CHURCHILL DOWNS INC
Form 10-Q
November 07, 2006

UNITED STATES
SECURITIES AND EXCHANGE COMMISSION
WASHINGTON, D.C. 20549

**FORM 10-Q**

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

**For the quarterly period ended September 30, 2006**

**OR**

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

**For the transition period from _____ to _____**

Commission file number 0-1469

(Exact name of registrant as specified in its charter)

| | |
|---|---|
| Kentucky | 61-0156015 |
| (State or other jurisdiction of incorporation or organization) | (IRS Employer Identification No.) |

700 Central Avenue, Louisville, Kentucky 40208
(Address of principal executive offices) (zip code)

(502) 636-4400
(Registrant's telephone number, including area code)

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

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

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

The number of shares outstanding of registrant's common stock at November 2, 2006 was 13,373,387 shares.

**CHURCHILL DOWNS INCORPORATED**
**INDEX TO QUARTERLY REPORT ON FORM 10-Q**
**For the Quarter Ended September 30, 2006**

Return to Index

**PART I. FINANCIAL INFORMATION**

**ITEM 1. FINANCIAL STATEMENTS**

**CHURCHILL DOWNS INCORPORATED**
**CONDENSED CONSOLIDATED BALANCE SHEETS**
**(Unaudited) (in thousands)**

| | September 30, 2006 | December 31, 2005 |
|---|---|---|
| **ASSETS** | | |
| Current assets: | | |
| Cash and cash equivalents | $ 24,863 | $ 22,347 |
| Restricted cash | 16,721 | 4,946 |
| Accounts receivable, net of allowance for doubtful accounts of $679 at September 30, 2006 and $786 at December 31, 2005 | 38,268 | 42,823 |
| Deferred income taxes | 3,907 | 3,949 |
| Income taxes receivable | 2,079 | 697 |
| Other current assets | 12,046 | 6,942 |
| Assets held for sale | - | 3,938 |
| Total current assets | 97,884 | 85,642 |
| Other assets | 13,120 | 13,020 |
| Plant and equipment, net | 347,544 | 342,845 |
| Goodwill | 53,528 | 53,528 |
| Other intangible assets, net | 17,594 | 18,130 |
| Total assets | $ 529,670 | $ 513,165 |
| **LIABILITIES AND SHAREHOLDERS' EQUITY** | | |
| Current Liabilities: | | |
| Accounts payable | $ 23,843 | $ 27,844 |
| Purses payable | 26,727 | 14,195 |
| Accrued expenses | 45,356 | 41,844 |
| Dividends payable | - | 6,520 |
| Deferred revenue | 14,725 | 26,216 |
| Liabilities associated with assets held for sale | - | 790 |
| Total current liabilities | 110,651 | 117,409 |
| Long-term debt | 19,154 | 33,793 |
| Other liabilities | 23,215 | 21,448 |
| Deferred revenue | 18,443 | 18,614 |
| Deferred income taxes | 5,119 | 5,670 |
| Total liabilities | 176,582 | 196,934 |
| Commitments and contingencies | | |
| Shareholders' equity: | | |
| Preferred stock, no par value; 250 shares authorized; no shares issued | - | - |
| Common stock, no par value; 50,000 shares authorized; issued 13,285 shares September 30, 2006 and 13,132 shares December 31, 2005 | 123,260 | 121,270 |
| Retained earnings | 229,828 | 198,001 |
| Unearned stock compensation | - | (3,040) |
| Total shareholders’ equity | 353,088 | 316,231 |
| Total liabilities and shareholders’ equity | $ 529,670 | $ 513,165 |

The accompanying notes are an integral part of the Condensed Consolidated Financial Statements.

Return to Index

**CHURCHILL DOWNS INCORPORATED**
**CONDENSED CONSOLIDATED STATEMENTS OF NET EARNINGS AND COMPREHENSIVE EARNINGS**
**for the three and nine months ended September 30, 2006 and 2005**
**(Unaudited) (in thousands, except per share data)**

| | Three Months Ended September 30, 2006 | Three Months Ended September 30, 2005 | Nine Months Ended September 30, 2006 | Nine Months Ended September 30, 2005 |
|---|---|---|---|---|
| Net revenues | $ 106,350 | $ 101,661 | $ 324,684 | $ 315,129 |
| Operating expenses | 91,742 | 88,177 | 256,010 | 252,452 |
| Gross profit | 14,608 | 13,484 | 68,674 | 62,677 |
| Selling, general and administrative expenses | 11,452 | 10,244 | 35,018 | 34,918 |
| Insurance recoveries, net of losses | (1,832) | (1,363) | (12,954) | (1,363) |
| Operating income | 4,988 | 4,603 | 46,610 | 29,122 |
| Other income (expense): | | | | |
| Interest income | 272 | 135 | 634 | 296 |
| Interest expense | (526) | (265) | (1,708) | (950) |
| Unrealized gain on derivative instruments | 204 | 204 | 612 | 614 |
| Miscellaneous, net | (92) | 715 | 510 | 1,308 |
| | (142) | 789 | 48 | 1,268 |
| Earnings from continuing operations before provision for income taxes | 4,846 | 5,392 | 46,658 | 30,390 |
| Provision for income taxes | (2,128) | (2,233) | (19,772) | (13,240) |
| Net earnings from continuing operations | 2,718 | 3,159 | 26,886 | 17,150 |
| Discontinued operations, net of income taxes: | | | | |
| Earnings (loss) from operations | 1,832 | (1,441) | 744 | (5,143) |
| Gain on sale of assets | 4,197 | 69,917 | 4,197 | 69,917 |
| Net earnings | 8,747 | 71,635 | 31,827 | 81,924 |
| Other comprehensive (loss) income, net of income taxes: | | | | |
| Change in fair value of cash flow hedges | - | (215) | - | 180 |
| Comprehensive earnings | $ 8,747 | $ 71,420 | $ 31,827 | $ 82,104 |
| Net earnings per common share data: | | | | |
| Basic | | | | |
| Net earnings from continuing operations | $ 0.20 | $ 0.24 | $ 1.98 | $ 1.28 |
| Discontinued operations | 0.44 | 5.12 | 0.37 | 4.86 |
| Net earnings | $ 0.64 | $ 5.36 | $ 2.35 | $ 6.14 |
| Diluted | | | | |
| Net earnings from continuing operations | $ 0.20 | $ 0.23 | $ 1.97 | $ 1.27 |
| Discontinued operations | 0.44 | 5.07 | 0.36 | 4.80 |
| Net earnings | $ 0.64 | $ 5.30 | $ 2.33 | $ 6.07 |
| Weighted average shares outstanding: | | | | |
| Basic | 13,149 | 12,913 | 13,116 | 12,893 |
| Diluted | 13,656 | 13,511 | 13,635 | 13,507 |

The accompanying notes are an integral part of the Condensed Consolidated Financial Statements.

Return to Index

**CHURCHILL DOWNS INCORPORATED**
**CONDENSED CONSOLIDATED STATEMENTS OF CASH FLOWS**
**for the nine months ended September 30,**
**(Unaudited) (in thousands)**

| | | 2006 | | 2005 |
|---|---|---|---|---|
| Cash flows from operating activities: | | | | |
| Net earnings | $ | 31,827 | $ | 81,924 |
| Adjustments to reconcile net earnings to net cash provided by operating activities: | | | | |
| Depreciation and amortization | | 15,670 | | 18,883 |
| Unrealized gain on derivative instruments | | (612) | | (614) |
| Loss (gain) on sale of business | | 3,666 | | (112,370) |
| Other | | 1,301 | | 870 |
| Increase (decrease) in cash resulting from changes in operating assets and liabilities: | | | | |
| Restricted cash | | (11,775) | | (5,477) |
| Accounts receivable | | (4,673) | | 1,852 |
| Other current assets | | (5,222) | | (2,674) |
| Income taxes | | (1,382) | | 40,740 |
| Accounts payable | | 242 | | (9,522) |
| Purses payable | | 12,287 | | 13,767 |
| Accrued expenses and other liabilities | | 5,950 | | 2,021 |
| Deferred revenue | | (2,434) | | (2,944) |
| Other assets and liabilities | | 1,859 | | 6,044 |
| Net cash provided by operating activities | | 46,704 | | 32,500 |
| Cash flows from investing activities: | | | | |
| Additions to plant and equipment | | (21,746) | | (40,594) |
| Proceeds on sale of fixed assets | | 15 | | 3 |
| Proceeds from sale of business, net of cash sold | | (347) | | 248,323 |
| Net cash (used in) provided by investing activities | | (22,078) | | 207,732 |
| Cash flows from financing activities: | | | | |
| Borrowings on bank line of credit | | 217,480 | | 445,202 |
| Repayments of bank line of credit | | (233,082) | | (570,202) |
| Repayments of Senior Notes | | - | | (100,000) |
| Change in book overdraft | | (4,161) | | (901) |
| Payment of dividends | | (6,520) | | (6,430) |
| Windfall tax benefit from share-based compensation | | 483 | | - |
| Common stock issued | | 3,549 | | 2,612 |
| Net cash used in financing activities | | (22,251) | | (229,719) |
| Net increase in cash and cash equivalents | | 2,375 | | 10,513 |
| Cash and cash equivalents, beginning of period | | 22,488 | | 27,712 |
| Cash and cash equivalents, end of period | | 24,863 | | 38,225 |
| Cash and cash equivalents included in assets held for sale | | - | | (345) |
| Cash and cash equivalents in continuing operations | $ | 24,863 | $ | 37,880 |
| Cash paid during the period for: | | | | |

| | | | | |
|---|---|---|---|---|
| Interest | $ | 622 | $ | 10,082 |
| Income taxes | $ | 13,244 | $ | 12,678 |
| Schedule of non-cash activities: | | | | |
| Plant and equipment additions included in accounts payable/accrued expenses | $ | 1,483 | $ | 2,621 |
| Issuance of common stock in connection with restricted stock plan | $ | 216 | $ | 277 |

The accompanying notes are an integral part of the Condensed Consolidated Financial Statements.

5

Return to Index

NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS
(Unaudited)

**1. Basis of Presentation**

The accompanying Condensed Consolidated Financial Statements are presented in accordance with the requirements of Form 10-Q and consequently do not include all of the disclosures required by accounting principles generally accepted in the United States of America or those normally made in Churchill Downs Incorporated's (the "Company") Annual Report on Form 10-K. The year-end Condensed Consolidated Balance Sheet data was derived from audited financial statements but does not include all disclosures required by accounting principles generally accepted in the United States of America. Accordingly, the reader of this Quarterly Report on Form 10-Q should refer to the Company's Annual Report on Form 10-K for the year ended December 31, 2005 for further information. The accompanying Condensed Consolidated Financial Statements have been prepared in accordance with the Company's customary accounting practices and have not been audited.

Certain prior period financial statement amounts have been reclassified to conform to the current period presentation. In the opinion of management, all adjustments considered necessary for a fair statement of this information have been made and all such adjustments are of a normal recurring nature.

The Company's revenues and earnings are significantly influenced by its racing calendar. Therefore, revenues and operating results for any interim quarter are generally not indicative of the revenues and operating results for the year and may not be comparable with results for the corresponding period of the previous year. The Company historically has had very few live racing days during the first quarter, with a majority of its live racing occurring in the second, third and fourth quarters, including the running of the Kentucky Derby and the Kentucky Oaks during the second quarter, the quarter during which the Company typically generates the majority of its annual operating income.

Long-Lived Assets

In the event that facts and circumstances indicate that the carrying amount of tangible or intangible long-lived assets or groups of assets may be impaired, an evaluation of recoverability is performed. If an evaluation was required, the estimated future undiscounted cash flows associated with the assets would be compared to the assets' carrying amount to determine if an impairment loss should be recorded. In addition, goodwill is otherwise tested for impairment on an annual basis in accordance with Statement of Financial Accounting Standards ("SFAS") No. 142, "Goodwill and Other Intangible Assets." In assessing whether goodwill is impaired, the fair market value of the related reporting unit is compared to its carrying amount, including goodwill. If the carrying amount of the reporting unit exceeds its fair market value, the second step of the goodwill impairment test is performed to measure the amount of impairment loss, if any. The second step of the goodwill impairment test consists of comparing the implied fair value of reporting unit goodwill with the carrying amount of that goodwill. If the carrying amount of reporting unit goodwill exceeds the implied fair value of that goodwill, an impairment loss is recognized equal to such excess. The implied fair value of goodwill is determined in the same manner as the amount of goodwill recognized in a business combination is determined. The Company completed the required impairment tests of goodwill and indefinite-lived intangible assets as of March 31, 2006, and no adjustment to the carrying value of goodwill was required.

