

SCIENTIFIC GAMES CORP  
Form 10-Q/A  
August 14, 2003

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**UNITED STATES  
SECURITIES AND EXCHANGE COMMISSION**

Washington, D.C. 20549

**Form 10-Q/A  
AMENDMENT NO. 1**

{Mark One}

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

For the quarterly period ended September 30, 2002

OR

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

Commission File number: 0-13063

**SCIENTIFIC GAMES CORPORATION**

(Exact name of registrant as specified in its charter)

**Delaware**

(State or other jurisdiction of  
incorporation or organization)

**81-0422894**

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

**750 Lexington Avenue, New York, New York 10022**

(Address of principal executive offices)

(Zip Code)

**(212) 754-2233**

(Registrant's telephone number, including area code)

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

APPLICABLE ONLY TO CORPORATE ISSUERS:

Indicate the number of shares outstanding of each of the issuer's classes of common stock as of November 12, 2002:

Class A Common Stock: 58,380,625

Class B Common Stock: None

**SCIENTIFIC GAMES CORPORATION AND SUBSIDIARIES**

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AND OTHER INFORMATION**

**THREE MONTHS ENDED SEPTEMBER 30, 2002**

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**EXPLANATORY NOTE**

This Amendment No. 1 on Form 10-Q/A filed by Scientific Games Corporation (the "Company") amends the Company's Quarterly Report on Form 10-Q for the quarterly period ended September 30, 2002.

Subsequent to the filing of such Quarterly Report, it was determined that a portion of the deferred tax asset, in the form of a net operating loss carryforward, recognized by the Company in the fourth quarter of 2002 should have been recognized at the time of the Company's acquisition of Scientific Games Holdings Corp. ("SGHC") on September 6, 2000 as a reduction to the goodwill resulting from the acquisition of SGHC. Accordingly, the Company has amended and restated its consolidated financial statements as of and for the year ended October 31, 2000, the two-month period ended December 31, 2000, each of the quarterly periods in the years ended December 31, 2001 and 2002, and the years ended December 31, 2001 and 2002. This Form 10-Q/A is being filed to give effect to such amendments and restatements by amending and

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restating the following sections of the Company's Quarterly Report: (i) Financial Statements (including the Notes to Consolidated Financial Statements) (Part I, Item 1); and (ii) Management's Discussion and Analysis of Financial Condition and Results of Operations (Part I, Item 2). For convenience, Parts I and II of the Company's Quarterly Report are included in their entirety in this Form 10-Q/A, although the items therein are not amended except as specifically indicated in this explanatory note. In addition to the foregoing amendments, (x) Item 6 of Part II (Exhibits and Reports on Form 8-K) is being amended to include currently dated certifications of the Company's Chief Executive Officer and Chief Financial Officer pursuant to Section 906 of the Sarbanes-Oxley Act of 2002 as Exhibits 99.1 and 99.2, respectively, and (y) the Quarterly Report is also being amended to include currently dated certifications of the Company's Chief Executive Officer and Chief Financial Officer pursuant to Section 302 of the Sarbanes-Oxley Act of 2002 and to reflect such certifications in Disclosure Controls and Procedures (Part I, Item 4). No other information in the Company's Quarterly Report is being amended by this Form 10-Q/A.

The Company has not updated the information in this Form 10-Q/A to speak as of a date after the filing of the Company's Quarterly Report, and this Form 10-Q/A does not amend or update the information in such Quarterly Report in any way other than to give effect to the amendments and restatements described above, to the extent specified.

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### SCIENTIFIC GAMES CORPORATION AND SUBSIDIARIES CONSOLIDATED BALANCE SHEETS (In thousands, except per share amounts)

	<u>Restated December 31, 2001</u>	<u>Restated September 30, 2002</u>
	(Audited)	(Unaudited)
<b>ASSETS</b>		
Current assets:		
Cash and cash equivalents	\$ 12,649	8,821
Restricted cash	708	753
Accounts receivable, net of allowance for doubtful accounts	50,410	55,622
Inventories	19,547	29,785
Prepaid expenses, deposits and other current assets	14,829	12,089
	<u>98,143</u>	<u>107,070</u>
Property and equipment, at cost	364,837	390,713
Less accumulated depreciation	168,049	193,760
	<u>196,788</u>	<u>196,953</u>
Goodwill, net	179,099	183,460
Other intangible assets, net	60,169	58,133
Other assets and investments	51,597	46,310
	<u>585,796</u>	<u>591,926</u>
<b>Total assets</b>	<b>\$ 585,796</b>	<b>591,926</b>
<b>LIABILITIES AND STOCKHOLDERS' EQUITY</b>		
Current liabilities:		
Current installments of long-term debt	\$ 9,437	12,201
Accounts payable	26,632	22,529

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	Restated December 31, 2001	Restated September 30, 2002
Accrued liabilities	51,118	49,394
Interest payable	8,381	2,068
<b>Total current liabilities</b>	<b>95,568</b>	<b>86,192</b>
Deferred income taxes	16,250	23,525
Other long-term liabilities	23,440	24,102
Long-term debt, excluding current installments	430,298	334,583
<b>Total liabilities</b>	<b>565,556</b>	<b>468,402</b>
<b>Commitments and contingencies</b>		
<b>Stockholders' equity:</b>		
Series A convertible preferred stock, par value \$1.00 per share, 1,600 shares authorized, 1,220 and 1,275 shares outstanding at December 31, 2001 and September 30, 2002, respectively	1,220	1,275
Series B preferred stock, par value \$1.00 per share, 2 shares authorized, none and 1.238 shares outstanding at December 31, 2001 and September 30, 2002, respectively		1
Class A common stock, par value \$0.01 per share, 199,300 shares authorized, 41,203 and 57,529 shares outstanding at December 31, 2001 and September 30, 2002, respectively	412	575
Class B non-voting common stock, par value \$0.01 per share, 700 shares authorized, none outstanding		
Additional paid-in capital	275,510	380,131
Accumulated losses	(246,383)	(252,610)
Treasury stock, at cost	(135)	(1,418)
Accumulated other comprehensive loss	(10,384)	(4,430)
<b>Total stockholders' equity</b>	<b>20,240</b>	<b>123,524</b>
<b>Total liabilities and stockholders' equity</b>	<b>\$ 585,796</b>	<b>591,926</b>

See accompanying notes to consolidated financial statements.

**SCIENTIFIC GAMES CORPORATION AND SUBSIDIARIES**  
**CONSOLIDATED STATEMENTS OF OPERATIONS**  
**Three Months Ended September 30, 2001 and 2002**  
**(Unaudited, in thousands, except per share amounts)**

	Restated 2001	Restated 2002
<b>Operating revenues:</b>		
Services	\$ 93,418	93,932
Sales	13,785	21,220

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	Restated 2001	Restated 2002
	<u>107,203</u>	<u>115,152</u>
<b>Operating expenses (exclusive of depreciation and amortization shown below):</b>		
Services	57,603	54,846
Sales	9,367	14,233
Amortization of service contract software (Note 2)	1,179	1,233
	<u>68,149</u>	<u>70,312</u>
Total gross profit	39,054	44,840
Selling, general and administrative expenses	13,166	14,812
Depreciation and amortization	12,111	9,066
	<u>13,777</u>	<u>20,962</u>
<b>Operating income</b>		
	<u>13,777</u>	<u>20,962</u>
<b>Other deductions:</b>		
Interest expense	12,322	9,783
Other (income) expense	(72)	670
	<u>12,250</u>	<u>10,453</u>
Income before income tax expense and extraordinary item	1,527	10,509
Income tax expense	2,948	1,443
	<u>1,527</u>	<u>10,509</u>
Income (loss) before extraordinary item	(1,421)	9,066
Extraordinary item, net of tax early retirement of debt		14,853
	<u>(1,421)</u>	<u>9,066</u>
Net loss	(1,421)	(5,787)
Convertible preferred stock paid-in-kind dividend	1,790	1,899
	<u>1,790</u>	<u>1,899</u>
Net loss available to common stockholders	\$ (3,211)	(7,686)
	<u>\$ (3,211)</u>	<u>(7,686)</u>
<b>Basic and diluted net income (loss) per share (Note 2):</b>		
Basic income (loss) before extraordinary item available to common stockholders	\$ (0.08)	0.13
	<u>\$ (0.08)</u>	<u>0.13</u>
Diluted income (loss) before extraordinary item available to common stockholders	\$ (0.08)	0.10
	<u>\$ (0.08)</u>	<u>0.10</u>
Basic extraordinary item, net of tax	\$	(0.26)
	<u>\$</u>	<u>(0.26)</u>
Diluted extraordinary item, net of tax	\$	(0.17)
	<u>\$</u>	<u>(0.17)</u>
Basic net loss available to common stockholders	\$ (0.08)	(0.13)
	<u>\$ (0.08)</u>	<u>(0.13)</u>
Diluted net loss available to common stockholders	\$ (0.08)	(0.07)
	<u>\$ (0.08)</u>	<u>(0.07)</u>
<b>Weighted average number of shares used in per share calculations:</b>		
Basic shares	40,383	57,301

	Restated 2001	Restated 2002
Diluted shares	40,383	87,360

See accompanying notes to consolidated financial statements.

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**SCIENTIFIC GAMES CORPORATION AND SUBSIDIARIES**  
**CONSOLIDATED STATEMENTS OF OPERATIONS**  
**Nine Months Ended September 30, 2001 and 2002**  
**(Unaudited, in thousands, except per share amounts)**

	Restated 2001	Restated 2002
Operating revenues:		
Services	\$ 273,098	283,195
Sales	58,786	53,196
	<u>331,884</u>	<u>336,391</u>
Operating expenses (exclusive of depreciation and amortization shown below):		
Services	173,664	163,332
Sales	36,088	35,147
Amortization of service contract software (Note 2)	3,136	3,656
	<u>212,888</u>	<u>202,135</u>
Total gross profit	118,996	134,256
Selling, general and administrative expenses	41,812	44,925
Depreciation and amortization	36,352	27,932
	<u>40,832</u>	<u>61,399</u>
Operating income	40,832	61,399
Other deductions:		
Interest expense	38,610	32,795
Other expense	109	441
	<u>38,719</u>	<u>33,236</u>
Income before income tax expense and extraordinary item	2,113	28,163
Income tax expense	5,145	13,984
	<u>(3,032)</u>	<u>14,179</u>
Income (loss) before extraordinary item	(3,032)	14,179
Extraordinary item, net of tax early retirement of debt		14,853
	<u>(3,032)</u>	<u>(674)</u>
Net loss	(3,032)	(674)
Convertible preferred stock paid-in-kind dividend	5,233	5,553

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	Restated 2001	Restated 2002
	<u>          </u>	<u>          </u>
Net loss available to common stockholders	\$ (8,265)	(6,227)
	<u>          </u>	<u>          </u>
<b>Basic and diluted net income (loss) per share (Note 2):</b>		
Basic income (loss) before extraordinary item available to common stockholders	\$ (0.21)	0.18
	<u>          </u>	<u>          </u>
Diluted income (loss) before extraordinary item available to common stockholders	\$ (0.21)	0.16
	<u>          </u>	<u>          </u>
Basic extraordinary item, net of tax	\$	(0.31)
	<u>          </u>	<u>          </u>
Diluted extraordinary item, net of tax	\$	(0.28)
	<u>          </u>	<u>          </u>
Basic net loss available to common stockholders	\$ (0.21)	(0.13)
	<u>          </u>	<u>          </u>
Diluted net loss available to common stockholders	\$ (0.21)	(0.12)
	<u>          </u>	<u>          </u>
<b>Weighted average number of shares used in per share calculations:</b>		
Basic shares	40,252	47,518
	<u>          </u>	<u>          </u>
Diluted shares	40,252	53,877
	<u>          </u>	<u>          </u>

See accompanying notes to consolidated financial statements.

**SCIENTIFIC GAMES CORPORATION AND SUBSIDIARIES**  
**CONDENSED CONSOLIDATED STATEMENTS OF CASH FLOWS**  
**Nine Months Ended September 30, 2001 and 2002**  
**(Unaudited, in thousands)**

	Restated 2001	Restated 2002
	<u>          </u>	<u>          </u>
<b>Cash flows from operating activities:</b>		
Net loss	\$ (3,032)	(674)
	<u>          </u>	<u>          </u>
<b>Adjustments to reconcile net income to cash provided by operating activities:</b>		
Depreciation and amortization	39,488	31,588
Non-cash interest expense	1,797	1,740
Changes in operating assets and liabilities, net of effects of business acquisitions	(243)	(24,577)
Extraordinary item early retirement of debt		14,853
Other	3,354	9,355
	<u>          </u>	<u>          </u>
Total adjustments	44,396	32,959
	<u>          </u>	<u>          </u>

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	Restated 2001	Restated 2002
Net cash provided by operating activities	41,364	32,285
<b>Cash flows from investing activities:</b>		
Capital expenditures	(5,103)	(10,995)
Wagering systems expenditures	(25,329)	(8,457)
Business acquisition, net of cash acquired		(4,104)
Increase in other assets and liabilities, net	(9,776)	(5,255)
Net cash used in investing activities	(40,208)	(28,811)
<b>Cash flows from financing activities:</b>		
Net borrowings (repayments) under lines of credit	3,000	(4,230)
Payments on long-term debt	(4,392)	(102,485)
Proceeds from the issuance of common stock	552	97,749
Net cash used in financing activities	(840)	(8,966)
Effect of exchange rate changes on cash	(190)	1,664
Increase (decrease) in cash and cash equivalents	126	(3,828)
Cash and cash equivalents, beginning of period	6,488	12,649
Cash and cash equivalents, end of period	\$ 6,614	8,821
<b>Supplemental disclosure of cash flow information:</b>		
<b>Cash paid during the period for:</b>		
Interest	\$ 44,209	37,716
Net income taxes	\$ 490	2,318
<b>Non-cash financing activity during the period:</b>		
Convertible preferred stock paid-in-kind dividends	\$ 5,233	5,553
Write-off of deferred financing fees included in extraordinary item	\$	3,452

See accompanying notes to consolidated financial statements.

**SCIENTIFIC GAMES CORPORATION AND SUBSIDIARIES**  
**NOTES TO CONSOLIDATED FINANCIAL STATEMENTS**  
(Unaudited, in thousands, except per share amounts)

**(1) Restatement of Previously Reported Financial Statements**

Subsequent to the issuance of the Company's consolidated financial statements for the year ended December 31, 2002 and the quarterly period ended March 31, 2003, it was determined that a portion of the deferred tax asset, in the form of a net operating loss carryforward



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("NOL"), recognized in the fourth quarter of 2002, should have been recognized at the time of the acquisition of Scientific Games Holdings Corp. ("SHGC") on September 6, 2000 as a reduction to the goodwill resulting from the acquisition of SGHC. As a result: (i) deferred tax assets recognized at the date of the acquisition of SGHC have been increased with a corresponding reduction in the carrying value of SGHC goodwill; (ii) goodwill amortization has been reduced for the periods from the date of acquisition of SGHC through December 31, 2001; and (iii) deferred income tax assets recognized during the period from the date of the acquisition of SGHC through December 31, 2002 have been adjusted to reflect the amount considered more likely than not realizable based on the reversing effect of taxable or deductible temporary differences and the Company's NOL. In addition, the Company's restated income tax expense for the first quarter of fiscal 2002 reflects a charge of \$9,790 related to the adoption of Statement of Financial Accounting Standards No. 142, Goodwill and Other Intangible Assets ("SFAS 142"), which caused a reduction in the recorded amount of the NOL to reflect the reduction in the amount of net taxable temporary differences that are expected to reverse during the NOL carryforward period because of the cessation of amortization of certain indefinite lived intangible assets. The restatements did not impact the amounts presented in the consolidated statements of cash flows for net cash provided by operating activities, net cash used in investing activities or net cash provided by or used in financing activities in any of the restated periods, although it did impact certain non-cash components of cash flows from operating activities.

