MULTIMEDIA GAMES INC
Form 10-Q
February 09, 2007
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UNITED STATES

SECURITIES AND EXCHANGE COMMISSION

Washington, D.C. 20549

Form 10-Q

(Mark One)

x QUARTERLY REPORT PURSUANT TO SECTION 13 OR 15 (d) OF THE SECURITIES EXCHANGE ACT OF 1934
For the quarterly period ended December 31, 2006

OR

¨ TRANSITION REPORT PURSUANT TO SECTION 13 OR 15 (d) OF THE SECURITIES EXCHANGE ACT OF 1934
For the transition period from _____ to_____

Commission File Number: 001-14551

Multimedia Games, Inc.

(Exact name of Registrant as specified in its charter)

Texas	**74-2611034**
(State or other jurisdiction of incorporation or organization)	**(IRS Employer Identification No.)**
206 Wild Basin Road, Building B, Fourth Floor	**78746**

Austin, Texas
(Address of principal executive offices) **(Zip Code)**

(512) 334-7500

(Registrant s telephone number, including area code)

Registrant s website: www.multimediagames.com

None

(Former name, former address and former fiscal year, if changed since last report)

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

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

Large accelerated filer ¨ Accelerated filer x Non-accelerated filer ¨

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

APPLICABLE ONLY TO CORPORATE ISSUERS:

As of February 2, 2007, there were 27,613,195 shares of the Registrant s common stock, par value $0.01 per share, outstanding.

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PART I

FINANCIAL INFORMATION

Item 1. Financial Statements

MULTIMEDIA GAMES, INC.

CONSOLIDATED BALANCE SHEETS

As of December 31, 2006 and September 30, 2006

(In thousands, except shares)

(Unaudited)

	December 31, 2006	September 30, 2006
ASSETS		
CURRENT ASSETS:		
Cash and cash equivalents	$ 3,200	$ 4,939
Accounts receivable, net of allowance for doubtful accounts of $1,022 and $1,007, respectively	16,510	17,825
Inventory	3,600	3,600
Prepaid expenses and other	2,429	2,562
Notes receivable	15,970	16,969
Deferred income taxes	1,754	1,623
Total current assets	**43,463**	**47,518**
Restricted cash and long-term investments	959	986
Leased gaming equipment, net	34,304	31,095
Property and equipment, net	85,730	86,264
Notes receivable	46,286	49,399
Intangible assets, net	45,362	46,120
Other assets	921	1,100
Deferred income tax	8,988	6,059
Total assets	**$ 266,013**	**$ 268,541**
LIABILITIES AND STOCKHOLDERS EQUITY		
CURRENT LIABILITIES:		
Current portion of revolving lines of credit	$ 13,613	$ 12,821
Current portion of long-term debts and capital leases	3,163	4,954
Accounts payable and accrued expenses	30,322	31,671
Federal and state income tax payable	1,912	2,125
Deferred revenue	1,667	1,782
Total current liabilities	**50,677**	**53,353**
Revolving lines of credit	45,092	43,193
Long-term debts and capital leases, less current portion	1,242	1,340
Other long-term liabilities	2,668	2,710

Total liabilities	**99,679**	**100,596**
Commitments and contingencies		
Stockholders equity:		
Preferred stock:		
Series A, $0.01 par value, 1,800,000 shares authorized, no shares issued and outstanding		
Series B, $0.01 par value, 200,000 shares authorized, no shares issued and outstanding		
Common stock, $0.01 par value, 75,000,000 shares authorized, 31,522,043 and 31,422,818 shares issued, and 27,610,658 and 27,511,433 shares outstanding, respectively	315	314

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MULTIMEDIA GAMES, INC.

CONSOLIDATED BALANCE SHEETS (Continued)

As of December 31, 2006 and September 30, 2006

(In thousands, except shares)

(Unaudited)

	December 31, 2006	September 30, 2006
Additional paid-in capital	75,287	74,121
Treasury stock, 3,911,385 shares at cost	(24,741)	(24,741)
Retained earnings	115,430	118,242
Accumulated other comprehensive income	43	9
Total stockholders equity	**166,334**	**167,945**
Total liabilities and stockholders equity	**$ 266,013**	**$ 268,541**

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

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MULTIMEDIA GAMES, INC.

CONSOLIDATED STATEMENTS OF OPERATIONS

For the Three Months Ended December 31, 2006 and 2005

(In thousands, except per-share amounts)

(Unaudited)

	Three Months Ended December 31,	
	2006	**2005**
REVENUES:		
Gaming revenue:		
Class II	$ 14,775	$ 24,404
Oklahoma compact	6,409	1,772
Charity	4,177	4,668
All other	2,479	1,861
Gaming equipment, system sale and lease revenue	326	625
Other	884	708
Total revenues	**29,050**	**34,038**
OPERATING COSTS AND EXPENSES:		
Cost of gaming equipment and systems sold and royalty fees paid	523	597
Selling, general and administrative expenses	18,612	15,958
Amortization and depreciation	14,477	14,343
Total operating costs and expenses	**33,612**	**30,898**
Operating income (loss)	**(4,562)**	**3,140**
OTHER INCOME (EXPENSE):		
Interest income	1,574	481
Interest expense	(1,310)	(966)
Income (loss) before income taxes	**(4,298)**	**2,655**
Income tax expense (benefit)	(1,486)	1,126
Net income (loss)	$ (2,812)	$ 1,529
Basic earnings (loss) per share	$ (0.10)	$ 0.06
Diluted earnings (loss) per share	$ (0.10)	$ 0.05

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

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MULTIMEDIA GAMES, INC.

CONSOLIDATED STATEMENTS OF CASH FLOWS

For the Three Months Ended December 31, 2006 and 2005

(In thousands)

(Unaudited)

	Three Months Ended December 31,	
	2006	**2005**
CASH FLOWS FROM OPERATING ACTIVITIES:		
Net income (loss)	$ (2,812)	$ 1,529
Adjustments to reconcile net income (loss) to cash and cash equivalents provided by operating activities:		
Amortization	1,722	1,700
Depreciation	12,755	12,643
Accretion of contract rights	1,499	982
Loss on disposal of long-lived assets	580	
Provisions for inventory and long-lived assets	181	
Deferred income taxes	(3,060)	(2,731)
Share-based compensation	421	682
Provision for of doubtful accounts	345	41
Interest income from imputed interest	(652)	
Changes in operating assets and liabilities:		
Accounts receivable	1,005	6,063
Inventory		80
Contract costs in excess of billing		(393)
Prepaid expenses and other	312	355
Federal and state income tax payable	(213)	56
Notes receivable	755	111
Accounts payable and accrued expenses	(1,349)	(6,018)
Other long-term liabilities	(15)	(188)
Deferred revenue	(115)	(211)
NET CASH PROVIDED BY OPERATING ACTIVITIES	**11,359**	**14,701**
CASH FLOWS FROM INVESTING ACTIVITIES:		
Acquisition of property and equipment and leased gaming equipment	(16,880)	(8,952)
Proceeds from disposal of assets	784	
Acquisition of intangible assets	(1,197)	(1,416)
Advances under development agreements	(926)	(5,914)
Repayments under development agreements	3,574	2,763
NET CASH USED IN INVESTING ACTIVITIES	**(14,645)**	**(13,519)**
CASH FLOWS FROM FINANCING ACTIVITIES:		
Proceeds from exercise of stock options, warrants, and related tax benefit	746	267
Principal payments of long-term debt and capital leases	(1,889)	(3,753)
Proceeds from revolving lines of credit	7,500	17,400
Payments on revolving lines of credit	(4,809)	(8,443)

Purchase of treasury stock		(1,107)
NET CASH PROVIDED BY FINANCING ACTIVITIES	**1,548**	**4,364**
EFFECT OF EXCHANGE RATES ON CASH	(1)	
Net increase (decrease) in cash and cash equivalents	(1,739)	5,546
Cash and cash equivalents, beginning of period	4,939	118
Cash and cash equivalents, end of period	$ 3,200	$ 5,664
SUPPLEMENTAL CASH FLOW DATA:		
Interest paid	$ 1,270	$ 909
Income tax paid	$ 1,756	$ 3,688
NON-CASH TRANSACTIONS:		
Imputed interest resulting from development agreement note receivable	1,519	

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

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1. SIGNIFICANT ACCOUNTING POLICIES

The accompanying consolidated financial statements should be read in conjunction with the Company s consolidated financial statements and footnotes contained within the Company s Annual Report on Form 10-K for the year ended September 30, 2006, as amended by Amendment No. 1 on Form 10-K/A thereto.

The financial statements included herein as of December 31, 2006, and for each of the three months ended December 31, 2006 and 2005, have been prepared by the Company without an audit, pursuant to accounting principles generally accepted in the United States, and the rules and regulations of the Securities and Exchange Commission, or SEC. They do not include all of the information and footnotes required by accounting principles generally accepted in the United States for complete financial statements. The information presented reflects all adjustments consisting solely of normal recurring adjustments which are, in the opinion of management, considered necessary to present fairly the financial position, results of operations, and cash flows for the periods. Operating results for the three months ended December 31, 2006, are not necessarily indicative of the results which will be realized for the year ending September 30, 2007.

For a description of the Company s significant accounting policies, see Note 1, Summary of Significant Accounting Policies, to the consolidated financial statements in the Company s Annual Report on Form 10-K for the fiscal year ended September 30, 2006.

Reclassification. Reclassifications were made to the prior-period consolidated balance sheet and consolidated statement of cash flows to conform to the current-period financial statement presentation. This reclassification did not have an impact on the Company s previously reported results of operations.

