | (113,259 )                          | (41,145 )   |
| Cash flows from financing activities:                        |                                     |             |
| Net borrowings (repayments) under revolving credit facility  | 66,000                              | (191,000 )  |
| Net proceeds (repayments) of long-term debt                  | (564 )                              | 198,665     |
| Excess tax benefit from equity-based compensation plan       | 2,814                               |             |
| Net proceeds from issuance of common stock                   | 8,602                               | 8,360       |
| Net cash provided by financing activities                    | 76,852                              | 16,025      |
| Effect of exchange rate changes on cash and cash equivalents | 506                                 | 140         |
| Increase (decrease) in cash and cash equivalents             | (1,737 )                            | 5,440       |
| Cash and cash equivalents, beginning of period               | 38,942                              | 27,791      |
| Cash and cash equivalents, end of period                     | \$ 37,205                           | \$ 33,231   |

See accompanying notes to consolidating financial statements.

## SCIENTIFIC GAMES CORPORATION AND SUBSIDIARIES

## NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

(Unaudited, in thousands, except per share amounts)

## Notes to Consolidated Financial Statements

## (1) Consolidated Financial Statements

*Basis of Presentation*

The consolidated balance sheet as of March 31, 2007, the consolidated statements of income for the three months ended March 31, 2006 and 2007, and the condensed consolidated statements of cash flows for the three months ended March 31, 2006 and 2007, have been prepared by Scientific Games Corporation (together with its consolidated subsidiaries, the Company) without audit. In the opinion of management, all adjustments necessary to present fairly the consolidated financial position of the Company as of March 31, 2007 and the results of its operations for the three months ended March 31, 2006 and 2007 and its cash flows for the three months ended March 31, 2006 and 2007 have been made.

Certain information and footnote disclosures normally included in consolidated financial statements prepared in accordance with accounting principles generally accepted in the United States of America have been condensed or omitted. These consolidated financial statements should be read in conjunction with the consolidated financial statements and notes thereto included in the Company's 2006 Annual Report on Form 10-K. The results of operations for the period ended March 31, 2007 are not necessarily indicative of the operating results for a full year.

*Basic and Diluted Net Income Per Share*

The following represents a reconciliation of the numerator and denominator used in computing basic and diluted net income per share available to common stockholders for the three months ended March 31, 2006 and 2007:

|                                                                  | Three Months Ended March 31, |           |
|------------------------------------------------------------------|------------------------------|-----------|
|                                                                  | 2006                         | 2007      |
| <b>Income (numerator)</b>                                        |                              |           |
| Net income                                                       | \$ 22,370                    | \$ 24,759 |
| <b>Shares (denominator)</b>                                      |                              |           |
| Basic weighted-average common shares outstanding                 | 90,166                       | 91,993    |
| Effect of dilutive securities-stock options and preferred shares | 3,006                        | 3,295     |
| Diluted weighted-average common shares outstanding               | \$ 93,172                    | \$ 95,288 |
| <b>Basic and diluted per share amounts</b>                       |                              |           |
| Basic net income per share                                       | \$ 0.25                      | \$ 0.27   |
| Diluted net income per share                                     | \$ 0.24                      | \$ 0.26   |

The weighted-average diluted shares outstanding for the three month periods ended March 31, 2006 and 2007 excludes the effect of approximately 185 and 1,142 out-of-the-money options, respectively, as their effect would be anti-dilutive.

The aggregate number of shares that the Company could be obligated to issue upon conversion of its \$275,000, 0.75% convertible senior subordinated debentures due 2024 (the Convertible Debentures), which the Company sold in December 2004, is approximately 9,450. The Convertible Debentures provide for net share settlement upon exercise and the Company has purchased a bond hedge to mitigate the potential economic dilution from conversion.

During the first quarter of 2007, the average price of the Company's common stock exceeded the specified conversion price. For the three months ended March 31, 2007, the Company has included 684 shares related to its Convertible Debentures in its diluted weighted-average common shares outstanding. Such shares were excluded from the three months ended March 31, 2006 calculation, as they were anti-dilutive. The Company has not included the offset from the bond hedge as it would be anti-dilutive; however, when the Convertible Debentures mature, the diluted share amount will decrease because the bond hedge will offset the economic dilution from conversion.



**(2) Acquisitions**

In conjunction with the purchase of substantially all of the online assets of EssNet AB ( EssNet ) in March of 2006, the Company 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. The table below summarizes the payments made to date, adjustments and the balance of the accrued integration costs from the closing date to March 31, 2007.

|                            | Accrued<br>Costs at<br>Closing | Payments  | Adjustments<br>to<br>Goodwill | Accrued<br>Balance<br>December 31,<br>2006 | Payments | Adjustments<br>to<br>Goodwill | Accrued<br>Balance<br>March 31,<br>2007 |
|----------------------------|--------------------------------|-----------|-------------------------------|--------------------------------------------|----------|-------------------------------|-----------------------------------------|
| Severance pay and benefits | \$ 17,644                      | (6,576 )  | (7,818 )                      | 3,250                                      | (1,107 ) | 234                           | 2,377                                   |
| Lease termination          | 1,475                          | (570 )    | 11                            | 916                                        | (191 )   | 39                            | 764                                     |
| Contractual obligations    | 7,598                          | (4,536 )  | 2,320                         | 5,382                                      | (398 )   | 4,075                         | 9,059                                   |
|                            | \$ 26,717                      | (11,682 ) | (5,487 )                      | 9,548                                      | (1,696 ) | 4,348                         | 12,200                                  |

**(3) Operating Segment Information**

Statement of Financial Accounting Standards ( SFAS ) No. 131, *Disclosures about Segments of an Enterprise and Related Information* ( SFAS 131 ), defines operating segments to be those components of a business for which separate financial information is available that is regularly evaluated by management in making operating decisions and in assessing performance. SFAS 131 further requires that segment information be presented consistently with the basis and manner in which management internally disaggregates financial information for the purposes of assisting in making internal operating decisions.

The Printed Products Group provides instant ticket and related services that 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 licensed brand products and includes prepaid phone cards for cellular phone service providers. In addition, as a result of the acquisition of 80% of the common stock of International Lotto Corp., SRL ( ILC ) in December 2006, Printed Products now has an agreement with certain charities in Peru which gives the Company the right to participate in the operation of a lottery in Peru. The Lottery Systems Group offers online, instant and video lottery products and online and instant ticket validation systems. Its business includes the supply of transaction processing software for the accounting and validation of both instant and online lottery games, point-of-sale terminal hardware sales, central site computers and communication hardware sales and ongoing support and maintenance for these products. The Diversified Gaming Group provides services and systems to private and public operators in the wide area gaming markets and the pari-mutuel wagering industry. The product offerings include 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.

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The following tables represent revenues, profits, depreciation, amortization and selling, general and administrative expenses for the three month periods ended March 31, 2006 and 2007, by current reportable segments. Corporate expenses, including interest expense, other income, and corporate depreciation and amortization are not allocated to the reportable segments.

|                                                               | <b>Three Months Ended March 31, 2006</b> |                                  |                                     |               |
|---------------------------------------------------------------|------------------------------------------|----------------------------------|-------------------------------------|---------------|
|                                                               | <b>Printed<br/>Products<br/>Group</b>    | <b>Lottery<br/>Systems Group</b> | <b>Diversified<br/>Gaming Group</b> | <b>Totals</b> |
| Service revenues                                              | \$ 93,579                                | 52,717                           | 30,664                              | 176,960       |
| Sales revenues                                                | 14,121                                   | 14,699                           | 2,349                               | 31,169        |
| Total revenues                                                | 107,700                                  | 67,416                           | 33,013                              | 208,129       |
| Cost of services (exclusive of depreciation and amortization) | 46,291                                   | 27,673                           | 20,984                              | 94,948        |
| Cost of sales (exclusive of depreciation and amortization)    | 10,773                                   | 11,592                           | 2,179                               | 24,544        |
| Selling, general and administrative expenses                  | 11,356                                   | 7,449                            | 2,441                               | 21,246        |
| Depreciation and amortization                                 | 5,185                                    | 10,493                           | 3,396                               | 19,074        |
| Segment operating income                                      | \$ 34,095                                | 10,209                           | 4,013                               | 48,317        |
| Unallocated corporate costs                                   |                                          |                                  |                                     | \$ 11,364     |
| Consolidated operating income                                 |                                          |                                  |                                     | \$ 36,953     |