Accordingly, the Company has amended and restated its consolidated financial statements for the year ended October 31, 2000, the two-month period ended December 31, 2000, each of the quarterly periods in the years ended December 31, 2001 and 2002 and the years ended December 31, 2001 and 2002. Conforming changes reflecting these revisions have been made in the Company's Management's Discussion and Analysis of Financial Condition and Results of Operations and Consolidated Financial Statements and Notes to Consolidated Financial Statements.

The effects of the restatement on previously reported consolidated financial statements at December 31, 2001 and for the quarter and nine months ended September 30, 2001 and 2002 are summarized below.

	December 31, 2001		September 30, 2002	
	As Previously Reported	As Restated	As Previously Reported	As Restated
<b>Selected Balance Sheet Data:</b>				
Goodwill, net	\$ 195,255	179,099	199,616	183,460
Total assets	601,952	585,796	608,082	591,926
Deferred income taxes	28,568	16,250	25,167	23,525
Accumulated losses	(242,545)	(246,383)	(238,096)	(252,610)
Total stockholders' equity	24,078	20,240	138,038	123,524
Total liabilities and stockholders' equity	\$ 601,952	585,796	608,082	591,926

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	Quarter Ended September 30, 2001		Quarter Ended September 30, 2002		Nine Months Ended September 30, 2001		Nine Months Ended September 30, 2002	
	As Previously Reported	As Restated	As Previously Reported	As Restated	As Previously Reported	As Restated	As Previously Reported	As Restated
Depreciation and amortization	\$ 12,599	12,111	9,066	9,066	37,818	36,352	27,932	27,932
Operating income	13,289	13,777	20,962	20,962	39,366	40,832	61,399	61,399
Income before income tax expense (benefit) and extraordinary item	1,039	1,527	10,509	10,509	647	2,113	28,163	28,163
Income tax expense (benefit)	(483)	2,948	1,215	1,443	(378)	5,145	3,308	13,984
Income (loss) before extraordinary item	1,522	(1,421)	9,294	9,066	1,025	(3,032)	24,855	14,179
Net income (loss)	1,522	(1,421)	(5,559)	(5,787)	1,025	(3,032)	10,002	(674)
Net income (loss) available to common stockholders	\$ (268)	(3,211)	(7,458)	(7,686)	(4,208)	(8,265)	4,449	(6,227)

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	Quarter Ended September 30, 2001		Quarter Ended September 30, 2002		Nine Months Ended September 30, 2001		Nine Months Ended September 30, 2002		
Basic and diluted net income (loss) per share:									
Basic income (loss) before extraordinary item available to common stockholders	\$	(0.01)	(0.08)	0.13	0.13	(0.10)	(0.21)	0.41	0.18
Diluted income (loss) before extraordinary item available to common stockholders	\$	(0.01)	(0.08)	0.11	0.10	(0.10)	(0.21)	0.32	0.16
Basic extraordinary item, net of tax				(0.26)	(0.26)			(0.31)	(0.31)
Diluted extraordinary item, net of tax				(0.17)	(0.17)			(0.19)	(0.28)
Basic net income (loss) available to common stockholders	\$	(0.01)	(0.08)	(0.13)	(0.13)	(0.10)	(0.21)	0.09	(0.13)
Diluted net income (loss) available to common stockholders	\$	(0.01)	(0.08)	(0.06)	(0.07)	(0.10)	(0.21)	0.13	(0.12)
Weighted average number of shares used in per share calculations:									
Basic Shares		40,383	40,383	57,301	57,301	40,252	40,252	47,518	47,518
Diluted Shares		40,383	40,383	87,360	87,360	40,252	40,252	77,790	53,877

**(2) Consolidated Financial Statements**

*Basis of Presentation*

The consolidated balance sheet as of September 30, 2002 and the consolidated statements of operations for the three and nine months ended September 30, 2001 and 2002, and the consolidated condensed statements of cash flows for the nine months then ended, have been prepared by the Company without audit. In the opinion of management, all adjustments necessary to present fairly the financial position of the Company at September 30, 2002 and the results of its operations for the three

and nine months ended September 30, 2001 and 2002 and its cash flows for the nine months ended September 30, 2001 and 2002 have been made.

Certain information and footnote disclosures normally included in financial statements prepared in accordance with accounting principles generally accepted in the United States of America have been condensed or omitted. These consolidated financial statements should be read in conjunction with the financial statements and notes thereto included in the Company's 2001 Annual Report on Form 10-K, as modified by the foregoing. The results of operations for the period ended September 30, 2002 are not necessarily indicative of the operating results for the full year.

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Certain items in prior periods' financial statements have been classified to conform with the current year presentation. The consolidated statements of operations reflect the reclassification of "amortization of service contract software" as a component of operating expenses, which amounts had been included in depreciation and amortization in previous years' filings.

### *Basic and Diluted Net Income (Loss) Per Share*

The following represents a reconciliation of the numerator and denominator used in computing basic and diluted income (loss) available to common stockholders per share for the three and nine months ended September 30, 2001 and 2002:

	Three Months Ended September 30,		Nine Months Ended September 30,	
	Restated 2001	Restated 2002	Restated 2001	Restated 2002
<b>Income (loss) (numerator)</b>				
Net loss available to common stockholders	\$ (3,211)	(7,686)	(8,265)	(6,227)
Add back extraordinary item		14,853		14,853
Income (loss) before extraordinary item available to common stockholders (basic)	(3,211)	7,167	(8,265)	8,626
Add back preferred stock paid-in-kind dividend (1)		1,899		
Income (loss) before extraordinary item and preferred dividend available to common stockholders (diluted)	\$ (3,211)	9,066	(8,265)	8,626
Extraordinary item early retirement of debt (basic and diluted)	\$	14,853		14,853
Net income (loss) after extraordinary item available to common stockholders (basic)	(3,211)	(7,686)	(8,265)	(6,227)
Add back preferred stock paid-in-kind dividend(1)		1,899		
Net loss after extraordinary item, without preferred dividend, available to common stockholders (diluted)	\$ (3,211)	(5,787)	(8,265)	(6,227)

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	Three Months Ended September 30,		Nine Months Ended September 30,	
	Restated 2001	Restated 2002	Restated 2001	Restated 2002
<b>Shares (denominator)</b>				
Basic weighted average common shares outstanding	40,383	57,301	40,252	47,518
Effect of diluted securities-stock options, warrants, convertible preferred shares and deferred shares(2)(3)		30,059		6,359
Diluted weighted average common shares outstanding	40,383	87,360	40,252	53,877
<b>Basic and diluted per share amounts</b>				
Basic income (loss) per share before extraordinary item available to common stockholders	\$ (0.08)	0.13	(0.21)	0.18

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	Three Months Ended September 30,		Nine Months Ended September 30,		
Diluted income (loss) per share before extraordinary item available to common stockholders(2)(3)	\$	(0.08)	0.10	(0.21)	0.16
Basic extraordinary item, net of tax per share	\$		(0.26)		(0.31)
Diluted extraordinary item, net of tax per share(3)	\$		(0.17)		(0.28)
Basic net income (loss) per share available to common stockholders	\$	(0.08)	(0.13)	(0.21)	(0.13)
Diluted net income (loss) per share available to common stockholders(3)	\$	(0.08)	(0.07)	(0.21)	(0.12)

(1) Series A Convertible Preferred Stock paid-in-kind dividend is not included in the calculation of diluted net income per share in the three months ended September 30, 2002 since the preferred stock is assumed to have been converted.

(2) Potential common shares are not included in the calculation of dilutive net loss per share in the three and nine months ended September 30, 2001 since the inclusion would be anti-dilutive.

(3) As per Statement of Financial Accounting Standards No. 128, *Earnings Per Share* ("SFAS 128"), whenever a company reports an extraordinary item, the same number of potential common shares used in computing the diluted per-share amounts for income before extraordinary items must be used in computing all other reported diluted per share amounts, even if those amounts are anti-dilutive to their respective basic per-share amounts.

At September 30, 2001 and 2002, the Company had outstanding stock options, warrants, Performance Accelerated Restricted Stock Units, and Series A Convertible Preferred Stock, which could potentially dilute basic earnings per share in the future. (See Notes 13 and 14 to the Consolidated Financial Statements for the year ended December 31, 2001 in the Company's 2001 Annual Report on Form 10-K, as modified by the foregoing.)

### (3) Acquisition of Interest in SERCHI

On June 5, 2002 the Company completed the purchase of 65% of the equity of Serigrafica Chilena S.A. ("SERCHI"). Subsequent to the acquisition, the Company changed the name of SERCHI to Scientific Games Latino America S.A. The purchase price was approximately \$3,900 in cash and up to \$4,355 in cash or stock payable to SERCHI stockholders upon the achievement of certain financial performance levels of SERCHI over the next four years. The acquisition was recorded using the purchase method of accounting and the acquired assets and liabilities have been recorded at their estimated fair values at the date of acquisition. The excess of the purchase price over the fair values of the net assets acquired is currently estimated to be approximately \$3,301 and has been recorded as goodwill. This estimate is subject to revisions until the valuations of SERCHI's assets and liabilities are completed. The operating results of the SERCHI business have been included in the consolidated statements of operations since the date of acquisition. Had the operating results of SERCHI been included as if the transaction had been consummated on January 1, 2002, the pro forma operating results of the Company for the three and nine month periods ended September 30, 2002 would not have been materially different.

### (4) Business Segments

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The following tables represent revenues, profits, depreciation, amortization, and capital expenditures for the three and nine months ended September 30, 2001 and 2002, and assets at September 30, 2001 and 2002, by business segment. Corporate expenses, interest expense and other (income) deductions are not allocated to business segments.

### Three Months Ended September 30, 2001

	Restated Lottery Group	Pari-Mutuel Group	Venue Management Group	Telecommunications Products Group	Restated Totals
Service revenues	\$ 57,201	21,053	15,164		93,418
Sales revenues	3,358	1,498		8,929	13,785
<b>Total revenues</b>	<b>60,559</b>	<b>22,551</b>	<b>15,164</b>	<b>8,929</b>	<b>107,203</b>
Cost of service	34,528	12,352	10,723		57,603
Cost of sales	2,410	862		6,095	9,367
Amortization of service contract software (Note 2)	513	666			1,179
<b>Total operating expenses</b>	<b>37,451</b>	<b>13,880</b>	<b>10,723</b>	<b>6,095</b>	<b>68,149</b>
Gross profit	23,108	8,671	4,441	2,834	39,054
Selling, general and administrative expenses	6,394	2,607	672	1,101	10,774
Depreciation and amortization	8,271	2,932	681	150	12,034
<b>Segment operating income</b>	<b>8,443</b>	<b>3,132</b>	<b>3,088</b>	<b>1,583</b>	<b>16,246</b>
Unallocated corporate expense					2,469
<b>Consolidated operating income</b>					<b>\$ 13,777</b>
Capital and wagering systems expenditures	\$ 7,084	461	224	192	7,961

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### Three Months Ended September 30, 2002

	Lottery Group	Pari-Mutuel Group	Venue Management Group	Telecommunications Products Group	Totals
Service revenues	\$ 56,568	21,326	16,038		93,932
Sales revenues	7,824	1,320		12,076	21,220
<b>Total revenues</b>	<b>64,392</b>	<b>22,646</b>	<b>16,038</b>	<b>12,076</b>	<b>115,152</b>
Cost of service	31,309	12,256	11,281		54,846
Cost of sales	5,450	674		8,109	14,233
Amortization of service contract software (Note 2)	570	663			1,233
<b>Total operating expenses</b>	<b>37,329</b>	<b>13,593</b>	<b>11,281</b>	<b>8,109</b>	<b>70,312</b>

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Three Months Ended September 30, 2002

Gross profit	27,063	9,053	4,757	3,967	44,840
Selling, general and administrative expenses	5,927	2,136	776	1,205	10,044
Depreciation and amortization	4,982	2,866	460	634	8,942
Segment operating income	16,154	4,051	3,521	2,128	25,854
Unallocated corporate expense					4,892
Consolidated operating income					\$ 20,962
Capital and wagering systems expenditures	\$ 2,826	2,721	325	64	5,936

Nine Months Ended September 30, 2001

	Restated Lottery Group	Pari-Mutuel Group	Venue Management Group	Telecom-munications Products Group	Restated Totals
Service revenues	\$ 165,952	60,657	46,489		273,098
Sales revenues	11,886	15,919		30,981	58,786
Total revenues	177,838	76,576	46,489	30,981	331,884
Cost of service	105,142	35,651	32,871		173,664
Cost of sales	7,801	9,768		18,519	36,088
Amortization of service contract software (Note 2)	1,191	1,945			3,136
Total operating expenses	114,134	47,364	32,871	18,519	212,888
Gross profit	63,704	29,212	13,618	12,462	118,996
Selling, general and administrative expenses	19,176	7,967	1,974	3,647	32,764
Depreciation and amortization	23,814	9,142	2,003	1,164	36,123
Segment operating income	20,714	12,103	9,641	7,651	50,109
Unallocated corporate expense					9,277
Consolidated operating income					\$ 40,832
Assets at September 30, 2001	\$ 295,201	221,809	33,044	35,742	585,796
Capital and wagering systems expenditures	\$ 25,405	3,051	759	1,217	30,432

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Nine Months Ended September 30, 2002

	Restated Lottery Group	Pari-Mutuel Group	Venue Management Group	Telecommunications Products Group	Restated Totals
Service revenues	\$ 174,092	61,983	47,120		283,195
Sales revenues	15,662	4,630		32,904	53,196
<b>Total revenues</b>	<b>189,754</b>	<b>66,613</b>	<b>47,120</b>	<b>32,904</b>	<b>336,391</b>
Cost of service	96,024	34,939	32,369		163,332
Cost of sales	11,158	2,219		21,770	35,147
Amortization of service contract software (Note 2)	1,691	1,965			3,656
<b>Total operating expenses</b>	<b>108,873</b>	<b>39,123</b>	<b>32,369</b>	<b>21,770</b>	<b>202,135</b>
Gross profit	80,881	27,490	14,751	11,134	134,256
Selling, general and administrative expenses	19,452	6,473	2,090	3,428	31,443
Depreciation and amortization	16,193	8,547	1,315	1,579	27,634
<b>Segment operating income</b>	<b>45,236</b>	<b>12,470</b>	<b>11,346</b>	<b>6,127</b>	<b>75,179</b>
Unallocated corporate expense					13,780
<b>Consolidated operating income</b>					<b>\$ 61,399</b>
Assets at September 30, 2002	\$ 295,588	223,021	35,037	38,280	591,926
Capital and wagering systems expenditures	\$ 10,620	6,220	1,270	1,342	19,452

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

	Three Months Ended September 30,		Nine Months Ended September 30,	
	Restated 2001	2002	Restated 2001	2002
Reportable consolidated operating income	\$ 13,777	20,962	40,832	61,399
Interest expense	12,322	9,783	38,610	32,795
Other (income) expense	(72)	670	109	441
Income before income tax expense and extraordinary item	\$ 1,527	10,509	2,113	28,163

**(5) Comprehensive Income (Loss)**

*Foreign Exchange Agreements*

During the third quarter of 2002, the Company entered into derivative contracts to hedge part of its foreign currency exposure with respect to future cash receipts under its contract with the Ontario Lottery Commission. These instruments, which have a notional value of Canadian

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dollars \$17,333, have been designated as cash flow hedges. For the three months and nine months ended September 30, 2002, the Company recorded a credit to comprehensive income (loss) of \$162 for the change in the fair value of these foreign exchange instruments.