Recent Accounting Pronouncements Issued. On July 13, 2006, the Financial Accounting Standards Board, or FASB, issued FASB Interpretation No. 48, or FIN 48, Accounting for Uncertainty in Income Taxes, an interpretation of Statement of Financial Accounting Standards, or SFAS, No. 109, Accounting for Income Taxes. FIN 48 clarifies the accounting for uncertainty in income taxes recognized in an enterprise s financial statements in accordance with SFAS No. 109. FIN 48 also prescribes a recognition threshold and measurement attribute for the financial statement recognition, and for the measurement of a tax position taken or expected to be taken in a tax return. The new FASB standard also provides guidance on derecognition, classification, interest and penalties, accounting in interim periods, disclosure, and transition. The interpretation is effective for fiscal years beginning after December 15, 2006. The Company is currently evaluating the effect, if any, of FIN 48 on its consolidated financial statements.

In September 2006, the Securities and Exchange Commission issued Staff Accounting Bulletin, or SAB, No. 108, Financial Statements Considering the Effects of Prior Year Misstatements when Quantifying Misstatements in Current Year Financial Statements. SAB 108 requires companies to quantify the impact of correcting all misstatements, including both the carryover and reversing effects of prior-year misstatements on the current year financial statements. This pronouncement is effective for the Company in fiscal 2007. The Company does not believe SAB 108 will have a material effect on the financial statements and related disclosures.

In September 2006, the FASB issued SFAS No. 157, Fair Value Measurements, which defines fair value, establishes a framework for measuring fair value in generally accepted accounting principles and expands disclosures about fair value measurements. SFAS 157 will be applied prospectively and will be effective for periods beginning after November 15, 2007. The Company is currently evaluating the effect, if any, of SFAS 157 on its consolidated financial statements.

2. Development Agreements

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

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past and in the future, the Company may by mutual agreement and for consideration, amend these contracts to reduce its floor space at the facilities. Any proceeds received for the reduction of floor space is first applied against the intangible asset recovered for that particular development agreement, if any.

To date, the Company has advanced approximately to $146.0 million toward development agreements. Currently, the Company does not have any commitments to fund development agreements, although the Company may decide to commit funds for future development agreements.

Management reviews intangible assets related to development agreements for impairment whenever events or changes in circumstances indicate that the carrying amount of an asset may not be recoverable. For the three months ended December 31, 2006, there was no impairment to the assets carrying values.

The following net amounts related to advances made under development agreements and were recorded in the following balance sheet captions:

	December 31, 2006	September 30, 2006
	(In thousands)	
Included in:		
Notes receivable	$ 62,256	$ 64,705
Property and equipment, net of accumulated depreciation	6,778	7,493
Intangible assets contract rights, net of accumulated amortization	34,007	34,146
Total	$ 103,041	$ 106,344

3. Property and Equipment and Leased Gaming Equipment

The Company s property and equipment and leased gaming equipment consisted of the following:

	December 31, 2006	September 30, 2006	Estimated Useful Lives
Gaming equipment and third-party gaming content licenses available for deployment	$ 32,284	$ 29,946	(A)
Deployed gaming equipment	87,356	84,958	3-5 years
Deployed third-party gaming content licenses	18,821	16,840	3 years
Tribal gaming facilities and portable buildings	17,377	18,874	5-7 years
Third-party software costs	8,105	7,969	3-5 years
Vehicles	6,843	6,843	3-10 years
Other	3,211	3,192	3-7 years
Total property and equipment	173,997	168,622	
Less accumulated depreciation and amortization	(88,267)	(82,358)	
Total property and equipment, net	**$ 85,730**	**$ 86,264**	
Leased gaming equipment	$ 132,504	$ 123,397	3 years
Less accumulated depreciation	(98,200)	(92,302)	
Total leased gaming equipment, net	**$ 34,304**	**$ 31,095**	

(A) Gaming equipment and third-party gaming content licenses will begin depreciating when they are placed in service.
During the quarter ended December 31, 2006, the Company wrote off $485,000 of third-party gaming content licenses and installation costs.

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4. Intangible Assets

The Company s intangible assets consisted of the following:

	December 31, 2006	September 30, 2006	Estimated Useful Lives
		(In thousands)	
Contract rights under development agreements	$ 42,886	$ 41,526	5-7 years
Internally developed gaming software	21,517	20,899	1-5 years
Noncompete agreement	2,053	2,053	5 years
Patents and trademarks	6,944	6,554	1-5 years
Other	2,283	2,172	3-5 years
Total intangible assets	75,683	73,204	
Less accumulated amortization all other	(30,321)	(27,084)	
Total Intangible assets, net	**$ 45,362**	**$ 46,120**	

During the quarter ended December 31, 2006, the Company wrote off internally developed gaming software of $95,000.

5. Notes Receivable.

The Company s notes receivable consisted of the following:

	December 31, 2006	September 30, 2006
	(In thousands)	
Notes receivable from development agreements	$ 62,256	$ 64,705
Notes receivable from equipment sales		963
Other notes receivable		700
Notes receivable	62,256	66,368
Less current portion	(15,970)	(16,969)
Notes receivable non-current	$ 46,286	$ 49,399

6. Credit Facility, Long-Term Debt and Capital Leases.

The Company s Credit Facility, long-term debt and capital leases consisted of the following:

	December 31, 2006	September 30, 2006
	(In thousands)	
Revolving lines of credit	$ 58,705	$ 56,014

Less current portion	(13,613)	(12,821)
Long-term revolving lines of credit	$ 45,092	$ 43,193
Term loan facility	$ 2,500	$ 3,750
Other long-term debt	1,539	1,705
Capital lease obligations	366	839
Long-term debt and capital leases	4,405	6,294
Less current portion	(3,163)	(4,954)
Long-term debt and capital leases, less current portion	$ 1,242	$ 1,340

Effective June 2006, the Company amended its Credit Facility, which provides the Company with a term loan facility, or the Term Loan, a revolving line of credit, or the Revolver, and reducing lines of credit, or the Reducing Revolvers.

As of December 31, 2006, the Term Loan has an outstanding balance of $2.5 million, and is due in monthly principal installments of $416,667, plus interest at Prime (or 8.25% as of December 31, 2006), with all principal and interest due in June 2007. There is no additional funding available under the Term Loan.

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The revolving lines of credit include the Revolver and the Reducing Revolvers. The Revolver provides the Company with up to $25.0 million for working capital needs. The Revolver has an outstanding balance of $23.9 million, leaving $1.1 million available. The Revolver matures in June 2008 and bears interest at Prime. The Reducing Revolvers provide the Company for borrowings up to $35.0 million and $9.5 million, which is advanceable based on the Company s unfinanced capital expenditures. The $35.0 million Reducing Revolver began reducing in December 2005 and as of the December 2006 quarter began reducing at a rate of $2.8 million per quarter until maturity in June 2009. As of December 31, 2006, the $35.0 million Reducing Revolver has an availability of $25.3 million, all of which has been drawn and is outstanding. The $9.5 million Reducing Revolver is reduced by $791,000 each quarter, beginning in June 2007 and matures in June 2009. As of December 31, 2006, all of the $9.5 million has been drawn and is outstanding under the Reducing Revolver. Availability under the Revolvers is further reduced by $1.0 million for outstanding letters of credit. The Reducing Revolvers bear interest at Prime.

The Credit Facility is collateralized by substantially all of the Company s assets, and also contains financial covenants as defined in the agreement. These include a maximum indebtedness to earnings before interest, tax, depreciation and amortization, or EBITDA, ratio of 1.50:1.00, a maximum total liabilities to tangible net worth ratio of 1.25:1.00, a minimum trailing twelve-month EBITDA of $60.0 million, and a maximum rolling four-quarter capital expenditures rate of $175.0 million, including amounts advanced under development agreements. The Company was in compliance with these covenants as of December 31, 2006.

Other long-term debt at December 31, 2006, represents a five-year loan related to financing the Company s corporate aircraft, and various three-to five-year loans for the purchase of automobiles and property and equipment.

7. Earnings Per Common Share.

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

	Three Months Ended December 31,	
	2006	2005
	(In thousands, except shares and per share amounts)	
Income (loss) available to common stockholders	$ (2,812)	$ 1,529
Weighted average common shares outstanding	27,534,490	27,014,114
Effect of dilutive securities:		
Options		1,839,889
Weighted average common and potential shares outstanding	27,534,490	28,854,003
Basic earnings (loss) per share	$ (0.10)	$ 0.06
Diluted earnings (loss) per share	$ (0.10)	$ 0.05

For the three months ended December 31, 2006, options to purchase approximately 1.8 million shares of common stock, with exercise prices ranging from $7.61 to $21.53, were not included in the computation of diluted earnings per share due to the antidilutive effect and approximately 1.7 million equivalent shares were not included due to the loss generated in the current quarter. For the three months ended December 31, 2005, options to purchase approximately 2.1 million shares of common stock, with exercise prices ranging from $7.61 to $21.53, were not included in the computation of diluted earnings per share due to the antidilutive effect, as previously reported.

8. COMMITMENTS AND CONTINGENCIES

Litigation

Diamond Games. The Company is a defendant, along with others, including Clifton Lind, Robert Lannert, Gordon Graves, Video Gaming Technologies, Inc., or VGT, and its president, Jon Yarborough, in a lawsuit filed on November 16, 2004 in the State Court in Oklahoma City, Oklahoma, alleging five causes of action: 1) Deceptive Trade Practices, 2) Unfair Competition, 3) Wrongful Interference with Diamond Games, Inc. s, or Diamond Games , Business; 4) Malicious Wrong / Prima Facie Tort; and 5) Restraint of Trade. The Company filed a motion to dismiss the case, challenging subject matter jurisdiction of the Oklahoma state courts. The motion was denied. A

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motion to reconsider was likewise denied. Relief was sought from the Supreme Court of Oklahoma by an Application for a Writ of Prohibition. The application for a writ was denied on October 10, 2005. The case asserts that the Company offered allegedly illegal Class III games on the MegaNanza® and Reel Time Bingo® gaming systems to Native American tribes in Oklahoma. Diamond Games claims that the offer of these games negatively affected the market for its pull-tab game, Lucky Tab II. Diamond Games also alleges that the Company s development agreements with Native American tribes unfairly interfere with the ability of Diamond Games to successfully conduct its business. Diamond Games is seeking unspecified damages and injunctive relief; however, the Company believes the claims of Diamond Games are without merit and intends to defend the case vigorously. The Company s defense will include a continued challenge to the jurisdiction of the Oklahoma state courts over matters directly involving the self-governance of Native American tribes involved in Indian gaming, which has been recognized as a governmental enterprise. At the present time, the case is in the preliminary stages of discovery. Given the inherent uncertainties in any litigation, the Company is unable to make any prediction as to the outcome.