|                                                               | <b>Three Months Ended March 31, 2007</b> |                                  |                                     |               |
|---------------------------------------------------------------|------------------------------------------|----------------------------------|-------------------------------------|---------------|
|                                                               | <b>Printed<br/>Products<br/>Group</b>    | <b>Lottery<br/>Systems Group</b> | <b>Diversified<br/>Gaming Group</b> | <b>Totals</b> |
| Service revenues                                              | \$ 104,631                               | 54,331                           | 52,031                              | 210,993       |
| Sales revenues                                                | 9,262                                    | 11,049                           | 10,962                              | 31,273        |
| Total revenues                                                | 113,893                                  | 65,380                           | 62,993                              | 242,266       |
| Cost of services (exclusive of depreciation and amortization) | 55,662                                   | 29,391                           | 31,694                              | 116,747       |
| Cost of sales (exclusive of depreciation and amortization)    | 7,624                                    | 6,238                            | 8,623                               | 22,485        |
| Selling, general and administrative expenses                  | 11,481                                   | 7,997                            | 5,348                               | 24,826        |
| Depreciation and amortization                                 | 8,400                                    | 14,131                           | 6,322                               | 28,853        |
| Segment operating income                                      | \$ 30,726                                | 7,623                            | 11,006                              | 49,355        |
| Unallocated corporate costs                                   |                                          |                                  |                                     | \$ 14,544     |
| Consolidated operating income                                 |                                          |                                  |                                     | \$ 34,811     |

The following table provides a reconciliation of segment operating income to the consolidated income before income tax expense for each period:

|                                   | <b>Three Months Ended March 31,</b> |             |
|-----------------------------------|-------------------------------------|-------------|
|                                   | <b>2006</b>                         | <b>2007</b> |
| Reported segment operating income | \$ 48,317                           | \$ 49,355   |
| Unallocated corporate costs       | (11,364 )                           | (14,544 )   |
| Consolidated operating income     | 36,953                              | 34,811      |
| Interest expense                  | (7,202 )                            | (12,892 )   |
| Other income                      | 643                                 | 390         |
| Equity in income of joint venture | 1,576                               | 11,878      |
| Income before income tax expense  | \$ 31,970                           | \$ 34,187   |

In evaluating financial performance, the Company focuses on operating profit as a segment's measure of profit or loss. Operating income is before interest income, interest expense, equity in net income in joint ventures, corporate expenses and income taxes. The accounting policies of the reportable segments are the same as those described in the summary of significant accounting policies except for accounting for income tax contingencies (see Critical Accounting Policies in this Form 10-Q for the three months ended March 31, 2007 and Note 1 of the Company's Notes to Consolidated Financial Statements in the Company's Annual Report on Form 10-K for the year ended December 31, 2006).

#### (4) Equity Investments in Joint Ventures

The Company is a member of Consorzio Lotterie Nazionali, a consortium consisting principally of the Company, 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, the Company is a supplier of 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 Company accounts for this investment using the equity method of accounting. For the three months ended March 31, 2006 and 2007, the Company recorded income of approximately \$1,674 and \$11,563, respectively, representing its share of the earnings of the consortium for the indicated periods.

Effective February 28, 2007, the Company sold its racing communications business and its 70% interest in NASRIN, its data communications business, to Roberts Communications Network, LLC (RCN) in exchange for a 29.4% interest in the RCN consolidated business. RCN provides communications services to racing and non-racing customers using both satellite and terrestrial services. Since the date of acquisition, the Company's share of the earnings of RCN is reflected in the caption Equity in net income of joint ventures in the Consolidated Statements of Income. The Company's carrying value in RCN, which is equal to the carrying value of the assets exchanged, is reflected in the caption Other assets and investments in the Consolidated Balance Sheets. The interest in RCN is not material to the Company's operations.

#### (5) Comprehensive Income

The following presents a reconciliation of net income to comprehensive income for the three month periods ended March 31, 2006 and 2007:

|                                       | <b>Three Months Ended March 31,</b> |             |
|---------------------------------------|-------------------------------------|-------------|
|                                       | <b>2006</b>                         | <b>2007</b> |
| Net income                            | \$ 22,370                           | \$ 24,759   |
| Other comprehensive income (loss)     |                                     |             |
| Foreign currency translation gain     | 740                                 | 1,720       |
| Unrealized gain (loss) on investments | (775 )                              | 114         |
| Other comprehensive income (loss)     | (35 )                               | 1,834       |
| Comprehensive income                  | \$ 22,335                           | \$ 26,593   |

**(6) Inventories**

Inventories consist of the following:

|                           | <b>December 31,<br/>2006</b> | <b>March 31,<br/>2007</b> |
|---------------------------|------------------------------|---------------------------|
| Parts and work-in-process | \$ 23,517                    | \$ 25,742                 |
| Finished goods            | 35,947                       | 38,496                    |
|                           | <b>\$ 59,464</b>             | <b>\$ 64,238</b>          |

Point of sale terminals manufactured by the Company may be sold to customers or included as part of a long-term wagering system contract. Parts and work-in-process includes costs for equipment expected to be sold. Costs incurred for equipment associated with specific wagering system contracts not yet placed in service are classified as construction in progress in property and equipment and are not depreciated.

**(7) Long-Term Debt**

During January 2007, the Company amended its existing credit agreement dated as of December 31, 2004, as amended and restated as of July 7, 2006 to provide for a new \$200,000 senior secured term loan (the "Term Loan E") and to make certain other changes (as amended in January 2007, the "January 2007 Amended and Restated Credit Agreement"). The proceeds from the Term Loan E were used to pay down approximately \$188,000 of borrowings under the Company's revolving credit facility due 2009 (the "Revolver"). The Company paid approximately \$600 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 the January 2007 Amended and Restated Credit Agreement, the interest rate with respect to the borrowings under the Revolver will vary, depending upon the Company's 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 the Company's 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.

The 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 the Company and its 100%-owned domestic subsidiaries; (ii) 100% of the capital stock of all of the direct and indirect 100%-owned domestic subsidiaries and 65% of the Company's interest in the capital stock of the 100%-owned first-tier foreign subsidiaries of the Company; and (iii) all inter-company indebtedness owing between the Company and its 100%-owned domestic subsidiaries. The January 2007 Amended and Restated Credit Agreement is supported by guarantees provided by all of the Company's 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 \$80,000 per annum.

The January 2007 Amended and Restated Credit Agreement contains certain covenants that, among other things, limit the Company's ability, and the ability of certain of the Company's 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 the Company's 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 the Company's indebtedness, the amount of the Company's 6.25% senior subordinated notes due 2012 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 the Company's 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 one-time expenses and acquisition-related costs, in each case for the period being measured, all of the foregoing as determined on a consolidated basis for the Company and its subsidiaries in accordance with GAAP.

The Company was in compliance with its covenants as of March 31, 2007.

On March 31, 2007, the Company had approximately \$249,321 available for additional borrowing or letter of credit issuance under the Revolver under the January 2007 Amended and Restated Credit Agreement. There were no borrowings and \$50,679 in outstanding letters of credit under the Revolver as of March 31, 2007.