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### *Interest Rate Agreements*

Statement of Financial Accounting Standards No. 133, *Accounting for Derivative Instruments and Hedging Activities* ("SFAS 133"), as amended by SFAS 138, *Accounting for Certain Derivative Instruments and Certain Hedging Activities* an amendment of FASB Statement No. 133, establishes accounting and reporting standards for derivative instruments and hedging activities. It requires entities to record all derivative instruments on the balance sheet at fair value. Changes in the fair value of derivatives are recorded in each period in current operations or other comprehensive income (loss), based on whether a derivative is designated as part of a hedge transaction and the type of hedge transaction. The ineffective portion of all hedges is recognized in operations.

Pursuant to the terms of the Company's credit facility, the Company is required to maintain interest rate hedges for a notional amount of not less than \$140,000 for a period of not less than two years. In satisfaction of this requirement, the Company entered into three interest rate swap agreements in November 2000 which obligate the Company to pay a fixed LIBOR rate and entitle the Company to receive a variable LIBOR rate on an aggregate \$140,000 notional amount of debt. The Company has structured these interest rate swap agreements and intends to structure all such future agreements to qualify for hedge accounting pursuant to the provisions of SFAS 133. Accumulated other comprehensive losses resulting from the changes in fair value of the interest rate hedge instruments were \$7,249 and \$4,429 at December 31, 2001 and September 30, 2002, respectively. For the nine-month periods ended September 30, 2001 and 2002, the Company recorded a \$5,657 charge and a \$2,820 credit, respectively, to other comprehensive income (loss) for the change in fair value of the interest rate hedge instruments.

The following presents a reconciliation of net income (loss) to comprehensive income (loss) for the three and nine month periods ended September 30, 2001 and 2002:

	Three Months Ended September 30,		Nine Months Ended September 30,	
	Restated 2001	Restated 2002	Restated 2001	Restated 2002
Net loss	\$ (1,421)	(5,787)	(3,032)	(674)
Other comprehensive income (loss):				
Foreign currency translation	1,719	623	120	3,409
Unrealized gain (loss) on investments	(461)	(275)	(246)	(275)
Unrealized gain (loss) on cash flow hedge agreements	(3,035)	1,118	(5,657)	2,820
	(1,777)	1,466	(5,783)	5,954
Comprehensive income (loss)	\$ (3,198)	(4,321)	(8,815)	5,280

### (6) Inventories

Inventories consist of the following:

	December 31, 2001	September 30, 2002
Parts and work-in-process	\$ 10,130	18,880
Finished goods	9,417	10,905
	\$ 19,547	29,785



Parts and work-in-process include costs for equipment expected to be sold. Costs incurred for equipment associated with specific wagering system service contracts not yet placed in service are classified as construction in progress in property and equipment.

**(7) Capital Stock and Equity Offering**

On July 2, 2002, the Company completed the public offering and sale of 14,375 shares of its Class A Common Stock at \$7.25 per share (the "2002 Offering"). The proceeds after underwriter's discounts, before direct offering expenses, to the Company were approximately \$98,483. During the third quarter of 2002, the Company used the net proceeds of the 2002 Offering to redeem approximately \$82,957 of its 12<sup>1</sup>/<sub>2</sub>% Senior Subordinated Notes. (See Note 9 Redemption of Senior Subordinated Debt and Extraordinary Item.)

In connection with certain waivers and consents by holders of the Company's Series A Convertible Preferred Stock relating to the 2002 offering, the Company authorized 2.0 shares and issued an aggregate of 1.2376 shares of Series B Preferred Stock, pro rata, to the holders of the Series A Convertible Preferred Stock. The Series B Preferred Stock has voting rights that, together with the voting rights of the Series A Convertible Preferred Stock, effectively reduce the aggregate ownership percentage of Series A Convertible Preferred Stock (on an "as-converted" basis) that the holders are required to maintain in order to elect directors of the Company. The threshold for electing four directors was effectively reduced from 25% to 22.5% and the threshold for electing three directors was effectively reduced from 20% to 17.5%. The issuance of the Series B Preferred Stock did not affect the existing 10% and 5% thresholds for electing two directors and one director, respectively. The Series B Preferred Stock does not pay dividends and has a liquidation preference of no more than \$2 in the aggregate. The Company considers the aggregate \$1.238 book value of the Series B Preferred Stock to be a cost of raising capital, and consequently recorded that amount as a reduction of additional paid-in capital.

**(8) Debt**

At September 30, 2002, the Company had approximately \$33,212 available for borrowing under the Company's revolving credit facility (the "Facility"). There were approximately \$10,500 of borrowings outstanding under the Facility, and approximately \$21,288 in letters of credit were issued under the Facility at September 30, 2002. At December 31, 2001, the Company's available borrowing capacity under the Facility was \$30,960. As of September 30, 2002, there was \$51,000 outstanding under the Term A loan, \$215,600 outstanding under the Term B loans and \$67,043 outstanding under the Company's 12<sup>1</sup>/<sub>2</sub>% Senior Subordinated Notes.

**(9) Redemption of Senior Subordinated Debt and Extraordinary Item**

The net proceeds from the 2002 Offering were used to redeem approximately \$82,957 of the Company's 12<sup>1</sup>/<sub>2</sub>% Senior Subordinated Notes in the third quarter of 2002. In connection with this redemption, the Company paid the noteholders redemption premiums aggregating approximately \$11,094 and paid the term loan lenders and banks related fees of approximately \$1,044, to amend the term loan facility to permit the Company to use the majority of the net proceeds from the 2002 offering to redeem the subordinated debt rather than pay down the term loans. These payments, together with the related write-off of previously deferred financing costs of \$3,452, partially offset by the recording of a state income tax benefit of approximately \$737, or a total of approximately \$14,853, was reflected as an extraordinary item in the third quarter of 2002. In November 2002, the Company used the remaining net proceeds of approximately \$1,741 to repay a portion of its senior credit facilities. Following the mandatory repayment of the Term A and Term B loans, there was \$50,022 outstanding under the Term A loans and \$214,837 outstanding under the Term B loans.

As of September 30, 2002, the average annual interest rates on the Term A loans and Term B loans under the Company's senior credit facilities were 4<sup>7</sup>/<sub>8</sub>% and 6<sup>1</sup>/<sub>8</sub>%, respectively, and the annual interest rate on the senior subordinated notes was 12<sup>1</sup>/<sub>2</sub>%. The Term A and Term B loans mature on

September 30, 2006 and September 30, 2007, respectively, and the senior subordinated notes mature on August 15, 2010.

Based on the redemptions of the Company's 12<sup>1</sup>/<sub>2</sub>% Senior Subordinated Notes, and the repayment of the Term A and Term B loans in November 2002, the Company expects to recognize annual interest expense savings of approximately \$11,000 per year.

See also "Management's Discussion and Analysis of Financial Condition and Results of Operations," included in this report on Form 10-Q and the Consolidated Financial Statements and the notes thereto included in the Company's 2001 Annual Report on Form 10-K, as modified by the foregoing.

**(10) Goodwill and Intangible Assets, Impairment of Long-Lived Assets and Long-Lived Assets to be Disposed Of**

In June 2001, the Financial Accounting Standards Board ("FASB") issued Statement No. 141, *Business Combinations* ("SFAS 141"), and Statement No. 142, *Goodwill and Other Intangible Assets* ("SFAS 142"), and in August 2001 the FASB issued Statement No. 144, *Accounting for the Impairment or Disposal of Long-Lived Assets* ("SFAS 144"). SFAS 141 requires that the purchase method of accounting be used for all business combinations initiated or completed after June 30, 2001. The Company adopted the provisions of SFAS 141 upon issuance. SFAS 141 also specifies criteria that intangible assets acquired in a purchase method business combination must meet to be recognized and reported apart from goodwill. SFAS 142 requires, commencing January 1, 2002, that goodwill and intangible assets with indefinite useful lives no longer be amortized. Instead, they will be tested for impairment at least annually in accordance with the provisions of SFAS 142. SFAS 142 also requires that intangible assets with definite useful lives be amortized over their respective estimated useful lives to their estimated residual values, and reviewed for impairment in accordance with SFAS 144. Goodwill and intangible assets acquired by the Company in its business combinations completed before July 1, 2001 continued to be amortized through December 31, 2001.

SFAS 142 requires that the Company evaluate its existing intangible assets and goodwill that were acquired in a prior purchase business combination, and make any necessary reclassifications in order to conform with the new criteria in SFAS 141 for recognition apart from goodwill. The Company also adopted SFAS 142 and, accordingly, is required to reassess the useful lives and residual values of all intangible assets acquired in purchase business combinations and to make any necessary amortization period adjustments by the end of the first interim period after adoption. In addition, to the extent an intangible asset is identified as having an indefinite useful life, the Company is required to test the intangible asset for impairment within the first interim period. Any impairment loss will be measured as of the date of adoption and recognized as the cumulative effect of a change in accounting principle in the first interim period.

In connection with the transitional goodwill impairment evaluation, SFAS 142 and SFAS 144 require that the Company perform an assessment of whether there is an indication that goodwill is impaired as of the date of adoption. To the extent a reporting unit's carrying amount (as defined in SFAS 142) exceeds its fair value, the Company must perform the second step of the transitional impairment test. In the second step, the Company must compare the implied fair value of the reporting unit's goodwill, determined by allocating the reporting unit's fair value to all of its assets (recognized and unrecognized) and liabilities in a manner similar to a purchase price allocation in accordance with SFAS 141, to its carrying amount, both of which would be measured as of the date of adoption. This second step is required to be completed as soon as possible, but no later than the end of the year of adoption. Any transitional impairment loss will be recognized as the cumulative effect of a change in accounting principle in the Company's consolidated statement of operations.

The Company had unamortized goodwill of approximately \$179,099 and unamortized identifiable intangible assets in the amount of approximately \$60,169 at December 31, 2001, all of which were subject to the transition provisions of SFAS 141 and SFAS 142. In connection with the adoption of SFAS 142, the Company evaluated its intangible assets and determined that its right to operate its Connecticut OTBs and its trade name with net carrying amounts of approximately \$11,681 and \$30,093, respectively, at December 31, 2001, have indefinite useful lives and, accordingly, the Company ceased amortization as of January 1, 2002. In addition, as required by SFAS 142, the Company reclassified its employee work force intangible asset with a net carrying value of approximately \$3,170, net of related deferred tax liabilities of \$2,113, to goodwill effective January 1, 2002. Amortization expense of these intangible assets and goodwill was approximately \$16,909 for the year ended December 31, 2001. As a result of adopting SFAS 142, the Company also reduced the recognized amount of its NOL from \$18,520 to \$8,730 to reflect the reduction in the amount of the net taxable temporary differences that are expected to reverse during the loss carryforward period because of the cessation of amortization of the tradename and employee workforce intangible assets. This NOL reduction was charged to income tax expense in the first quarter of 2002. The Company also evaluated the remaining useful lives of its intangible assets that will continue to be amortized and has determined that no revision to the useful lives will be required. The Company completed its initial impairment review of intangible assets with indefinite useful lives during the first quarter of 2002 with no material adjustments to the December 31, 2001 balances for these assets. The Company completed its initial impairment review of goodwill during the second quarter 2002 with no material adjustments to the December 31, 2001 balances for these assets. The Company has determined its reporting units to be the same as its reportable segments, and all assets including goodwill have been allocated to the reporting units.

SFAS 144 addresses financial accounting and reporting for the impairment or disposal of long-lived assets and supersedes Statement No. 121, *Accounting for the Impairment of Long-Lived Assets and for Long-Lived Assets to Be Disposed Of* ("SFAS 121"). However, SFAS 144 retains the fundamental provisions of SFAS 121 for (a) recognition and measurement of the impairment of long-lived assets to be held and used and (b) measurement of long-lived assets to be disposed of by sale. SFAS 144 supersedes the accounting and reporting provisions of APB

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Opinion No. 30, *Reporting the Results of Operations-Reporting the Effects of Disposal of a Segment of a Business, and Extraordinary, Unusual and Infrequently Occurring Events and Transactions*, for the disposal of a segment of a business. However, SFAS 144 retains the requirement of Opinion 30 to report discontinued operations separately from continuing operations and extends that reporting to a component of an entity that either has been disposed of (by sale, by abandonment, or in distribution to owners) or is classified as held for sale. SFAS 144 also amends ARB No. 51, *Consolidated Financial Statements*, to eliminate the exception to consolidation for a temporarily controlled subsidiary. The Company adopted SFAS 144 effective January 1, 2002. The adoption of SFAS 144 for long-lived assets held for sale had no material impact on the Company's consolidated financial statements for the first nine months of 2002. The provisions of this statement for assets held for sale or other disposal generally are required to be applied prospectively after the adoption date to newly initiated disposal activities and therefore, will depend on future actions initiated by management. As a result, the Company cannot determine the potential effects that adoption of SFAS 144 will have on its financial statements with respect to future disposal decisions, if any.

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The following disclosure presents certain information on the Company's acquired intangible assets subject to amortization as of December 31, 2001 and September 30, 2002. Amortized intangible assets are being amortized over their estimated useful lives, as indicated below, with no estimated residual values.