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

Pursuant to an agreement between the Company and Bally Technologies, Inc., or Bally, the Company currently sublicenses the right to practice the technology stated in the 035 Patent in Native American gaming jurisdictions in the United States. Bally obtained from Oasis the right to sublicense those rights to the Company, and that sublicense remains in effect today. Under the sublicense from Bally, in the event that the Company desires to expand its own rights beyond Native American gaming jurisdictions, the agreement provides the Company the following options: 1) to pursue legal remedies to establish its rights independent of the 035 Patent; or 2) to negotiate directly and enter into a separate agreement with Oasis for such rights, paying either a specified one-time license fee per jurisdiction or a unit fee per gaming machine.

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

At the Company s request, the court issued Gamco an order to show cause that it has standing to sue us. On September 27, 2005, the court dismissed Gamco s lawsuit for lack of standing. The court granted Gamco leave to file an amended complaint for infringement, if any, that might have occurred during the time Gamco owned the patent. Gamco amended its complaint on November 14, 2005, alleging that the Company sold or offered to sell master processing units as part of the service to be provided to the New York State Lottery. On December 7, 2005, the Company filed a motion to dismiss the amended complaint, asserting that no equipment, including any master processing units, were sold or offered for sale to the New York State Lottery, and that no alleged infringing equipment was used in the New York State Lottery during the time that Gamco owned the 035 Patent.

Prior to the hearing on the Company s motion to dismiss, Gamco entered into a Modification Agreement with IGT which purports to grant Gamco additional rights to pursue the Company for infringement for operating the central determinant system in New York. On January 27, 2006, Gamco filed a motion to dismiss its amended complaint, without prejudice, with the express intent of filing another patent infringement complaint based on the Modification Agreement.

On February 28, 2006, the court denied both the Company s and Gamco s motions to dismiss. The court granted Gamco leave to file a second amended complaint. On March 27, 2006, Gamco filed its Supplemental and Second Amended Complaint. On April 17, 2006, the Company filed another motion to dismiss, challenging the sufficiency of the rights granted by IGT to Gamco to sue the Company for patent infringement. At a hearing held on June 12, 2006, the court denied the Company s motion. On July 13, 2006, the Company filed a Motion for Reconsideration or, in the alternative, Certification of the Question for Interlocutory Appeal to the Federal Circuit Court of Appeals. On September 1, 2006, the court granted the Company s motion in part, and denied the Company s motion in part. The court acknowledged that it was creating new case law by permitting Gamco to sue

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the Company for patent infringement, given Gamco s limited patent rights. As a result, the court granted the Company s request to certify the court s ruling for direct review by the Federal Circuit. The Company filed its Request for Interlocutory Appeal with the Federal Circuit on September 18, 2006. The Company s request was granted by the Federal Circuit on November 1, 2006. The Company s motion to stay the case with the district court, pending the outcome of the Federal Circuit s decision on appeal, has been granted.

The Company continues to vigorously defend this matter. Given the inherent uncertainties in any litigation, the Company is unable to make any prediction as to the outcome.

Aristocrat Technologies, Inc. On January 27, 2005, Aristocrat Technologies, Inc. filed suit in the U.S. District Court for the Central District of California against us, alleging that deployment of the Company s networked central-determinant instant lottery system infringes U.S. Letters Patent No. 4,817,951, entitled Player Operable Lottery Machine Having Display Means Displaying Combination of Game Result Indicia, or the 951 Patent. Aristocrat is seeking an injunction, damages, and a trebling of damages for willful infringement. The Company s analysis indicates that its lottery system does not infringe the 951 Patent. The matter is scheduled for a Markman Hearing to construe the claims of the 951 Patent, on March 9, 2007. A trial date of August 14, 2007 has also been set. The Company intends to vigorously defend the suit, and at the appropriate time, to file dispositive motions asking the court to dismiss the suit. Given the inherent uncertainties in any litigation, the Company is unable to make any prediction as to the outcome.

Alabama Civil Lawsuit. In May 2006, a civil lawsuit was filed against the Company and another defendant in the Macon County Circuit Court. The plaintiff alleges that a credit screen on a bingo machine located at the Victoryland facility in Shorter, Alabama, momentarily showed that plaintiff had won $40 million. The plaintiff now alleges that plaintiff is owed the $40 million. A trial date has not been set and the parties presently are engaged in discovery. The Company intends to vigorously defend the suit, and at the appropriate time, file dispositive motions asking the court to dismiss the suit.

HomeBingo Network, Inc. On May 16, 2005, HomeBingo Network filed suit in the U.S. District Court for the Northern District of New York, against the Company and the gaming entity of the Miami Tribe of Oklahoma, alleging that deployment of Reel Time Bingo and other bingo games infringes U.S. Letters Patent No. 6,186,892, entitled Bingo Game for use on the Interactive Communication Network which Relies upon Probabilities for Winning. HomeBingo seeks an injunction, damages in the amount of a reasonable royalty, and a trebling of damages for willful infringement. The Company received no demand or prior indication that this suit was going to be filed. The Miami Tribe of Oklahoma has been dismissed from the lawsuit on the basis of tribal immunity, and as such, a lack of jurisdiction. The litigation is in the discovery phase. A patent claim construction hearing was completed on November 20, 2006, and the Company prevailed on all contested claim construction issues. The Company intends to vigorously defend this matter. Given the inherent uncertainties in any litigation, the Company is unable to make any prediction as to the outcome.

Mifal Hapayis. In April 2006, Mifal Hapayis, or Mifal, operator of the Israeli Lottery System, filed a third-party-claim against the Company seeking indemnity from damage that Mifal may incur due to an infringement suit filed against it by Ecotech Financial Systems Ltd., or Ecotech. The Company does not believe that it owes an indemnity obligation to Mifal with respect to the claims of Ecotech, particularly because the Company believes that its gaming system that is installed in Israel does not infringe the patent of Ecotech, and because the Company does not believe that the Ecotech patent is valid. The Company intends to vigorously defend the third-party claim. Although continuing to assert noninfringement and invalidity of the patent, the Company has tendered a settlement offer by which it would receive a worldwide right to practice the patent. Given the inherent uncertainties in any litigation, the Company is unable to make any prediction as to the outcome.

Support Consultants, Inc. On July 13, 2006, Support Consultants, Inc. et al., or SCI, filed a suit in Superior Court for the County of Riverside, California against the Company. The complaint alleges that the Company owes $830,000 in unpaid commissions relating to the placement of Class II games in California. SCI also seeks recovery of prejudgment interest, court costs and attorneys fees. The Company removed the case to federal court in the Central District of California, Eastern Division, and the Company is seeking a declaration that SCI is not entitled to the $830,000. The Company intends to vigorously defend this matter; however, given the inherent uncertainties in any litigation, the Company is unable to make any predictions as to the outcome.

Johnson Act. On November 21, 2003, the Department of Justice, or DOJ, filed a Petition for a Writ of Certiorari in the Supreme Court seeking review of the two U.S. Circuit Court cases that examined whether the Johnson Act prohibits Native American tribes from offering certain types of electronic gaming devices. Specifically, the DOJ sought review of *United States of America v. Santee Sioux Tribe of Nebraska, a Federally Recognized Native*

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American Tribe, on Petition for a Writ of Certiorari to the U.S. Court of Appeals for the Eighth Circuit, and *John D. Ashcroft, Attorney General, et al., v. Seneca-Cayuga Tribe of Oklahoma, et al.* on Petition for a Writ of Certiorari to the U.S. Court of Appeals for the Tenth Circuit. In the petitions, the DOJ asserted that the Johnson Act prohibits Native American tribes from operating certain electronic gambling devices without a compact with the appropriate state.

On February 27, 2004, the Supreme Court declined to grant the DOJ s Petitions for Writs of Certiorari. Although the Company s machines were not the subject of the lawsuits, the DOJ s arguments and reasoning appeared to encompass the machines offered by the Company for the Class II market. Since the Supreme Court declined to accept these cases for review, the lower courts decisions affirming the right of the tribes to offer games such as those manufactured and sold by the Company as legal electronic aids to bingo for the Class II market will continue to stand. Significant legal uncertainty has been eliminated concerning the Company s ability to continue to offer Class II games played with the assistance of technologic aids in the Company s principal market.

In October 2005, the DOJ made available to the public proposed legislation the agency has drafted amending the Johnson Act. After conducting a series of consultation meetings with Native American tribes, the DOJ released a newly revised draft bill that, if enacted, could materially and adversely affect the Company s Class II gaming market. The proposed legislation would classify electronic technologic aids used by Native American tribes in Class II games, such as bingo, as gambling devices, and would authorize the use of such Class II devices by Native American tribes only if such devices are certified by the National Indian Gaming Commission, or NIGC, as Class II technologic aids. The proposed legislation authorizes the NIGC to promulgate regulations regarding the use of technologic aids. The NIGC regulations must maintain a distinction between Class II technologic aids and Class III gambling devices based upon the internal and external characteristics of the gambling devices and the manner in which the games using gambling devices are played. The DOJ was unable to find congressional sponsors for its proposed bill during the 109th Congress, which concluded in December 2006.

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

On November 30, 2004, the Company received letters from the Acting General Counsel of the NIGC advising it that based on the fee the Company receives under its agreements with other tribes, collectively, the tribes, those agreements may evince a proprietary interest by the Company in the tribes gaming activities, in violation of the Indian Gaming Regulatory Act of 1988, or IGRA, and the tribes gaming ordinances. The NIGC invited the Company and the tribes to submit any explanation or information that would establish that the agreement terms do not violate the requirement that the tribes maintain sole proprietary interest in the gaming operation. The NIGC letters also advised that some of the agreements may also constitute management contracts, thereby requiring the approval of the NIGC Chairman.