# (8) Goodwill and Intangible Assets

The following disclosure presents certain information regarding the Company's acquired intangible assets as of December 31, 2006 and March 31, 2007. Amortizable intangible assets are amortized over their estimated useful lives, as indicated below, with no estimated residual values.

| Intangible Assets                                    | Weighted<br>Average<br>Amortization<br>Period (Years) | Gross Carrying<br>Amount | Accumulated<br>Amortization | Net Balance |
|------------------------------------------------------|-------------------------------------------------------|--------------------------|-----------------------------|-------------|
| <b>Balance as of December 31, 2006</b>               |                                                       |                          |                             |             |
| Amortizable intangible assets:                       |                                                       |                          |                             |             |
| Patents                                              | 13                                                    | \$ 8,839                 | (1,207 )                    | 7,632       |
| Customer lists                                       | 11                                                    | 28,705                   | (12,179 )                   | 16,526      |
| Customer service contracts                           | 15                                                    | 3,691                    | (1,889 )                    | 1,802       |
| Licenses                                             | 10                                                    | 49,751                   | (12,611 )                   | 37,140      |
| Intellectual property                                | 4                                                     | 21,622                   | (4,115 )                    | 17,507      |
| Lottery contracts                                    | 5                                                     | 34,747                   | (19,889 )                   | 14,858      |
|                                                      | 9                                                     | 147,355                  | (51,890 )                   | 95,465      |
| Non-amortizable intangible assets:                   |                                                       |                          |                             |             |
| Trade name                                           |                                                       | 38,115                   | (2,118 )                    | 35,997      |
| Connecticut off-track betting system operating right |                                                       | 34,108                   | (8,319 )                    | 25,789      |
|                                                      |                                                       | 72,223                   | (10,437 )                   | 61,786      |
| Total intangible assets                              |                                                       | \$ 219,578               | (62,327 )                   | 157,251     |
| <b>Balance as of March 31, 2007</b>                  |                                                       |                          |                             |             |
| Amortizable intangible assets:                       |                                                       |                          |                             |             |
| Patents                                              | 13                                                    | \$ 8,853                 | (1,356 )                    | 7,497       |
| Customer lists                                       | 11                                                    | 28,798                   | (13,213 )                   | 15,585      |
| Customer service contracts                           | 15                                                    | 3,733                    | (1,972 )                    | 1,761       |
| Licenses                                             | 10                                                    | 51,811                   | (14,343 )                   | 37,468      |
| Intellectual property                                | 4                                                     | 21,717                   | (5,466 )                    | 16,251      |
| Lottery contracts                                    | 5                                                     | 34,782                   | (21,710 )                   | 13,072      |
|                                                      | 9                                                     | 149,694                  | (58,060 )                   | 91,634      |
| Non-amortizable intangible assets:                   |                                                       |                          |                             |             |
| Trade name                                           |                                                       | 38,142                   | (2,118 )                    | 36,024      |
| Connecticut off-track betting system operating right |                                                       | 34,158                   | (8,319 )                    | 25,839      |
|                                                      |                                                       | 72,301                   | (10,438 )                   | 61,863      |
| Total intangible assets                              |                                                       | \$ 221,995               | (68,498 )                   | 153,497     |

The aggregate intangible amortization expense for the three month periods ended March 31, 2006 and 2007 was approximately \$2,700 and \$7,300, respectively.

The table below reconciles the change in the carrying amount of goodwill, by reporting segment, for the period from December 31, 2006 to March 31, 2007. In 2007, the Company recorded (a) a \$1,113 increase in goodwill associated with the purchase price valuation and allocation adjustments associated with the acquisition of Games Media Limited ( Games Media ), (b) a \$4,218 increase in goodwill associated with the final purchase price valuation and allocation adjustments associated with the acquisition of most of the online lottery assets of EssNet, (c) a \$624 increase in goodwill associated with the purchase price valuation and allocation adjustments associated with the acquisition of 80% of the common stock of ILC, (d) a \$136 increase in goodwill associated with the purchase price valuation and allocation adjustments associated with the acquisition of Printpool Honsel GmbH ( Honsel ), (e) a \$17 increase in goodwill associated with the purchase price valuation and allocation adjustments associated with certain other acquisitions and (f) an increase in goodwill of \$2,162 as a result of foreign currency translation.

| Goodwill                        | Printed<br>Products<br>Group | Lottery<br>Systems<br>Group | Diversified<br>Gaming<br>Group | Totals  |
|---------------------------------|------------------------------|-----------------------------|--------------------------------|---------|
| Balance as of December 31, 2006 | \$ 259,710                   | 184,509                     | 189,511                        | 633,730 |
| Adjustments                     | 970                          | 5,233                       | 2,067                          | 8,270   |
| Balance as of March 31, 2007    | \$ 260,680                   | 189,742                     | 191,578                        | 642,000 |



**(9) Pension and Other Post-Retirement Plans**

The Company has two defined benefit pension plans. It has a defined benefit plan for its U.S. based union employees. Retirement benefits under this plan are based upon the number of years of credited service up to a maximum of 30 years for the majority of the employees. It also has a defined benefit plan for its U.K. based union employees. Retirement benefits under the U.K. plan are based on an employee's average compensation over the two years preceding retirement. The Company's policy is to fund the minimum contribution permissible by the respective tax authorities.

The following table sets forth the combined amount of net periodic benefit cost recognized for the three month periods ended March 31, 2006 and 2007.

|                                                         | Three Months Ended March 31, |        |
|---------------------------------------------------------|------------------------------|--------|
|                                                         | 2006                         | 2007   |
| <b>Components of net periodic pension benefit cost:</b> |                              |        |
| Service cost                                            | \$ 547                       | \$ 476 |
| Interest cost                                           | 551                          | 776    |
| Expected return on plan assets                          | (562 )                       | (869 ) |
| Amortization of actuarial gains/losses                  | 289                          | 241    |
| Amortization of prior service costs                     | 6                            | 11     |
| Net periodic cost                                       | \$ 831                       | \$ 635 |

The Company has a 401(k) plan covering all U.S. based employees who are not covered by a collective bargaining agreement. Under the plan, participants are eligible to receive matching contributions of 50 cents on the dollar from the Company for the first 6% of participant contributions for a match of up to 3% of eligible compensation. The Company has a 401(k) plan for all union employees which does not provide for Company contributions.

**(10) Income Taxes**

On January 1, 2007, the Company adopted Financial Accounting Standards Board ( 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. As a result of the implementation of FIN 48, the Company recognized an increase in the liability for unrecognized tax benefits of approximately \$1,376, which was accounted for as a reduction to the Company's accumulated earnings as of January 1, 2007. The total amount of unrecognized tax benefits as of January 1, 2007 was approximately \$4,113. Of this amount, approximately \$3,607, if recognized, would be included in the Company's statement of operations and have an impact on the Company's effective tax rate. Also as a result of the implementation of FIN 48, the Company recognized accrued interest related to unrecognized tax benefits of \$120, which was accounted for as a reduction to the Company's accumulated earnings as of January 1, 2007. The Company recognizes interest accrued for unrecognized tax benefits in interest expense and recognizes penalties in income tax expense. As of the date of adoption of FIN 48, the Company had accrued approximately \$259 for the payment of interest and penalties.

The Company and its subsidiaries file income tax returns in the U.S. federal jurisdiction, and various states and foreign jurisdictions. With few exceptions, the Company is no longer subject to U.S. federal, state and local, or non-U.S. income tax examinations by tax authorities for years before 2001. The Company does not believe that the amount of uncertain tax positions will change by a significant amount within the next 12 months. In the event of subsequent recognition, the entire amount recognized would impact the effective tax rate.

The effective tax rates for the three months ended March 31, 2006 and 2007 of 30.0% and 27.6%, respectively, were determined using an estimated annual effective tax rate, which was less than the federal statutory rate of 35% due to lower tax rates applicable to the increase in the Company's earnings from operations outside the United States and the tax benefit of the 2004 debt restructuring.

# (11) Stockholders Equity

As of March 31, 2007, the Company had a total of 2,000 shares of preferred stock, \$1.00 par value, authorized for issuance, including 229 authorized shares of Series A Convertible Preferred Stock and 1 authorized share of Series B Preferred Stock. No shares of preferred stock are currently outstanding.

The Company has two classes of common stock, consisting of Class A common stock and Class B non-voting common stock. All shares of Class A common stock and Class B common stock entitle holders to the same rights and privileges except that the Class B common stock is non-voting. Each share of Class B common stock is convertible into one share of Class A common stock. The following demonstrates the change in the number of Class A common shares outstanding during the fiscal year ended December 31, 2006 and during the three months ended March 31, 2007:

|                                                                                                | December 31,<br>2006 | March 31,<br>2007 |
|------------------------------------------------------------------------------------------------|----------------------|-------------------|
| Shares issued and outstanding as of beginning of period                                        | 89,869               | 91,628            |
| Shares issued as part of equity-based compensation plans and the ESPP, net of RSUs surrendered | 2,054                | 882               |
| Other shares issued                                                                            | 29                   |                   |
| Shares repurchased into treasury stock                                                         | (324 )               |                   |
| Shares issued and outstanding as of end of period                                              | 91,628               | 92,510            |

On December 15, 2006, the Company entered into a licensing agreement with Hasbro, Inc. ( Hasbro ) for the use of certain Hasbro brands in multiple lottery platforms. Under the terms of the agreement, on February 28, 2007, the Company issued to Hasbro warrants (the Warrants ) to purchase 40 shares of the Company's Class A common stock for \$32.98 per share. The Warrants may be exercised at any time before February 28, 2012. The fair value of the Warrants on the date of grant was \$480. Such amount is reflected in the caption Other assets and investments in the Consolidated Balance Sheets.