Intangible Assets	Weighted Average Amortization Period	Gross Carrying Amount	Accumulated Amortization	Net Balance
<b>Balance at December 31, 2001</b>				
Amortizable intangible assets:				
Patents	15	\$ 915	79	836
Customer lists	14	14,600	2,324	12,276
Employee work force	5	7,200	1,917	5,283
Trade name	20	32,200	2,107	30,093
Connecticut off-track betting system operating rights	20	20,000	8,319	11,681
		<u>74,915</u>	<u>14,746</u>	<u>60,169</u>
Total intangible assets		\$ 74,915	14,746	60,169
<b>Balance at September 30, 2002</b>				
Amortizable intangible assets:				
Patents	15	\$ 1,026	146	880
Customer lists	14	14,600	3,659	10,941
Customer service contracts	15	2,789	590	2,199
		<u>18,415</u>	<u>4,395</u>	<u>14,020</u>
Non-amortizable intangible assets:				
Trade name		32,200	2,107	30,093
Connecticut off-track betting system operating rights		22,339	8,319	14,020
		<u>54,539</u>	<u>10,426</u>	<u>44,113</u>
Total intangible assets		\$ 72,954	14,821	58,133

The aggregate intangible amortization expense for the nine-month period ended September 30, 2002 was approximately \$1,559. The estimated intangible asset amortization expense for the year ending December 31, 2002 and for each of the subsequent four years ending December 31, 2006 are \$2,046, \$2,046, \$1,761, \$1,013 and \$726, respectively.

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The table below reconciles the change in the carrying amount of goodwill, by reporting unit, which is the same as operating segment, for the period from December 31, 2001 to September 30, 2002. The Company recorded a \$3,170 increase in goodwill at January 1, 2002 in connection with the reclassification of employee work force intangible assets of \$5,283 less related deferred tax liability of \$2,113 acquired prior to July 1, 2001 that did not meet the criteria for recognition apart from goodwill under SFAS 141. Goodwill in the amount of \$2,110, net of amortization, which was directly related to the value of customer contracts acquired as part of the September 1, 1999 acquisition of Datasport assets and an interest in Datek, was reclassified to intangible assets effective January 1, 2002. Goodwill

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in the amount of \$3,301 was recorded in the first nine months of 2002 in connection with the acquisition of a majority interest in SERCHI.

Goodwill	Restated Lottery Group	Pari-Mutuel Group	Venue Management Group	Telecommunications Products Group	Restated Totals
Balance at December 31, 2001	\$ 176,502	2,597			179,099
Effect of adoption of SFAS 141 and SFAS 142:					
Reclassification of employee workforce intangible asset, net of tax	3,170				3,170
Reclassification of customer service contract to intangible assets		(2,110)			(2,110)
Record the goodwill acquired in the acquisition of a majority interest in SERCHI	3,301				3,301
Balance at September 30, 2002	\$ 182,973	487			183,460

The following table compares pro forma net income (loss) available to common stockholders for the three months and nine months ended September 30, 2001, adjusted to reflect the adoption of

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SFAS 142 on January 1, 2001, to the reported net income for the three months and nine months ended September 30, 2002:

	Three Months Ended September 30,		Nine Months Ended September 30,	
	Restated 2001	Restated 2002	Restated 2001	Restated 2002
	Pro Forma	As Reported	Pro Forma	As Reported
<b>Adjusted income available to common stockholders:</b>				
Adjusted income before extraordinary item	\$ 1,719	9,066	4,466	14,179
Adjusted net loss available to common stockholders	\$ (71)	(7,686)	(767)	(6,227)
<b>Adjusted earnings per share amounts basic and diluted:</b>				
Adjusted income (loss) before extraordinary item per share available to common stockholders:				
Basic	\$	0.13	(0.02)	0.18

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	Three Months Ended September 30,		Nine Months Ended September 30,		
Diluted(1)	\$	0.10	(0.02)	0.16	
Adjusted net income (loss) per share available to common stockholders:					
Basic	\$	(0.13)	(0.02)	(0.13)	
Diluted(1)	\$	(0.07)	(0.02)	(0.12)	
<b>Shares used in calculating adjusted per share amounts:</b>					
Basic		40,383	57,301	40,252	47,518
Diluted(1)		40,383	87,360	40,252	53,877
<b>Reconciliation of reported net income to adjusted net income (loss):</b>					
Reported net loss available to common Stockholders	\$	(3,211)	(7,686)	(8,265)	(6,227)
Add back: Amortization of goodwill and intangible assets With indefinite lives, net of tax benefit		3,140		7,498	
Adjusted net income (loss) available to common Stockholders	\$	(71)	(7,686)	(767)	(6,227)

(1) The fully diluted earnings per share calculations for the three months ended September 30, 2002 assume the preferred shares are converted to common shares and there are no preferred dividends in that period.

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

The Company conducts substantially all of its business through its domestic and foreign subsidiaries. The Company's 12<sup>1</sup>/<sub>2</sub>% Series B Senior Subordinated Notes due 2010 (the "Notes") and Facility issued on September 6, 2000 in connection with the acquisition of Scientific Games Holdings Corp. ("SGHC") are fully, unconditionally and jointly and severally guaranteed by substantially all of the Company's wholly owned domestic subsidiaries (the "Guarantor Subsidiaries").

Presented below is condensed consolidating financial information for (i) Scientific Games Corporation (the "Parent Company"), which includes the activities of Scientific Games Management Corporation, (ii) the Guarantor Subsidiaries and (iii) the wholly owned foreign subsidiaries and the non-wholly owned domestic and foreign subsidiaries (the "Non-Guarantor Subsidiaries") as of

December 31, 2001 and September 30, 2002 and for the nine months ended September 30, 2001 and 2002. The condensed consolidating financial information has been presented to show the nature of assets held, results of operations and cash flows of the Parent Company, Guarantor Subsidiaries and Non-Guarantor Subsidiaries assuming the guarantee structure of the Notes was in effect at the beginning of the periods presented. Separate financial statements for Guarantor Subsidiaries are not presented based on management's determination that they would not provide additional information that is material to investors.

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

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**SCIENTIFIC GAMES CORPORATION AND SUBSIDIARIES**  
**SUPPLEMENTAL CONDENSED CONSOLIDATING BALANCE SHEET**  
**December 31, 2001**  
(in thousands)

	Restated Parent Company	Restated Guarantor Subsidiaries	Non-Guarantor Subsidiaries	Restated Eliminating Entries	Restated Consolidated
<b>ASSETS</b>					
Cash and cash equivalents	\$ 7,612	(415)	5,452		12,649
Accounts receivable, net		34,322	16,088		50,410
Inventories		16,524	3,558	(535)	19,547
Other current assets	973	9,344	5,190	30	15,537
Property and equipment, net	2,159	156,224	38,822	(417)	196,788
Investment in subsidiaries	249,365			(249,365)	
Goodwill	183	176,502	2,414		179,099
Intangible assets		54,928	5,241		60,169
Other assets	20,378	44,056	6,487	(19,324)	51,597
<b>Total assets</b>	<b>\$ 280,670</b>	<b>491,485</b>	<b>83,252</b>	<b>(269,611)</b>	<b>585,796</b>
<b>LIABILITIES AND STOCKHOLDERS' EQUITY</b>					
Current installments of long-term debt	\$ 9,018	9	410		9,437
Current liabilities	14,999	50,672	19,661	799	86,131
Long-term debt, excluding current installments	429,917	10	371		430,298
Other non-current liabilities	1,903	32,702	4,356	729	39,690
Intercompany balances	(195,407)	169,896	27,154	(1,643)	
Stockholders' equity	20,240	238,196	31,300	(269,496)	20,240
<b>Total liabilities and stockholders' equity</b>	<b>\$ 280,670</b>	<b>491,485</b>	<b>83,252</b>	<b>(269,611)</b>	<b>585,796</b>

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**SCIENTIFIC GAMES CORPORATION AND SUBSIDIARIES**  
**SUPPLEMENTAL CONDENSED CONSOLIDATING BALANCE SHEET**  
**September 30, 2002**  
(unaudited, in thousands)

	Restated Parent Company	Restated Guarantor Subsidiaries	Non-Guarantor Subsidiaries	Restated Eliminating Entries	Restated Consolidated
<b>ASSETS</b>					
Cash and cash equivalents	\$ 1,130	(373)	8,064		8,821

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	Restated Parent Company	Restated Guarantor Subsidiaries	Non-Guarantor Subsidiaries	Restated Eliminating Entries	Restated Consolidated
Accounts receivable, net		36,861	18,801	(40)	55,622
Inventories		24,641	5,680	(536)	29,785
Other current assets	576	8,642	3,594	30	12,842
Property and equipment, net	3,655	147,268	46,523	(493)	196,953
Investment in subsidiaries	322,068	4,150		(326,218)	
Goodwill	183	179,672	3,605		183,460
Intangible assets		52,962	5,171		58,133
Other assets	16,157	41,681	5,091	(16,619)	46,310
<b>Total assets</b>	<b>\$ 343,769</b>	<b>495,504</b>	<b>96,529</b>	<b>(343,876)</b>	<b>591,926</b>
<b>LIABILITIES AND STOCKHOLDERS' EQUITY</b>					
Current installments of long-term debt	\$ 11,264	9	928		12,201
Current liabilities	9,033	45,095	19,055	808	73,991
Long-term debt, excluding current installments	334,258	3	322		334,583
Other non-current liabilities	10,517	29,984	6,969	157	47,627
Intercompany balances	(144,827)	122,218	24,261	(1,652)	
Stockholders' equity	123,524	298,195	44,994	(343,189)	123,524
<b>Total liabilities and stockholders' equity</b>	<b>\$ 343,769</b>	<b>495,504</b>	<b>96,529</b>	<b>(343,876)</b>	<b>591,926</b>

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**SCIENTIFIC GAMES CORPORATION AND SUBSIDIARIES**  
**SUPPLEMENTAL CONDENSED STATEMENT OF OPERATIONS**  
**Three Months Ended September 30, 2001**  
**(unaudited, in thousands)**

	Restated Parent Company	Restated Guarantor Subsidiaries	Non-Guarantor Subsidiaries	Restated Eliminating Entries	Restated Consolidated
Operating revenues	\$	84,712	25,559	(3,068)	107,203
Operating expenses		52,036	17,809	(2,875)	66,970
Amortization of service contract software (Note 2)		1,079	100		1,179
<b>Gross profit</b>		<b>31,597</b>	<b>7,650</b>	<b>(193)</b>	<b>39,054</b>
Selling, general and administrative expenses	2,392	8,008	2,985	(219)	13,166
Depreciation and amortization	77	11,118	937	(21)	12,111
<b>Operating income (loss)</b>	<b>(2,469)</b>	<b>12,471</b>	<b>3,728</b>	<b>47</b>	<b>13,777</b>
Interest expense	12,170	80	540	(468)	12,322
Other (income) expense	203	(742)	78	389	(72)
	(14,842)	13,133	3,110	126	1,527

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	Restated Parent Company	Restated Guarantor Subsidiaries	Non-Guarantor Subsidiaries	Restated Eliminating Entries	Restated Consolidated
Income (loss) before equity in income of subsidiaries and income taxes					
Equity in income of subsidiaries	16,852			(16,852)	
Income tax expense (benefit)	3,431	(1,059)	576		2,948
<b>Net income (loss)</b>	<b>\$ (1,421)</b>	<b>14,192</b>	<b>2,534</b>	<b>(16,726)</b>	<b>(1,421)</b>

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**SCIENTIFIC GAMES CORPORATION AND SUBSIDIARIES**  
**SUPPLEMENTAL CONDENSED STATEMENT OF OPERATIONS**  
**Three Months Ended September 30, 2002**  
(unaudited, in thousands)

	Restated Parent Company	Guarantor Subsidiaries	Non-Guarantor Subsidiaries	Eliminating Entries	Restated Consolidated
Operating revenues	\$	85,093	32,079	(2,020)	115,152
Operating expenses		49,340	21,776	(2,037)	69,079
Amortization of service contract software (Note 2)		1,133	100		1,233
Gross profit		34,620	10,203	17	44,840
Selling, general and administrative expenses	4,768	6,900	3,147	(3)	14,812
Depreciation and amortization	124	6,994	1,950	(2)	9,066
<b>Operating income (loss)</b>	<b>(4,892)</b>	<b>20,726</b>	<b>5,106</b>	<b>22</b>	<b>20,962</b>
Interest expense	9,496	190	423	(326)	9,783
Other (income) expense	283	(505)	594	298	670
Income (loss) before equity in income of subsidiaries and income taxes and extraordinary item	(14,671)	21,041	4,089	50	10,509
Equity in income of subsidiaries	23,965			(23,965)	
Income tax expense	228	45	1,170		1,443
<b>Net income (loss) before extraordinary item</b>	<b>9,066</b>	<b>20,996</b>	<b>2,919</b>	<b>(23,915)</b>	<b>9,066</b>
Extraordinary item	14,853				14,853
<b>Net income (loss)</b>	<b>\$ (5,787)</b>	<b>20,996</b>	<b>2,919</b>	<b>(23,915)</b>	<b>(5,787)</b>

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**SCIENTIFIC GAMES CORPORATION AND SUBSIDIARIES**  
**SUPPLEMENTAL CONDENSED STATEMENT OF OPERATIONS**  
**Nine Months Ended September 30, 2001**  
(unaudited, in thousands)



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	Restated Parent Company	Restated Guarantor Subsidiaries	Non-Guarantor Subsidiaries	Restated Eliminating Entries	Restated Consolidated
Operating revenues	\$	254,387	87,104	(9,607)	331,884
Operating expenses		158,360	60,546	(9,154)	209,752
Amortization of service contract software (Note 2)		2,836	300		3,136
Gross profit		93,191	26,258	(453)	118,996
Selling, general and administrative expenses	9,048	23,854	9,164	(254)	41,812
Depreciation and amortization	229	32,449	3,735	(61)	36,352
Operating income (loss)	(9,277)	36,888	13,359	(138)	40,832
Interest expense	38,363	202	1,594	(1,549)	38,610
Other (income) expense	(335)	(1,777)	768	1,453	109
Income (loss) before equity in income of subsidiaries and income taxes	(47,305)	38,463	10,997	(42)	2,113
Equity in income of subsidiaries	49,171			(49,171)	
Income tax expense (benefit)	4,898	(2,917)	3,164		5,145
Net income (loss)	\$ (3,032)	41,380	7,833	(49,213)	(3,032)

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**SCIENTIFIC GAMES CORPORATION AND SUBSIDIARIES**  
**SUPPLEMENTAL CONDENSED STATEMENT OF OPERATIONS**  
**Nine Months Ended September 30, 2002**  
**(unaudited, in thousands)**

	Restated Parent Company	Guarantor Subsidiaries	Non-Guarantor Subsidiaries	Eliminating Entries	Restated Consolidated
Operating revenues	\$	257,228	86,978	(7,815)	336,391
Operating expenses		147,067	59,141	(7,729)	198,479
Amortization of service contract software (Note 2)		3,356	300		3,656
Gross profit		106,805	27,537	(86)	134,256
Selling, general and administrative expenses	13,482	23,229	8,223	(9)	44,925
Depreciation and amortization	298	21,969	5,673	(8)	27,932
Operating income (loss)	(13,780)	61,607	13,641	(69)	61,399
Interest expense	32,087	595	1,080	(967)	32,795
Other (income) expense	(7)	(1,776)	1,355	869	441
Income (loss) before equity in income of subsidiaries and income taxes and extraordinary item	(45,860)	62,788	11,206	29	28,163
Equity in income of subsidiaries	70,715			(70,715)	
Income tax expense	10,676	143	3,165		13,984