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

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

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

On March 29, 2006, the United States Senate Committee on Indian Affairs reported to the Senate floor the IGRA Amendments of 2006, or S.2078. If enacted, S.2078, or similar legislation, would, among other things, expand the NIGC s authority to review and approve consulting agreements, development agreements, financing agreements and agreements whereby compensation to the non-tribal party is based on a percentage of gaming revenues. Under the

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current law, the Company s equipment lease agreements and development and financing agreements with Native American tribes do not require the approval of the NIGC. Under S.2078, however, many of the Company s Native American gaming contracts would require NIGC approval. As part of the review and approval process, the NIGC could materially and adversely affect the terms of the contracts, and the Company, its board of directors and significant shareholders would have to undergo a background investigation prior to approval of the contracts. On June 7, 2006, the Committee Report on S.2078 was filed in the Senate. Because of objections by a number of senators to the bill, there was no further action on S.2078 in the Senate before the end of the 109th Congress. The bill therefore died, and must be reintroduced during the 110th Congress before it can be considered further by the Congress.

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

Other. Existing federal and state regulations may also impose civil and criminal sanctions for various activities prohibited in connection with gaming operations, including false statements on applications, and failure or refusal to obtain necessary licenses described in the regulations.

9. Related Party Transactions

During the quarter ended December 31, 2006, in connection with executing a content license agreement, the Company paid $25,000 to a family member of the former Chairman of the Board. In addition, the Company paid $18,000 to the former Chairman of the Board, in connection with a consulting arrangement.

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ITEM 2. Management s Discussion and Analysis of Financial Condition and Results of Operations

Overview

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

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

Class II Market

We derive our Class II gaming revenues from participation arrangements with our Native American customers. Under these arrangements, we retain ownership of the gaming equipment installed at our customers tribal gaming facilities, and receive revenue based on a percentage of the hold per day generated by each gaming system. Our portion of the hold per day is reported by us as Gaming revenue Class II and represents the total amount that end users wager, less the total amount paid to end users for prizes, and the amounts retained by the facilities for their share of the hold. Our New Generation gaming system operates at a speed considerably faster than our Legacy system, generally resulting in end users playing a greater number of games on our New Generation system in the same amount of time. As a result of the faster speed of play and higher payout ratios, we believe that end users derive a higher level of satisfaction from playing our New Generation games. We believe that this enhanced satisfaction results in end users playing more games and for longer periods of time than on our Legacy system, resulting in higher play on our New Generation system. Currently, the majority of our customer sites have been upgraded with our Gen 5 gaming system. The product is replacing the Gen IV back-office system that we introduced in late 2003, which allowed us to enhance prior systems by adding bonus-round games and wide-area progressive jackpots to our extensive library of game titles. Currently, both systems are utilized in the field, as we are transitioning to the Gen5 System. The Gen5 product features a more robust database for accounting, player tracking and database marketing, enhancing hardware and software redundancy, providing customers with currency accounting and player tracking support capabilities for third-party vendor games, and for offering the ability to include Class II and Class III compacted games on a single integrated system.

As the market has grown, we have seen new competitors with significant gaming experience and financial resources enter the Class II market. As the rules and regulations governing Class II gaming are clarified by court decisions and by new rule-making procedures, we expect there to be even more competition. New tribal-state compacts, such as the Oklahoma gaming legislation passed by referendum in 2004, have also led to increased competition. In addition, we continue to experience an extended period of inaction relative to enforcement of existing restrictions on non-Class II devices, which is forcing us to continue competing against games that do not appear to comply with the published regulatory restrictions on Class II games. As a result of this increased competition in Oklahoma, and continued conversion to games played under the compact, we have and may continue to experience pressure on our pricing model and hold per day, with the result that gaming providers are competing on the basis of price as well as the entertainment value and technological superiority of their products. We have also experienced and expect to continue to experience a decline in the number of our Class II games deployed in Oklahoma, in accordance with our recent conversion strategy. While we will continue to compete by regularly introducing new and more entertaining games with technological enhancements that we believe will appeal to end users, we believe that the level of revenue retained by our customers from their installed base of player terminals will become a more significant

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competitive factor, one that may require us to change the terms of our participation arrangements with customers. We will continue the deployment of one-touch, compact-compliant Class III games in Oklahoma, which will reduce the number of Class II machines in play. Because of the dynamics of our markets in Oklahoma and elsewhere, we believe that a simple business model based upon the average hold per player terminal per day has become less relevant in predicting our performance, as our participation arrangements with customers have become less standardized and more complex.

Oklahoma Compact Market

During 2004, the Oklahoma Legislature passed legislation authorizing certain forms of gaming at racetracks, and additional types of games at tribal gaming facilities, pursuant to a tribal-state compact. The Oklahoma gaming legislation allows tribes to sign a compact with the state of Oklahoma to operate an unlimited number of electronic instant bingo games, electronic bonanza-style bingo games, electronic amusement games, and non-house-banked tournament card games. In addition, certain horse tracks in Oklahoma are allowed to operate a limited number of instant and bonanza-style bingo games and electronic amusement games. As of December 31, 2006, we had placed approximately 3,324 player terminals at 29 facilities that are operating under the Oklahoma compact. Currently, all games operating under the Oklahoma State compact are at a 20% revenue share.

Charity Market

As of December 31, 2006, we had 2,371 high speed, standard bingo games installed for the charity market in three Alabama facilities. Charity bingo and other forms of charity gaming are operated by or for the benefit of nonprofit organizations for charitable, educational and other lawful purposes. These games are typically only interconnected within the gaming facility where the terminals are located. Regulation of charity gaming is vested with each individual state, and in some states, regulatory authority is delegated to county or municipal governmental units. We typically place player terminals under participation arrangements in the charity market and receive a percentage of the hold per day generated by each of the player terminals. In addition, we have installed a limited number of charity player terminals in the state of Louisiana and as of December 31, 2006, we had 170 units installed.

All Other Gaming Markets.

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

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

State Video Lottery Market. Beginning in January 2004, we began the first operation of our central determinant system for the video lottery terminal network that the New York Lottery operates at licensed New York State racetrack casinos. As payment for providing and maintaining the central determinant system, we receive a small portion of the network-wide hold per day. This contract provides for a three-year term with an additional three one-year automatic renewal under certain conditions. In January 2006, we began installing video lottery terminals in Iowa. During the fiscal year ended September 30, 2006, legislation in Iowa required the removal of all video lottery terminals on or before May 3, 2006. During fiscal year 2006, all installed terminals had been removed. During the period the terminals were active, we effectively received hold-per-day-based payments for providing the player terminals, and an additional percentage of the hold per day for providing the system.

International Commercial Bingo Market. On March 17, 2006, we entered into a contract with Apuestas Internacionales, S.A. de C.V., or Apuestas, a subsidiary of Grupo Televisa, S.A., to provide traditional and electronic bingo gaming, technical assistance, and related services for Apuestas locations in Mexico.

As of December 31, 2006, we had installed 919 player terminals at five sites in Mexico under this contract. To date, there are not as many permanent facilities opened as we originally projected, and the hold per day is below our original expectations.

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Promotional Sweepstakes Market

On December 15, 2005, one of our subsidiaries leased a promotional sweepstakes system to the operator of the Birmingham Race Course, a greyhound race course in Birmingham, Alabama. The promotional sweepstakes system allowed a patron to obtain free sweepstakes entries either by purchasing a product or service or by other means whereby no purchase was necessary. There were a number of methods that allowed a patron to redeem sweepstakes entries, including having the predetermined outcome displayed by video card readers.

On December 22, 2005, the Jefferson County, Alabama Sheriff served a search warrant at the Birmingham Race Course. Pursuant to the search warrant, the sheriff shut down the promotional sweepstakes system. On January 31, 2006, the Jefferson County, Alabama Circuit Court issued a Declaratory Judgment and Injunction that declared that the promotional sweepstakes was legal under Alabama law. On March 22, 2006, the Jefferson County District Attorney appealed the entire final judgment to the Alabama Supreme Court. On December 1, 2006, the Alabama Supreme Court issued an opinion, reversing the Jefferson County, Alabama Circuit Court and rendering judgment in favor of District Attorney Barber, finding that the promotional sweepstakes was unlawful under Alabama s gambling laws.

As of January 31, 2007, we removed all of our games from the facility and recorded a write-off of $111,000 for all unamortized installation and software costs as of December 31, 2006.

Revenues from the Promotional Sweepstakes are included in Other revenues in statements of operations.

Development Agreements

As we seek to continue the growth in our customer base and to expand our installed base of player terminals, a key element of our strategy has become entering into development agreements with various Native American tribes to help fund new or expand existing tribal gaming facilities. Pursuant to these agreements, we advance funds to the tribes for the construction of new tribal gaming facilities or for the expansion of existing facilities.

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

In return for the amounts advanced by us, we receive a commitment for a fixed number of player terminal placements in the facility or a fixed percentage of the available gaming floor space, and a fixed percentage of the hold per day from those terminals over the term of the development agreement. Certain of the agreements contain player terminal performance standards that could allow the facility to reduce a portion of our guaranteed floor space. We are aware that certain of our games may not currently meet these performance standards. In addition, certain development agreements allow the facilities to buy out floor space after advances that are subject to repayment, have been repaid.

We have in the past and in the future expect to, reduce the number of player terminals in certain of our Class II facilities as a result of ongoing competitive pressures faced by our customers from alternative gaming facilities and pressures faced by our machines from competitors products. We have in the past and in the future may also, by mutual agreement and for consideration, amend these contracts in order to reduce the number of player terminals at these facilities.

To date, we have we have advanced approximately to $146.0 million toward development agreements. Currently, we do not have any commitments to fund development agreements, although we may decide to commit funds for future development agreements.