Revenue Recognition

The Company's pari-mutuel revenues include commissions on pari-mutuel wagering at its racetracks and off-track betting facilities ("OTBs") (net of state and local pari-mutuel taxes), plus simulcast host fees from other wagering sites and source market fees generated from contracts with in-home wagering providers. In addition to the commissions and fees earned on pari-mutuel wagering, the Company earns pari-mutuel related streams of revenues from sources that are not directly related to wagering. These other revenues are primarily derived from statutory racing regulations in some of the states where the facilities are located and can fluctuate materially year-to-year. Non-pari-mutuel revenues are primarily generated from admissions, sponsorships, licensing rights and broadcast fees, concessions, video poker, lease income and other sources and are recognized when the related service is performed. Non-pari-mutuel revenues also include the Indiana riverboat admissions subsidy, which is recognized ratably over the Company's fiscal year.

Return to Index

NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS
(Unaudited)

Pari-mutuel revenues are recognized upon occurrence of the live race that is presented for wagering and after that live race is made official by the respective state's racing regulatory body. Additional non-wagering revenues such as admissions, programs and concession revenues are recognized as delivery of the product or services has occurred.

Greater than 70% of the Company's annual revenues are generated by pari-mutuel wagering on live and simulcast racing content and in-home wagering. Live racing handle includes patron wagers made on live races at the Company's racetracks and also wagers made on imported simulcast signals at the Company's racetracks during live meets. Import simulcasting handle includes wagers on imported signals at the Company's racetracks when the respective racetracks are not conducting live race meets and at the Company's OTBs throughout the year. Export handle includes all patron wagers made on live racing signals sent to other tracks, OTBs and in-home wagering. In-home wagering, or advance deposit wagering, consists of patron wagers through a pre-funded account.

The Company retains as revenue a pre-determined percentage or commission on the total amount wagered on live and import simulcasting sources, and the balance is distributed to the winning patrons. The gross percentages retained on live racing and import simulcasting at the Company's various locations range from approximately 16% to 21%. In general, the fees earned from export simulcasting are contractually determined and average approximately 3.5%. All commissions and fees earned from pari-mutuel wagering are shared with horsemen through payment of purses based on local contracts and statutes and average approximately 50%.

Purse Expense

The Company recognizes purse expense from the statutorily or contractually required percentage of revenue that is required to be paid out in the form of purses to the winning owners of horses in races run at the Company's racetracks in the period in which wagering occurs. The Company incurs a liability for all unpaid purses to be paid out. The Company may pay out purses in excess of statutorily or contractually required amounts resulting in purse overpayments, which are expensed as incurred. Recoveries of purse overpayments are recognized in the period they are realized.

Share-Based Compensation

In December 2004, the Financial Accounting Standards Board issued SFAS No. 123(R), "Share-Based Payment" ("SFAS No. 123(R)"), which requires companies to measure compensation costs for all share-based payments (including employee stock options) at fair value for interim or annual periods beginning after June 15, 2005. In April 2005, the U.S. Securities and Exchange Commission issued a rule allowing public companies to delay the adoption of SFAS No. 123(R) to annual periods beginning after June 15, 2005. As a result, the Company adopted SFAS No. 123(R) using the modified-prospective transition method, beginning on January 1, 2006, and therefore began to expense the fair value of all outstanding options related to an employee stock purchase plan over their remaining vesting periods to the extent the options were not fully vested as of the adoption date and will begin to expense the fair value of all options granted subsequent to December 31, 2005 over their requisite service periods. During the three and nine months ended September 30, 2006, the Company recorded $13 thousand and $69 thousand, respectively, net of a related income tax benefit of $8 thousand and $48 thousand, respectively, of additional share-based compensation expense as a result of adopting SFAS No. 123(R). Previous periods have not been restated. See Note 5 for further details.

## 2. Discontinued Operations

Sale of Stock of Racing Corporation of America ("RCA")

On September 28, 2006, the Company completed the sale of all issued and outstanding common shares of stock (the "Stock") of RCA, the parent company of Ellis Park Race Course ("Ellis Park"), to EP Acquisition, LLC (the "Purchaser") pursuant to the Stock Purchase Agreement (the "Agreement") dated July 15, 2006. In conjunction with the sale of the Stock, the Company recognized a tax benefit of $7.9 million, which is included in discontinued operations, during the three and nine months ended September 30, 2006.

Return to Index

NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS
(Unaudited)

Financial Information

In accordance with SFAS No. 144, "Accounting for the Impairment or Disposal of Long-Lived Assets," the results of operations of Hollywood Park Racetrack, sold on September 23, 2005, and Ellis Park, for all periods presented, and the gains on the sales have been classified as discontinued operations, net of income taxes, in the Condensed Consolidated Statement of Net Earnings and Comprehensive Earnings. Set forth below is a summary of the results of discontinued operations for the three and nine months ended September 30, 2006 and 2005 (in thousands):

| | Three Months Ended September 30, | | Nine Months Ended September 30, | |
|---|---|---|---|---|
| | 2006 | 2005 | 2006 | 2005 |
| Net revenues | $ 9,234 | $ 26,680 | $ 10,953 | $ 82,105 |
| Operating expenses | 6,407 | 25,230 | 9,947 | 75,723 |
| Gross profit | 2,827 | 1,450 | 1,006 | 6,382 |
| Selling, general and administrative expenses | 753 | 151 | 1,152 | 3,858 |
| Insurance recoveries, net of losses | (1,293) | - | (1,367) | - |
| Operating income | 3,367 | 1,299 | 1,221 | 2,524 |
| Other income (expense): | | | | |
| Interest income | - | 6 | - | 20 |
| Interest expense | - | (3,173) | - | (8,806) |
| Miscellaneous, net | (15) | 6 | 48 | 80 |
| Other income (expense) | (15) | (3,161) | 48 | (8,706) |
| Earnings (loss) before income taxes | 3,352 | (1,862) | 1,269 | (6,182) |
| (Provision) benefit for income taxes | (1,520) | 421 | (525) | 1,039 |
| Earnings (loss) from operations | 1,832 | (1,441) | 744 | (5,143) |
| Gain on sale of business, net of income taxes | 4,197 | 69,917 | 4,197 | 69,917 |
| Net earnings | $ 6,029 | $ 68,476 | $ 4,941 | $ 64,774 |

Set forth below is a summary of the net assets held for sale, which relate to Ellis Park, as of December 31, 2005 (in thousands):

| | December 31, 2005 |
|---|---|
| Current assets: | |
| Cash and cash equivalents | $ 141 |
| Other current assets | 112 |
| Plant and equipment, net | 3,685 |
| Assets held for sale | 3,938 |
| Current liabilities: | |
| Accounts payable | 113 |
| Purses payable | 369 |
| Accrued expenses | 128 |
| Deferred revenue | 3 |
| Other liabilities | 177 |
| Liabilities associated with assets held for sale | 790 |
| Net assets held for sale | $ 3,148 |

Tornado Damage

On November 6, 2005, a tornado caused significant damage to portions of southwestern Indiana and northwestern Kentucky, including Henderson, Kentucky, the location of Ellis Park Race Course and its on-site simulcast facility. Ellis Park sustained damage to its stable area, as well as several other buildings at the racetrack. Under existing insurance policies, the Company is required to pay a $500 thousand deductible related to any recoveries for damages. As of September 30, 2006, the Company has received $8.1 million in insurance recoveries.

Return to Index

NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS
(Unaudited)

**3. Natural Disasters**

Hurricane Katrina

On August 29, 2005, Hurricane Katrina caused significant damage to the metropolitan New Orleans, Louisiana area. A significant portion of the assets of the Company's Louisiana Operations suffered damages from Hurricane Katrina. The Company carries property and casualty insurance, as well as business interruption insurance. Under existing policies, the Company is required to pay a $500 thousand deductible related to any recoveries for damages. The Company is currently working with its insurance carriers to determine to what extent insurance proceeds may exceed any losses. The Company has not yet determined the ultimate impact that Hurricane Katrina will have on its results of operations. As of September 30, 2006, the Company has received $18.0 million in insurance recoveries.

Hurricane Wilma

On October 24, 2005, Hurricane Wilma caused significant damage to Miami, as well as other parts of South Florida. A significant portion of the assets of Calder Race Course suffered damages from Hurricane Wilma. The Company carries property and casualty insurance as well as business interruption insurance. Under existing policies, the Company is required to pay a deductible equal to 2% of the total insured value on an insurable unit basis related to any recoveries for damages. The Company is currently working with its insurance carriers to determine to what extent insurance proceeds may exceed any losses. As of September 30, 2006, the Company has received $4.0 million in insurance recoveries.

Financial Information

The casualty losses and related insurance recoveries have been included as components of operating income in the Company’s Condensed Consolidated Statements of Net Earnings and Comprehensive Earnings. Set forth below is a summary of the impact of the natural disasters on the results of operations of the Company for the three and nine months ended September 30, 2006 (in thousands):

| | Three Months ended September 30, 2006 | | | | | |
|---|---|---|---|---|---|---|
| | | Casualty Losses | | Insurance Recoveries | | Insurance Recoveries, Net of Losses |
| Louisiana Operations | | - | | - | | - |
| Calder Race Course | $ | (168) | $ | 2,000 | $ | 1,832 |
| Total | $ | (168) | $ | 2,000 | $ | 1,832 |

| | Nine Months ended September 30, 2006 | | | | | |
|---|---|---|---|---|---|---|
| | | Casualty Losses | | Insurance Recoveries | | Insurance Recoveries, Net of Losses |
| Louisiana Operations | $ | (5,543) | $ | 15,827 | $ | 10,284 |
| Calder Race Course | | (1,330) | | 4,000 | | 2,670 |
| Total | $ | (6,873) | $ | 19,827 | $ | 12,954 |

As of December 31, 2005, approximately $1.8 million of insurance proceeds were included as a current liability in the Company’s Consolidated Balance Sheets, which represent amounts recovered for costs yet to be incurred.

Return to Index

NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS
(Unaudited)

## 4. Earnings Per Share

The following is a reconciliation of the numerator and denominator of the earnings per common share computations (in thousands, except per share data):

| | Three Months Ended September 30, | | Nine Months Ended September 30, | |
|---|---|---|---|---|
| | 2006 | 2005 | 2006 | 2005 |
| Numerator for basic net earnings from continuing operations per common share: | | | | |
| Net earnings from continuing operations | $ 2,718 | $ 3,159 | $ 26,886 | $ 17,150 |
| Net earnings from continuing operations allocated to participating securities | (90) | (107) | (897) | (582) |
| Numerator for basic net earnings from continuing operations per common share | $ 2,628 | $ 3,052 | $ 25,989 | $ 16,568 |
| | | | | |
| Numerator for basic net earnings per common share: | | | | |
| Net earnings | $ 8,747 | $ 71,635 | $ 31,827 | $ 81,924 |
| Net earnings allocated to participating securities | (291) | (2,426) | (1,062) | (2,779) |
| Numerator for basic net earnings per common share | $ 8,456 | $ 69,209 | $ 30,765 | $ 79,145 |
| | | | | |
| Numerator for diluted net earnings per common share: | | | | |
| Net earnings from continuing operations | $ 2,718 | $ 3,159 | $ 26,886 | $ 17,150 |
| Discontinued operations, net of income taxes | 6,029 | 68,476 | 4,941 | 64,774 |
| Net earnings | $ 8,747 | $ 71,635 | $ 31,827 | $ 81,924 |
| | | | | |
| Denominator for net earnings per common share: | | | | |
| Basic | 13,149 | 12,913 | 13,116 | 12,893 |
| Plus dilutive effect of stock options | 54 | 145 | 66 | 161 |
| Plus dilutive effect of convertible note | 453 | 453 | 453 | 453 |
| Diluted | 13,656 | 13,511 | 13,635 | 13,507 |
| | | | | |
| Earnings per common share: | | | | |
| Basic | | | | |

| | | | | | | | | |
|---|---|---|---|---|---|---|---|---|
| Net earnings from continuing operations | $ | 0.20 | $ | 0.24 | $ | 1.98 | $ | 1.28 |
| Discontinued operations | | 0.44 | | 5.12 | | 0.37 | | 4.86 |
| Net earnings | $ | 0.64 | $ | 5.36 | $ | 2.35 | $ | 6.14 |
| | | | | | | | | |
| Diluted | | | | | | | | |
| Net earnings from continuing operations | $ | 0.20 | $ | 0.23 | $ | 1.97 | $ | 1.27 |
| Discontinued operations | | 0.44 | | 5.07 | | 0.36 | | 4.80 |
| Net earnings | $ | 0.64 | $ | 5.30 | $ | 2.33 | $ | 6.07 |

Options to purchase 69 thousand and 38 thousand shares for the three months ended September 30, 2006 and 2005, respectively, and options to purchase 36 thousand and 28 thousand shares for the nine months ended September 30, 2006 and 2005, respectively, were not included in the computation of earnings per common share assuming dilution because the options' exercise prices were greater than the average market price of the common shares during the respective periods.