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	Restated Parent Company	Guarantor Subsidiaries	Non-Guarantor Subsidiaries	Eliminating Entries	Restated Consolidated
Net income (loss) before extraordinary item	14,179	62,645	8,041	(70,686)	14,179
Extraordinary item	14,853				14,853
Net income (loss)	\$ (674)	62,645	8,041	(70,686)	(674)

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**SCIENTIFIC GAMES CORPORATION AND SUBSIDIARIES**  
**SUPPLEMENTAL CONDENSED STATEMENT OF CASH FLOWS**  
**Nine Months Ended September 30, 2001**  
**(unaudited, in thousands)**

	Restated Parent Company	Restated Guarantor Subsidiaries	Non-Guarantor Subsidiaries	Restated Eliminating Entries	Restated Consolidated
Net income (loss)	\$ (3,032)	41,380	7,833	(49,213)	(3,032)
Depreciation and amortization	229	35,285	4,035	(61)	39,488
Equity in income of subsidiaries	(49,171)			49,171	
Extraordinary item					
Non-cash interest expense	1,797				1,797
Changes in operating assets and liabilities	(12,733)	11,746	(202)	946	(243)
Other non-cash adjustments	6,027	(3,295)	622		3,354
Net cash provided by (used in) operating activities	(56,883)	85,116	12,288	843	41,364
<b>Cash flows from investing activities:</b>					
Capital and wagering systems expenditures	(239)	(25,215)	(5,191)	213	(30,432)
Other assets and investments	(978)	(6,519)	(2,336)	57	(9,776)
Net cash used in investing activities	(1,217)	(31,734)	(7,527)	270	(40,208)
<b>Cash flows from financing activities:</b>					
Net borrowing under lines of credit	3,000				3,000
Payments on long-term debt	(3,946)	(7)	(632)	193	(4,392)
Proceeds from stock issue	552				552
Other, principally intercompany balances	58,650	(52,224)	(5,120)	(1,306)	
Net cash provided by (used in) financing activities	58,256	(52,231)	(5,752)	(1,113)	(840)
Effect of exchange rate changes on cash	56	(369)	123		(190)
Increase (decrease) in cash and cash equivalents	212	782	(868)		126

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	Restated Parent Company	Restated Guarantor Subsidiaries	Non-Guarantor Subsidiaries	Restated Eliminating Entries	Restated Consolidated
Cash and cash equivalents, beginning of period	867	(50)	5,671		6,488
Cash and cash equivalents, end of period	\$ 1,079	732	4,803		6,614

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**SCIENTIFIC GAMES CORPORATION AND SUBSIDIARIES**  
**SUPPLEMENTAL CONDENSED STATEMENT OF CASH FLOWS**  
**Nine Months Ended September 30, 2002**  
**(unaudited, in thousands)**

	Restated Parent Company	Guarantor Subsidiaries	Non-Guarantor Subsidiaries	Eliminating Entries	Restated Consolidated
Net income (loss)	\$ (674)	62,645	8,041	(70,686)	(674)
Depreciation and amortization	298	25,325	5,973	(8)	31,588
Equity in income of subsidiaries	(70,715)			70,715	
Extraordinary item	14,853				14,853
Non-cash interest expense	1,740				1,740
Changes in operating assets and liabilities	(4,839)	(15,658)	(3,187)	(893)	(24,577)
Other non-cash adjustments	10,539	(1,375)	191		9,355
Net cash provided by (used in) operating activities	(48,798)	70,937	11,018	(872)	32,285
Cash flows from investing activities:					
Capital and wagering systems expenditures	(1,717)	(12,077)	(5,741)	83	(19,452)
Business acquisition, net of cash acquired		(4,150)	46		(4,104)
Other assets and investments	144	(3,233)	1,215	(3,381)	(5,255)
Net cash used in investing activities	(1,573)	(19,460)	(4,480)	(3,298)	(28,811)
Cash flows from financing activities:					
Net repayments under lines of credit	(4,250)		20		(4,230)
Payments on long-term debt	(101,295)	(7)	(1,183)		(102,485)
Proceeds from stock issue	97,749				97,749
Other, principally intercompany balances	51,685	(52,207)	(3,648)	4,170	
Net cash provided by (used in) financing activities	43,889	(52,214)	(4,811)	4,170	(8,966)
Effect of exchange rate changes on cash		779	885		1,664
	(6,482)	42	2,612		(3,828)

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	Restated Parent Company	Guarantor Subsidiaries	Non-Guarantor Subsidiaries	Eliminating Entries	Restated Consolidated
Increase (decrease) in cash and cash equivalents					
Cash and cash equivalents, beginning of period	7,612	(415)	5,452		12,649
Cash and cash equivalents, end of period	\$ 1,130	(373)	8,064		8,821

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**SCIENTIFIC GAMES CORPORATION AND SUBSIDIARIES  
MANAGEMENT'S DISCUSSION AND ANALYSIS OF FINANCIAL CONDITION  
AND RESULTS OF OPERATIONS FOR  
THE NINE MONTHS ENDED SEPTEMBER 30, 2002**

**Background**

On January 29, 2002, we transferred the listing of our Class A common stock to the Nasdaq National Market from the American Stock Exchange and changed our trading symbol to "SGMS."

The following discussion addresses our financial condition as of September 30, 2002 and the results of our operations for the three and nine month periods ended September 30, 2002, compared to the same periods in the prior year. This discussion should be read in conjunction with Management's Discussion and Analysis of Financial Condition and Results of Operations for the fiscal year ended December 31, 2001, included in our 2001 Annual Report on Form 10-K, as modified by the foregoing.

We operate in four business segments: Lottery Group, Pari-mutuel Group, Venue Management Group and Telecommunications Products Group. Our Lottery Group provides instant tickets and related services and lottery systems. Instant ticket and related services includes ticket design and manufacturing as well as value-added services, including game design, sales and marketing support, inventory management and warehousing and fulfillment services. In addition, this division includes promotional instant tickets and pull-tab tickets that we sell to both lottery and non-lottery customers. Our lottery systems business includes the supply of transaction processing software for the accounting and validation of both instant ticket and on-line lottery games, point-of-sale terminal hardware sales, central site computers and communication hardware sales, and ongoing support and maintenance services for these products. This product line also includes software and hardware and support services for sports betting and credit card processing systems.

Our Pari-mutuel Group is comprised of our North American and international on-track, off-track and inter-track pari-mutuel services, simulcasting and communications services, and video gaming, as well as sales of pari-mutuel systems and equipment.

Our Venue Management Group is comprised of our Connecticut off-track betting operations, and our Dutch on-track and off-track betting operations.

Our Telecommunications Products Group is comprised of our prepaid cellular phone cards business.

Our revenues are derived from two principal sources: service revenues and sales revenues. Service revenues are earned pursuant to multi-year contracts to provide instant tickets and related services and on-line lottery and pari-mutuel wagering systems and services, or are derived from wagering by customers at facilities we own or lease. Sales revenues are derived from sales of prepaid phone cards and from the sale of wagering systems, equipment, and software licenses.

The first and fourth quarters of the calendar year traditionally comprise the weakest season for our pari-mutuel wagering business. As a result of inclement weather during the winter months, a number of racetracks do not operate and those that do operate often experience missed racing days. This adversely affects the amounts wagered and our corresponding service revenues. Wagering equipment sales and software license revenues usually reflect a limited number of large transactions, which do not recur on an annual basis. Consequently, revenues and operating results can vary substantially from period to period as a result of the timing of revenue recognition for major equipment sales and software licensing transactions. In addition, instant ticket and prepaid phone card sales may vary depending on the season and timing of contract

awards, changes in customer budgets, inventory ticket levels, lottery retail sales and general economic conditions. Operating results may also vary significantly from period to period depending on the addition or disposition of business units in each period.

### **Critical Accounting Policies**

Our consolidated financial statements and accompanying notes are prepared in accordance with accounting principles generally accepted in the United States of America. Preparing consolidated financial statements requires us to make estimates and assumptions that affect the reported amounts of assets, liabilities, revenue, and expenses. These estimates and assumptions are affected by the application of our accounting policies. Our significant accounting policies are described in Note 1 to our 2001 Annual Report on Form 10-K, as modified by the foregoing. Critical accounting policies are those that require application of management's most difficult, subjective, or complex judgments, often as a result of matters that are inherently uncertain and may change in subsequent periods. Critical accounting policies for us include revenue recognition on percentage of completion contracts related to lottery development projects and pari-mutuel systems software development projects, capitalization of software development costs, evaluation of the recoverability of assets, the assessment of litigation and contingencies, including income and other taxes. Actual results could differ from estimates.

### **Results of Operations: See Note 4 Business Segments**

### **Restatement of Previously Reported Financial Statements**

Subsequent to the issuance of our consolidated financial statements for the year ended December 31, 2002 and the quarterly period ended March 31, 2003, it was determined that a portion of the deferred tax asset, in the form of a NOL, recognized in the fourth quarter of 2002 should have been recognized at the time of the acquisition of SGHC on September 6, 2000 as a reduction to the goodwill resulting from the acquisition of SGHC. As a result: (i) deferred tax assets recognized at the date of the acquisition of SGHC have been increased with a corresponding reduction in the carrying value of SGHC goodwill; (ii) goodwill amortization has been reduced for the periods from the date of acquisition of SGHC through December 31, 2001; and (iii) deferred income tax assets recognized during the period from the date of the acquisition of SGHC through December 31, 2002 have been adjusted to reflect the amount considered more likely than not realizable based on the reversing effect of taxable or deductible temporary differences and the Company's NOL. In addition, we restated income tax expense for the first quarter of fiscal 2002 to reflect a charge of \$9.8 million related to the adoption of SFAS 142, which caused a reduction in the amount of the NOL to reflect the reduced amount of net taxable temporary differences that are expected to reverse during the NOL carryforward period because of the cessation of amortization of certain indefinite lived intangible assets. The restatements did not impact the amounts presented in the consolidated statements of cash flows for net cash provided by operating activities, net cash used in investing activities or net cash provided by or used in financing activities in any of the restated periods, although it did impact certain non-cash components of cash flows from operating activities.

Accordingly, we have amended and restated our consolidated financial statements as of and for the year ended October 31, 2000, the two-month period ended December 31, 2000, each of the quarterly periods in the years ended December 31, 2001 and 2002, and the years ended December 31, 2001 and 2002. Conforming changes reflecting these revisions have been made in our Management's Discussion and Analysis of Financial Condition and Results of Operations and Consolidated Financial Statements and Notes to Consolidated Financial Statements.

### **Three Months Ended September 30, 2002 compared to Three Months Ended September 30, 2001**

#### *Revenue Analysis*

Lottery Group revenue of \$64.4 million in the three months ended September 30, 2002 improved \$3.8 million from the same period in 2001. A \$0.6 million decrease in service revenue is attributable principally to: the loss of approximately \$3.7 million of service revenue related to the New York State cooperative services contract, which had already been awarded to another company at the time we

acquired SGHC; a \$0.3 million decrease resulting from the absence of the French lottery business that was sold in the third quarter of 2001; and the absence of a large Powerball lottery run in the current period, estimated at \$0.8 million. These decreases were partially offset by a \$1.8 million growth in our on-line and instant ticket lottery businesses due to the start-up of the South Carolina Educational Lottery in January 2002, and the acquisition of a majority interest in SERCHI in June 2002. In the three months ended September 30, 2002, equipment

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sales increased \$4.5 million from the same period in 2001 due to the timing of a terminal sale to a foreign customer.

Pari-mutuel Group service revenue of \$21.3 million in the three months ended September 30, 2002 increased \$0.3 million from the same period in 2001 from revenue improvements in the North American and European racing operations. Sales revenue of \$1.3 million in the three months ended September 30, 2002 decreased \$0.2 million from same period in 2001 due to the timing and mix of products sold.

Venue Management Group service revenue of \$16.0 million in the three months ended September 30, 2002 increased \$0.9 million from the same period in 2001, primarily reflecting higher Handle (or gross wagering dollars) related revenue in both the Connecticut OTB and Dutch operations.

Telecommunications Products Group sales revenue of \$12.1 million in the three months ended September 30, 2002 was \$3.1 million higher than in the same period in 2001, reflecting a 61% growth in the volume of tickets produced during the quarter, partially offset by competitive price reductions which began in the third quarter of 2001.

### *Gross Profit Analysis*

The total gross profit earned of \$44.8 million, or 39% of revenues, in the three months ended September 30, 2002 increased \$5.8 million from the same period in 2001. This increase included \$3.3 million in improved gross margins in the service businesses that resulted primarily from the new lottery and cooperative services contracts, higher instant ticket sales due in part to the acquisition of a majority interest in SERCHI, and higher North American and European pari-mutuel revenues. These improvements in services gross profits were complemented by a \$2.6 million increase in sales margins reflecting the timing of equipment sales and \$1.1 million of volume-related margin improvements in the Telecommunications Products Group.

The Lottery Group gross profit of \$27.1 million, or 42% of revenues, in the three months ended September 30, 2002 increased \$4.0 million from \$23.1 million, or 38% of revenues, in the same period in 2001. Gross margin improvements of \$1.2 million compared to the same period in 2001 were realized as a result of continued retail growth at many of our cooperative services contracts, as well as the start-up of the South Carolina Educational Lottery in January of 2002. In addition, approximately \$0.7 million of gross margin improvement is attributable to continued cost reductions in our instant ticket and related services business, \$0.9 million of gross margin improvement is due to the addition of SERCHI, and \$1.4 million of gross margin improvement was contributed by higher lottery terminal and equipment sales to foreign customers in the three months ended September 30, 2002 as compared to the same period in 2001.

Pari-mutuel Group gross profit of \$9.1 million, or 40% of revenues, in the three months ended September 30, 2002 increased \$0.4 million from \$8.7 million, or 38% of revenues, in the same period in 2001. This increase is attributable to the continued growth of the North American and European operations and the benefits from on-going cost reduction programs.

Venue Management Group gross profit of \$4.8 million, or 30% of revenues, in the three months ended September 30, 2002, increased \$0.3 million from \$4.4 million, or 29% of revenues, in the same

period in 2001. This improvement primarily reflects the effect of the operating agreement in The Netherlands and Handle related margin improvements in Connecticut.

The Telecommunications Products Group gross profit of \$4.0 million, or 33% of revenues, in the three months ended September 30, 2002 increased \$1.2 million from \$2.8 million, or 32% of revenues, in the same period in 2001 as a 61% increase in sales volume was partially offset by competitive price reductions.

### *Expense Analysis*

Selling, general and administrative expenses of \$14.8 million in the three months ended September 30, 2002 were \$1.6 million higher than in the same period in 2001, primarily due to the reversal in the prior year quarter of a \$1.5 million litigation reserve when the lawsuit was settled, coupled with the additional operational expenses of SERCHI, in which we acquired a majority interest in June 2002.