Recent Developments

On December 15, 2005, we leased a promotional sweepstakes system to the operator of the Birmingham Race Course, a greyhound race course in Birmingham, Alabama. The promotional sweepstakes system allowed a patron to obtain free sweepstakes entries either by purchasing a product or service or by other means whereby no purchase was necessary. There were a number of methods that allowed a patron to redeem sweepstakes entries, including having the predetermined outcome displayed by video card readers.

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As of January 31, 2007, we removed all of our games from the facility and recorded a write-off for all unamortized installation and software costs as of December 31, 2006.

On February 7, 2007, we executed a reduction of 65 full-time and part-time employees, including 19 engaged in field operations and business development, 36 in system and game development, 2 in accounting functions, and 8 in other general administrative and executive functions. Severance of approximately $200,000 will be paid in the quarter ending March 31, 2007. We expect annual reductions in salary and wages and the related employee benefits of approximately $4.0 million beginning the third fiscal quarter of 2007.

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RESULTS OF OPERATIONS

The following tables outline our end-of-period and average installed base of gaming terminals for the three months ended December 31, 2006 and 2005.

	At December 31, 2006	2005
End-of-period installed gaming terminal base		
Class II gaming terminals		
New Generation system - Reel Time Bingo®	5,943	8,915
Legacy system	362	390
Oklahoma compact games	3,324	1,229
Other player terminals(1)	3,460	2,589

	Three Months Ended December 31, 2006	2005
Average installed gaming terminal base:		
Class II gaming terminals		
New Generation system - Reel Time Bingo	6,659	9,283
Legacy system	367	436
Oklahoma compact games	2,859	1,105
Other player terminals(1)	3,289	2,572

(1) Other gaming terminals include charity and Mexico.

At December 31, 2006, there were 1,318 sweepstakes video readers installed, and the average installed base for the three months ended December 31, 2006, was 1,318. At December 31, 2005, there were no sweepstakes video readers installed, and the average installed base for the three months ended December 31, 2005, was 78. These sweepstakes video readers are not included in the counts above. During January 2007, we removed all of the sweepstakes video readers that were installed in Alabama.

Three Months Ended December 31, 2006, Compared to Three Months Ended December 31, 2005

Total revenues for the three months ended December 31, 2006, were $29.1 million, compared to $34.0 million for the same period of 2005. This decrease is primarily the result of a decrease in the average install base of Class II games and, to a lesser extent, a decrease in the average hold per day and revenue share of these games. These decreases were due to competitive factors, including competing with new compact games in Oklahoma. These decreases were partially offset by an increase in the average number of Oklahoma compact games in place during the quarter.

Gaming Revenue Class II

Class II gaming revenues decreased by $9.6 million, or 39%, from $24.4 million in the three months ended December 31, 2005, to $14.8 million in the three months ended December 31, 2006.

Reel Time Bingo revenue was $14.0 million for the quarter ended December 31, 2006, compared to $23.7 million in the quarter ended December 31, 2005, a $9.6 million, or 41% decrease. The average installed base of gaming terminals and the average hold per day decreased 28% and 9%, respectively. Accretion of contract rights related to development agreements, which is recorded as a reduction of revenue, increased $517,000, to $1.5 million, or 53%, in the three months ended December 31, 2006, compared to $982,000 in the three months ended December 31, 2005. During fiscal 2007, we will continue to convert Reel Time Bingo player terminals to games played under the compact, which are included in Gaming revenue Oklahoma compact, and we expect this trend to continue in the future as Reel Time Bingo competes with the higher hold per day of compact games. In addition, as a result of the conversion from Reel Time Bingo to

games played under the compact, our revenue share percentage will decrease to the market rate for compact games.

Legacy revenue decreased $27,000, or 4%, to $726,000 in the three months ended December 31, 2006, from $753,000 in the three months ended December 31, 2005. The average installed base of Legacy gaming terminals decreased 16%, which was partially offset by a 13% increase in hold per day. We expect the number of Legacy terminals to continue to decrease as they are replaced with higher earning Oklahoma compact and Reel Time Bingo terminals.

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Gaming Revenue Oklahoma Compact

In March 2005, we began converting Reel Time Bingo gaming terminals to games that could be played under the Oklahoma compact. These games generated revenue of $6.4 million in the three months ended December 31, 2006, compared to $1.8 million during the same period of 2005. The average installed base and hold per day increased 159% and 40%, respectively.

Gaming Revenue Charity

Charity gaming revenues decreased 11%, to $4.2 million for the December 2006 quarter, compared to $4.7 million for the same quarter of 2005. The average installed gaming terminal base and hold per day decreased 2% and 11%, respectively, in the three months ended December 31, 2006, compared to the same period in 2005. The decreases were due to competitive factors including our terminals not linking to one facility s player tracking system and the proliferation of gray-area games. We expect that the hold per day will improve, as enforcement against gray-area providers in the state of Alabama has recently begun.

Gaming Revenue All Other

Class III rental and back-office fees decreased 30%, to 916,000 in the three months ended December 31, 2006, from $1.3 million during the same period of 2005. As of January 2006, we no longer have any rental customers. We continue to receive a small back-office fee from each of the twelve gaming facilities where we are located.

Revenues from the New York Lottery system increased 99% to $1.1 million in the three months ended December 31, 2006, from $557,000 in the three months ended December 31, 2005. Currently, eight of the nine planned racetrack casinos are operating, with approximately 11,200 total terminals. The last of the planned openings is scheduled for fiscal 2008. To date, we have realized substantially less revenue than anticipated from our New York Lottery operations, in significant part due to delays in the opening of planned racetrack casino operations at several racetracks. At the current placement levels, we expect to have break-even operations for the New York lottery system and to be achieving profitable operations after all of the facilities are operating.

As of December 31, 2006, we had installed 919 player terminals at five sites in Mexico compared to no terminals installed in the prior period. To date, there are not as many permanent facilities opened as we originally projected, and the hold per day is below our original expectations. Our revenue share is in the range of the other markets in which we operate. Due to the delays in opening facilities and the lower hold per day, we have not achieved break-even operations in this market.

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

Gaming equipment and system sale and lease revenue decreased $299,000, or 48% to $326,000 for the quarter ended December 31, 2006, from $625,000 for the same period of 2005. In the periods ended December 31, 2006 and 2005, gaming equipment sale revenue included revenues of $266,000 and $281,000, respectively, related to a certain equipment sale being recognized ratably over the term of the agreement. License revenues for the three months ended December 31, 2006, were $41,000, compared to $303,000 for the three months ended December 31, 2005, a decrease of $262,000, or 86%. Total cost of sales, which includes cost of royalty fees, decreased $74,000, or 12% to $523,000 in the three months ended December 31, 2006, from $597,000 in the three months ended December 31, 2005. The decrease relates to the decreased gaming equipment and system sale revenue discussed above, and decreased royalty fees due to lower revenue on some licensed game themes in play.

Other Revenue

Other revenues increased $176,000, or 25% to $884,000 for the quarter ended December 31, 2006, from $708,000 during the same period of 2005. The increase was primarily the result of the installation of 1,318 video sweepstakes readers in Alabama in December 2005. In January 2007, all the video sweepstakes readers were removed.

Selling, General and Administrative Expenses

Selling, general and administrative expenses increased approximately $2.7 million, or 17%, to $18.6 million for the three months ended December 31, 2006, from $16.0 million in the same period of 2005. This increase was primarily a result of a) an increase in consulting and contract labor of approximately $1.0 million; b) a write-off of third-party gaming content licenses, installation costs and systems of $575,000, compared to no write-offs in the prior period; c) an increase in legal, professional and lobbying services of approximately $323,000 due to our involvement in litigation; d) an increase in bad debts of $303,000; e) repairs and maintenance, transportation and related costs increased $326,000; and f) an increase in salaries and wages and the related

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employee benefits of approximately $263,000 relating to additional staff to design and develop gaming systems and content and monitor and develop new markets (at December 31, 2006, we employed 500 full-time and part-time employees, compared to 476 at December 31, 2005.) These increases were partially offset by a $257,000 decrease in share-based compensation, and a $236,000 decrease in travel costs.

Depreciation and Amortization

Depreciation expense increased 1%, to $12.8 million for the three months ended December 31, 2006, from $12.6 million for the corresponding three-month period ended December 31, 2005. We expect depreciation expense to increase as we increase our installed base of Oklahoma compacted games. Amortization expense for both periods was $1.7 million.

Other Income and Expense

Interest income increased 227%, to $1.6 million for the three months ended December 31, 2006, from $481,000 in the same period of 2005, due to the higher balances of notes receivable bearing variable interest rates. We entered into a development agreement with a customer under which approximately $42.3 million in advanced funds will be reimbursed based upon levels of revenues generated from the facility. We calculated an imputed interest on this receivable utilizing an interest rate range of 6% to 8.25% correlated to the timing of the original advances. These interest rates are applied over the expected reimbursement period. We recorded $652,000 of imputed interest income during the three months ended December 31, 2006, in accordance with Accounting Principles Board Opinion, or APB, No. 21, Interest on Payables and Receivables.

Interest expense increased 36%, to $1.3 million for the first fiscal quarter of 2007, from $966,000 for the same quarter of fiscal 2006, due primarily to an increase in amounts outstanding under our Credit Facility. The Credit Facility provides us with a $20.0 million term loan facility, or the Term Loan, a $25.0 million revolving line of credit, or the Revolver, and $35.0 million and $9.5 million in reducing revolving lines of credit, or the Reducing Revolvers. As of December 31, 2006, nearly all availability under our existing Credit Facility has been drawn. We are currently seeking alternatives to expand our current Credit Facility.

Income tax expense decreased by $2.6 million, to an income tax benefit of $1.5 million for the three months ended December 31, 2006, from an income tax expense of $1.1 million in the same period of 2005. These figures represent effective tax rates of 34.6% and 42.4% for the three months ended December 31, 2006 and 2005, respectively. Statement of Financial Accounting Standards, or SFAS, No. 123(R), Share-Based Payment. is a revision of SFAS No. 123, Accounting for Stock Based Compensation. SFAS No 123(R) includes several modifications to the way that income taxes are recorded in the financial statements. The expense for incentive stock option grants is only deductible for tax purposes at the time that the taxable event takes place, which could cause variability in our effective tax rates recorded throughout our fiscal year. The higher effective tax rate for the three months ended December 31, 2006, was primarily a result of loss recorded in the current quarter.