Return to Index

NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS
(Unaudited)

## 5. Share-Based Compensation

At September 30, 2006, the Company has share-based employee compensation plans as described below. The total compensation expense related to these plans, which include a restricted stock plan as well as an employee stock purchase plan, was $184 thousand and $62 thousand, net of an income tax benefit of $141 thousand and $45 thousand, for the three months ended September 30, 2006 and 2005, respectively, and $585 thousand and $173 thousand, net of an income tax benefit of $413 thousand and $134 thousand for the nine months ended September 30, 2006 and 2005, respectively. Prior to January 1, 2006, the Company accounted for these plans under the recognition and measurement provisions of Accounting Principles Board Opinion No. 25, "Accounting for Stock Issued to Employees" ("APB No. 25"). Accordingly, the Company generally recognized compensation expense only when it granted options with a discounted exercise price. Any resulting compensation expense was recognized ratably over the associated service period, which was generally the vested term.

Prior to January 1, 2006, the Company provided pro forma disclosure amounts in accordance with SFAS No. 148, "Accounting for Stock-Based Compensation - Transaction and Disclosure," as if the fair value method defined by SFAS No. 123, "Accounting for Stock-Based Compensation" has been applied to its share-based compensation.

Effective January 1, 2006, the Company adopted the fair value recognition provisions of SFAS No. 123(R) using the modified prospective transition method and therefore has not restated prior periods' results. Under this transition method, share-based compensation expense for the nine months ended September 30, 2006 included compensation expense for all share-based compensation awards granted prior to, but not yet vested as of, January 1, 2006, based on the grant date fair value estimated in accordance with the original provisions of SFAS No. 123. Share-based compensation expense for all share-based payment awards granted after January 1, 2006, is based on the grant-date fair value estimated in accordance with the provisions of SFAS No. 123(R). The Company recognized these compensation costs for only those shares expected to vest on a straight-line basis over the requisite service period of the award, which is generally the option vesting term of one year for options related to an employee stock purchase plan.

As a result of adopting SFAS No. 123(R), the impact to the Condensed Consolidated Financial Statements for the three months ended September 30, 2006 on earnings from continuing operations before provision for income taxes and net earnings from continuing operations was $21 thousand and $13 thousand lower, respectively, than if the Company had continued to account for share-based compensation under APB No. 25. The impact to the Condensed Consolidated Financial Statements for the nine months ended September 30, 2006 on earnings from continuing operations before provision for income taxes and net earnings from continuing operations was $117 thousand and $69 thousand lower, respectively. Such impact relates to the recognition of expense of the fair value of all outstanding options associated with the Company's Employee Stock Purchase Plan (the "Employee Stock Purchase Plan") over their requisite service period. Amounts previously recorded as unearned compensation within shareholders' equity on the Condensed Consolidated Balance Sheets were reclassified to common stock as of January 1, 2006. In addition, prior to the adoption of SFAS No. 123(R), the Company presented the tax benefit of stock option exercises as operating cash flows. Upon adoption of SFAS No. 123(R), tax benefits resulting from tax deductions in excess of the compensation cost recognized for those options are classified as financing cash flows.

Return to Index

NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS
(Unaudited)

The Company accounted for share-based compensation in accordance with APB No. 25 for the three and nine months ended September 30, 2005. Had the compensation cost for the Company's share-based compensation plans been determined consistent with SFAS No. 123(R), the Company's net earnings from continuing operations and net earnings from continuing operations per common share for the three and nine months ended September 30, 2005 would approximate the pro forma amounts presented below:

| (in thousands, except per share data) | Three Months Ended September 30, 2005 | | Nine MonthsEnded September 30, 2005 | |
|---|---|---|---|---|
| Net earnings from continuing operations, as reported | $ | 3,159 | $ | 17,150 |
| Add: Stock based compensation expense included in reported net earnings from continuing operations | | 64 | | 173 |
| Deduct: Pro forma stock-based compensation expense, net of tax benefit | | (118) | | (747) |
| Pro forma net earnings from continuing operations | $ | 3,105 | $ | 16,576 |
| | | | | |
| Net earnings from continuing operations per common share: | | | | |
| As reported | | | | |
| Basic | $ | 0.24 | $ | 1.28 |
| Diluted | $ | 0.23 | $ | 1.27 |
| Pro forma | | | | |
| Basic | $ | 0.23 | $ | 1.24 |
| Diluted | $ | 0.23 | $ | 1.23 |

Employee Stock Options

The Company sponsors the Churchill Downs Incorporated 2003 Stock Option Plan (the "03 Plan"), the Churchill Downs Incorporated 1997 Stock Option Plan (the "97 Plan"), and the Churchill Downs Incorporated 1993 Stock Option Plan (the "93 Plan"), also collectively referred to as the "Stock Option Plans." These share-based incentive compensation plans are described below.

No stock options are available under the 93 Plan. On March 13, 2003, the Board of Directors suspended the 97 Plan effective upon the shareholders' approval of the 03 Plan. Awards issued under the 97 Plan prior to its suspension were unaffected by such suspension. On November 13, 2003, the Board of Directors terminated the 03 Plan, effective upon the shareholders' approval of the Churchill Downs Incorporated 2004 Restricted Stock Plan (the "Restricted Stock Plan"). Awards issued under the 03 Plan prior to its termination were unaffected by such termination.

The Stock Option Plans provide that the exercise price of any incentive stock option may not be less than the fair market value of the common stock on the date of grant. All outstanding stock options have contractual terms of ten years and generally vest three years from the date of grant.

Return to Index

NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS
(Unaudited)

Activity for the Company's Stock Option Plans during the quarters ended March 31, 2006, June 30, 2006 and September 30, 2006 is presented below (in thousands, except per share data):

| | Number of Shares Under Option | Weighted Average Exercise Price |
|---|---|---|
| Balance, December 31, 2005 | 525 | $ 28.30 |
| Granted | - | - |
| Exercised | (59) | $ 19.01 |
| Cancelled/Forfeited | (10) | $ 34.64 |
| | | |
| Balance, March 31, 2006 | 456 | $ 29.37 |
| Granted | - | - |
| Exercised | (36) | $ 24.75 |
| Cancelled/Forfeited | (1) | $ 38.92 |
| | | |
| Balance, June 30, 2006 | 419 | $ 29.72 |
| Granted | - | - |
| Exercised | (44) | $ 41.03 |
| Cancelled/Forfeited | - | - |
| | | |
| Balance, September 30, 2006 | 375 | $ 29.96 |

The following table summarizes information about stock options outstanding and exercisable at September 30, 2006 (in thousands, except per share data):

| | Shares Under Option | Weighted Average Remaining Contractual Life | Weighted Average Exercise Price | Aggregate Intrinsic Value per Share (1) | Aggregate Intrinsic Value (1) |
|---|---|---|---|---|---|
| Options outstanding, exercisable and vested at September 30, 2006 | 375 | 4.3 | $29.96 | $12.10 | $4,538 |

(1) Computed based upon the amount by which the fair market value of the Company’s common stock at September 30, 2006 of $42.06 per share exceeded the weighted average exercise price.

The total intrinsic value of stock options exercised during the three and nine months ended September 30, 2006 was $0.6 million and $2.4 million, compared with $1.0 million and $1.4 million for the three and nine months ended September 30, 2005, respectively. Cash received from stock option exercises totaled $1.2 million and $3.2 million for the three and nine months ended September 30, 2006, respectively, and $1.6 million and $2.3 million for the three and nine months ended September 30, 2005, respectively.

At December 31, 2005, there were 514 thousand options exercisable with a weighted average exercise price of $28.17.

Restricted Stock Plan

On November 13, 2003, the Board of Directors adopted the Restricted Stock Plan, which was subsequently approved by the shareholders in June of 2004. The Restricted Stock Plan permits the award of common stock to directors and key employees, including officers, of the Company and its subsidiaries who are from time to time responsible for the management, growth and protection of the business of the Company and its subsidiaries. Up to 315 thousand shares of common stock have been reserved and set aside out of the Company's authorized but unissued common stock for issuance under the Restricted Stock Plan. Restricted shares generally vest in full five years from the date of grant or upon retirement at or after age 60. The fair value of restricted shares under the Restricted Stock Plan is

Return to Index

NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS
(Unaudited)

determined by the product of the number of shares granted and the grant date market price of the Company's common stock. For grants made prior to January 1, 2006, the fair value of restricted shares is expensed on a straight-line basis over the requisite service period of five years. For nonvested restricted shares granted prior to January 1, 2006, the unrecognized compensation expense was recognized immediately in current earnings using the nominal vesting approach upon retirement at or after age 60 of a participant. The Company recorded approximately $303 thousand and $881 thousand of compensation expense, included in net earnings from continuing operations, during the three and nine months ended September 30, 2006, respectively, and $109 thousand and $307 thousand of compensation expense, included in net earnings from continuing operations, during the three and nine months ended September 30, 2005, respectively. SFAS No. 123(R), as described above, requires the use of the non-substantive vesting period approach for new grants. That is, compensation expense must be recognized immediately for awards granted to retirement eligible employees or over the period from the grant date to the date retirement eligibility is achieved, if that is expected to occur during the nominal vesting period. If the Company had used the non-substantive vesting approach for awards existing prior to January 1, 2006, compensation expense included in net earnings from continuing operations during the three and nine months ended September 30, 2006 would have been $161 thousand and $632 thousand, respectively, and $169 and $376 thousand during the three and nine months ended September 30, 2005, respectively.

Activity for the Restricted Stock Plan for the quarters ended March 31, 2006, June 30, 2006 and September 30, 2006 is presented below (in thousands, except per share data):

| | Number of Shares | Weighted Average Grant Date Fair Value |
|---|---|---|
| Balance, December 31, 2005 | 88 | $ 39.47 |
| Granted | - | - |
| Vested | - | - |
| Cancelled/Forfeited | - | - |
| | | |
| Balance, March 31, 2006 | 88 | $ 39.47 |
| Granted | 5 | $ 43.20 |
| Vested | - | - |
| Cancelled/Forfeited | (1) | $ 44.02 |
| | | |
| Balance, June 30, 2006 | 92 | $ 39.61 |
| Granted | - | - |
| Vested | - | - |
| Cancelled/Forfeited | - | - |
| | | |
| Balance, September 30, 2006 | 92 | $ 39.61 |

As of September 30, 2006, there was $2.3 million unrecognized share-based compensation expense related to nonvested restricted stock awards that the Company expects to recognize over a weighted average period of 3.7 years.

Employee Stock Purchase Plan

Under the Employee Stock Purchase Plan, the Company is authorized to sell, pursuant to short-term stock options, shares of its common stock to its full-time (or part-time for at least 20 hours per week and at least five months per year) employees at a discount from the common stock's fair market value. The Employee Stock Purchase Plan operates on the basis of recurring, consecutive one-year periods. Each period commences on August 1 and ends on the following July 31.

On the first day of each 12-month period, August 1, the Company offers to each eligible employee the opportunity to purchase common stock. Employees who elect to participate for each period have a designated percentage of their compensation withheld (after-tax) and applied to the purchase of shares of common stock on the last day of the period, July 31. The Employee Stock Purchase Plan allows withdrawals, terminations and reductions on the amounts being deducted. The purchase price for the common stock is 85% of the lesser of the fair market value of the common stock on (i) the first day of the period, or (ii) the last day of the period. No employee may purchase common stock under the Employee Stock Purchase Plan valued at more than $25 thousand for each calendar year.

Return to Index

NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS
(Unaudited)

Under the Employee Stock Purchase Plan, the Company sold approximately ten thousand shares of common stock to employees pursuant to options granted on August 1, 2005 and exercised on July 31, 2006. Because the plan year overlaps the Company’s fiscal year, the number of shares to be sold pursuant to options granted on August 1, 2006 can only be estimated because the 2006 plan year is not yet complete. The Company’s estimate of options granted in 2006 under the Plan is based on the number of shares sold to employees under the Plan for the 2005 plan year, adjusted to reflect the change in the number of employees participating in the Plan in 2006. During the three and nine months ended September 30, 2006, the Company recognized $21 thousand and $117 thousand of compensation expense related to the unvested portion of the grant made during the 2005 and 2006 plan years.