Depreciation and amortization expense of \$9.1 million in the three months ended September 30, 2002 decreased \$3.0 million from \$12.1 million in the same period in 2001. Depreciation expense was \$0.4 million higher in the three months ended September 30, 2002 than in the same period in 2001, primarily as a result of higher depreciation on new computer systems and terminals acquired in connection with the

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start-up of the new on-line lotteries and enhancements to our Leeds, England printing facility. Amortization expense was \$3.4 million lower in the three months ended September 30, 2002 than in the same period in 2001, primarily as a result of the adoption of SFAS 141 and SFAS 142 effective January 1, 2002.

Interest expense of \$9.8 million in the three months ended September 30, 2002 decreased \$2.5 million from \$12.3 million in the same period in 2001 as a result of lower average debt levels following the repurchase of \$83.0 million of our 12<sup>1</sup>/<sub>2</sub>% Senior Subordinated Notes and lower average interest rates on the outstanding term loans. (See "Liquidity, Capital Resources and Working Capital" for a discussion of the 2002 Offering and the repurchase of our 12<sup>1</sup>/<sub>2</sub>% Senior Subordinated Notes.)

### *Extraordinary Item*

In connection with the redemption of our 12<sup>1</sup>/<sub>2</sub>% Senior Subordinated Notes, we paid the holders of such notes redemption premiums aggregating approximately \$11.2 million and we paid the Term A and Term B lenders a fee of approximately \$1.0 million to amend the term loan facility to permit us to use the majority of the net proceeds from the 2002 Offering to redeem our 12<sup>1</sup>/<sub>2</sub>% Senior Subordinated Notes rather than to pay down the term loans. These fees plus the write-off of approximately \$3.5 million of previously deferred financing costs related to the redeemed debt, partially offset by the state income tax benefit of \$0.7 million attributable to these expenses, or a total of \$14.9 million, was reflected as an extraordinary expense in the accompanying financial statements.

### *Income Tax Expense (Benefit)*

Income tax expense was \$2.9 million in the three months ended September 30, 2002, as compared to income tax expense of \$1.4 million in the three months ended September 30, 2001. This expense primarily reflects foreign and state taxes. We had U.S. based taxable income in 2001 and expect to have U.S. based taxable income in 2002. In the fourth quarter of 2002, we will reassess whether our recorded net operating loss valuation allowance of approximately \$50.0 million is still appropriate or whether such allowance should be reduced or even eliminated, considering the demonstrated improvement in our financial results. Any such adjustments will be reflected in the results of operations for the fourth quarter of 2002.

## **Results of Operations: See Note 4 Business Segments**

### **Nine Months Ended September 30, 2002 compared to Nine Months Ended September 30, 2001**

#### *Revenue Analysis*

Lottery Group revenue of \$189.8 million in the nine months ended September 30, 2002 improved \$11.9 million from the same period in 2001. An \$8.1 million increase in service revenue is attributable to: an incremental \$15.9 million growth in our on-line lottery business due to the start-up of the on-line lotteries in Maine and Iowa in July 2001, the start-up of the South Carolina Educational Lottery in January 2002, the acquisition of SERCHI in June 2002, and revenue increases in Florida and Georgia. These increases were partially offset by a \$5.3 million decrease resulting from the absence of the French lottery business that was sold in the third quarter of 2001 and a \$2.0 million decrease in cooperative services revenues attributable principally to the loss of the New York State cooperative services contract, which had already been awarded to another company at the time we acquired SGHC. In the nine months ended September 30, 2002, equipment sales increased \$3.8 million from the same period in 2001 due to the timing of equipment sales to a foreign customer.

Pari-mutuel Group service revenue of \$62.0 million in the nine months ended September 30, 2002 increased \$1.3 million from the same period in 2001 as revenue improvements in the North American racing operations, NASRIN services and simulcasting services were partially offset by lower service revenues in the French operations and lower revenues in the German racing operations due to lower simulcast fees as a result of a racetrack/bookmaker dispute in the first quarter of 2002. Sales revenue of \$4.6 million in the nine months ended September 30, 2002 decreased \$11.3 million from same period in 2001 principally due to the completion in 2001 of a system and terminals sale to our customer in Turkey.

Venue Management Group service revenue of \$47.1 million in the nine months ended September 30, 2002 was \$0.6 million higher than in the same period in 2001, primarily reflecting higher Handle related revenue in the Connecticut OTB operations from the growth in telephone account wagering, partially offset by reduced revenues earlier this year, following the closing of the Milford jai-alai fronton.

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Telecommunications Products Group sales revenue of \$32.9 million in the nine months ended September 30, 2002 was \$1.9 million higher than in the same period in 2001, reflecting a 33% growth in the volume of tickets produced, partially offset by competitive price reductions which began in the third quarter of 2001.

### *Gross Profit Analysis*

The total gross profit earned of \$134.3 million in the nine months ended September 30, 2002 increased \$15.3 million from the same period in 2001. This increase included \$20.4 million in improved gross margins in the service businesses that resulted primarily from the additional new lotteries in Maine and Iowa in July 2001, the start-up of the South Carolina Educational Lottery in January 2002, continued retail sales growth at many of our cooperative service customers, and higher pari-mutuel and venue management revenues. These improvements were offset by a \$4.6 million decrease in sales margins reflecting the fewer sales of equipment and systems to foreign customers, partially offset by volume related margin improvements in the Telecommunications Products Group.

The Lottery Group gross profit of \$80.9 million, or 43% of revenues, in the nine months ended September 30, 2002 increased \$17.2 million from \$63.7 million, or 36% of revenues, in the same period in 2001. Service revenue gross margin improvements of \$17.3 million were realized as a result of the additions of the Maine and Iowa on-line lotteries in July 2001 and the start-up of the South Carolina Educational Lottery in January 2002, continued retail sales growth at many of our cooperative service customers, and cost reductions in our instant ticket and related services business, plus the addition of

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SERCHI in June 2002, all partially offset by a \$1.4 million reduction due to the sale of the French lottery business in the third quarter of 2001. These margin improvements were supplemented by a \$0.4 increase in margins due to higher lottery equipment sales.

Pari-mutuel Group gross profit of \$27.5 million, or 41% of revenues, in the nine months ended September 30, 2002 decreased \$1.7 million from \$29.2 million, or 38% of revenues, in the same period in 2001. For the period, service revenue gross profit improved \$2.0 million as a result of continued growth of the North American operations and the benefits from on-going European and North American cost reduction programs. In the same period, sales revenue gross margin declined \$3.8 million due to the completion in 2001 of a sale to our customer in Turkey.

Venue Management Group gross profit of \$14.8 million, or 31% of revenues, in the nine months ended September 30, 2002 increased \$1.1 million from \$13.6 million, or 29% of revenues, in the same period in 2001. This improvement primarily reflects the effect of the new operating agreement in The Netherlands, and expanded telephone account wagering and continued cost controls in our Connecticut operations.

The Telecommunications Products Group gross profit of \$11.1 million, or 34% of revenues, in the nine months ended September 30, 2002 decreased \$1.3 million from \$12.5 million, or 40% of revenues, in the same period in 2001 as a 33% growth in the volume of tickets produced was offset by continued competitive price reductions which began in the third quarter of 2001.

### *Expense Analysis*

Selling, general and administrative expenses of \$44.9 million in the nine months ended September 30, 2002 were \$3.1 million higher than in the same period in 2001 primarily due to the reversal in the prior year period of a \$1.5 million litigation reserve when the lawsuit was settled, coupled with higher proposal costs, professional services and compensation, plus the inclusion of the additional operational expenses of SERCHI, in which we acquired a majority interest in June 2002. These increases were partially offset by cost reductions in the North American pari-mutuel business and reduced expenses as a result of the sale of the French lottery business in the third quarter of 2001.

Depreciation and amortization expense of \$27.9 million in the nine months ended September 30, 2002 decreased \$8.4 million from \$36.4 million in the same period in 2001. Depreciation expense increased \$1.1 million in the nine months ended September 30, 2002 from the same period in 2001, primarily as a result of higher depreciation on new computer systems and terminals acquired in connection with the start-up of the new on-line lotteries and enhancements to our Leeds, England printing facility. Amortization expense was \$8.9 million lower in the nine months ended September 30, 2002 than in the same period in 2001, primarily as a result of the adoption of SFAS 141 and SFAS 142 effective January 1, 2002.

Interest expense of \$32.8 million in the nine months ended September 30, 2002 decreased \$5.8 million from \$38.6 million in the same period in 2001 primarily due to lower average interest rates on the outstanding term loans, plus the effect of lower average debt levels following the third quarter 2002 repurchase of \$83.0 million of our 12<sup>1</sup>/<sub>2</sub>% Senior Subordinated Notes. (See "Liquidity, Capital Resources and Working Capital" for a discussion of the 2002 Offering and the repurchase of our 12<sup>1</sup>/<sub>2</sub>% Senior Subordinated Notes.)



*Extraordinary Item*

In connection with the redemption of the 12<sup>1</sup>/<sub>2</sub>% Senior Subordinated Notes we paid the Subordinated noteholders redemption premiums aggregating approximately \$11.2 million and we paid the term loan lenders a fee of approximately \$1.0 million to amend the term loan facility to permit us to use the majority of the net proceeds from the equity offering to redeem subordinated debt rather

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than to pay down the term loans. These fees plus the write-off of approximately \$3.5 million of previously deferred financing costs related to the redeemed debt, partially offset by the state income tax benefit of \$0.7 million attributable to these expenses, or a total of \$14.9 million, was reflected as an extraordinary expense in the accompanying financial statements.

*Income Tax Expense*

Income tax expense was \$14.0 million in the nine months ended September 30, 2002. This amount primarily reflects foreign and state taxes, and a \$9.8 million charge in the first quarter of 2002 as a result of our adoption of SFAS 142, which caused us to reduce the recognized amount of our NOL from \$18.5 million to \$8.7 million to reflect the reduced amount of net taxable temporary differences that are expected to reverse during the NOL carryforward period because of the cessation of amortization of the tradename and employee workforce intangible assets. The income tax expense of \$5.1 million in the nine months ended September 30, 2001 was primarily for state and foreign taxes, net of a \$0.6 million benefit for an anticipated recovery of previously paid federal taxes. We had U.S. based taxable income in 2001 and expect to have U.S. based taxable income in 2002. In the fourth quarter of 2002, we will reassess whether our recorded net operating loss valuation allowance of approximately \$50.0 million is still appropriate or whether such allowance should be reduced or even eliminated, considering the demonstrated improvement in our financial results. Any such adjustments will be reflected in the results of operations for the fourth quarter of 2002.

**Liquidity, Capital Resources and Working Capital**

In order to finance the acquisition of SGHC and refinance substantially all of our then existing indebtedness, excluding our capital lease and other non-material obligations, we conducted a series of financings in September 2000. As a result, our capital structure changed significantly and, among other things, we became a significantly leveraged company. As a result of the acquisition and debt refinancing, we had total indebtedness including capital lease obligations outstanding of approximately \$439.7 million at December 31, 2001. We also recorded a substantial increase in fiscal 2000 in goodwill and other intangible assets in connection with the SGHC acquisition and a corresponding increase in amortization expense.

On July 2, 2002, we completed the public offering and sale of 14.4 million shares of our Class A Common Stock at a price of \$7.25 per share, and used the net proceeds of approximately \$98.5 million to redeem approximately \$83.0 million of our 12<sup>1</sup>/<sub>2</sub>% Senior Subordinated Notes. As a result of these transactions, our capital structure improved, Standard & Poor's and Moody's upgraded our credit ratings, and we expect to save approximately \$11 million per year in interest expense.

Our financing arrangements impose certain limitations on our and our subsidiaries' operations, including, at September 30, 2002, the maintenance of:

A minimum Consolidated Fixed Charge Coverage Ratio of 1.45. Consolidated Fixed Charge Coverage Ratio means, as of any date of determination, the ratio computed for our four most recent fiscal quarters of (x) Consolidated EBITDA to (y) the sum of (i) total interest expense less a majority of the non-cash amortization costs included in interest expense, (ii) all income taxes paid in cash, (iii) scheduled payments of principal on indebtedness and (iv) certain restricted payments. The amounts described in clauses (i) through (iii) are determined on a consolidated basis for us and our subsidiaries in accordance with accounting principles generally accepted in the United States of America, or GAAP.

A maximum Consolidated Leverage Ratio of 4.10 was reduced to 3.80 on October 1, 2002, and will be further reduced on the first day of each calendar quarter through January 1, 2007, from which date the ratio shall be 2.00. Consolidated Leverage Ratio means the ratio of (x) the aggregate stated balance sheet amount of our indebtedness determined on a consolidated basis

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in accordance with GAAP as of the last day of the fiscal quarter for which such determination is being made to (y) Consolidated EBITDA for the four consecutive fiscal quarters ended on the last day of the fiscal quarter for which such determination is being made.

A minimum Consolidated Interest Coverage Ratio of 2.10, which was increased to 2.25 on October 1, 2002, and will be increased on the first day of each calendar quarter through July 1, 2006, from which date the ratio shall be 3.50. Consolidated Interest Coverage Ratio means the ratio computed for our four most recent fiscal quarters of (x) Consolidated EBITDA to (y) total interest expense less a majority of the non-cash amortization costs included in interest expense.

A minimum Consolidated Net Worth of \$38.7 million plus an amount equal to 75% of the sum of our adjusted consolidated net income for each fiscal quarter for which adjusted consolidated net income is positive. Consolidated Net Worth means, as of any date of determination, the sum of our capital stock and that of our subsidiaries (including convertible preferred stock), plus our paid-in capital (subject to adjustment) and that of our subsidiaries, determined on a consolidated basis in accordance with GAAP, plus certain adjustments associated with the acquisition of SGHC and the financing thereof. As of September 30, 2002, the minimum Consolidated Net Worth required under this covenant was \$53.0 million.

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

Our financing arrangements also restrict our and certain of our subsidiaries' ability to finance future operations or capital needs or to engage in other business activities, by, among other things, limiting our ability to incur additional indebtedness, pay dividends, redeem capital stock, make certain investments, engage in sale-leaseback transactions, consummate certain asset sales, and create certain liens and other encumbrances on our assets. In March 2001, as a result of the financial performance of SGHC prior to its acquisition by us, certain transitional and operational matters occurring through December 31, 2000, and the timing of certain anticipated capital expenditures and associated borrowings in 2001, certain limitations were amended to be less restrictive. Among other changes, the Facility was modified so that the planned step-downs in fixed charge coverage ratios and leverage ratios were delayed by up to nine months through September 30, 2002. While we were in compliance with these covenants at September 30, 2002 and expect to continue to remain in compliance over the next 12 months, no assurances can be provided that we will be able to do so or that we will be able to continue to meet the covenant requirements beyond 12 months.

The foregoing description of certain limitations and restrictions imposed by our financing arrangements is a summary only and is not intended to be complete. If you wish to review the limitations and restrictions in their entirety, you should read the documents setting forth our financing arrangements, all of which have been filed as exhibits to our periodic filings with the SEC. Our contractual obligations and commercial commitments principally include obligations associated with our outstanding indebtedness and future minimum operating lease obligations, and they have not changed materially since December 31, 2001.