Our tax years ended 2002, 2003 and 2004 are currently under examination from the Internal Revenue Service, or IRS. We have received an assessment of approximately $686,000, primarily relating to the deductibility of certain lobbying expenses the IRS has determined should be disallowed. We have appealed the assessment to the IRS, and included in our appeal is a refund claim for overallocating nondeductible lobbying expenses. We have not recorded a reserve for the assessment because a liability is not probable at this time nor is it estimatable. If the assessment is upheld, our effective tax rate would be higher for the year ended September 30, 2007, or for the fiscal year in which the matter is settled.

RECENT ACCOUNTING PRONOUNCEMENTS

On July 13, 2006, the Financial Accounting Standards Board, or FASB, issued FASB Interpretation No. 48, or FIN 48, Accounting for Uncertainty in Income Taxes, an interpretation of SFAS No. 109, Accounting for Income Taxes. FIN 48 clarifies the accounting for uncertainty in income taxes recognized in an enterprise s financial statements in accordance with SFAS No. 109. FIN 48 also prescribes a recognition threshold and measurement attribute for the financial statement recognition and measurement of a tax position taken or expected to be taken in a tax return. The new FASB standard also provides guidance on derecognition, classification, interest and penalties, accounting in interim periods, disclosure, and transition. The interpretation became effective for fiscal years beginning after December 15, 2006. We are currently evaluating the effect, if any, of FIN 48 on our consolidated financial statements.

In September 2006, the Securities and Exchange Commission, or SEC issued Staff Accounting Bulletin, or SAB, No. 108, Financial Statements Considering the Effects of Prior Year Misstatements when Quantifying

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Misstatements in Current Year Financial Statements. SAB 108 requires companies to quantify the impact of correcting all misstatements, including both the carryover and reversing effects of prior year misstatements on the current year financial statements. This pronouncement is effective for us in fiscal 2007. We do not believe SAB 108 will have a material effect on the financial statements and related disclosures.

In September 2006, the FASB issued SFAS No. 157, Fair Value Measurements, which defines fair value, establishes a framework for measuring fair value in generally accepted accounting principles and expands disclosures about fair value measurements. SFAS 157 will be applied prospectively and will be effective for periods beginning after November 15, 2007. We are currently evaluating the effect, if any, of SFAS 157 on our consolidated financial statements.

CRITICAL ACCOUNTING POLICIES

For a description of our critical accounting policies and estimates, refer to Item 7, Management s Discussion and Analysis of Financial Condition and Results of Operations on our Form 10-K for the fiscal year ended September 30, 2006. We have not made any changes relating to the application of these policies in the three months ended December 31, 2006.

LIQUIDITY AND CAPITAL RESOURCES

At December 31, 2006, we had $3.2 million in unrestricted cash and cash equivalents, compared to $4.9 million at September 30, 2006. Our working capital deficit at December 31, 2006, increased to $7.2 million, compared to $5.8 million at September 30, 2006. The deficit increase was primarily the result of the timing of payments of accounts payable and accrued expenses, and the receipt of accounts and notes receivable. During the quarter ended December 31, 2006, we used $16.9 million for capital expenditures of property and equipment, $1.4 million for payments of accounts payable and accrued expenses, and were reimbursed $2.6 million, net of amounts advanced under development agreements.

As of December 31, 2006, our total contractual cash obligations were as follows (in thousands):

	Less than 1 year	1-3 years	3-5 years	More than 5 years	Total
Revolving lines of credit[1]	$ 16,427	$ 49,517	$ 810	$	$ 66,754
Long-term debt[2]	4,221	178	14		4,413
Capital leases[3]	353	10			363
Operating leases[4]	1,822	3,374	1,012		6,208
Purchase commitments[5]	21,849	10,479			32,328
Payments due under employment agreement[6]	250	500	500	1,771	3,021
Total	**$ 44,922**	**$ 64,058**	**$ 2,336**	**$ 1,771**	**$ 113,087**

(1) The revolving credit lines bear interest at a rate of Prime (8.25% as of December 31, 2006).
(2) Consists of various three-to-five-year loans for the purchase of automobiles and property and equipment at an overall average annual interest rate of 7.57%, a five-year loan related to financing our corporate aircraft at an annual interest rate of LIBOR plus 2.75% (8.08% as of December 31, 2006), and amounts borrowed under our Credit Facility at annual interest rate of Prime (8.25% as of December 31, 2006).
(3) Consists of various three-year capital leases for property and equipment at an overall average annual interest rate of 6.26%.
(4) Consists of operating leases for our facilities and office equipment that expire at various times through 2010.
(5) Consists of commitments to purchase third-party gaming content licenses and for the purchase of gaming terminals.
(6) Represents the expected future payments due, based on life expectancy tables, to the former Chief Executive Officer for his noncompete agreement entered into under his Employment Agreement.

During the quarter ended December 31, 2006, we generated $11.4 million in cash from our operations, compared to $14.7 million during the same period of 2005. This $3.3 million decrease in cash generated from operations over the prior period was primarily due to the lower earnings during the quarter ended December 31, 2006.

Cash used in investing activities increased to $14.7 million in the quarter ended December 31, 2006, from $13.5 million in the same period of 2005. The increase was primarily the result of a $7.9 million increase in the

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acquisition of Property and equipment and leased gaming equipment, and was partially offset by a $5.8 million decrease in advances, net of reimbursements, under development agreements. During the quarter ended December 31, 2006, additions to property and equipment consisted of the following:

	Capital Expenditures (In thousands)
Gaming equipment	$ 14,339
Third-party gaming content licenses	2,337
Other	204
Total	**$ 16,880**

Cash provided by financing activities decreased to $1.5 million in the quarter ended December 31, 2006, from $4.4 million in the same period of 2005. The decrease was primarily the result of a $6.3 million decrease in the net borrowings under the Revolving Lines of Credit and was partially offset by a $1.1 million decrease in the purchase of treasury stock and a decrease of $1.9 million in payments of long-term debt and capital leases.

Our capital expenditures for the next twelve months will depend upon the number of new player terminals that we are able to place into service at new or existing facilities and the actual number of repairs and equipment upgrades to the player terminals that are currently in the field. As a result of the earnings potential of compact games in the Oklahoma market, it is our strategy to either place compact games or to convert our Oklahoma Class II games to the compact games. As part of our strategy, we will offer compact games developed by us, as well as games from two other gaming suppliers. As a result, we have entered into purchase commitments to purchase player stations and licenses totaling $21.9 million.

To date, we have we have advanced approximately to $146.0 million toward development agreements. Currently, we do not have any commitments to fund development agreements, although we may decide to commit funds for future development agreements.

At December 31, 2006, our debt structure consisted of a Credit Facility, which provided us with a $20.0 million Term Loan, a $25.0 million Revolver, and $35.0 million and $9.5 million Reducing Revolvers. As of December 31, 2006, we may borrow up to $59.8 million. We have availability of $1.1 million, which is further reduced by $1.0 million, reflecting outstanding letters of credit. As of December 31, 2006, the current portion of the Revolver is $13.6 million, while the remaining $45.1 million is noncurrent. All of the term loan is current.

The Credit Facility contains financial covenants, as defined in the agreement, that include a maximum indebtedness to Earnings before interest, tax, depreciation and amortization, or EBITDA, ratio of 1.50:1.00, a maximum total liabilities to tangible net worth ratio of 1.25:1.00, a minimum trailing twelve-month EBITDA of $60.0 million, and a maximum rolling four-quarter capital expenditures rate, including advances made under development agreements, of $175.0 million. We were in compliance with these covenants as of December 31, 2006. We are currently seeking alternatives to expand our current Credit Facility.

We believe that our existing cash and cash equivalents, and cash provided from our operations can sustain our current operations, including all debt service requirements and purchase commitments. If our business does not continue to generate cash flows at current levels, or if the level of funding required in connection with our purchase commitments is greater than anticipated, we may need to raise additional financing. Sources of additional financing might include additional bank debt or the public or private sale of equity or debt securities. However, sufficient funds may not be available on terms acceptable to us or at all, from these sources or any others to enable us to execute our Oklahoma strategy and enter new markets, or to make necessary capital expenditures and/or to make discretionary investments in the future.

Stock Repurchase Authorizations

At December 31, 2006, there were approximately 887,000 shares authorized for repurchase. The timing and total number of shares repurchased will depend upon available cash, prevailing market conditions, other investment opportunities, and capital commitments.

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During the fiscal year ended September 2006, we repurchased 159,146 shares of our common stock with cash, at an average cost of $9.15. We repurchased no shares of our common stock during the quarter ended December 31, 2006, and 120,846 shares during the quarter ended December 31, 2005, at an average cost of $9.16.

Stock-Based Compensation

At December 31, 2006, we had approximately 4.8 million options outstanding, with exercise prices ranging from $1.00 to $21.53 per share. At December 31, 2006, approximately 4.1 million of the outstanding options were exercisable.

During the quarter ended December 31, 2006, we granted 60,000 stock options, having a weighted average exercise price of $9.33. The weighted average grant date fair value of such options was $4.70 per share. During the three months ended December 31, 2006, we issued 99,225 original issue shares of common stock as a result of stock option exercises

SEASONALITY

We believe our operations are not materially affected by seasonal factors, although we have experienced fluctuations in our revenues from period to period.