**6. Segment Information**

The Company has determined that it currently operates in the following seven segments: (1) Churchill Downs Racetrack, which includes its on-site simulcast facility and training facility; (2) Calder Race Course; (3) Arlington Park and its eight OTBs; (4) Hoosier Park racetrack,, its on-site simulcast facility and its three OTBs; (5) Louisiana Operations, including Fair Grounds, its nine OTBs and Video Services, Inc.; (6) Churchill Downs Simulcast Network ("CDSN"), the simulcast product provider of the Company; and (7) other investments, including Churchill Downs Simulcast Productions ("CDSP") and the Company’s various equity interests, which are not material. In accordance with the sale of the Stock of RCA, the segment formerly known as Kentucky Operations has been restated for all periods presented to reflect only the information of Churchill Downs Racetrack. Eliminations include the elimination of management fees and other intersegment transactions, primarily between CDSN and the racetracks.

The accounting policies of the segments are the same as those described in the "Summary of Significant Accounting Policies" in the Company’s Annual Report on Form 10-K for the year ended December 31, 2005. The Company uses revenues and EBITDA (defined as earnings before interest, taxes, depreciation and amortization) as key performance measures of results of operations for purposes of evaluating performance internally. Furthermore, management believes that the use of these measures enables management and investors to evaluate and compare from period to period, the Company’s operating performance in a meaningful and consistent manner. Because the Company uses EBITDA as a key performance measure of financial performance, the Company is required by accounting principles generally accepted in the United States of America to provide the information in this footnote concerning EBITDA. However, these measures should not be considered as an alternative to, or more meaningful than, net earnings (loss) (as determined in accordance with accounting principles generally accepted in the United States of America) as a measure of the Company’s operating results or operating cash flows (as determined in accordance with accounting principles generally accepted in the United States of America) as a measure of the Company’s liquidity. EBITDA of the corporate segment includes approximately $0.3 million and $0.4 million of management fees for the three months ended September 30, 2006 and 2005, respectively, and $0.3 million and $1.7 million of management fees for the nine months ended September 30, 2006 and 2005, respectively, related to Hollywood Park Racetrack and Ellis Park, which were sold on September 23, 2005 and September 28, 2006, respectively.

Return to Index

NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS
(Unaudited)

The table below presents information about reported segments for the three and nine months ended September 30, 2006 and 2005 (in thousands):

| | Three Months Ended September 30, | | Nine Months Ended September 30, | |
|---|---|---|---|---|
| | 2006 | 2005 | 2006 | 2005 |
| Net revenues from external customers: | | | | |
| Churchill Downs Racetrack | $ 8,078 | $ 6,708 | $ 79,980 | $ 75,385 |
| Arlington Park | 28,531 | 33,507 | 64,175 | 67,436 |
| Calder Race Course | 29,450 | 28,612 | 54,603 | 53,052 |
| Hoosier Park | 9,458 | 9,704 | 28,801 | 30,144 |
| Louisiana Operations | 15,048 | 7,474 | 48,966 | 38,951 |
| CDSN | 14,961 | 15,065 | 46,429 | 49,354 |
| Total racing operations | 105,526 | 101,070 | 322,954 | 314,322 |
| Other investments | 883 | 663 | 1,626 | 869 |
| Corporate | - | 136 | 162 | 556 |
| Net revenues from continuing operations | 106,409 | 101,869 | 324,742 | 315,747 |
| Discontinued operations | 9,175 | 26,472 | 10,895 | 81,487 |
| | $ 115,584 | $ 128,341 | $ 335,637 | $ 397,234 |
| Intercompany net revenues: | | | | |
| Churchill Downs Racetrack | $ 2,426 | $ 1,960 | $ 19,586 | $ 16,712 |
| Arlington Park | 5,453 | 6,103 | 8,451 | 8,714 |
| Calder Race Course | 3,807 | 3,665 | 6,831 | 6,646 |
| Hoosier Park | 69 | 27 | 165 | 101 |
| Louisiana Operations | - | - | 1,402 | 6,315 |
| Total racing operations | 11,755 | 11,755 | 36,435 | 38,488 |
| Other investments | 558 | 571 | 1,396 | 1,388 |
| Eliminations | (12,372) | (12,534) | (37,889) | (40,494) |
| | (59) | (208) | (58) | (618) |
| Discontinued operations | 59 | 208 | 58 | 618 |
| | $ - | $ - | $ - | $ - |
| Segment EBITDA and net earnings: | | | | |
| Churchill Downs Racetrack | $ (3,331) | $ (4,657) | $ 29,338 | $ 27,235 |
| Arlington Park | 2,415 | 8,330 | 1,219 | 8,342 |
| Calder Race Course | 6,855 | 5,065 | 6,306 | 1,844 |
| Hoosier Park | 22 | (39) | 296 | 843 |
| Louisiana Operations | 1,211 | (1,267) | 15,572 | (1,674) |
| CDSN | 3,833 | 3,745 | 11,397 | 12,062 |
| Total racing operations | 11,005 | 11,177 | 64,128 | 48,652 |
| Other investments | 471 | 1,139 | 1,485 | 1,695 |
| Corporate | (1,159) | (1,417) | (2,409) | (3,814) |
| Total | 10,317 | 10,899 | 63,204 | 46,533 |
| Eliminations | (120) | (183) | (90) | (155) |
| Depreciation and amortization | (5,097) | (5,194) | (15,382) | (15,334) |
| Interest income (expense), net | (254) | (130) | (1,074) | (654) |

| | | | | | | | |
|---|---|---|---|---|---|---|---|
| Provision for income taxes | | (2,128) | | (2,233) | (19,772) | | (13,240) |
| Net earnings from continuing operations | | 2,718 | | 3,159 | 26,886 | | 17,150 |
| Discontinued operations, net of income taxes | | 6,029 | | 68,476 | 4,941 | | 64,774 |
| Net earnings | $ | 8,747 | $ | 71,635 | $ 31,827 | $ | 81,924 |

16

Return to Index

NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS
(Unaudited)

The table below presents total asset information about reported segments (in thousands):

| | September 30, 2006 | December 31, 2005 |
|---|---|---|
| Total assets: | | |
| Churchill Downs Racetrack | $ 417,469 | $ 436,931 |
| Arlington Park | 87,007 | 84,797 |
| Calder Race Course | 96,594 | 92,155 |
| Hoosier Park | 38,256 | 33,317 |
| Louisiana Operations | 93,000 | 74,157 |
| CDSN | 11,018 | 11,018 |
| Other investments | 146,975 | 141,453 |
| Assets held for sale | - | 3,938 |
| | 890,319 | 877,766 |
| Eliminations | (360,649) | (364,601) |
| | $ 529,670 | $ 513,165 |

| | Nine Months Ended September 30, 2006 | 2005 |
|---|---|---|
| Capital expenditures: | | |
| Churchill Downs Racetrack | $ 5,189 | $ 26,582 |
| Ellis Park | 424 | 515 |
| Hollywood Park | - | 2,161 |
| Calder Race Course | 6,300 | 1,689 |
| Arlington Park | 1,984 | 4,801 |
| Hoosier Park | 299 | 392 |
| Louisiana Operations | 7,275 | 4,337 |
| Other Investments | 275 | 117 |
| | $ 21,746 | $ 40,594 |

**7. Recently Issued Accounting Pronouncements**

In July of 2006, the Financial Accounting Standards Board (the "FASB") issued FASB Interpretation No. 48, "Accounting for Uncertainty in Income Taxes - an interpretation of FASB Statement 109" ("FIN 48"). FIN 48 establishes, among other things, that a tax benefit from an uncertain position may only be recognized if it is "more likely than not" that the position is sustainable based on its technical merits. The tax benefit of a qualifying position will be measured by calculating the largest amount of tax benefit that is greater than 50 percent likely of being realized upon ultimate settlement with a taxing authority having full knowledge of all relevant information. The assessment of the recognition threshold and the measurement of the associated tax benefit might change as new information becomes available. Unrecognized tax benefits will be recognized in the period that the position reaches the recognition threshold, which might occur prior to absolute finality of the matter. Similarly, recognized tax benefits will be derecognized in the period in which the position falls below the threshold. FIN 48 also requires qualitative and quantitative disclosures, including discussion of reasonably possible changes that might occur in the recognized tax benefits over the next twelve months, a description of open tax years by major jurisdictions and a roll-forward of all unrecognized tax benefits, presented as a reconciliation of the beginning and ending balances of the unrecognized tax benefits on a worldwide aggregated basis. FIN 48 is effective for the Company as of January 1, 2007. The change in net assets, if any, that results from the application of FIN 48 will be recorded as an adjustment to retained earnings. Management has not yet determined the impact that the adoption of FIN 48 will have on the Company's consolidated financial position, results of operations and earnings per common share.

Return to Index

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

Information set forth in this discussion and analysis contains various "forward-looking statements" within the meaning of Section 27A of the Securities Act of 1933 and Section 21E of the Securities Exchange Act of 1934. The Private Securities Litigation Reform Act of 1995 (the "Act") provides certain "safe harbor" provisions for forward-looking statements. All forward-looking statements made in this Quarterly Report on Form 10-Q are made pursuant to the Act. The reader is cautioned that such forward-looking statements are based on information available at the time and/or management's good faith belief with respect to future events, and are subject to risks and uncertainties that could cause actual performance or results to differ materially from those expressed in the statements. Forward-looking statements speak only as of the date the statement was made. We assume no obligation to update forward-looking information to reflect actual results, changes in assumptions or changes in other factors affecting forward-looking information. Forward-looking statements are typically identified by the use of terms such as "anticipate," "believe," "could," "estimate," "expect," "intend," "may," "might," "plan," "predict," "project," "should," "will," and similar words, although some forward-looking statements are expressed differently. Although we believe that the expectations reflected in such forward-looking statements are reasonable, we can give no assurance that such expectations will prove to be correct. Important factors that could cause actual results to differ materially from expectations include: the effect of global economic conditions; the effect (including possible increases in the cost of doing business) resulting from future war and terrorist activities or political uncertainties; the economic environment; the impact of increasing insurance costs; the impact of interest rate fluctuations; the effect of any change in our accounting policies or practices; the financial performance of our racing operations; the impact of gaming competition (including lotteries and riverboat, cruise ship and land-based casinos) and other sports and entertainment options in those markets in which we operate; the impact of live racing day competition with other Florida, Illinois and Louisiana racetracks within those respective markets; costs associated with our efforts in support of alternative gaming initiatives; costs associated with Customer Relationship Management initiatives; a substantial change in law or regulations affecting pari-mutuel and gaming activities; a substantial change in allocation of live racing days; litigation surrounding the Rosemont, Illinois riverboat casino; changes in Illinois law that impact revenues of racing operations in Illinois; a decrease in riverboat admissions subsidy revenue from our Indiana operations; the impact of an additional Indiana racetrack and its wagering facilities near our operations; our continued ability to effectively compete for the country's top horses and trainers necessary to field high-quality horse racing; our continued ability to grow our share of the interstate simulcast market; our ability to execute our acquisition strategy and to complete or successfully operate planned expansion projects; our ability to successfully complete any divestiture transaction; our ability to adequately integrate acquired businesses; market reaction to our expansion projects; the loss of our totalisator companies or their inability to provide assurance on the reliability of their internal control processes through Statement on Auditing Standards No. 70 audits or to keep their technology current; the need for various alternative gaming approvals in Louisiana; our accountability for environmental contamination; the loss of key personnel; the impact of natural disasters, including Hurricanes Katrina, Rita and Wilma, on our operations and our ability to adjust the casualty losses through our property and business interruption insurance coverage; any business disruption associated with a natural disaster and/or its aftermath; and the volatility of our stock price.

*You should read this discussion in conjunction with the Condensed Consolidated Financial Statements included in this Quarterly Report on Form 10-Q and the Company's Annual Report on Form 10-K for the year ended December 31, 2005 for further information, including Part I - Item 1A for a discussion regarding some of the reasons that actual results may be materially different from those we anticipate, as modified by Part II - Item 1A of the Quarterly Report on Form 10-Q.*

### Overview

We conduct pari-mutuel wagering on live Thoroughbred, Quarter Horse and Standardbred horse racing and simulcast signals of races. Additionally, we offer racing services through our other interests, as well as alternative gaming through video poker machines in Louisiana.

Return to Index

We operate the Churchill Downs racetrack, its on-site simulcast facility and training facility in Louisville, Kentucky, which has conducted Thoroughbred racing since 1875 and is internationally known as the home of the Kentucky Derby.