# (12) Stock-Based Compensation

As of March 31, 2007, the Company had approximately 1,808 share options or restricted stock units authorized to be granted under its equity-based compensation plans.

## Stock Options

A summary of the changes in stock options outstanding under the Company's equity-based compensation plans during the three months ended March 31, 2007 is presented below:

|                                             | Number of<br>Options | Weighted<br>Average<br>Remaining<br>Contract<br>Term<br>(Years) | Weighted<br>Average<br>Exercise<br>Price<br>Per<br>Share | Aggregate<br>Intrinsic<br>Value |
|---------------------------------------------|----------------------|-----------------------------------------------------------------|----------------------------------------------------------|---------------------------------|
| Options outstanding as of December 31, 2006 | 6,972                | 6.3                                                             | \$ 16.89                                                 | \$ 117,732                      |
| Granted                                     | 635                  |                                                                 | 33.86                                                    |                                 |
| Exercised                                   | (810 )               |                                                                 | 11.54                                                    | 16,509                          |
| Canceled                                    | (14 )                |                                                                 | 26.01                                                    |                                 |
| Options outstanding as of March 31, 2007    | 6,783                | 6.7                                                             | \$ 19.10                                                 | \$ 93,156                       |
| Options exercisable as of March 31, 2007    | 3,194                | 4.9                                                             | \$ 11.00                                                 | \$ 69,733                       |

Weighted-average per share fair value of options granted during the three months ended:

March 31, 2007 \$ 13.70

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For the three months ended March 31, 2006 and 2007, the Company recognized equity-based compensation expense of approximately \$3,700 and \$3,900 respectively, related to the vesting of stock options and the related tax benefit of approximately \$1,700 and \$1,100 respectively. As of March 31, 2007, the Company had unearned compensation of approximately \$31,400 relating to stock option awards that will be amortized over a weighted-average period of approximately two years.

*Restricted Stock Units*

A summary of the changes in restricted stock units outstanding under the Company's equity compensation plans during the three months ended March 31, 2007 is presented below:

|                                          | <b>Number of<br/>Restricted<br/>Stock</b> | <b>Weighted<br/>Average Grant<br/>Date Fair<br/>Value<br/>Per Share</b> |
|------------------------------------------|-------------------------------------------|-------------------------------------------------------------------------|
| Non-vested units as of December 31, 2006 | 977                                       | \$ 30.93                                                                |
| Granted                                  | 376                                       | \$ 33.54                                                                |
| Vested                                   | (100 )                                    | \$ 30.68                                                                |
| Canceled                                 | (3 )                                      | \$ 27.77                                                                |
| Non-vested units as of March 31, 2007    | 1,250                                     | \$ 31.74                                                                |

For the three months ended March 31, 2006 and 2007, the Company recognized equity-based compensation expense of approximately \$700 and \$3,200 respectively, related to the vesting of restricted stock units and the related tax benefit of approximately \$300 and \$900 respectively. As of March 31, 2007, the Company had unearned compensation of approximately \$32,000 relating to restricted stock units that will be amortized over a weighted-average period of approximately two years.

**(13) Financial Information for Guarantor Subsidiaries and Non-Guarantor Subsidiaries**

The Company conducts substantially all of its business through its domestic and foreign subsidiaries. The 2004 Notes, the Convertible Debentures and the January 2007 Amended and Restated Credit Agreement are fully, unconditionally and jointly and severally guaranteed by substantially all of the Company's 100% owned domestic subsidiaries (the Guarantor Subsidiaries).

Presented below is condensed consolidating financial information for (i) Scientific Games Corporation (the Parent Company), (ii) the 100% owned Guarantor Subsidiaries and (iii) the 100% owned foreign subsidiaries and the non-100% owned domestic and foreign subsidiaries (collectively, the Non-Guarantor Subsidiaries) as of December 31, 2006 and March 31, 2007 and for the three months ended March 31, 2006 and 2007. The condensed consolidating financial information has been presented to show the nature of assets held, results of operations and cash flows of the Parent Company, Guarantor Subsidiaries and Non-Guarantor Subsidiaries, assuming the guarantee structure of the January 2007 Amended and Restated Credit Agreement, the Convertible Debentures and the 2004 Notes were in effect at the beginning of the periods presented. Separate financial statements for Guarantor Subsidiaries are not presented based on management's determination that they would not provide additional information that is material to investors.

The condensed consolidating financial information reflects the investments of the Parent Company in the Guarantor and Non-Guarantor Subsidiaries using the equity method of accounting. Corporate interest and administrative expenses have not been allocated to the subsidiaries.

## SCIENTIFIC GAMES CORPORATION AND SUBSIDIARIES

## SUPPLEMENTAL CONDENSED CONSOLIDATING BALANCE SHEET

December 31, 2006

(Unaudited, in thousands)

|                                                | Parent<br>Company | Guarantor<br>Subsidiaries | Non-<br>Guarantor<br>Subsidiaries | Eliminating<br>Entries | Consolidated |
|------------------------------------------------|-------------------|---------------------------|-----------------------------------|------------------------|--------------|
| <b>Assets</b>                                  |                   |                           |                                   |                        |              |
| Cash and cash equivalents                      | \$                | 4,070                     | 23,721                            |                        | 27,791       |
| Accounts receivable, net                       |                   | 125,598                   | 52,847                            |                        | 178,445      |
| Inventories                                    |                   | 45,801                    | 14,088                            | (425 )                 | 59,464       |
| Other current assets                           | 36,937            | 20,511                    | 21,554                            |                        | 79,002       |
| Property and equipment, net                    |                   | 294,952                   | 156,308                           | (600 )                 | 450,660      |
| Investment in subsidiaries                     | 574,579           | 194,556                   | 130,743                           | (899,878 )             |              |
| Goodwill                                       | 183               | 302,144                   | 331,403                           |                        | 633,730      |
| Intangible assets                              |                   | 106,605                   | 50,646                            |                        | 157,251      |
| Other assets                                   | 43,630            | 109,738                   | 25,947                            | (6,048 )               | 173,267      |
| Total assets                                   | \$ 655,329        | 1,203,975                 | 807,257                           | (906,951 )             | 1,759,610    |
| <b>Liabilities and stockholders' equity</b>    |                   |                           |                                   |                        |              |
| Current installments of long-term debt         | \$ 2,500          |                           | 648                               |                        | 3,148        |
| Current liabilities                            | 15,779            | 90,423                    | 84,594                            | 79                     | 190,875      |
| Long-term debt, excluding current installments | 912,000           |                           | 1,253                             |                        | 913,253      |
| Other non-current liabilities                  | 5,069             | 86,652                    | 32,529                            | 6                      | 124,256      |
| Intercompany balances                          | (808,097 )        | 740,091                   | 68,006                            |                        |              |
| Stockholders' equity                           | 528,078           | 286,809                   | 620,227                           | (907,036 )             | 528,078      |
| Total liabilities and stockholders' equity     | \$ 655,329        | 1,203,975                 | 807,257                           | (906,951 )             | 1,759,610    |