CONTINGENCIES

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

INFLATION AND OTHER COST FACTORS

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

FUTURE EXPECTATIONS AND FORWARD-LOOKING STATEMENTS

This Quarterly Report and the information incorporated herein by reference contain various forward-looking statements within the meaning of federal and state securities laws, including those identified or predicated by the words believes, anticipates, expects, plans, or similar expressions with forward-looking connotation. Such statements are subject to a number of risks and uncertainties that could cause the actual results to differ materially from those projected. Such factors include, but are not limited to, the uncertainties inherent in the outcome of any litigation of the type described in this Quarterly Report under PART II Item 1. Legal Proceedings, trends and other expectations described in PART I Item 2. Management s Discussion and Analysis of Financial Condition and Results of Operations, risk factors disclosed in our earnings and other press releases issued to the public from time to time, as well as those other factors as described under Part II Item 1a. Risk Factors set forth below. Given these uncertainties, readers of this Quarterly Report are cautioned not to place undue reliance upon such statements. All forward-looking statements in this document are based on information available to us as of the date hereof, and we assume no obligations to update any such forward-looking statements.

ITEM 3. QUANTITATIVE AND QUALITATIVE DISCLOSURES ABOUT MARKET RISK

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

We entered into a Credit Facility to provide us with additional liquidity to meet our short-term financing needs, as further described under PART I Item 1. Financial Statements Significant Accounting Policies Credit Facility, Long-Term Debt and Capital Leases. Pursuant to the Credit Facility, we may currently borrow up to a total of $59.8 million under the Revolvers. We have availability of $1.1 million, which is further reduced by $1.0 million, reflecting outstanding letters of credit.

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In connection with the development agreements we enter into with many of our Native American tribal customers, we are required to advance funds to the tribes for the construction and development of tribal gaming facilities, some of which are required to be repaid.

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

We estimate that a hypothetical increase of 100 basis points in interest rates would increase our interest expense by approximately $627,000, based on our variable debt outstanding of $62.4 million as of December 31, 2006. We do not currently manage this exposure with derivative financial instruments.

We account for currency translation from our Mexico operations in accordance with SFAS No. 52, Foreign Currency Translation. Balance sheet accounts are translated at the exchange rate in effect at each balance sheet date. Income statement accounts are translated at the average rate of exchange prevailing during the period. Translation adjustments resulting from this process are charged or credited to other comprehensive income. We do not currently manage this exposure with derivative financial instruments.

ITEM 4. CONTROLS AND PROCEDURES

Evaluation of Disclosure Controls and Procedures. As of the end of the period covered by this report, an evaluation was carried out under the supervision and with the participation of our management, including our Chief Executive Officer and Chief Financial Officer, of the effectiveness of the design and operation of management s disclosure controls and procedures (as defined in rules 13a-15(e) and 15d-15(e) under the Securities Exchange Act of 1934) to ensure information required to be disclosed in our filings under the Securities Exchange Act of 1934, is (i) recorded, processed, summarized and reported within the time periods specified in the Commission rules and forms; and (ii) accumulated and communicated to our management, including our Chief Executive Officer and Chief Financial Officer, as appropriate, to allow timely decisions regarding required disclosure. Management recognizes that any controls and procedures, no matter how well designed and operated, can only provide reasonable assurance of achieving desired control objectives, and management is necessarily required to apply its judgment when evaluating the cost-benefit relationship of potential controls and procedures. Based upon the evaluation, the Chief Executive Officer and Chief Financial Officer concluded that the design and operation of these disclosure controls and procedures were effective as of December 31, 2006.

Changes in Internal Control Over Financial Reporting. There were no changes in our internal control over financial reporting identified in management s evaluation during the first quarter of 2007 that have materially affected, or are reasonably likely to materially affect, our internal control over financial reporting.

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PART II

OTHER INFORMATION

ITEM 1. LEGAL PROCEEDINGS

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

ITEM 1A. RISK FACTORS

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

Historically, we have derived most of our revenue from the placement of Class II gaming terminals and systems for gaming activities conducted on Native American lands. These activities are subject to federal regulation under the Johnson Act, the Indian Gaming Regulatory Act of 1988, or IGRA, and under the rules and regulations adopted by both the NIGC and the gaming commissions that each Native American tribe establishes to regulate gaming. The Johnson Act broadly defines gambling devices to include any machine or mechanical device designed and manufactured primarily for use in connection with gambling, and that, when operated, delivers money or other property to a player as the result of the application of an element of chance. A government agency or court that literally applied this definition, and did not give effect to subsequent congressional legislation or to certain regulatory interpretations or judicial decisions, could determine that the manufacture and use of our electronic gaming terminals, and perhaps other key components of our Class II gaming systems that rely to some extent upon electronic equipment to run a game, constitute Class III gaming and, in the absence of a tribal-state compact, are illegal. Our tribal customers could be subject to significant fines and penalties if it is ultimately determined they are offering an illegal game, and an adverse regulatory or judicial determination regarding the legal status of our products could have material adverse consequences for our business, operating results and prospects.

Significantly, in October 2005, the DOJ made available to the public proposed legislation the agency has drafted amending the Gambling Devices Act, 15 U.S.C. § 1171, *et seq*. (commonly referred to as the Johnson Act). The proposed legislation, if enacted, could materially and adversely affect our Class II gaming market. The proposed legislation would classify electronic technologic aids used by Native American tribes in Class II games, such as bingo, as gambling devices, and would authorize the use of such Class II devices by Native American tribes only if such devices are certified by the NIGC as Class II technologic aids. The proposed legislation authorizes the NIGC to promulgate regulations regarding the use of technologic aids. The NIGC regulations must maintain a distinction between Class II technologic aids and Class III gambling devices based upon the internal and external characteristics of the gambling devices and the manner in which the games using gambling devices are played.

In November 2005 Senator John McCain introduced legislation designed in part to expand the authority of the NIGC to review contracts between Native American tribes and their suppliers. It is likely that expanding the authority of the NIGC to include review of contracts such as those we typically enter into with our tribal customers, would significantly encumber our contracting process and may have the effect of delaying, modifying or preventing otherwise profitable contractual relationships.

The market for electronic Class II gaming terminals and systems is subject to continuing ambiguity, due to the difficulty of reconciling the Johnson Act s broad definition of gambling devices with the provisions of IGRA that expressly make legal the play of bingo and tribes use of electronic, computer, or other technological aids in the play of bingo. Issues surrounding the classification of our games as Class II games that may generally be offered by our tribal customers without a tribal-state compact, or as Class III games that can only be offered by the tribes pursuant to such a compact, have affected our business in the past, and continue to do so. Government enforcement, regulatory action, judicial decisions, or the prospects or rumors thereof have in the past and will continue to affect our business, operating results and prospects. Although some of our games have been reviewed and approved as legal Class II games by the NIGC, we have placed and continue to derive revenue from a significant number of gaming terminals running games that have not been so approved. Our business and operating results would likely be adversely affected, at least in the short term, by any significant regulatory enforcement action involving our games. The trading price of our common stock has in the past and may in the future be subject to significant fluctuations based upon market perceptions of the legal status of our products.

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Native American gaming activities involving our games and systems are also subject to regulation by state and local authorities, to the extent such gaming activities constitute, or are perceived to constitute, Class III gaming. Class III gaming is illegal in most states unless conducted by a tribe pursuant to a compact between a tribe and the state in which the tribe is located. The Class III video lottery systems we offer, such as the systems and terminals operating in Washington State, are subject to regulation by authorities in that state and to the terms of the compacts between the tribes offering such games and the State of Washington. Gaming activities under the new tribal-state compact in Oklahoma are subject to the terms of the compact between such tribes and the State of Oklahoma. Regulatory interpretations and enforcement actions by state regulators could have significant and immediate adverse impacts on our business and operating results.

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

We also face risks from a lack of regulatory or judicial enforcement action. In particular, we believe we have lost market share to competitors who offer games that do not appear to comply with published regulatory restrictions on Class II games, and thereby offer features not available in our products.

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

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

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

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

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

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

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

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

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

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

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

As we expand into new markets, we expect to encounter business, legal and regulatory uncertainties similar to those we face in our Native American gaming business. Our strategy is to attempt to be an early entrant into new and evolving markets where the legal and regulatory environment may not be well settled or well understood. As a result, we may encounter legal and regulatory challenges that are difficult or impossible to foresee and which could result in an unforeseen adverse impact on planned revenues or costs associated with the new market opportunity. Regulatory action against our customers or equipment in these or in other markets could result in machine seizures and significant revenue disruptions, among other adverse consequences.

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

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

- Whether our resources and expertise will enable us to effectively operate and grow in such new markets;
- Whether our internal processes and controls will continue to function effectively within these new segments;
- Whether we have enough experience to accurately predict revenues and expenses in these new segments;
- Whether the diversion of management attention and resources from our traditional business, caused by entering into new market segments, will have harmful effects on our traditional business;
- Whether we will be able to successfully compete against larger companies who dominate the markets that we are trying to enter; and
- Whether we can timely perform under our agreements in these new markets.

We have only recently begun to develop international business, and we have realized revenue from the sale of an Electronic Instant Lottery System to the Israel National Lottery during fiscal 2006 and from contracts to supply Electronic Bingo Terminals to casinos in Mexico during fiscal 2006. Neither our transaction in Israel nor in Mexico has been profitable to date or is currently profitable, and may not lead to future profitable business. To date, there are not as many permanent facilities opened in Mexico as we originally projected, and the hold per day in certain of the open facilities in Mexico has not met our original expectations. There can be no assurances that our games will gain market acceptance in Mexico, additional facilities will open in Mexico, or that the hold per day will increase in those facilities in Mexico currently not meeting our expectations. International transactions are subject to various risks, including:

- Currency fluctuations;
- Higher operating costs due to local laws or regulations;
- Unexpected changes in regulatory requirements;
- Costs and risks of localizing products for foreign countries;
- Difficulties in staffing and managing geographically disparate operations;
- Greater difficulty in safeguarding intellectual property, licensing and other trade restrictions;
- Challenges negotiating and enforcing contractual provisions;

Repatriation of earnings; and

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

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

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

We provide linked interactive electronic bingo systems and gaming terminals to charitable bingo operations in Alabama. During January 2004, we began placing gaming terminals in Alabama, and as of December 31, 2006, we had 2,371 gaming terminals at three facilities. The Attorney General of Alabama has recently completed a review of the gaming within the state. He concluded that the games that we were operating in Alabama were a legal form of bingo. He also concluded that two of the facilities are operating under a valid constitutional amendment authorizing the facilities the ability to play electronic bingo. The municipal and county authorities who regulate gaming in Alabama look to the NIGC and Class II regulations for guidance in adopting, interpreting and enforcing the municipal and county regulations permitting the operation of our machines in such counties and municipalities. To the extent these authorities rely on the NIGC s standards, any determinations by the NIGC or developments in Class II regulations which negatively impact our games and systems may, therefore, be adopted by the counties and municipalities and negatively impact the operation of our business in Alabama.