The Facility, which expires in September 2006, provides for borrowings up to \$65.0 million to be used for working capital and general corporate purpose loans and for letters of credit. At September 30, 2002, we had outstanding borrowings of \$10.5 million and outstanding letters of credit of \$21.3 million under the Facility leaving us with a total availability of \$33.2 million as compared to \$31.0 million at December 31, 2001. Our ability to continue to borrow under the Facility will depend on remaining in compliance with the limitations imposed by our lenders, including maintenance of

specified financial covenants. Presently, we have not sought and, therefore, do not have any other financing commitments.

Our Series A Convertible Preferred Stock requires dividend payments at a rate of 6% per annum. To date, we have satisfied the dividend requirement using additional shares of Series A Convertible Preferred Stock. The terms of the Series A Convertible Preferred Stock provide us with the flexibility to satisfy the dividend in cash commencing on September 30, 2002, the date of the ninth quarterly dividend, subject to bank approval. We expect that we will continue to make such payments in-kind.

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Our pari-mutuel wagering and on-line lottery systems service contracts require us to, among other things, maintain the central computing system and related hardware in efficient working order, provide added software functionality upon request, provide on-site computer operators, and furnish necessary supplies. Our primary expenditures associated with these services are (a) personnel and related costs which are expensed as incurred and are included in Operating Expenses-Services in the consolidated statements of operations, and (b) the costs of service contract software which are capitalized as incurred and expensed over the life of their related contracts and included in Amortization of Service Contract Software in the consolidated statements of operations. Historically, the revenues we derive from our service contracts have exceeded the direct costs associated with fulfilling our obligations under these pari-mutuel wagering and lottery systems service contracts. We expect that we will continue to realize positive cash flow and operating income as we extend or renew existing service contracts. We also expect that we will enter into new contracts that are accretive to our cash flow. In addition, through advancements in technology, we are continually deploying more efficient and cost effective methods for manufacturing and delivering our products and services to our customers. We expect that technological efficiencies will continue to positively impact our future cash flows and operating results. We are not party to any other material short term or long term obligations or commitments pursuant to these service contracts.

Periodically, we bid on new pari-mutuel and on-line lottery contracts. Once awarded, these contracts generally require significant up-front capital expenditures for terminal assembly, customization of software, software and equipment installation and telecommunications configuration. Historically we have funded these up front costs through cash flows generated from operations, available cash on hand and borrowings under our credit facilities. Our ability to continue to procure new contracts will depend on, among other things, our then present liquidity levels and/or our ability to obtain additional financing at commercially acceptable rates to finance the initial up front costs. Once operational, long term service contracts have been accretive to our operating cash flow. For fiscal 2002, we anticipate that capital expenditures and software expenditures will be approximately \$25 million. However, the actual level of expenditures will ultimately depend on the extent to which we are successful in winning new contracts. The amount of capital expenditures in fiscal 2003 and beyond will largely depend on the extent to which we are successful in winning new contracts. Furthermore, our pari-mutuel wagering network consists of approximately 26,000 wagering terminals. Periodically, we elect to upgrade the technological capabilities of older terminals and replace terminals that have exhausted their useful lives. We presently have no commitments to replace our existing terminal base and our obligation to upgrade the terminals is discretionary. Servicing our installed terminal base requires that we maintain a supply of parts and accessories on hand. We are also required, contractually in some cases, to provide spare parts over an extended period of time, principally in connection with our systems and terminal sale transactions. To meet our contractual obligations and maintain sufficient levels of on-hand inventory quantities to service our installed base, we purchase inventory on an as needed basis. We presently have no inventory purchase obligations.

At September 30, 2002, our available cash and borrowing capacity totaled \$42.0 million compared to \$43.6 million at December 31, 2001. Our available cash and borrowing capacities fluctuate principally based on the timing of collections from our customers, cash expenditures associated with new and existing pari-mutuel wagering and lottery systems contracts, repayment of our outstanding debt and

changes in our working capital position. The decrease in our available cash and borrowing capacity from the levels at December 31, 2001 principally reflects the use of cash on hand to partially fund our wagering systems and other capital expenditures, to reduce accrued liabilities, to make payments of interest accrued on debt, and to fund the \$4.1 million acquisition of a majority interest in SERCHI.

Net cash provided by operating activities was \$32.3 million for the nine months ended September 30, 2002. Of this amount, \$56.9 million was provided from operations and \$24.6 million was used as a result of changes in working capital. The working capital changes occurred principally from (i) increases in inventory in anticipation of requirements for equipment, (ii) an increase in accounts receivable due to a terminal sale to a foreign customer, (iii) increases in prepaid assets as a result of the new on-line and instant ticket lottery accounts, (iv) decreases in accrued liabilities due to payments related to the new lottery accounts, inventory, and obligations incurred in connection with the acquisition of SGHC, and (v) the payment of accrued interest. In this period, we invested \$19.5 million for wagering systems and capital expenditures, \$5.3 million in software expenditures, \$4.1 million for a majority interest in SERCHI, and repaid \$4.2 million of revolving credit facility loans and \$6.2 million of long-term debt. These cash expenditures were funded primarily with net cash provided by operating activities and cash on hand. We also received approximately \$97.1 million from the 2002 Offering (see Note 7 Capital Stock and Equity Offering) after deducting the underwriting discounts and commissions and estimated offering expenses, and we used the net proceeds to redeem approximately \$83.0 million of our 12½% Senior Subordinated Notes. In connection with this redemption, we were required to pay the noteholders a premium of approximately \$11.2 million and bank amendment fees of approximately \$1.0 million.

A significant portion of our cash flows from operations must be used to pay our interest expense and repay our indebtedness, which will reduce the funds that would otherwise be available to us for our operations and capital expenditures. Interest expense on our outstanding debt was approximately \$32.8 million for the nine months ended September 30, 2002, including approximately \$1.7 million of non-cash charges. Approximately one-fifth of our debt is in variable rate instruments. Consequently, we are exposed to fluctuations in interest rates. The effect of a 0.125% change in the interest rates associated with our unhedged variable rate debt will result in a change of approximately \$187,000 per year in our interest expense assuming no change in our outstanding borrowings. To reduce the risks associated with fluctuations in the market interest

rates and in response to the requirements of our credit facility, we entered into three interest rate swap contracts for an aggregate notional amount of \$140 million. These interest rate swaps obligate us to pay a fixed LIBOR rate and entitle us to receive a variable LIBOR rate on an aggregate \$140 million notional amount of debt thereby creating the equivalent of fixed rate debt until May 30, 2003. We have structured these interest rate swap agreements and we intend to structure future interest rate swap agreements to qualify for hedge accounting pursuant to the provisions of SFAS 133. Changes in the fair value of interest rate swaps designated as hedging instruments that effectively offset the variability of cash flows associated with variable rate credit facility obligations are reported as a component of stockholders' equity. These amounts are subsequently reclassified into interest expense as a yield adjustment of the hedged credit facility obligation in the same period in which the related interest affects operations.

We believe that our cash flow from operations, available cash and available borrowing capacity under our revolving credit facility will be sufficient to meet our liquidity needs, including anticipated capital expenditures, for the foreseeable future; however, we cannot assure you that this will be the case. While we are not aware of any particular trends, our lottery contracts periodically renew and we cannot assure you that we will be successful in sustaining our cash flow from operations through renewal of our existing contracts or through the addition of new contracts. In addition, lottery customers in the United States generally require service providers to provide performance bonds in connection with each state contract. Because of financial and economic events that have occurred this past year, such as the September 11 attack, the bond market is experiencing unusual contraction, and

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we cannot assure you that we will continue to be able to obtain performance bonds on commercially reasonable terms or at all. While we are not aware of any reason to do so, if we need to refinance all or part of our indebtedness, including the remaining \$67.0 million of our 12<sup>1</sup>/<sub>2</sub>% Senior Subordinated Notes, on or before their maturity, or provide letters of credit or cash in lieu of performance bonds, we cannot assure you that we will be able to obtain new financing or to refinance any of our indebtedness, including our revolving credit facility and our 12<sup>1</sup>/<sub>2</sub>% Senior Subordinated Notes, on commercially reasonable terms or at all.

#### **Recent Developments**

On August 20, 2002, we were awarded a contract by the Arizona Lottery to be the exclusive provider of Cooperative Services to the Lottery and to be one of four companies selected to supply instant tickets to the Lottery for an initial five-year term and two one-year extensions. We anticipate that the contract will generate approximately \$18.0 million of revenue over the initial five-year term.

On September 3, 2002, we announced that our subsidiary, Scientific Games Latino America, has been chosen to supply instant ticket games to three Latin American customers: Loteria Nacional de El Salvador; Loteria Nacional de Nicaragua and a private foundation in Mexico, Vamos Mexico. We anticipate that the contracts will generate, in the aggregate, approximately \$4 million of revenue over their initial one-year terms.

On October 31, 2002, we announced that we had uncovered evidence of potential wrongdoing by an employee of Autotote Systems, Inc., our wholly owned pari-mutuel wagering subsidiary, during the course of conducting an internal investigation into the \$3 million winning wager on the Breeders' Cup Pick Six a wager that requires the bettor to select the winners of six consecutive thoroughbred horseraces. The winning wager, placed on Breeders' Cup races held on October 26, 2002 at Arlington Park in Illinois, was processed through Autotote's totalizator system at an off-track wagering location at Catskill OTB in New York. The employee suspected of wrongdoing was terminated, and we turned over evidence to law enforcement personnel. On November 12, 2002, the terminated employee, along with the holder of the winning wagering tickets and a third person, was charged in U.S. District Court for the Southern District of New York with conspiracy to commit wire fraud. We have been cooperating with regulatory authorities and law enforcement and are vigorously taking steps to resolve the matter. Among other things, steps are already underway to review computer systems and procedures and enhance security in connection with the delivery of totalizator services, including: beginning, within approximately 30 days, the use of independent third-party control systems at all of Autotote's U.S. pari-mutuel facilities (to be provided by eSuccess Solutions and similar to the systems already provided by eSuccess at our U.S. lottery installations); the creation of the new executive position of Chief Security Officer, reporting directly to our Chairman and Chief Executive Officer; the retention of Kroll, Inc., the world's leading risk mitigation and security company, to conduct an independent multi-disciplinary review of the Company's risk profile, including information technology and physical security, operational controls, hiring practices and internal compliance, with the intention of promptly implementing, wherever practicable, Kroll's recommendations; and coordinating with the other two U.S. totalizator companies to implement near-term measures to enhance computer security in the industry, and working with Ernst & Young LLP on their industry security study sponsored by the National Thoroughbred Racing Association. Although we believe that the potential losses, if any, that may arise from this matter would not result in a material adverse effect on our consolidated financial position or results of operations, it is not feasible to predict with certainty, and there can be no assurance that our business might not be materially affected.

#### **Forward-Looking Statements**

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Throughout this Form 10-Q/A we make "forward-looking statements" within the meaning of the United States Private Securities Litigation Reform Act of 1995. In some cases, forward-looking

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statements can be identified by the use of forward-looking terminology such as "may," "will," "estimate," "intend," "continue," "believe," "expect" or "anticipate," or the negatives thereof, variations thereon or similar terminology. The forward-looking statements contained in this Form 10-Q/A are generally located in the material set forth under the heading "Management's Discussion and Analysis of Financial Condition and Results of Operations" but may be found in other locations as well. These forward-looking statements generally relate to plans and objectives for future operations and are based upon management's reasonable estimates of future results or trends. Although we believe that the plans and objectives reflected in or suggested by such forward-looking statements are reasonable, such plans or objectives may not be achieved.

Actual results may differ from projected results due, but not limited, to unforeseen developments, including developments relating to the following:

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

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

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

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

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

an inability to renew or early termination of our contracts;

an inability to engage in future acquisitions;

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

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

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

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

In June 2001, the FASB issued Statement No. 143, *Accounting for Asset Retirement Obligations* ("SFAS 143"). SFAS 143 addresses financial accounting and reporting for obligations associated with the retirement of tangible long-lived assets and the associated asset retirement costs. It applies to legal obligations associated with the retirement of long-lived assets that result from the acquisition, construction, development and (or) the normal operation of a long-lived asset, except for certain obligations of lessees. This Statement amends FASB Statement No. 19, *Financial Accounting and Reporting by Oil and Gas Producing Companies*, and it applies to all entities. We are required to adopt SFAS 143, effective for calendar year 2003. We do not expect the adoption of SFAS 143 to have a material impact on our future consolidated operations or

financial position, as we are now constituted.

In April 2002, the FASB issued Statement No. 145, *Rescission of FASB Statements No. 4, 44 and 64, Amendment of FASB Statement No. 13, and Technical Corrections* ("SFAS 145"). SFAS 145 updates, clarifies and simplifies existing accounting pronouncements. SFAS 145 rescinds Statement 4, which

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required all gains and losses from extinguishment of debt to be aggregated and, if material, classified as an extraordinary item, net of related income tax effect. As a result, the criteria in Opinion 30 will now be used to classify those gains and losses because Statement 4 has been rescinded. Statement 44 was issued to establish accounting requirements for the effects of transition to the provisions of the Motor Carrier Act of 1980. Because the transition has been completed, Statement 44 is no longer necessary.

SFAS 145 amends Statement 13 to require that certain lease modifications that have economic effects similar to sale-leaseback transactions be accounted for in the same manner as sale-leaseback transactions. This amendment is consistent with the FASB's goal of requiring similar accounting treatment for transactions that have similar economic effects. SFAS 145 also makes technical corrections to existing pronouncements. While those corrections are not substantive in nature, in some instances, they may change accounting practice. We are required to adopt SFAS 145, effective for calendar year 2003. We are currently evaluating the impact that the adoption of SFAS 145 will have on our consolidated operations and financial position.

In July 2002, the FASB issued Statement No. 146, *Accounting for Costs Associated with Exit or Disposal Activities* ("SFAS 146"). SFAS 146 will spread out the reporting of expenses related to restructurings initiated after 2002 because a commitment to a plan to exit an activity or dispose of long-lived assets will no longer be enough to record a liability for the anticipated costs. Instead, companies will record exit and disposal costs when they are "incurred" and can be measured at fair value, and they will subsequently adjust the recorded liability for changes in estimated cash flows. We are required to adopt SFAS 146, prospectively for exit or disposal activities initiated after December 31, 2002. We do not expect the adoption of SFAS 146 to have a material impact on our future consolidated operations or financial position, as we are now constituted.

In October 2002, the FASB issued Statement No. 147, *Acquisitions of Certain Financial Institutions* ("SFAS 147"). SFAS 147 provides guidance on the accounting for the acquisition of a financial institution, and applies to all acquisitions except those between two or more mutual enterprises. We do not anticipate acquiring a financial institution and therefore do not expect the adoption of SFAS 147 to have a material impact on our future consolidated operations or financial position, as we are now constituted.