## SCIENTIFIC GAMES CORPORATION AND SUBSIDIARIES

## SUPPLEMENTAL CONDENSED CONSOLIDATING BALANCE SHEET

March 31, 2007

(Unaudited, in thousands)

|                                                | Parent<br>Company | Guarantor<br>Subsidiaries | Non-<br>Guarantor<br>Subsidiaries | Eliminating<br>Entries | Consolidated |
|------------------------------------------------|-------------------|---------------------------|-----------------------------------|------------------------|--------------|
| <b>Assets</b>                                  |                   |                           |                                   |                        |              |
| Cash and cash equivalents                      | \$                | 12,436                    | 20,795                            |                        | 33,231       |
| Accounts receivable, net                       |                   | 134,270                   | 59,242                            |                        | 193,512      |
| Inventories                                    |                   | 47,528                    | 17,135                            | (425 )                 | 64,238       |
| Other current assets                           | 22,052            | 23,427                    | 23,995                            |                        | 69,474       |
| Property and equipment, net                    |                   | 287,539                   | 164,652                           | (600 )                 | 451,591      |
| Investment in subsidiaries                     | 642,549           | 196,719                   | 145,550                           | (984,818 )             |              |
| Goodwill                                       | 183               | 302,149                   | 339,668                           |                        | 642,000      |
| Intangible assets                              |                   | 105,653                   | 47,844                            |                        | 153,497      |
| Other assets                                   | 43,889            | 126,257                   | 34,007                            | (6,038 )               | 198,115      |
| Total assets                                   | \$ 708,673        | 1,235,978                 | 852,888                           | (991,881 )             | 1,805,658    |
| <b>Liabilities and stockholders' equity</b>    |                   |                           |                                   |                        |              |
| Current installments of long-term debt         | \$ 4,500          |                           | 549                               |                        | 5,049        |
| Current liabilities                            | 29,316            | 71,160                    | 89,740                            | 79                     | 190,295      |
| Long-term debt, excluding current installments | 917,875           |                           | 1,146                             |                        | 919,021      |
| Other non-current liabilities                  | 5,070             | 85,370                    | 32,164                            | 6                      | 122,610      |
| Intercompany balances                          | (816,771 )        | 753,409                   | 63,362                            |                        |              |
| Stockholders' equity                           | 568,683           | 326,039                   | 665,927                           | (991,966 )             | 568,683      |
| Total liabilities and stockholders' equity     | \$ 708,673        | 1,235,978                 | 852,888                           | (991,881 )             | 1,805,658    |

## SCIENTIFIC GAMES CORPORATION AND SUBSIDIARIES

## SUPPLEMENTAL CONDENSED CONSOLIDATING STATEMENT OF INCOME

Three Months Ended March 31, 2006

(Unaudited, in thousands)

|                                                                                 | Parent<br>Company | Guarantor<br>Subsidiaries | Non-<br>Guarantor<br>Subsidiaries | Eliminating<br>Entries | Consolidated |
|---------------------------------------------------------------------------------|-------------------|---------------------------|-----------------------------------|------------------------|--------------|
| Operating revenues                                                              | \$                | 154,406                   | 59,570                            | (5,847 )               | 208,129      |
| Cost of services and cost of sales (exclusive of depreciation and amortization) |                   | 79,296                    | 46,043                            | (5,847 )               | 119,492      |
| Selling, general and administrative expenses                                    | 5,051             | 22,176                    | 5,223                             | (58 )                  | 32,392       |
| Depreciation and amortization                                                   |                   | 14,580                    | 4,712                             |                        | 19,292       |
| Operating income                                                                | (5,051 )          | 38,354                    | 3,592                             | 58                     | 36,953       |
| Interest expense                                                                | 6,797             | 256                       | 149                               |                        | 7,202        |
| Other (income) deductions                                                       |                   | (2,207 )                  | 55                                | (67 )                  | (2,219 )     |
| Income (loss) before equity in income of subsidiaries, and income taxes         | (11,848 )         | 40,305                    | 3,388                             | 125                    | 31,970       |
| Equity in income (loss) of subsidiaries                                         | 44,031            |                           |                                   | (44,031 )              |              |
| Income tax expense                                                              | 9,813             | 90                        | (303 )                            |                        | 9,600        |
| Net income                                                                      | \$ 22,370         | 40,215                    | 3,691                             | (43,906 )              | 22,370       |

## SCIENTIFIC GAMES CORPORATION AND SUBSIDIARIES

## SUPPLEMENTAL CONDENSED CONSOLIDATING STATEMENT OF INCOME

Three Months Ended March 31, 2007

(Unaudited, in thousands)

|                                                                                 | Parent<br>Company | Guarantor<br>Subsidiaries | Non-<br>Guarantor<br>Subsidiaries | Eliminating<br>Entries | Consolidated |
|---------------------------------------------------------------------------------|-------------------|---------------------------|-----------------------------------|------------------------|--------------|
| Operating revenues                                                              | \$                | 159,929                   | 84,657                            | (2,320 )               | 242,266      |
| Cost of services and cost of sales (exclusive of depreciation and amortization) |                   | 86,493                    | 54,960                            | (2,221 )               | 139,232      |
| Selling, general and administrative expenses                                    | 872               | 30,725                    | 7,647                             | (99 )                  | 39,145       |
| Depreciation and amortization                                                   |                   | 19,400                    | 9,678                             |                        | 29,078       |
| Operating income                                                                | (872 )            | 23,311                    | 12,372                            |                        | 34,811       |
| Interest expense                                                                | 12,551            | 274                       | 67                                |                        | 12,892       |
| Other income                                                                    | (209 )            | (11,712 )                 | (347 )                            |                        | (12,268 )    |
| Income (loss) before equity in income of subsidiaries, and income taxes         | (13,214 )         | 34,749                    | 12,652                            |                        | 34,187       |
| Equity in income (loss) of subsidiaries                                         | 46,654            |                           |                                   | (46,654 )              |              |
| Income tax expense                                                              | 8,681             | 33                        | 714                               |                        | 9,428        |
| Net income                                                                      | \$ 24,759         | 34,716                    | 11,938                            | (46,654 )              | 24,759       |



## SCIENTIFIC GAMES CORPORATION AND SUBSIDIARIES

## SUPPLEMENTAL CONDENSED CONSOLIDATING STATEMENT OF CASH FLOWS

Three Months Ended March 31, 2006

(Unaudited, in thousands)

|                                                         | Parent<br>Company | Guarantor<br>Subsidiaries | Non-<br>Guarantor<br>Subsidiaries | Eliminating<br>Entries | Consolidated |
|---------------------------------------------------------|-------------------|---------------------------|-----------------------------------|------------------------|--------------|
| Net cash provided by (used in) operating activities     | \$ (5,228 )       | 38,710                    | 774                               | (92 )                  | 34,164       |
| Cash flows from investing activities:                   |                   |                           |                                   |                        |              |
| Capital and wagering systems expenditures               |                   | (30,908 )                 | (4,579 )                          |                        | (35,487 )    |
| Business acquisitions, net of cash acquired             |                   |                           | (57,564 )                         |                        | (57,564 )    |
| Other assets and investments                            | (70,275 )         | (20,448 )                 | 7,680                             | 62,835                 | (20,208 )    |
| Net cash provided by (used in) investing activities     | (70,275 )         | (51,356 )                 | (54,463 )                         | 62,835                 | (113,259 )   |
| Cash flows from financing activities:                   |                   |                           |                                   |                        |              |
| Net proceeds/payments on long-term debt                 | 65,750            |                           | (314 )                            |                        | 65,436       |
| Net proceeds from stock issue                           | 8,602             |                           | 62,885                            | (62,885 )              | 8,602        |
| Excess tax benefit from equity-based compensation plans | 2,814             |                           |                                   |                        | 2,814        |
| Other, principally intercompany balances                | (1,663 )          | 3,909                     | (4,284 )                          | 2,038                  |              |
| Net cash provided by (used in) financing activities     | 75,503            | 3,909                     | 58,287                            | (60,847 )              | 76,852       |
| Effect of exchange rate changes on cash                 |                   | (100 )                    | 2,502                             | (1,896 )               | 506          |
| Increase (decrease) in cash and cash equivalents        |                   | (8,837 )                  | 7,100                             |                        | (1,737 )     |
| Cash and cash equivalents, beginning of period          |                   | 15,575                    | 23,367                            |                        | 38,942       |
| Cash and cash equivalents, end of period                | \$                | 6,738                     | 30,467                            |                        | 37,205       |