We also own and operate Arlington Park, a Thoroughbred racing operation in Arlington Heights, Illinois and its eight off-track betting facilities ("OTBs"); Calder Race Course, a Thoroughbred racing operation in Miami Gardens, Florida; and Fair Grounds Race Course (“Fair Grounds”), a Thoroughbred racing operation in New Orleans, Louisiana, its nine OTBs and Video Services, Inc. ("VSI") (collectively referred to as "Louisiana Operations"). Additionally, we are the majority owner and operator of Hoosier Park in Anderson, Indiana, which conducts Thoroughbred, Quarter Horse and Standardbred horse racing, its on-site simulcast facility and its three OTBs.

The Churchill Downs Simulcast Network ("CDSN") provides the principal oversight of interstate and international simulcast and wagering opportunities, as well as the marketing, sales, operations and data support efforts related to the Company-owned racing content.

**Recent Developments**

Sale of the stock of Racing Corporation of America (“RCA”)

On September 28, 2006 we sold all of the issued and outstanding common shares of stock (the “Stock”) of RCA, the parent company of Ellis Park Race Course (“Ellis Park”), to EP Acquisition, LLC. In conjunction with the sale of the Stock, the Company recognized a tax benefit of $7.9 million, which is included in discontinued operations, during the three and nine months ended September 30, 2006.

Employment Agreement - Robert L. Evans

On July 18, 2006, we entered into an employment agreement (the “Employment Agreement”) with Robert L. Evans, who has replaced Thomas H. Meeker as President and Chief Executive Officer of the Company, and now serves as a member of the Board of Directors of the Company (the “Board”), effective August 14, 2006. The Employment Agreement was approved by the Board.

The Employment Agreement has an initial term of employment for three years, with automatic one-year extensions (unless either party provides a written notice not to extend the term of employment at least 90 days prior to the then-current expiration date). The Employment Agreement provides for earlier termination under certain circumstances.

The Employment Agreement provides for an annual base salary of $450,000, with reviews for potential increase at the discretion of the Board. Mr. Evans will be first eligible to participate in the annual performance bonus plan for the performance period commencing January 1, 2007, with his initial target bonus opportunity for such period to be 75% of his base salary.

The Employment Agreement further provides that Mr. Evans will receive the following equity-based awards: (i) 65,000 restricted stock units representing shares of the Company’s common stock, vesting quarterly over five years, with Mr. Evans entitled to receive the shares underlying the units (along with a cash payment equal to accumulated dividend equivalents beginning with the lapse of forfeiture, plus interest at a 3% annual rate) six months after termination of employment; (ii) 90,000 restricted shares of the Company’s common stock, with vesting contingent upon the Company’s common stock reaching certain closing prices on Nasdaq for twenty consecutive trading days; (iii) 65,000 restricted shares of the Company’s common stock, vesting quarterly over five years, and contingent upon the Company's common stock reaching a certain closing price on Nasdaq for ten consecutive trading days; and (iv) a stock option, vesting quarterly over three years, to purchase an aggregate of 130,000 shares of the Company's common stock, with an exercise price equal to the fair market value of a share of the Company's common stock on the date of the grant.

Racing World

On April 3, 2006, we entered into a definitive agreement (the "Agreement") with Magna Entertainment Corporation ("MEC") and Racing UK to form a subscription television channel that will broadcast races from our racetracks, racetracks of MEC, as well as other North American and international racetracks, into the United Kingdom and Ireland. As part of the Agreement, the Company, MEC and Racing UK became owners of Racing World Limited. Under the terms of the Agreement, we have made a total investment in this venture of 375 thousand British pounds as of September 30, 2006.

Return to Index

Insurance Recoveries, Net of Losses

As of September 30, 2006, we have received $18.0 million and $4.0 million in insurance recoveries related to damages suffered from natural disasters by our Louisiana Operations and Calder Race Course, respectively. We recorded $13.0 million of insurance recoveries, net of losses in our net earnings from continuing operations for the nine months ended September 30, 2006. Please refer to Note 3 to our Condensed Consolidated Financial Statements for further details regarding the natural disasters and related casualty losses and insurance recoveries.

**Legislative and Regulatory Developments**

Federal

*WTO*

In 2003, the country of Antigua filed a formal complaint against the United States with the World Trade Organization ("WTO"), challenging the United States' ability to enforce certain Federal gaming laws (Sections 1084, 1952 and 1955 of Title 18 of the United States Code known as the Wire Act, the Travel Act and the Illegal Gambling Business Act, respectively, and collectively the "Acts") against foreign companies that were accepting Internet wagers from United States residents. At issue was whether the United States' enforcement of the Acts against foreign companies violated the General Agreement on Trade in Services ("GATS"). In November of 2004, a WTO panel ruled that the United States, as a signatory of GATS, could not enforce the Acts against foreign companies that were accepting Internet wagers from United States residents. The United States appealed the ruling and, in April of 2005, the WTO's appellate body ruled that the United States had demonstrated that the Acts were measures necessary to protect public morals or maintain public order, but that the United States did not enforce the Acts consistently between domestic companies and foreign companies as required by GATS. The WTO's appellate body specifically referenced the Interstate Horseracing Act ("IHA"), which appeared to authorize domestic companies to accept Internet wagers on horseracing, as being inconsistent with the United States' stated policy against Internet wagering. In arguments and briefs before the WTO's appellate body, the United States argued that the Acts, specifically the Wire Act, applies equally to domestic companies and foreign companies and the IHA does not create an exception for domestic companies to accept Internet wagering on horseracing. The WTO's appellate body did not rule on whether an exception for domestic U.S. companies was created under the IHA, but recommended that the WTO's Dispute Settlement Body request the United States to bring measures found to be inconsistent with GATS into conformity with its obligations under GATS. The United States was given until April 3, 2006 to bring its policies in line with the ruling, assuming it believed any changes were necessary. On April 10, 2006, the United States delegation to the WTO submitted a brief report to the Chairman of the Dispute Settlement Body ("U.S. Report") stating that no changes are necessary to bring U.S. policies in line with the ruling. In support of its position, the United States delegation informed the Dispute Settlement Body that on April 5, 2006, the United States Department of Justice confirmed the United States Government position regarding remote wagering on horseracing in testimony before a subcommittee of the United States House of Representatives. According to the U.S. Report, in that testimony, the Department of Justice stated its view that regardless of the IHA, existing criminal statutes prohibit the interstate transmission of bets or wagers, including wagers on horseracing, and informed the subcommittee that it is currently undertaking a civil investigation relating to a potential violation of law regarding this activity. Antigua has not indicated what actions, if any, it will take in response to the U.S. Report and the United States' position relative to interstate wagering on horseracing. The effect of the WTO ruling on the ability of domestic companies to accept Internet wagers and other account wagers on horseracing remains unclear. While the WTO decision does not affect any existing federal or state law, we cannot predict what actions, if any, the U.S. government will take in response to the request of the WTO in light of the appellate body report of the WTO and in light of the U.S. Report and what impact, if any, the appellate body report and the U.S. Report will have on our business and operations. One of the options available to Congress and the White House is to prohibit or restrict substantially the conduct of interstate simulcast wagering or account wagering. If the U.S. government elects to take such an approach (including through any action by the Department of Justice), it will have a material, adverse impact on our business, financial condition and results of operations.

Return to Index

*Other Federal Legislation*

On September 29, 2006, the United States Congress passed the Safe Port Act ("HR 4954"). An amendment to this act incorporated the Internet Gambling Enforcement Act ("HR 4411"). The act prohibits those involved in the business of betting or wagering from accepting any financial instrument, electronic or otherwise, for deposit that is intended to be utilized for unlawful Internet gambling. The definition of unlawful Internet gambling specifically excludes all activities which are legal under the Interstate Horseracing Act. The act also contains a "Sense of Congress" which explicitly states that the act is not intended to criminalize any activity currently permitted by federal law. The Secretary of the Treasury is directed to promulgate regulations to enforce the provisions of this act within 270 days. The Secretary is further directed to ensure the regulations do not prohibit any activity which is excluded from the definition of unlawful Internet gambling, including those activities legal under the Interstate Horseracing Act. President Bush signed the bill in to law on October 13, 2006.

Indiana

During April of 2005, Senate Enrolled Act 92 ("SEA 92"), a bill that makes it a Class D Felony for an operator to use the Internet to engage in unlawful gambling in Indiana or with a person located in Indiana, passed both chambers of the Indiana General Assembly and was signed by the Governor. An "operator," as defined by SEA 92, is a person who owns, maintains or operates an Internet site that is used for interactive gambling. Under SEA 92, effective July 1, 2005, an operator is guilty of professional gambling if it uses the Internet to accept, or offer to accept, for profit, money or other property risked in unlawful gambling in Indiana or in a transaction directly involving a person located in Indiana. We receive source market fees from various in-home wagering providers for the licensing of our live racing products in the distribution of such products through broadcast mediums such as television or the Internet. Some of these in-home wagering providers accept pari-mutuel wagers from Indiana residents. TVG, one of our major in-home providers in Indiana, has ceased operations in Indiana due to legal uncertainty created by SEA 92.

Florida

On November 2, 2004, Amendment 4, a slot machine question which sought to allow voters in Miami-Dade and Broward counties to hold local referenda on the issue, passed by a margin of 1.4%. On March 8, 2005, voters in Miami-Dade and Broward counties voted in separate local referenda to decide whether slot machines could be installed at the seven existing pari-mutuel sites in those counties, including Calder. Although the measure passed in Broward County, home of Gulfstream Park, it was unsuccessful in Miami-Dade County, where Calder is located. Slot machine gaming was approved by the Florida legislature during a special session of the Florida legislature on December 9, 2005. Slot operations are expected to commence in a staggered manner at Broward's four pari-mutuel wagering facilities from September of 2006 through 2008. We believe that the failure of the local referendum to pass in Miami-Dade County was due primarily to Governor Bush's active opposition to the measure during the final days of the campaign. We are preparing a strategy to seek passage in Miami-Dade County when the issue can again be placed on the ballot. The earliest that it can be placed on the ballot is March 8, 2007, but it may be 2008 before the issue is actually placed on the ballot. We are currently determining the most advantageous date for placing the issue on the ballot. The impact on our results of operations and financial position of the failed referendum in Miami-Dade County and the operation of slot machines at pari-mutuel wagering facilities in Broward County is uncertain at this time.

On August 8, 2006, the District Court of Appeals, First District, State of Florida rendered a decision in the case of Floridians Against Expanded Gambling ("FAEG"), et. al versus Floridians for a Level Playing Field, et. al. FAEG challenged the process by which signatures were collected in order to place a constitutional amendment on the ballot in 2004 allowing Miami-Dade and Broward County voters to approve slot machines in pari-mutuel facilities. The

District Court of Appeals reversed a decision of the Florida trial court, which granted summary judgment and dismissed the challenge, and remanded the case back to the trial court for an evidentiary hearing to determine whether sufficient signatures were collected in the petition process. A motion for rehearing by the entire Court of Appeals or in the alternative a motion for certification to the Florida Supreme Court has been filed.

Return to Index

Illinois

Pursuant to the Illinois Horse Racing Act, Arlington Park (and all other Illinois racetracks) is permitted to receive a payment commonly known as purse recapture. Generally, in any year that wagering on Illinois horse races at Arlington Park is less than 75% of wagering both in Illinois and at Arlington Park on Illinois horse races in 1994, Arlington Park is permitted to receive 2% of the difference in wagering in the subsequent year. The payment is funded from the Arlington Park purse account. Under the Illinois Horse Racing Act, the Arlington Park purse account is to be repaid via an appropriation by the Illinois General Assembly from the Illinois General Revenue Fund. However, this appropriation has not been made since 2001. Subsequently, Illinois horsemen unsuccessfully petitioned the Illinois Racing Board ("IRB") to prevent Illinois racetracks from receiving this payment in any year that the Illinois General Assembly did not appropriate the repayment to the racetrack's purse accounts from the General Revenue Fund. Further, the Illinois horsemen filed lawsuits seeking, among other things, to block payment to Illinois racetracks, as well as to recover the 2002 and 2003 amounts already paid to the Illinois racetracks. These lawsuits filed by the Illinois horsemen challenging the 2002 and 2003 reimbursements have been resolved in favor of Arlington Park and the other Illinois racetracks. Several bills were filed in the 2003, 2004 and 2005 sessions of the Illinois legislature that, in part, would eliminate the statutory right of Arlington Park and the other Illinois racetracks to continue to receive this payment. None of these bills passed. Since the statute remains in effect, Arlington Park continues to receive the recapture payment from the purse account. If Arlington Park loses the statutory right to receive this payment, there would be a material, adverse impact on Arlington Park's results of operations.

Under previously enacted legislation, the Illinois Horse Racing Equity fund was scheduled to receive a portion (up to 15% of adjusted gross receipts) of wagering tax from the tenth riverboat casino license issued. The grant of the tenth riverboat license is currently the subject of numerous legal challenges and, as such, is currently not an operational riverboat license. The funds were scheduled to be utilized for purses and track discretionary spending. Because the tenth license has never been operational, the Illinois Horse Racing Equity fund has never had any funds to distribute.