We have excess player stations not deployed at December 31, 2006, which were intended to be deployed at facilities in Mexico. If the opening of facilities is altered negatively, either by significant delay, or by cancellation, the realizable value of these assets could be reduced. In such instances we may be required to recognize increased expense on our income statement related to the impairment of these assets.

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

Our future performance will depend primarily on our ability to successfully and cost-effectively enter new gaming markets, and develop and introduce new and enhanced gaming systems and content that will be widely accepted both by our customers and their end users. We believe our business requires us to continually offer games and technology that play quickly and provide more entertainment value than those our competitors offer. However, consumer preferences can be difficult to predict, and we may offer new games or technologies that do not achieve market acceptance. In addition, we may experience future delays in game development, or we may not be successful in developing, introducing, and marketing new games or game enhancements on a timely and cost-effective basis.

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

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

For the three months ended December 31, 2006 and 2005, approximately 58% and 59%, respectively, of our gaming revenues were from Native American tribes located in Oklahoma, and approximately 42% and 40%, respectively, of our gaming revenues were from one tribe in that state. The significant concentration of our customers in Oklahoma means that local economic changes may adversely affect our customers, and therefore our business, disproportionately to changes in national economic conditions, including more sudden adverse economic declines or slower economic recovery from prior declines. The loss of any of our Oklahoma tribes as customers would have a material and adverse effect upon our financial condition and results of operations. In addition, the recent legislation allowing tribal-state compacts in Oklahoma has resulted in increased competition from other vendors, who we believe have avoided entry into the Oklahoma market due to its uncertain and ambiguous legal environment. The new legislation allows for other types of gaming, both at tribal gaming facilities and at Oklahoma racetracks. The loss of significant market share to these new gaming opportunities or our competitors products in Oklahoma could also have a material adverse effect upon our financial condition and results of operations.

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

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

In May 2004, the Oklahoma Legislature passed legislation authorizing certain forms of gaming at racetracks, and additional types of games at tribal gaming facilities, pursuant to a tribal-state compact. This legislation was subject to approval in a statewide referendum, which was subsequently obtained in the November 2004 elections. The Oklahoma gaming legislation allows the tribes to sign a compact with the State of Oklahoma to operate an unlimited number of electronic instant bingo games, electronic bonanza-style bingo games, electronic amusement games, and non-house-banked tournament card games. In addition, certain horse tracks in Oklahoma will be allowed to operate a limited number of instant and bonanza-style bingo games and electronic amusement games. As of December 31, 2006, we had placed 3,324 gaming terminals at 29 facilities that are operating under the Oklahoma compact. All vendors placing games at any of the racetracks under the compact will ultimately be required to be licensed by the State of Oklahoma. Pursuant to the compacts, vendors placing games at tribal facilities will have to be licensed by each tribe. All electronic games placed under the compact will have to be certified by independent testing laboratories to meet technical specifications. These technical specifications were published by the Oklahoma Horse Racing Commission and the individual tribal gaming authorities in the first calendar quarter of 2005. To date, independent testing labs have given wide latitude as to what constitutes a compliant game.

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We believe the recently adopted Oklahoma legislation significantly clarifies and expands the types of gaming permitted by Native American tribes in Oklahoma. We currently expect continued intensified competition from vendors currently operating in Oklahoma as well as from new market entrants. As a result, we anticipate further pressure on our market and revenue share percentages in Oklahoma. We believe the recent introduction of more aggressive instant bingo machines, with characteristics of traditional slot machines, into the Oklahoma market could adversely affect our operating results and market position in that state.

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

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

Although we believe our agreements with WMS and Aristocrat position us to compete effectively as resellers of Class III gaming equipment in the Oklahoma market and we also have plans to compete in the Oklahoma market by offering our own proprietary Class III gaming systems, there can be no assurance that our Class III offerings in Oklahoma will be successful or achieve market acceptance. If we are unsuccessful at converting our networked Class II player terminals into stand alone Class III player terminals in Oklahoma, our future operating results would be adversely affected.

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

We enter into development agreements to provide financing for construction and/or remodeling of gaming facilities, primarily in the state of Oklahoma. Under our development agreements, we secure a long-term revenue share percentage and a fixed number of gaming terminal placements in the facility, in exchange for development and construction funding.

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

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

The NIGC has expressed its view that our development agreements violate the requirements of IGRA and tribal gaming regulations, which state that the Native American tribes must hold sole proprietary interest in the tribes gaming operations, which presents additional risks for our business. See Certain Risk Factors Changes in regulation or regulatory interpretations could require us to modify the terms of our contracts with customers.

In addition, certain of the agreements contain performance standards for our gaming terminals that could allow the facility to reduce a portion of our gaming terminals. We are aware that certain of our games may not currently meet these performance standards and that, accordingly, certain of our customers may have contractual rights to reduce the percentage of our machines in their facilities.

In the past we have, and in the future we expect to, reduce our floor space in certain of our Class II facilities as a result of ongoing competitive pressures faced by our customers from alternative gaming facilities and faced by our machines from competitors products. In addition, future NIGC decisions could affect our ability to place our games with these tribes. See Certain Risk Factors Enforcement of remedies or contracts against Native American tribes could be difficult.

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

We compete with other vendors for customers, primarily on the basis of the amount of profit our gaming products generate for our customers in relation to other vendors gaming products. We believe that the most important factor influencing our customers product selection is the appeal of those products to end users. This appeal has a direct effect on the volume of play by end users, and drives the amount of revenues generated for and by our customers. Our ability to remain competitive depends primarily on our ability to continuously develop new game themes and systems that appeal to end users, and to introduce those game themes and systems in a timely manner. See Certain Risk Factors Our future performance will depend on our ability to develop and introduce new gaming systems and to enhance existing games that are widely accepted and played. We may not be able to continue to develop and introduce appealing new game themes and systems that meet the emerging requirements in a timely manner, or at all. In addition, others may independently develop games similar to our games, and competitors may introduce noncompliant games that unfairly compete in certain markets due to uneven regulatory enforcement policies.

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

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

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

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

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

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

We rely upon patent, copyright, trademark and trade secret laws, license agreements and employee nondisclosure agreements to protect our proprietary rights and technology, but these laws and contractual provisions provide only

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

Our contracts with Native American customers include a limited waiver of each tribe s sovereign immunity, and generally provide that any dispute regarding interpretation, performance or enforcement shall be submitted to, and resolved by, arbitration in accordance with the Commercial Arbitration Rules of the American Arbitration Association, and that any award, determination, order or relief resulting from such arbitration is binding and may be entered in any court having jurisdiction. In the event that such waiver of sovereign immunity is held to be ineffective, we could be precluded from judicially enforcing any rights or remedies against a tribe. These rights and remedies include, but are not limited to, our right to enter Native American lands to retrieve our property in the event of a breach of contract by the tribe party to that contract.

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

We may incur prize payouts in excess of game revenues.

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

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

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

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

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

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

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

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

Worsening economic conditions may adversely affect our business.

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

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

We did not repurchase shares of its common stock during the most recently completed quarter. As of December 31, 2006, the maximum number of shares that may be repurchased under the plans or programs was approximately 887,000. For a description of our authorized stock repurchase plans, see PART I Item 2. Management s Discussion and Analysis of Financial Condition and Results of Operations.

ITEM 3. DEFAULTS UPON SENIOR SECURITIES

None.

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

None.

ITEM 5. OTHER INFORMATION

None.

ITEM 6. EXHIBITS

(a) Exhibits

See Exhibit Index.

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SIGNATURES

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

Date: February 9, 2006

Multimedia Games, Inc.

By: /s/ Randy S. Cieslewicz
Randy S. Cieslewicz
Interim Chief Financial Officer

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

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EXHIBIT INDEX

EXHIBIT NO.	TITLE	LOCATION
3.1	Amended and Restated Articles of Incorporation	(1)
3.2	Amendment to Articles of Incorporation	(2)
3.3	Amended and Restated Bylaws	(3)
10.1	Agreement dated October 24, 2006 by and among Multimedia Games, Inc. and Liberation Investments, L.P., a Delaware limited partnership (LILP), Liberation Investments, Ltd., a private offshore investment corporation (LILtd), Liberation Investment Group, LLC, a Delaware limited liability company and general partner of LILP and a discretionary investment	(4)
10.2	Consulting Agreement dated October 23, 2006 by and between Multimedia Games, Inc. and Sarnoff Entertainment Corporation	(4)
31.1	Certification of Chief Executive Officer, pursuant to Section 302 of the Sarbanes Oxley Act of 2002	(*)
31.2	Certification of Chief Financial Officer, pursuant to Section 302 of the Sarbanes Oxley Act of 2002	(*)
32.1	Certification of the Chief Executive Officer and Chief Financial Officer, Pursuant to U.S.C. Section 1350, as adopted, pursuant to Section 906 of the Sarbanes Oxley Act of 2002	(*)

(1) Incorporated by reference to our Form 10-QSB filed with the Securities and Exchange Commission, or SEC, for the quarter ended March 31, 1997.
(2) Incorporated by reference to our Form 10-Q filed with the SEC for the quarter ended December 31, 2003.
(3) Incorporated by reference to our Form 10-K filed with the SEC for the fiscal year ended September 30, 2003.
(4) Incorporated by reference to our Form 8-K filed with the Securities and Exchange Commission on October 26, 2006.
(*) Filed herewith.