## SCIENTIFIC GAMES CORPORATION AND SUBSIDIARIES

## SUPPLEMENTAL CONDENSED CONSOLIDATING STATEMENT OF CASH FLOWS

Three Months Ended March 31, 2007

(Unaudited, in thousands)

|                                                     | Parent<br>Company | Guarantor<br>Subsidiaries | Non-<br>Guarantor<br>Subsidiaries | Eliminating<br>Entries | Consolidated |
|-----------------------------------------------------|-------------------|---------------------------|-----------------------------------|------------------------|--------------|
| Net cash provided by operating activities           | \$ 5,667          | 14,457                    | 10,296                            |                        | 30,420       |
| Cash flows from investing activities:               |                   |                           |                                   |                        |              |
| Capital and wagering systems expenditures           |                   | (8,860 )                  | (17,148 )                         |                        | (26,008 )    |
| Business acquisitions, net of cash acquired         |                   |                           | (336 )                            |                        | (336 )       |
| Other assets and investments                        | (20,263 )         | (8,355 )                  | (22,624 )                         | 36,441                 | (14,801 )    |
| Net cash provided by (used in) investing activities | (20,263 )         | (17,215 )                 | (40,108 )                         | 36,441                 | (41,145 )    |
| Cash flows from financing activities:               |                   |                           |                                   |                        |              |
| Net proceeds/payments on long-term debt             | 7,875             |                           | (210 )                            |                        | 7,665        |
| Net proceeds from stock issue                       | 8,360             | 5                         | 36,436                            | (36,441 )              | 8,360        |
| Other, principally intercompany balances            | (1,639 )          | 11,119                    | (9,308 )                          | (172 )                 |              |
| Net cash provided by (used in) financing activities | 14,596            | 11,124                    | 26,918                            | (36,613 )              | 16,025       |
| Effect of exchange rate changes on cash             |                   |                           | (32 )                             | 172                    | 140          |
| Increase (decrease) in cash and cash equivalents    |                   | 8,366                     | (2,926 )                          |                        | 5,440        |
| Cash and cash equivalents, beginning of period      |                   | 4,072                     | 23,719                            |                        | 27,791       |
| Cash and cash equivalents, end of period            | \$                | 12,438                    | 20,793                            |                        | 33,231       |

**(14) Impact of Recently Issued Accounting Standards**

In September 2006, the FASB issued SFAS No. 157, *Fair Value Measurements*, ( SFAS 157 ). This standard 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. The adoption of SFAS 157 is not expected to have a material impact on the Company's consolidated financial statements.

In September 2006, the FASB ratified the consensus reached by the Emerging Issues Task Force in Issue 06-5 *Accounting for Purchases of Life Insurance - Determining the Amount That Could be Realized in Accordance with FASB Technical Bulletin 85-4* ( EITF 06-5 ). EITF 06-5 addresses determining the amount that could be realized under a life insurance contract in accordance with Technical Bulletin 85-4 and requires a policyholder to consider any additional amounts included in the contractual terms of the policy other than solely the cash surrender value in determining the amount that could be realized under the insurance contract. Policyholders should determine the amount that could be realized under the life insurance contract assuming the surrender of an individual-life by individual-life policy (or certificate by certificate in a group policy). Any amount that is ultimately realized by the policyholder upon the assumed surrender of the final policy (or final certificate in a group policy) shall be included in the amount that could be realized under the insurance contract. The accounting provisions of EITF 06-5 became effective on January 1, 2007. The adoption of EITF 06-5 had no impact on the Company's 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. The Company is currently assessing the impact of SFAS 159 on its consolidated financial statements.

**(15) Subsequent Event**

On May 1, 2007, the Company acquired Oberthur Gaming Technologies ( OGT ). OGT is a leading manufacturer of instant lottery tickets and operates three instant ticket plants located in Montreal, Canada; Sydney, Australia and San Antonio, Texas. The purchase price was approximately \$100,000 (approximately one-third of which is attributable to U.S. assets), subject to certain adjustments. The Company expects its acquisition of OGT will allow it to strengthen its international presence in Canada and Australia and offer its customers an expanded array of products and services. The Company has financed the acquisition through borrowings under its Revolver. OGT will be included in the Printed Products segment beginning in the second quarter of 2007.

## Item 2. Management's Discussion and Analysis of Financial Condition and Results of Operations

The following discussion addresses the results of operations of Scientific Games Corporation (together with its consolidated subsidiaries, we or the Company), for the three months ended March 31, 2007, compared to the corresponding period in the prior year. This discussion should be read in conjunction with Management's Discussion and Analysis of Financial Condition and Results of Operations for the fiscal year ended December 31, 2006, included in our 2006 Annual Report on Form 10-K.

Our results may vary significantly from period to period depending on the addition or disposition of business units in each period. 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 for the three month periods ended March 31, 2006 and 2007 (see Note 3 of the Company's Notes to the Consolidated Financial Statements in the Company's Annual Report of Form 10-K for the year ended December 31, 2006).

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®, National Basketball Association, Harley-Davidson®, Wheel-of-Fortune®, Hasbro®, 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, online and video 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.

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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. The purchase price was approximately \$60 million in cash.

### *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. public house market, and our pari-mutuel gaming operations in Connecticut, Maine and the Netherlands.

Effective February 28, 2007, we sold our racing communications business and our 70% interest in NASRIN, our data communications business, to Roberts Communications Network, LLC ( RCN ) in exchange for a 29.4% interest in the RCN consolidated business. RCN provides communications services to racing and non-racing customers using both satellite and terrestrial services. The acquisition of the interest in RCN was not material to our operations.

On December 22, 2006, we acquired Games Media. 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. 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. 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.

## **Results of Operations**

### **Three Months Ended March 31, 2007 Compared to Three Months Ended March 31, 2006**

The following analysis compares the results of operations for the quarter ended March 31, 2007 to the results of operations for the quarter ended March 31, 2006.

#### *Overview*

#### *Revenue Analysis*

For the quarter ended March 31, 2007, total revenue was \$242.3 million compared to \$208.1 million for the quarter ended March 31, 2006, an increase of \$34.2 million or 16%. Our service revenue for the quarter ended March 31, 2007 was \$211.0 million compared to \$177.0 million for the quarter ended March 31, 2006, an increase of \$34.0 million, or 19%. The increase is primarily attributable to the acquisitions of EssNet in March 2006 and Global Draw in April 2006 and increased sales of instant lottery tickets. Our sales revenue for the three months ended March 31, 2007 was \$31.3 million compared to \$31.2 million in the prior year quarter, an increase of \$0.1 million. The increase primarily reflects sales resulting from the acquisition of Games Media in December 2006, partially offset by a reduction in terminal sales and a decrease in phone card sales.

#### *Expense Analysis*

Cost of services of \$116.7 million for the quarter ended March 31, 2007 were \$21.8 million or 23% higher than for the quarter ended March 31, 2006. The increase is primarily related to the acquisitions of EssNet and Global Draw and higher costs associated with increased ticket sales. Cost of sales of \$22.5 million for the quarter ended March 31, 2007 were \$2.0 million or 8% lower than the quarter ended March 31, 2006 reflecting a change in the mix of product sales.

Selling, general and administrative expenses of \$39.1 million for the quarter ended March 31, 2007 were \$6.7 million or 21% higher than for the quarter ended March 31, 2006. This increase was primarily related to the acquisitions of EssNet, Global Draw and Games Media and higher incentive compensation costs incurred in the quarter ended March 31, 2007, partially offset by cost savings associated with employee reduction initiatives in 2006.

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Depreciation and amortization expense of \$29.1 million for the quarter ended March 31, 2007 increased \$9.8 million from the same period in 2006, primarily due to the acquisition of Global Draw and the amortization of deferred installation costs on Lottery Systems contracts and licensed properties acquired during 2006.

Interest expense of \$12.9 million for the quarter ended March 31, 2007 increased \$5.7 million or 79% from the same period in 2006, primarily attributable to higher market rates on our floating rate debt and increased borrowings to fund our purchases of EssNet, Global Draw and Games Media.

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Equity in net income of joint ventures primarily reflects our share of the net income of the Italian joint venture in connection with the operation of the Italian Gratta e Vinci instant lottery. For the quarter ended March 31, 2007, our share of the Italian consortium's net income totaled \$11.6 million compared to \$1.7 million in the quarter ended March 31, 2006. The increase in income for the quarter ended March 31, 2007 reflects the continued growth of instant ticket sales in Italy.

Income tax expense was \$9.4 million for the quarter ended March 31, 2007 and \$9.6 million for the quarter ended March 31, 2006. The effective income tax rate for the quarter ended March 31, 2007 and 2006 was approximately 27.6% and 30.0% respectively. The decrease in the effective income tax rate was primarily due to lower tax rates applicable to the increase in our earnings from operations outside the United States.