In the Spring of 2006 session of the Illinois General Assembly, legislation was passed to create and fund the Horse Racing Equity Trust fund. The Horse Racing Equity Trust fund is to be funded from revenues of Illinois riverboat casinos that meet a certain threshold. Sixty percent of the funds are to be used for horsemen's purses (57% for thoroughbred meets and 43% for standardbred meets). The remaining 40% is to be distributed to racetracks (30.4% of that total for Arlington Park) and is to be used for improving, maintaining, marketing and operating Arlington Park and may be used for backstretch services and capital improvements. The legislation expires two years after its immediate effective date. The governor of Illinois signed the legislation on May 26, 2006 as Public Act 94-0805.

In an effort to prevent implementation of Public Act 94-0805, the four Illinois riverboat casinos that meet the threshold to contribute to the fund filed a complaint on May 30, 2006 in the Circuit Court of Will County, Illinois. The complaint was filed against the State Treasurer and the IRB to enjoin the imposition and collection of the 3% "surcharge" from the casinos, which was to be deposited in the Horse Racing Equity Trust fund. The riverboats have been paying the monies into a special escrow account and have demanded that the monies not be distributed. A temporary restraining order was granted to prevent distribution of these monies. The complaint alleges that Public Act 94-0805 is unconstitutional. The Illinois Attorney General will represent Illinois on this matter. As of the date of the filing of this Quarterly Report on Form 10-Q, management does not know the impact that the ultimate outcome of this matter will have on our consolidated financial position and results of operations.

During January and February when there is no live racing in Illinois, the IRB designates a Thoroughbred racetrack as the host track in Illinois. The IRB designated Arlington Park as host track in Illinois during January of 2006 for 29 days, which is the same as January of 2005. In addition, Arlington Park was designated as host track for eight days during February of 2006, which resulted in an increase of $0.5 million in pre-tax earnings for the month of February of 2006 compared to the same period of 2005. The IRB appointed Arlington Park the host track in Illinois during January 2007 for 30 days, which is an increase of one day compared to the same period of 2006. In addition, Arlington Park was appointed the host track for 15 days in February 2007, which is an increase of seven days compared to the same period of 2006. Arlington Park's future designation as the host track is subject to the annual designation by the IRB. A change in the number of days that Arlington Park is designated "host track" could have a material, adverse impact on our results of operations.

Return to Index

Kentucky

The Kentucky horse industry continues to seek legal authority to offer alternative forms of gaming at Kentucky's eight existing racetracks. Alternative forms of gaming would enable our Kentucky racetracks to better compete with neighboring gaming venues by providing substantial new revenues for purses and capital improvements. Several alternative gaming bills were filed in the 2006 session of the Kentucky General Assembly, including two bills filed in the House and two in the Senate. The Kentucky Equine Education Project ("KEEP"), an alliance of the Commonwealth's equine industry leaders, including our Company, supported legislation that called for a statewide voter referendum in the Fall of 2006 to amend the State constitution to allow Kentucky's eight racetracks to offer full casino gaming. The Commonwealth's share of the new revenue would have been earmarked for education, healthcare, local development and environmental concerns benefiting the entire Commonwealth under the KEEP plan. For several reasons, including active and public opposition by the Senate President and the governor publicly questioning the economics of alternative gaming, no alternative gaming legislation was passed. While KEEP has stated that the legalization of casino gaming will not be a primary legislative pursuit of KEEP in the 2007 session of the Kentucky General assembly, we anticipate legislative activity with regard to this issue and bills have been pre-filed which would permit casino gaming at Kentucky's racetracks. We plan to participate actively in that effort.

Kentucky statutes provide for the payment of supplemental purses by Kentucky racetracks for designated races won by Kentucky-bred horses. A portion of the excise tax collected on live, inter-track and simulcast wagering is available to reimburse each Kentucky racetrack for monies paid out as supplemental purses. The payment of the monies is administered through the Kentucky Thoroughbred Development Fund (the “KTDF”). Ellis Park is currently seeking reimbursement for approximately $1.3 million and Churchill Downs Racetrack is seeking reimbursement for approximately $1.2 million from the KTDF for monies paid out as supplemental purses in 2005 and 2006. The Kentucky Horse Racing Authority has requested the Kentucky State Auditor to audit the KTDF to determine amounts owed to Ellis Park as well as other racetracks. In the event amounts are recovered from the KTDF by Ellis Park, such amounts will be remitted to the Company in accordance with the Stock Purchase Agreement between EP Acquisition, LLC and the Company related to the sale of the stock of RCA. The timing and outcome of the audit are unknown at this time.

Louisiana

We have received all statutory, regulatory and other authorizations to operate slot machines at Fair Grounds. Failure to maintain the necessary gaming licenses to own and operate slot machines at Fair Grounds could have a material, adverse impact on our results of operations. Under the Louisiana statute, Fair Grounds was permitted to operate 500 slot machines. As a result of Hurricane Katrina, the agreement between Harrah's Casino in New Orleans and the State of Louisiana has been amended to eliminate the $350.0 million gaming revenue threshold before Fair Grounds may operate 700 slot machines. Conforming legislation was passed in the 2006 session of the Louisiana legislature. Due to Hurricane Katrina, we are currently evaluating the feasibility of beginning construction of a new slot facility.

Churchill Downs Louisiana Horseracing Company, LLC has completed the process to seek the necessary local zoning change and permits. On August 18, 2005, the New Orleans City Council passed ordinances approving hours of operation for slot machines at Fair Grounds as part of its conditional use permit. The ordinances also established additional provisos negotiated by Churchill Downs Louisiana Horseracing Company, LLC and the New Orleans City Council relating to other conditional use activities.

In April 2005, the New Orleans City Council instructed the city attorney to file a declaratory judgment action to determine if installation of slot machines at Fair Grounds would violate the City Charter. The Louisiana Attorney General has expressed an opinion that the addition of slots at the racetrack would not violate the City Charter. In June of 2005, a resident living near Fair Grounds filed a lawsuit alleging, among other claims, that slot machines at the racetrack would be a violation of the City Charter, which limits New Orleans to one land-based casino. On October 22, 2006, the Court granted our motion to dismiss. It is uncertain whether the plaintiff will appeal the Court's ruling. We do not believe the installation of slot machines at Fair Grounds violates the City Charter.

Return to Index

**Critical Accounting Policies**

Our Condensed Consolidated Financial Statements have been prepared in conformity with accounting principles generally accepted in the United States of America. Accordingly, we are required to make estimates, judgments and assumptions that we believe are reasonable based on historical experience, contract terms, observance of known trends in our company and the industry as a whole, and information available from other outside sources. Our estimates affect the reported amounts of assets and liabilities and related disclosures of contingent assets and liabilities at the date of the financial statements and the reported amounts of revenues and expenses during the reporting period. Actual results may differ from those initial estimates. In general, however, our estimates have historically approximated actual results.

Our most significant estimates relate to the valuation of plant and equipment, receivables, goodwill and other intangible assets, which may be significantly affected by changes in the regulatory environment in which we operate, and to the aggregate costs for retentions under our liability and workers' compensation policies. Additionally, estimates are used for determining income tax liabilities and the valuation of interest rate risk derivative contracts (interest rate swaps) and other derivative instruments.

We evaluate our goodwill, intangible and other long-lived assets in accordance with the application of Statement of Financial Accounting Standards ("SFAS") No. 142, "Goodwill and Intangible Assets" and SFAS No. 144, "Accounting for the impairment or disposal of Long-Lived Assets." For goodwill and intangible assets, we review the carrying values at least annually during the first quarter of each year or whenever events or changes in circumstances indicate that the carrying value of these assets may not be recoverable. We assign estimated useful lives to our intangible assets based on the period of time the asset is expected to contribute directly or indirectly to future cash flows. We consider certain factors when assigning useful lives such as legal, regulatory, competition and other economic factors. Intangible assets with finite lives are amortized using the straight-line method.

While we believe that our estimates of future revenues and cash flows are reasonable, different assumptions could materially affect our assessment of useful lives and fair market values. Changes in assumptions may cause modifications to our estimates for amortization or impairment, thereby impacting our results of operations. If the estimated lives of our intangible assets were to decrease based on the factors mentioned above, amortization expense could increase significantly.

Our business can be impacted positively and negatively by legislative and regulatory changes and by alternative gaming competition. A significant negative impact from these activities could result in a significant impairment of our plant and equipment and/or our goodwill and intangible assets in accordance with generally accepted accounting principles.

In connection with losses incurred from natural disasters, insurance proceeds are collected on existing business interruption and property and casualty insurance policies. When losses are sustained in one period and the amounts to be recovered are collected in a subsequent period, management uses estimates and judgment to determine the amounts that are probable of recovery under such policies as specified in Financial Accounting Standards Board Interpretation No. 30, "Accounting for Involuntary Conversion of Nonmonetary Assets to Monetary Assets."

We also use estimates and judgments for financial reporting to determine our current tax liability, as well as those taxes deferred until future periods. Net deferred and accrued income taxes represent significant assets and liabilities of the Company. In accordance with the liability method of accounting for income taxes as specified in SFAS 109, "Accounting for Income Taxes," we recognize the amount of taxes payable or refundable for the current year and deferred tax assets and liabilities for the future tax consequences of events that have been recognized in our financial statements or tax returns.

Adjustments to deferred taxes are determined annually based upon changes in differences between the book basis and tax basis of our assets and liabilities, measured by future tax rates we estimate will be applicable when these differences are expected to reverse. Changes in current tax laws, enacted tax rates or the estimated level of taxable income or non-deductible expenses could change the valuation of deferred tax assets and liabilities and affect the overall effective tax rate and tax provision.

Return to Index

In the past, we have utilized interest rate swap contracts to hedge exposure to interest rate fluctuations on our variable rate debt and have designated these swaps as cash flow hedges of anticipated interest payments. Our interest rate swap contracts match the critical terms of the underlying debt, thus qualifying for hedge accounting. Such critical terms include notional amounts, benchmark interest rate basis, interest reset dates and payment dates. The fair market value of the swaps was recorded on the balance sheet as an asset or liability with the offset recorded in accumulated other comprehensive income net of income taxes. Any changes in the fair market value of the swaps were adjusted to the asset or liability account and recorded net of the income taxes in other comprehensive income.

We maintain an allowance for doubtful accounts receivable that have been deemed to have a high risk of collectibility. We analyze historical collection trends and customer creditworthiness when evaluating the adequacy of our allowance for doubtful accounts receivable. Any changes in our assumptions or estimates could impact our bad debt expense and results of operations.

For our business insurance renewals over the past several years, we have assumed more risk than in prior years, primarily through higher retentions and higher maximum losses for stop-loss insurance for certain coverages. Our March 1, 2006 business insurance renewals included substantially the same coverages and retentions as previous years. However, our property retentions in Florida and Louisiana increased significantly for wind damage. We estimate insurance liabilities for workers compensation and general liability losses based on our historical loss experience, certain actuarial assumptions of loss development factors and current industry trends. Any changes in our assumptions, actuarial assumptions or loss experience could impact the total insurance cost and overall results of operations. Our ability to obtain insurance coverage at acceptable costs in future years under terms and conditions comparable to the current year is uncertain.

**Consolidated Net Revenues**

Our net revenues and earnings are significantly influenced by our racing calendar. Therefore, revenues and operating results for any interim quarter are not generally indicative of the revenues and operating results for the year, and may not be comparable with results for the corresponding period of the previous year. We historically have very few live racing days during the first quarter of each year, with a majority of our live racing occurring in the second, third and fourth quarters, including the running of the Kentucky Derby and Kentucky Oaks in the second quarter, the quarter during which we typically generate the majority of our annual operating income.

Our pari-mutuel revenues include commissions on pari-mutuel wagering at our racetracks and off-track betting facilities (net of state and local pari-mutuel taxes), plus simulcast host fees from other wagering sites and source market fees generated from contracts with our in-home wagering providers. In addition to the commissions earned on pari-mutuel wagering, we earn pari-mutuel related streams of revenues from sources that are not directly related to wagering. These other revenues are primarily derived from statutory racing regulations in some of the states where our facilities are located and can fluctuate materially year-to-year. Non-pari-mutuel revenues are primarily generated from admissions, sponsorships, licensing rights and broadcast fees, Indiana riverboat admissions subsidy, concessions, video poker, lease income and other sources.