## QUANTITATIVE AND QUALITATIVE DISCLOSURES ABOUT MARKET RISK

Our products and services are sold to a diverse group of customers throughout the world. As such, we are subject to certain risks and uncertainties as a result of changes in general economic conditions, sources of supply, competition, foreign exchange rates, tax reform, litigation and regulatory developments. The diversity and breadth of our products and geographic operations mitigate the risk that adverse changes in any event would materially affect our financial position. Additionally, as a result of the diversity of our customer base, we do not consider ourselves exposed to concentration of credit risks. These risks are further minimized by setting credit limits, ongoing monitoring of customer account balances, and assessment of the customers' financial strengths.

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

For fiscal 2001, inflation was not a significant factor in our results of operations, and we were not impacted by significant pricing changes in our costs, except for personnel related expenditures. We are unable to forecast the prices or supply of substrate, component parts or other raw materials in 2002, but we currently do not anticipate any substantial changes that will materially affect our operating results.

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

In the normal course of business, we are exposed to fluctuations in interest rates and equity market risks as we seek debt and equity capital to sustain our operations. At September 30, 2002 approximately one-fifth of our debt was in fixed rate instruments. We consider the fair value of all financial instruments to be not materially different from their carrying value at year-end. The following table provides information about our financial instruments that are sensitive to changes in interest rates. The table presents principal cash flows and related weighted-average interest rates by expected maturity dates. In the third quarter of 2002 we completed the 2002 Offering and used approximately \$83.0 million of the net proceeds to redeem a portion of our 12 $\frac{1}{2}$ % Senior Subordinated Notes. See "Liquidity, Capital Resources and Working Capital."

### Principal Amount by Expected Maturity Average Interest Rate Expected Maturity Date (dollars in thousands) September 30, 2002

	2002	2003	2004	2005	2006	Thereafter	Total	Fair Value
Long-term debt:								
Fixed interest rate	\$						67,043	74,820
Interest rate							12.5%	12.5%
Variable interest rate	\$	2,800	11,950	14,950	17,200	75,100	155,100	277,100
Average interest rate		5.12%	5.11%	5.06%	5.03%	5.99%	6.13%	5.91%

During the third quarter of 2002, we entered into derivative contracts to hedge part of our foreign currency exposure with respect to future cash receipts under our contract with the Ontario Lottery Commission. These instruments, which have a notional value of Canadian dollars \$17.3 million, have been designated as cash flow hedges. For the three months and nine months ended September 30, 2002, the Company recorded a credit to other comprehensive income (loss) of \$0.162 million for the change in the fair value of these foreign exchange instruments.

In November 2000, to reduce the risks associated with fluctuations in market interest rates and in response to requirements in the Facility (see Note 9 to the Consolidated Financial Statements for the year ended December 31, 2001 in our 2001 Annual Report on Form 10-K, as modified by the foregoing), we entered into three interest rate swap contracts for an aggregate notional amount of \$140.0 million. The following table provides information about our derivative financial instruments. The table presents notional amounts and weighted-average swap rates by contractual maturity dates. We do not hold any market risk instruments for trading purposes.

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### Notional Amount by Expected Maturity Derivative Financial instruments Expected Maturity Date (dollars in thousands) September 30, 2002

	2002	2003	2004	2005	2006	Thereafter	Total	Fair Value
Interest rate swaps:								
Variable to fixed	\$	140,000					140,000	135,408
Pay 3-month LIBOR			6.52%				6.52%	
Canadian currency hedge:								
Notional value	c\$	13,000	4,333				17,333	\$ 162
Exchange rate		1.59	1.59				1.59	

We are also exposed to fluctuations in foreign currency exchange rates as the financial results of our foreign subsidiaries are translated into U.S. dollars in consolidation. Assets and liabilities outside the United States are primarily located in the United Kingdom, Germany, The Netherlands, France and Austria. Our investment in foreign subsidiaries with a functional currency other than the U.S. dollar are generally considered long-term investments. Accordingly, we do not hedge these net investments. Translation gains and losses historically have not been material. We manage our foreign currency exchange risks on a global basis by one or more of the following: (i) securing payment from our customers in U.S. dollars, when possible, (ii) utilizing borrowings denominated in foreign currency, and (iii) entering into foreign currency exchange contracts. In addition, a significant portion of the cost attributable to our foreign operations is incurred in the local currencies. We believe that a 10% adverse change in currency exchange rates would not have a significant adverse effect on our net earnings or cash flows. We

may, from time to time, enter into foreign currency exchange or other contracts to hedge the risk associated with certain firm sales commitments, anticipated revenue streams and certain assets and liabilities denominated in foreign currencies.

Our cash and cash equivalents and investments are in high-quality securities placed with a wide array of financial institutions with high credit ratings. This investment policy limits our exposure to concentration of credit risks.

## DISCLOSURE CONTROLS AND PROCEDURES

(a) Evaluation of Disclosure Controls and Procedures

As of a date within the 90 days prior to the date of this Form 10-Q/A, we performed an evaluation, 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 our disclosure controls and procedures (as such term is defined in rules 13a-14(c) and 15d-14(c) under the Securities Exchange Act of 1934, as amended, or the Exchange Act). Based upon that evaluation, our management, including our Chief Executive Officer and Chief Financial Officer, concluded that our disclosure controls and procedures were effective as of the evaluation date in ensuring that all material information required to be included in this Form 10-Q/A has been made known to them in a timely fashion.

(b) Changes in Internal Controls

There have been no significant changes in our internal controls or in other factors that could significantly affect our internal controls subsequent to the evaluation date.

## SCIENTIFIC GAMES CORPORATION AND SUBSIDIARIES Three Months Ended September 30, 2002

### PART II. OTHER INFORMATION

#### Item 1. Legal Proceedings

No significant changes have occurred with respect to legal proceedings as disclosed in our Annual Report on Form 10-K for the year ended December 31, 2001 or our Quarterly Report on Form 10-Q for the quarter ended June 30, 2002 (the "June 30 Form 10-Q").

Our Quarterly Report for the quarter ended March 31, 2002 contained disclosure concerning a class action suit filed on behalf of public stockholders of MDI Entertainment, Inc. against multiple parties, including us and MDI, to enjoin our then proposed acquisition of MDI. On May 8, 2002, we and MDI announced that we had mutually and amicably terminated negotiations with respect to that contemplated acquisition. The class action suit was subsequently dismissed upon the filing of a notice of dismissal by the plaintiffs.

#### Item 2. Changes in Securities and Use of Proceeds

As previously reported in the June 30 Form 10-Q, in connection with certain waivers and consents by holders of our Series A Convertible Preferred Stock relating to our public offering of 14,375,000 shares of Class A Common Stock in July 2002, we designated a new series of 2,000 shares of preferred stock, par value \$1.00 per share, as Series B Preferred Stock, and in July 2002 we issued an aggregate of 1,237,604 shares of Series B Preferred Stock, pro rata, to the holders of the Series A Convertible Preferred Stock. The Series B Preferred Stock has voting rights that, together with the voting rights of the Series A Convertible Preferred Stock, effectively reduce the aggregate ownership percentage of Series A Convertible Preferred Stock (on an "as-converted" basis) that the holders are required to maintain in order to elect our directors. The threshold for electing four directors was effectively reduced from 25% to 22.5% and the threshold for electing three directors was effectively reduced from 20% to 17.5%. The issuance of the Series B Preferred Stock did not affect the existing 10% and 5% thresholds for electing two directors and one director, respectively. The Series B Preferred Stock does not pay dividends and has a liquidation preference of no more than \$2,000 in the aggregate.



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Issuance of shares of Series B Preferred Stock to holders of the Series A Convertible Preferred Stock constitutes a private transaction exempt from the registration requirements of the Securities Act of 1933, as amended, under Section 4(2) thereof.

### Item 3. Defaults Upon Senior Securities

None.

### Item 4. Submission of Matters to a Vote of Stockholders

The Annual Meeting of our Stockholders was held on September 10, 2002 to elect ten directors, to approve the adoption of an amendment to our Restated Certificate of Incorporation to increase the number of authorized shares of our Common Stock from 100,000,000 to 200,000,000, to approve the adoption of our 2002 Employee Stock Purchase Plan, and to ratify the appointment of KPMG LLP as our independent auditors for the fiscal year ending December 31, 2002. The holders of our Class A Common Stock and our Series A Convertible Preferred Stock at the close of business on August 1, 2002, the record date for the Annual Meeting, voted together as a single class with respect to all matters other than the election of the four directors designated by the holders of the Preferred Stock, Messrs. Antonio Belloni, Rosario Bifulco, Peter A. Cohen and Michael S. Immordino. The holders of the Preferred Stock voted as a separate class with respect to the election of such directors. The holders of 50,612,929 shares of our Class A Common Stock and 1,144,717 shares of our Series A Convertible

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Preferred Stock, representing a total of 73,058,359 votes of such Common Stock and Preferred Stock on an 'as-converted' basis, were present in person or represented by proxy at the Annual Meeting. All matters put before the stockholders were approved as follows:

	<u>For</u>	<u>Withheld</u>	<u>Against</u>	<u>Abstain</u>
<i>Item 1</i>	<i>Election of Directors</i>			
	64,653,082	8,405,277		
	72,388,396	669,963		
	72,936,036	122,323		
	72,981,536	76,823		
	72,164,736	893,623		
	72,433,896	624,463		
	1,144,717			
	1,144,717			
	1,144,717			
	1,144,717			
<i>Item 2</i>	71,192,654(1)		1,817,574	48,131
<i>Item 3</i>	72,435,904(2)		555,775	66,680
<i>Item 4</i>	71,912,857		1,100,299	45,203

(1) Includes a majority of the outstanding shares of our Class A Common Stock and a majority of the outstanding shares of our Series A Convertible Preferred Stock.

(2) Includes a majority of the outstanding shares of our Series A Convertible Preferred Stock.

**Item 5. Other Information**

None.

**Item 6. Exhibits and Reports on Form 8-K**

(a)

Exhibits

- 3.(i) Certificate of Amendment to the Restated Certificate of Incorporation of the Company, filed with the Secretary of State of the State of Delaware on September 26, 2002 (incorporated by reference to Exhibit 3.(i) to the Company's Quarterly Report on Form 10-Q for the Quarter ended September 30, 2002, filed November 14, 2002 (the "September 2002 10-Q")).
- 10.1 2002 Employee Stock Purchase Plan (incorporated by reference to Exhibit 10.1 to the September 2002 10-Q).
- 99.1 Certification of the Chief Executive Officer of the Company pursuant to 18 U.S.C. Section 1350, as adopted pursuant to Section 906 of the Sarbanes-Oxley Act of 2002.
- 99.2 Certification of the Chief Financial Officer of the Company pursuant to 18 U.S.C. Section 1350, as adopted pursuant to Section 906 of the Sarbanes-Oxley Act of 2002.

(b)

Reports on Form 8-K

None.

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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.

*SCIENTIFIC GAMES CORPORATION*  
(Registrant)

By: /s/ DEWAYNE E. LAIRD

Name: DeWayne E. Laird  
Title: *Vice President & Chief Financial Officer*  
*(principal financial and accounting officer)*

Dated: August 13, 2003

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**CERTIFICATION**

I, A. Lorne Weil, certify that:

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1. I have reviewed this Amendment No. 1 on Form 10-Q/A to Quarterly Report on Form 10-Q of Scientific Games Corporation;
2. Based on my knowledge, this amendment does not contain any untrue statement of a material fact or omit to state a material fact necessary to make the statements made, in light of the circumstances under which such statements were made, not misleading with respect to the period covered by this amendment;
3. Based on my knowledge, the financial statements, and other financial information included in this amendment, fairly present in all material respects the financial condition, results of operations and cash flows of the registrant as of, and for, the periods presented in this amendment;
4. The registrant's other certifying officers and I are responsible for establishing and maintaining disclosure controls and procedures (as defined in Exchange Act Rules 13a-14 and 15d-14) for the registrant and we have:
  - a) Designed such disclosure controls and procedures to ensure that material information relating to the registrant, including its consolidated subsidiaries, is made known to us by others within those entities, particularly during the period in which this amendment is being prepared;
  - b) Evaluated the effectiveness of the registrant's disclosure controls and procedures as of a date within 90 days prior to the filing date of this amendment (the "Evaluation Date"); and
  - c) Presented in this amendment our conclusions about the effectiveness of the disclosure controls and procedures based on our evaluation as of the Evaluation Date;
5. The registrant's other certifying officers and I have disclosed, based on our most recent evaluation, to the registrant's auditors and the audit committee of registrant's board of directors (or persons performing the equivalent function):
  - a) All significant deficiencies in the design or operation of internal controls which could adversely affect the registrant's ability to record, process, summarize and report financial data and have identified for the registrant's auditors any material weaknesses in internal controls; and
  - b) Any fraud, whether or not material, that involves management or other employees who have a significant role in the registrant's internal controls; and
6. The registrant's other certifying officers and I have indicated in this amendment whether or not there were significant changes in internal controls or in other factors that could significantly affect internal controls subsequent to the date of our most recent evaluation, including any corrective actions with regard to significant deficiencies and material weaknesses.

Date: August 13, 2003

/s/ A. Lorne Weil

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A. Lorne Weil  
*Chief Executive Officer*

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### CERTIFICATION

I, DeWayne E. Laird, certify that:

1. I have reviewed this Amendment No. 1 on Form 10-Q/A to Quarterly Report on Form 10-Q of Scientific Games Corporation;
2. Based on my knowledge, this amendment does not contain any untrue statement of a material fact or omit to state a material fact necessary to make the statements made, in light of the circumstances under which such statements were made, not misleading with respect to the period covered by this amendment;

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3. Based on my knowledge, the financial statements, and other financial information included in this amendment, fairly present in all material respects the financial condition, results of operations and cash flows of the registrant as of, and for, the periods presented in this amendment;
4. The registrant's other certifying officers and I are responsible for establishing and maintaining disclosure controls and procedures (as defined in Exchange Act Rules 13a-14 and 15d-14) for the registrant and we have:
- a) Designed such disclosure controls and procedures to ensure that material information relating to the registrant, including its consolidated subsidiaries, is made known to us by others within those entities, particularly during the period in which this amendment is being prepared;
  - b) Evaluated the effectiveness of the registrant's disclosure controls and procedures as of a date within 90 days prior to the filing date of this amendment (the "Evaluation Date"); and
  - c) Presented in this amendment our conclusions about the effectiveness of the disclosure controls and procedures based on our evaluation as of the Evaluation Date;
5. The registrant's other certifying officers and I have disclosed, based on our most recent evaluation, to the registrant's auditors and the audit committee of registrant's board of directors (or persons performing the equivalent function):
- a) All significant deficiencies in the design or operation of internal controls which could adversely affect the registrant's ability to record, process, summarize and report financial data and have identified for the registrant's auditors any material weaknesses in internal controls; and
  - b) Any fraud, whether or not material, that involves management or other employees who have a significant role in the registrant's internal controls; and

6. The registrant's other certifying officers and I have indicated in this amendment whether or not there were significant changes in internal controls or in other factors that could significantly affect internal controls subsequent to the date of our most recent evaluation, including any corrective actions with regard to significant deficiencies and material weaknesses.

Date: August 13, 2003

/s/ DeWayne E. Laird

DeWayne E. Laird  
Chief Financial Officer

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### INDEX TO EXHIBITS

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