### *Segment Overview*

#### *Printed Products*

For the quarter ended March 31, 2007, total revenue for Printed Products was \$113.9 million compared to \$107.7 million in the quarter ended March 31, 2006, an increase of \$6.2 million or 6%. For the quarter ended March 31, 2007, service revenue for Printed Products was \$104.6 million compared to \$93.6 million in the corresponding period in the prior year, an increase of \$11.0 million, or 12%. The increase was primarily attributable to increased sales of instant lottery tickets.

Printed Products sales revenue for the quarter ended March 31, 2007, was \$9.3 million compared to \$14.1 million for the quarter ended March 31, 2006, a decrease of \$4.8 million, or 34%. The decrease was primarily the result of decreased phone card sales prices and quantities reflecting a continuing market driven shift to lower priced products.

Cost of services of \$55.7 million for the quarter ended March 31, 2007 were \$9.4 million or 20% higher than from the same period in 2006. This increase is due to higher operating costs as a result of increased ticket sales and costs associated with the acquisition of ILC. Cost of sales of \$7.6 million for the quarter ended March 31, 2007 were \$3.2 million or 30% lower than the quarter ended March 31, 2006 primarily due to decreased phone card sales revenues.

Selling, general and administrative expenses of \$11.5 million for the quarter ended March 31, 2007 were \$0.1 million or 1% higher than in the quarter ended March 31, 2006.

Depreciation and amortization expense of \$8.4 million for the quarter ended March 31, 2007 increased \$3.2 million or 62%, as compared to the quarter ended March 31, 2006, primarily due to amortization of acquired licensed properties, new equipment for our U.S. manufacturing business and the acquisition of ILC in December 2006.

#### *Lottery Systems*

For the quarter ended March 31, 2007, total revenue for Lottery Systems was \$65.4 million compared to \$67.4 million in the quarter ended March 31, 2006, a decrease of \$2.0 million, or 3%. Lottery Systems service revenue for the quarter ended March 31, 2007 was \$54.3 million compared to \$52.7 million for the quarter ended March 31, 2006, an increase of \$1.6 million, or 3%. The increase was primarily due to the acquisition of EssNet (\$3.4 million) and increased international lottery sales, partially offset by the absence of a large Powerball jackpot that occurred in the quarter ended March 31, 2006.

Lottery Systems sales revenue for the quarter ended March 31, 2007 was \$11.0 million compared to \$14.7 million for the quarter ended March 31, 2006, a decrease of \$3.7 million, or 25%. The decrease was primarily due to the absence of a one-time sale of terminals in Germany that accounted for \$8.2 million of revenue in the quarter ended March 31, 2006, partially offset by a \$5.2 million sale of ticket checker machines in Canada. Add-on sales of terminals and other equipment continue to suffer from legislative uncertainty in the German market.

Cost of services of \$29.4 million for the quarter ended March 31, 2007 was \$1.7 million or 6% higher than in the quarter ended March 31, 2006. This increase is due to additional operating costs as a result of the acquisition of EssNet and increased international lottery sales, partially offset by incremental costs associated with a large Powerball jackpot during the quarter ended March 31, 2006. Cost of sales of \$6.2 million for the quarter ended March 31, 2007 were \$5.4 million or 47% lower than during the quarter ended March 31, 2006 reflecting a reduction in terminal and software sales and a decrease in phone card sales, partially offset by increased sales of ticket checker machines in Canada.

Selling, general and administrative expenses of \$8.0 million for the quarter ended March 31, 2007 were \$0.6 million or 8% higher than in the quarter ended March 31, 2006 primarily due to increased incentive compensation cost, partially offset by reduced costs associated with cost reduction initiatives that occurred in 2006.

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Depreciation and amortization expense of \$14.1 million for the quarter ended March 31, 2007 increased \$3.6 million or 34%, as compared to the quarter ended March 31, 2006, primarily due to the amortization of deferred installation costs of new Lottery Systems contracts in Maryland and Mexico and the acquisition of EssNet.

### *Diversified Gaming*

For the quarter ended March 31, 2007, total revenue for Diversified Gaming was \$63.0 million compared to \$33.0 million in the quarter ended March 31, 2006, an increase of \$30.0 million, or 91%. Diversified Gaming service revenue for the first quarter of 2007 was \$52.0 million compared to \$30.7 million from the quarter ended March 31, 2006, an increase of \$21.3 million, or 69%. The increase in service revenues primarily reflects the acquisitions of Global Draw (\$19.7 million) in April 2006 and Shoreline (\$2.1 million) in April 2006, partially offset by the sale of our racing communications business (\$1.0 million) in March 2007.

The Diversified Gaming sales revenue for the quarter ended March 31, 2007 was \$11.0 million compared to \$2.3 million in the same fiscal quarter in the prior year, an increase of \$8.7 million. The increase was primarily due to the acquisition of Games Media (\$10.3 million) in December 2006, partially offset by lower pari-mutuel equipment sales in 2007 (\$1.9 million).

Cost of services of \$31.7 million for the quarter ended March 31, 2007 were \$10.7 million or 51% higher than the quarter ended March 31, 2006. This increase is primarily due to the acquisitions of Global Draw in April 2006 and Shoreline in April 2006. Cost of sales of \$8.6 million for the quarter ended March 31, 2007 were \$6.4 million higher than the quarter ended March 31, 2006 due to the acquisition of Games Media in December 2006, partially offset by lower pari-mutuel sales in 2007.

Selling, general and administrative expenses of \$5.3 million for the quarter ended March 31, 2007 were \$2.9 million higher than in the quarter ended March 31, 2006. This increase is primarily due to the acquisition of Global Draw in April 2006 and Games Media in December 2006.

Depreciation and amortization expense, including amortization of service contract software, of \$6.3 million for the quarter ended March 31, 2007 increased \$2.9 million as compared to the quarter ended March 31, 2006, primarily due to the increased depreciation resulting from the acquisition of Global Draw in April 2006.

### **Critical Accounting Policies**

On January 1, 2007, we adopted Financial Accounting Standards Board ( FASB ) Interpretation No. 48, *Accounting for Uncertainty in Income Taxes* ( FIN 48 ) and began accounting for income tax contingencies in accordance with the guidance provided in FIN 48. Previous to the adoption of FIN 48, we accounted for income tax contingencies solely in accordance with the SFAS No. 5, *Accounting for Contingencies* ( SFAS 5 ). See Note 10 to the Consolidated Financial Statements in this Form 10-Q for additional information on FIN 48.

There have been no other material changes to our critical accounting policies from those discussed under the caption Critical Accounting Policies in Item 7. Management's Discussion and Analysis of Financial Condition and Results of Operations in our Annual Report on Form 10-K for the fiscal year ended December 31, 2006.

### **Liquidity, Capital Resources and Working Capital**

During January 2007, we amended our existing credit agreement dated as of December 31, 2004, as amended and restated as of July 7, 2006 to provide for a new \$200,000 senior secured term loan (the Term Loan E ) and to make certain other changes (as amended in January 2007, 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 revolving credit facility due 2009 (the 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 100%-owned 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.

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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 6.25% senior subordinated notes due 2012 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.

We were in compliance with the covenants as of March 31, 2007.

On March 31, 2007, we had approximately \$249.3 million available for additional borrowing or letter of credit issuance under the Revolver under the January 2007 Amended and Restated Credit Agreement. There were no borrowings and \$50.7 million in outstanding letters of credit under the Revolver as of March 31, 2007.

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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 Cost of 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. During the remainder of fiscal 2007, we expect to replace approximately 6,000 and 7,000 existing pari-mutuel and fixed odds betting terminals, respectively, for a total cost of approximately \$47 million. 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.

On May 1, 2007, we acquired Oberthur Gaming Technologies ( OGT ) for \$100 million. We financed the acquisition through borrowings under our Revolver.

As of March 31, 2007, our available cash and borrowing capacity totaled \$282.6 million compared to \$82.4 million as of December 31, 2006. The amount of our available cash fluctuates principally based on the timing of collections from our customers, cash expenditures associated with new and existing online lottery systems service and pari-mutuel and fixed odds wagering contracts, borrowings or repayments under our credit facilities and changes in our working capital position.