Pari-mutuel revenues are recognized upon occurrence of the live race that is presented for wagering and after that live race is made official by the respective states' racing regulatory body. Additional non-wagering revenues such as admissions, programs and concession revenues are recognized as delivery of the product or services has occurred.

Greater than 70% of our annual revenues are generated by pari-mutuel wagering on live and simulcast racing content and in-home wagering. Live racing handle includes patron wagers made on live races at our live tracks and also wagers made on imported simulcast signals at our racetracks during our live meets. Import simulcasting handle includes wagers on imported signals at our racetracks when the respective tracks are not conducting live race meets and at our OTBs throughout the year. Export handle includes all wagers made on our live racing signals sent to other tracks, OTBs and in-home wagering. In-home wagering, or advance deposit wagering, consists of patron wagers through a pre-funded account.

We retain as revenue a predetermined percentage or commission on the total amount wagered on live and import simulcasting sources, and the balance is distributed to the winning patrons. The gross

Return to Index

percentages retained on live racing and import simulcasting at our various locations range from approximately 16% to 21%. In general, the fees earned from export simulcasting are contractually determined and average approximately 3.5%. All commissions and fees earned from pari-mutuel wagering are shared with horsemen through payment of purses based on local contracts and statutes and average approximately 50%.

Return to Index

**Results Of Continuing Operations**

The following table sets forth, for the periods indicated, certain operating data:

| (In thousands, except per share data and live race days) | Three Months Ended September 30, 2006 | 2005 | Change Amount | % |
|---|---|---|---|---|
| Total pari-mutuel handle | $ 915,100 | $ 942,357 | $ (27,257) | (3)% |
| Number of live race days | 142 | 148 | (6) | (4)% |
| | | | | |
| Net pari-mutuel revenues | $ 83,952 | $ 82,921 | $ 1,031 | 1% |
| Other operating revenues | 22,398 | 18,740 | 3,658 | 20% |
| Total net revenues | $ 106,350 | $ 101,661 | $ 4,689 | 5% |
| | | | | |
| Gross profit | $ 14,608 | $ 13,484 | $ 1,124 | 8% |
| Gross margin percentage | 14% | 13% | | |
| | | | | |
| Operating income | $ 4,988 | $ 4,603 | $ 385 | 8% |
| Net earnings from continuing operations | $ 2,718 | $ 3,159 | $ (441) | (14)% |
| | | | | |
| Effective tax rate | 44% | 41% | | |
| | | | | |
| Diluted net earnings from continuing operations per common share | $ 0.20 | $ 0.23 | | |

Three Months Ended September 30, 2006 Compared to the Three Months Ended September 30, 2005

Our total net revenues increased $4.7 million primarily due to increased revenues from the Louisiana Operations as a result of increased wagering at our video poker operations as well as an increase in import simulcasting pari-mutuel revenues. Net revenues from the Churchill Downs Racetrack increased primarily as a result of four more live racing days during the three months ended September 30, 2006 compared to the same period of 2005. A decrease in net revenues from Arlington Park partially offset these increases primarily as a result of four fewer live racing days during the three months ended September 30, 2006 compared to the same period of 2005. Further discussion of net revenue variances by our reported segments is detailed below.

**Consolidated Expenses**

The following table is a summary of our consolidated expenses:

| (In thousands) | Three Months Ended September 30, 2006 | 2006 | Change Amount | % |
|---|---|---|---|---|
| Purse expenses | $ 37,935 | $ 35,283 | $ 2,652 | 8% |
| Depreciation/amortization | 5,097 | 5,194 | (97) | (2)% |
| Other operating expenses | 48,710 | 47,700 | 1,010 | 2% |

| | | | | | | | |
|---|---|---|---|---|---|---|---|
| SG&A expenses | | 11,452 | | 10,244 | | 1,208 | 12% |
| Insurance recoveries, net of losses | | (1,832) | | (1,363) | | (469) | (34)% |
| Total expenses from continuing operations | $ | 101,362 | $ | 97,058 | $ | 4,304 | 4% |
| | | | | | | | |
| Percent of revenue | | 95% | | 95% | | | |

Three Months Ended September 30, 2006 Compared to the Three Months Ended September 30, 2005

Total expenses increased 4% during the three months ended September 30, 2006, primarily as a result of increased purse and other operating expenses from the Louisiana Operations of $2.3 million and $0.7 million, respectively, which is consistent with higher business levels experienced from our video poker operations and import simulcasting pari-mutuel operations. Corporate expenses increased primarily due to increased costs associated with the retirement and replacement of the chief executive officer and increased payroll costs. Further discussion of expense variances by our reported segments is detailed below.

Return to Index

**Other Income (Expense)**

The following table is a summary of our other income (expense):

| In thousands) | Three Months Ended September 30, | | Change | |
|---|---|---|---|---|
| | 2006 | 2005 | $ | % |
| Interest income | $ 272 | $ 135 | $ 137 | 101% |
| Interest expense | (526) | (265) | (261) | (98)% |
| Unrealized gain on derivative instruments | 204 | 204 | - | - |
| Miscellaneous, net | (92) | 715 | (807) | (113)% |
| Other income (expense) | $ (142) | $ 789 | $ (931) | (118)% |

Three Months Ended September 30, 2006 Compared to the Three Months Ended September 30, 2005

Significant items affecting the comparability of other income and expense include:

- During the three months ended September 30, 2005, we recognized a minority interest benefit within miscellaneous income related to Hoosier Park in the amount of $0.3 million.
- During the three months ended September 30, 2005, we recognized $0.3 million of miscellaneous income related to consideration received for the extension of an option to purchase an interest in Hoosier Park.

**Net Revenues By Segment**

The following table presents net revenues, including intercompany revenues, by our reported segments:

| (In thousands) | Three Months Ended September 30, | | Change | |
|---|---|---|---|---|
| | 2006 | 2005 | $ | % |
| Churchill Downs Racetrack | $ 10,504 | $ 8,668 | $ 1,836 | 21% |
| Arlington Park | 33,984 | 39,610 | (5,626) | (14)% |
| Calder Race Course | 33,257 | 32,277 | 980 | 3% |
| Hoosier Park | 9,527 | 9,731 | (204) | (2)% |
| Louisiana Operations | 15,048 | 7,474 | 7,574 | 101% |
| CDSN | 14,961 | 15,065 | (104) | (1)% |
| Total Racing Operations | 117,281 | 112,825 | 4,456 | 4% |
| Other Investments | 1,441 | 1,234 | 207 | 17% |
| Corporate | - | 136 | (136) | (100)% |
| Eliminations | (12,372) | (12,534) | 162 | 1% |
| Net revenues from continuing operations | $ 106,350 | $ 101,661 | $ 4,689 | 5% |

Three Months Ended September 30, 2006 Compared to the Three Months Ended September 30, 2005

Significant items affecting comparability of our revenues by segment include:

- Net revenues from the Louisiana Operations increased significantly primarily as a result of increased wagering at our video poker operations as well as an increase in import simulcasting pari-mutuel revenues. Since the reopening of our OTBs in Louisiana after Hurricane Katrina, we have experienced a significant rise in business levels that we believe is attributable to the limited entertainment options available in the Gulf Coast region during the hurricane reconstruction.

Return to Index

- Net revenues from the Churchill Downs Racetrack increased primarily as a result of four more live racing days during the three months ended September 30, 2006 compared to the same period of 2005.
- Net revenues from Arlington Park decreased primarily as a result of four fewer live racing days during the three months ended September 30, 2006 compared to the same period of 2005. In addition, net revenues decreased due to a decline in average starters per race as well as lower pari-mutuel wagering in general.

**Expenses by Segment**

The following table presents total expenses, including intercompany expenses, by our reported segments:

| (In thousands) | Three Months Ended September 30, 2006 | Three Months Ended September 30, 2005 | Change $ | Change % |
|---|---|---|---|---|
| Churchill Downs Racetrack | $ 16,404 | $ 15,570 | $ 834 | 5% |
| Arlington Park | 32,301 | 32,276 | 25 | - |
| Calder Race Course | 27,334 | 27,935 | (601) | (2)% |
| Hoosier Park | 9,883 | 10,144 | (261) | (3)% |
| Louisiana Operations | 14,251 | 9,468 | 4,783 | 51% |
| CDSN | 11,128 | 11,321 | (193) | (2)% |
| Total Racing Operations | 111,301 | 106,714 | 4,587 | 4% |
| Other Investments | 944 | 937 | 7 | 1% |
| Corporate | 5,350 | 3,388 | 1,962 | 58% |
| Eliminations | (16,233) | (13,981) | (2,252) | (16)% |
| Total expenses from continuing operations | $ 101,362 | $ 97,058 | $ 4,304 | 4% |

Three Months Ended September 30, 2006 Compared to the Three Months Ended September 30, 2005

Significant items affecting comparability of our expenses by segment include:

- Expenses from the Louisiana Operations increased primarily as a result of increased purses caused by the higher business levels previously mentioned. Also, during the three months ended September 30, 2005, we recognized a reduction of selling, general and administrative expenses of $1.4 million related to an estimate of insurance proceeds that management determined are probable of recovery in connection with losses recognized from Hurricane Katrina by the Louisiana Operations.
- Corporate expenses increased primarily as a result of increased costs associated with the retirement and replacement of the chief executive officer and increased payroll costs.

Return to Index

## Discontinued Operations

The following table presents earnings from discontinued operations for the three months ended September 30, 2006 and 2005:

| (In thousands) | Three Months Ended September 30, 2006 | Three Months Ended September 30, 2005 | Change $ | Change % |
|---|---|---|---|---|
| Net revenues | $ 9,234 | $ 26,680 | $ (17,446) | (65)% |
| Operating expenses | 6,407 | 25,230 | (18,823) | (75)% |
| Gross profit | 2,827 | 1,450 | 1,377 | 95% |
| Selling, general and administrative expenses | 753 | 151 | 602 | 399% |
| Insurance recoveries, net of losses | (1,293) | - | (1,293) | (100)% |
| Operating income | 3,367 | 1,299 | 2,068 | 159% |
| Other income (expense): | | | | |
| Interest income | - | 6 | (6) | (100)% |
| Interest expense | - | (3,173) | 3,173 | 100% |
| Miscellaneous, net | (15) | 6 | (21) | (350)% |
| | (15) | (3,161) | 3,146 | 100% |
| Earnings (loss) before income taxes | 3,352 | (1,862) | 5,214 | 280% |
| (Provision) benefit for income taxes | (1,520) | 421 | (1,941) | (461)% |
| Earnings (loss) from operations | 1,832 | (1,441) | 3,273 | 227% |
| Gain on sale of assets, net of income taxes | 4,197 | 69,917 | (65,720) | (94)% |
| Net earnings | $ 6,029 | $ 68,476 | $ (62,447) | (91)% |

Significant items affecting comparability of earnings from discontinued operations include:

- The results of operations of discontinued operations for the three months ended September 30, 2006 include the results of operations of Ellis Park compared to those of Hollywood Park and Ellis Park for the three months ended September 30, 2005.

## Results Of Continuing Operations

The following table sets forth, for the periods indicated, certain operating data:

| (In thousands, except per share data and live race days) | Nine Months Ended September 30, 2006 | Nine Months Ended September 30, 2005 | Change $ | Change % |
|---|---|---|---|---|
| Total pari-mutuel handle | $ 2,449,582 | $ 2,606,322 | $ (156,740) | (6)% |
| Number of live race days | 348 | 398 | (50) | (13)% |
| | | | | |
| Net pari-mutuel revenues | $ 219,501 | $ 221,708 | $ (2,207) | (1)% |
| Other operating revenues | 105,183 | 93,421 | 11,762 | 13% |
| Total net revenues | $ 324,684 | $ 315,129 | $ 9,555 | 3% |

| | | | | | | | |
|---|---|---|---|---|---|---|---|
| Gross profit | $ | 68,674 | $ | 62,677 | $ | 5,997 | 10% |
| Gross margin percentage | | 21% | | 20% | | | |
| | | | | | | | |
| Operating income | $ | 46,610 | $ | 29,122 | $ | 17,488 | 60% |
| Net earnings from continuing operations | $ | 26,886 | $ | 17,150 | $ | 9,736 | 57% |
| | | | | | | | |
| Effective tax rate | | 42% | | 44% | | | |
| | | | | | | | |
| Diluted net earnings from continuing operations per common share | $ | 1.97 | $ | 1.27 | | | |

30

Return to Index

Nine Months Ended September 30, 2006 Compared to the Nine Months Ended September 30, 2005

Our total net revenues increased $9.6 million primarily due to increased revenues during the week of the Kentucky Derby, which resulted in higher revenues in our Churchill Downs Racetrack and CDSN. We also experienced incremental net revenues from increased wagering at our video poker operations in Louisiana as well as increased import simulcasting pari-mutuel revenues. These increased net revenues were partially offset by decreased net revenues from Arlington Park primarily caused by a decline in average starters per race as well as lower pari-mutuel wagering in general. These increased net revenues were also partially offset by decreased net revenues from the Louisiana Operations and CDSN primarily as a result of 49 fewer live racing days at Fair Grounds due to the business interruption caused by Hurricane Katrina. Further discussion of net revenue variances by our reported segments is detailed below.