The \$5.4 million increase in our available cash from the December 31, 2006 level principally reflects the net cash provided by operating activities for the three months ended March 31, 2007 of \$30.4 million along with \$7.7 million of additional net borrowings, offset by wagering and other capital expenditures and other investing activities totaling \$40.8 million and acquisition related payments of \$0.3 million and the effects of exchange rates. The \$30.4 million of net cash provided by operating activities is derived from approximately \$51.1 million of net cash provided by operations offset by approximately \$20.7 million from changes in working capital. The working capital changes occurred principally from increases in accounts receivable and inventory, and a decrease in accounts payable, partially offset by an increase in accrued interest and other current liabilities. Capital expenditures of \$2.5 million in the three months ended March 31, 2007 are less than similar expenditures totaling \$4.2 million in the corresponding period in 2006. Wagering system expenditures totaled \$23.5 million in the three months ended March 31, 2007, compared to \$31.2 million in the corresponding period in 2006, and consisted primarily of new lottery contracts in Mexico, Michigan and Maryland and fixed odds betting terminals related to Global Draw contracts with its customers. Other intangible assets and software expenditures during the three months ended March 31, 2007 consisted primarily of licensed properties, lottery contracts in Mexico, Michigan and Maryland and gaming contracts related to Global Draw. Cash flow from financing activities principally reflects the borrowings under the January 2007 Amended and Restated Credit Agreement.

We believe that our cash flow from operations, available cash and available borrowing capacity under the January 2007 Amended and Restated Credit Agreement 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.

## Recent Developments

## Edgar Filing: SCIENTIFIC GAMES CORP - Form 10-Q

On May 1, 2007, we acquired Oberthur Gaming Technologies ( OGT ). OGT is a leading manufacturer of instant lottery tickets and operates three instant ticket plants located in Montreal, Canada; Sydney, Australia and San Antonio, Texas. The purchase price was approximately \$100 million (approximately one-third of which is attributable to U.S. assets), subject to certain adjustments. We expect our acquisition of OGT will allow us to strengthen our international presence in Canada and Australia and offer our customers an expanded array of products and services. We financed the acquisition through borrowings under our Revolver. OGT will be included in the Printed Products segment beginning in the second quarter of 2007.

### **Impact of Recently Issued Accounting Standards**

In September 2006, the FASB issued Statement of Financial Accounting Standards ( SFAS ) No. 157, *Fair Value Measurements*, ( SFAS 157 ). This standard 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. The adoption of SFAS 157 is not expected to have a material impact on our consolidated financial statements.

In September 2006, the FASB ratified the consensus reached by the Emerging Issues Task Force in Issue 06-05 *Accounting for Purchases of Life Insurance - Determining the Amount That Could be Realized in Accordance with FASB Technical Bulletin 85-4* ( EITF 06-5 ). EITF 06-5 addresses determining the amount that could be realized under a life insurance contract in accordance with Technical Bulletin 85-4 and requires a policyholder to consider any additional amounts included in the contractual terms of the policy other than solely the cash surrender value in determining the amount that could be realized under the insurance contract. Policyholders should determine the amount that could be realized under the life insurance contract assuming the surrender of an individual-life by individual-life policy (or certificate by certificate in a group policy). Any amount that is ultimately realized by the policyholder upon the assumed surrender of the final policy (or final certificate in a group policy) shall be included in the amount that could be realized under the insurance contract. The accounting provisions of EITF 06-5 became effective on January 1, 2007. The adoption of EITF 06-5 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 statements.

### **Item 3. Quantitative and Qualitative Disclosures about Market Risk**

We have no material changes to the disclosure on this matter made in our Annual Report on Form 10-K for the year ended December 31, 2006.

### **Item 4. Controls and Procedures**

#### **Evaluation of Disclosure Controls and Procedures**

We have evaluated the effectiveness of the design and operation of our disclosure controls and procedures (as defined in Rules 13a-15(e) and 15d-15(e) under the Securities Exchange Act of 1934, as amended (the Exchange Act ) as of the end of the period covered by this Form 10-Q. The evaluation was conducted under the supervision and with the participation of our management, including our Chief Executive Officer and our Chief Financial Officer. Based upon that evaluation, the Chief Executive Officer and Chief Financial Officer concluded that our disclosure controls and procedures were effective in alerting management in a timely fashion to all material information required to be included in our periodic filings with the Securities and Exchange Commission.

There were no changes in our internal control over financial reporting during the quarter ended March 31, 2007 that have materially affected, or are reasonably likely to materially affect, our internal control over financial reporting.

**PART II. OTHER INFORMATION****Item 2. Unregistered Sales of Equity Securities and Use of Proceeds**

On December 15, 2006, we entered into a licensing agreement with Hasbro, Inc. ( "Hasbro" ) for the use of certain Hasbro brands in multiple lottery platforms. Under the terms of the agreement, on February 28, 2007, we issued to Hasbro warrants to purchase 40,000 shares of our Class A common stock for \$32.98 per share (the "Warrants" ). The Warrants may be exercised at any time before February 28, 2012. The securities were issued in a private transaction in reliance upon an exemption from registration under Section 4(2) of the Securities Act of 1933, as amended.

The shares underlying the Warrants were included in a Registration Statement on Form S-3 filed with the Securities and Exchange Commission on March 30, 2007 (Registration No. 333-141720).

**ISSUER PURCHASES OF EQUITY SECURITIES**

| Period               | Total Number of<br>Shares<br>Purchased (1) | Average<br>Price Paid<br>per Share | Total Number of Shares<br>Purchased as Part of<br>Publicly Announced Plans<br>or Programs | Approximate Dollar Value<br>of Shares that May Yet Be<br>Purchased Under the Plans<br>or Programs (2) |
|----------------------|--------------------------------------------|------------------------------------|-------------------------------------------------------------------------------------------|-------------------------------------------------------------------------------------------------------|
| 1/1/2007 - 1/31/2007 |                                            | \$                                 |                                                                                           | \$ 190.2 million                                                                                      |
| 2/1/2007 - 2/28/2007 | 27,734                                     | \$ 33.20                           |                                                                                           | \$ 190.2 million                                                                                      |
| 3/1/2007 - 3/31/2007 | 194                                        | \$ 32.77                           |                                                                                           | \$ 190.2 million                                                                                      |
| Total                | 27,928                                     | \$ 33.20                           |                                                                                           | \$ 190.2 million                                                                                      |

(1) The activity in this column reflects shares acquired from employees to satisfy the withholding taxes associated with the vesting of restricted stock awards during the three months ended March 31, 2007.

(2) 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. 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. There were no shares repurchased as part of the publicly announced repurchase program during the three months ended March 31, 2007.

**Item 6. Exhibits**

**Exhibit  
Number**

- 10.1 Amendment and Restatement Agreement, dated as of January 24, 2007, including as Exhibit A thereto, the Amended and Restated Credit Agreement, dated as of December 23, 2004, as amended and restated as of January 24, 2007, among the Company, as Borrower, the several lenders from time to time parties thereto, and JPMorgan Chase Bank, N.A., as administrative agent (incorporated by reference to Exhibit 10.1 to the Company's Current Report on Form 8-K filed on January 31, 2007).
- 10.2 Letter Agreement dated February 15, 2007 between the Company and MacAndrews & Forbes Holdings Inc. (incorporated by reference to Exhibit 10.1 to the Company's Current Report on Form 8-K filed on February 16, 2007).
- 10.3 Employment Agreement dated March 1, 2007 by and between the Company and Stephen L. Gibbs. ( ) \*
- 31.1 Certification of the Chief Executive Officer of the Company pursuant to Rule 13a-14(a) under the Securities Exchange Act of 1934. ( )
- 31.2 Certification of the Chief Financial Officer of the Company pursuant to Rule 13a-14(a) under the Securities Exchange Act of 1934. ( )
- 32.1 Certification of the Chief Executive Officer of the Company pursuant to 18 U.S.C. Section 1350, as adopted pursuant to Section 906 of the Sarbanes-Oxley Act of 2002. ( )
- 32.2 Certification of the Chief Financial Officer of the Company pursuant to 18 U.S.C. Section 1350, as adopted pursuant to Section 906 of the Sarbanes-Oxley Act of 2002. ( )

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\* Management contracts and compensation plans and arrangements.

( ) Filed herewith.

**SIGNATURES**

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

SCIENTIFIC GAMES CORPORATION  
(Registrant)

By: /s/ DeWayne E. Laird  
Name: DeWayne E. Laird  
Title: Vice President and Chief Financial Officer  
(principal financial officer)

Dated: May 10, 2007

**INDEX TO EXHIBITS**

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