Significant items affecting comparability of operating income, net earnings from continuing operations and diluted net earnings from continuing operations per common share included:

- During the nine months ended September 30, 2006, we recorded a net gain of $13.0 million compared to $1.4 million during the same period of 2005 related to insurance recoveries, net of losses associated with damages sustained from natural disasters that occurred during 2005 by the Louisiana Operations and Calder Race Course.
- We incurred $3.0 million of expenses related to alternative gaming initiatives in Florida during the nine months ended September 30, 2005.
- Our effective tax rate decreased from 44% to 42% resulting primarily from the non-deductibility of legislative initiative costs recognized during 2005.

**Consolidated Expenses**

The following table is a summary of our consolidated expenses:

| (In thousands) | Nine Months Ended September 30, 2006 | Nine Months Ended September 30, 2005 | Change $ | Change % |
|---|---|---|---|---|
| Purse expenses | $ 100,532 | $ 97,629 | $ 2,903 | 3% |
| Depreciation/amortization | 15,382 | 15,334 | 48 | - |
| Other operating expenses | 140,096 | 139,489 | 607 | - |
| SG&A expenses | 35,018 | 34,918 | 100 | - |
| Insurance recoveries, net of losses | (12,954) | (1,363) | (11,591) | (850)% |
| Total expenses from continuing operations | $ 278,074 | $ 286,007 | $ (7,933) | (3)% |
| | | | | |
| Percent of revenue | 86% | 91% | | |

Nine Months Ended September 30, 2006 Compared to the Nine Months Ended September 30, 2005

Total expenses decreased 3% during the nine months ended September 30, 2006, primarily as a result of an increase in insurance recoveries, net of losses of $11.6 million related to damages sustained from natural disasters that occurred during 2005 by the Louisiana Operations and Calder Race Course. Purse expenses of Churchill Downs Racetrack increased consistent with the higher net revenues experienced during the week of the Kentucky Derby. Further discussion of expense variances by our reported segments is detailed below.

Return to Index

## Other Income (Expense)

The following table is a summary of our other income (expense):

| (In thousands) | Nine Months Ended September 30, 2006 | Nine Months Ended September 30, 2005 | Change $ | Change % |
|---|---|---|---|---|
| Interest income | $ 634 | $ 296 | $ 338 | 114% |
| Interest expense | (1,708) | (950) | (758) | (80)% |
| Unrealized gain on derivative instruments | 612 | 614 | (2) | - |
| Miscellaneous, net | 510 | 1,308 | (798) | (61)% |
| Other income (expense) | $ 48 | $ 1,268 | $ (1,220) | (96)% |

Nine Months Ended September 30, 2006 Compared to the Nine Months Ended September 30, 2005

Significant items affecting the comparability of other income and expense include:

- During the nine months ended September 30, 2006, we recognized $0.6 million of losses related to our equity investment in Racing World.

## Net Revenues By Segment

The following table presents net revenues, including intercompany revenues, by our reported segments:

| (In thousands, except per share data and live race days) | Nine Months Ended September 30, 2006 | Nine Months Ended September 30, 2005 | Change $ | Change % |
|---|---|---|---|---|
| Churchill Downs Racetrack | $ 99,566 | $ 92,097 | $ 7,469 | 8% |
| Arlington Park | 72,626 | 76,150 | (3,524) | (5)% |
| Calder Race Course | 61,434 | 59,698 | 1,736 | 3% |
| Hoosier Park | 28,966 | 30,245 | (1,279) | (4)% |
| Louisiana Operations | 50,368 | 45,266 | 5,102 | 11% |
| CDSN | 46,429 | 49,354 | (2,925) | (6)% |
| Total Racing Operations | 359,389 | 352,810 | 6,579 | 2% |
| Other Investments | 3,022 | 2,257 | 765 | 34% |
| Corporate | 162 | 556 | (394) | (71)% |
| Eliminations | (37,889) | (40,494) | 2,605 | 6% |
| Net revenues from continuing operations | $ 324,684 | $ 315,129 | $ 9,555 | 3% |

Nine Months Ended September 30, 2006 Compared to the Nine Months Ended September 30, 2005

Significant items affecting comparability of our revenues by segment include:

- Net revenues from Churchill Downs Racetrack increased primarily as a result of a successful Kentucky Derby, including continued benefits realized from the newly renovated Churchill Downs racetrack facility as well as higher non-wagering revenues associated with the Kentucky Derby.

- Net revenues from the Louisiana Operations increased primarily as a result of increased wagering at our video poker operations in Louisiana as well as increased import simulcasting pari-mutuel revenues. These increased net revenues were partially offset by decreased net revenues from the Louisiana Operations and CDSN primarily as a result of 49 fewer live racing days at Fair Grounds due to the business interruption caused by Hurricane Katrina.
- Net revenues from Arlington Park decreased primarily as a result of a decline in average starters per race as well as lower pari-mutuel wagering in general.

Return to Index

**Expenses by Segment**

The following table presents total expenses, including intercompany expenses, by our reported segments:

| (In thousands, except per share data and live race days) | Nine Months Ended September 30, | | Change | |
|---|---|---|---|---|
| | 2006 | 2005 | $ | % |
| Churchill Downs Racetrack | $ 77,972 | $ 71,471 | $ 6,501 | 9% |
| Arlington Park | 73,652 | 70,857 | 2,795 | 4% |
| Calder Race Course | 57,556 | 59,948 | (2,392) | (4)% |
| Hoosier Park | 29,816 | 30,584 | (768) | (3)% |
| Louisiana Operations | 36,588 | 49,083 | (12,495) | (25)% |
| CDSN | 35,032 | 37,293 | (2,261) | (6)% |
| Total Racing Operations | 310,616 | 319,236 | (8,620) | (3)% |
| Other Investments | 2,066 | 2,141 | (75) | (4)% |
| Corporate | 15,764 | 12,280 | 3,484 | 28% |
| Eliminations | (50,372) | (47,650) | (2,722) | (6)% |
| Total expenses from continuing operations | $ 278,074 | $ 286,007 | $ (7,933) | (3)% |

Nine Months Ended September 30, 2006 Compared to the Nine Months Ended September 30, 2005

Significant items affecting comparability of our expenses by segment include:

- During the nine months ended September 30, 2006, we recorded insurance recoveries, net of losses of $10.3 million compared to $1.4 million during the same period of 2005 related to damages sustained from Hurricane Katrina that occurred during 2005 by the Louisiana Operations. Expenses from the Louisiana Operations and CDSN also decreased as a result of 49 fewer live racing days at Fair Grounds due to the business interruption caused by Hurricane Katrina. A shortened race meet was conducted at Harrah's Louisiana Downs from November 19, 2005 through January 22, 2006 resulting in 12 racing days during the nine months ended September 30, 2006 as compared to 61 days during the nine months ended September 30, 2005. Increased purse expenses and pari-mutuel related expenses as a result of increased business levels partially offset these declines.
- We incurred $3.0 million of expenses related to the alternative gaming initiatives in Florida during the nine months ended September 30, 2005. During the nine months ended September 30, 2006, we recorded insurance recoveries, net of losses of $2.7 million related to damages sustained from Hurricane Wilma that occurred during 2005. Higher property insurance expense partially offset this decrease, which was caused by the occurrence of significant natural disasters during 2005.
- Churchill Downs Racetrack expenses increased primarily as a result of increased expenses related to the Kentucky Derby, including higher expenses associated with fulfilling sponsorships related to the Kentucky Derby. Also, depreciation expense increased due to the recognition of a full nine months of depreciation expense related to the newly renovated Churchill Downs racetrack facility that was completed during 2005.
- Arlington Park expenses increased primarily as a result of less purse overpayment recoveries during the nine months ended September 30, 2006 in addition to the generation of additional purse overpayments during the same period.
- Corporate expenses increased during the nine months ended September 30, 2006 compared to the nine months ended September 30, 2005 primarily as a result of increased costs associated with the retirement and replacement of the chief executive officer and increased payroll costs.

33

Return to Index

## Discontinued Operations

The following table presents earnings from discontinued operations for the nine months ended September 30, 2006 and 2005:

| (In thousands, except per share data and live race days) | Nine Months Ended September 30, 2006 | 2005 | Change $ | % |
|---|---|---|---|---|
| Net revenues | $ 10,953 | $ 82,105 | $ (71,152) | (87)% |
| Operating expenses | 9,947 | 75,723 | (65,776) | (87)% |
| Gross profit | 1,006 | 6,382 | (5,376) | (84)% |
| Selling, general and administrative expenses | 1,152 | 3,858 | (2,706) | (70)% |
| Insurance recoveries, net of losses | (1,367) | - | (1,367) | (100)% |
| Operating income | 1,221 | 2,524 | (1,303) | (52)% |
| Other income (expense): | | | | |
| Interest income | - | 20 | (20) | (100)% |
| Interest expense | - | (8,806) | 8,806 | 100% |
| Miscellaneous, net | 48 | 80 | (32) | (40)% |
| | 48 | (8,706) | 8,754 | 101% |
| Earnings (loss) before income taxes | 1,269 | (6,182) | 7,451 | 121% |
| (Provision) benefit for income taxes | (525) | 1,039 | (1,564) | (151)% |
| Earnings (loss) from operations | 744 | (5,143) | 5,887 | 114% |
| Gain on sale of assets, net of income taxes | 4,197 | 69,917 | (65,720) | (94)% |
| Net earnings | $ 4,941 | $ 64,774 | $ (59,833) | (92)% |

Significant items affecting comparability of earnings from discontinued operations include:

· The results of operations of discontinued operations for the nine months ended September 30, 2006 include the results of operations of Ellis Park compared to those of Hollywood Park and Ellis Park for the nine months ended September 30, 2005.

## Consolidated Balance Sheet

The following table is a summary of our overall financial position as of September 30, 2006 and December 31, 2005:

| (In thousands) | September 30, 2006 | December 31, 2005 | Change $ | % |
|---|---|---|---|---|
| Total assets | $ 529,670 | $ 513,165 | $ 16,505 | 3% |
| Total liabilities | $ 176,582 | $ 196,934 | $ (20,352) | (10)% |
| Total shareholders' equity | $ 353,088 | $ 316,231 | $ 36,857 | 12% |

Significant items affecting comparability of our consolidated balance sheet include:

· Total assets increased primarily as a result of increased restricted cash balances generated by the collection of amounts to be paid out as purses during future racing meets, which was primarily caused by the previously mentioned higher business levels in the Louisiana Operations.

- Total liabilities decreased primarily as a result of the pay-off of long-term debt using cash generated from operations. Deferred revenue decreased $11.7 million primarily due to recognition of revenue for luxury suite sales, corporate sponsor events, season boxes, membership sales and future wagering related to the 2006 Kentucky Derby and Kentucky Oaks race days. Dividends payable decreased $6.5 million as a result of the payment of 2005 dividends during the nine months ended September 30, 2006. Purses payable increased $12.5 million primarily due to amounts generated by improved business levels in the Louisiana Operations and the live race meet at Hoosier Park.

Return to Index

## Liquidity and Capital Resources

The following table is a summary of our liquidity and capital resources:

| (In thousands) | Nine Months Ended September 30, 2006 | Nine Months Ended September 30, 2005 | Change $ | Change % |
|---|---|---|---|---|
| Operating activities | $ 46,704 | $ 32,500 | $ 14,204 | 44% |
| Investing activities | $ (22,078) | $ 207,732 | $ (229,810) | (111)% |
| Financing activities | $ (22,251) | $ (229,719) | $ 207,468 | 90% |

Significant items affecting comparability of our liquidity and capital resources include:

- The increase in operating activities is primarily the result of cash generated by the collection of insurance proceeds related to damages sustained from natural disasters that occurred during 2005.
- During the nine months ended September 30, 2005, we received $248.3 million of net proceeds in connection with the sale of the assets of Hollywood Park, resulting in the decrease in investing activities. Reduced capital expenditures related to the Churchill Downs racetrack facility renovation project referred to as the “Master Plan” partially offset this decrease.
- We made repayments in excess of our borrowings on our revolving loan facilities of $15.6 million during the nine months ended September 30, 2006 compared to $225.0 million during the nine months ended September 30, 2005 due to the fact that excess cash was generated from the sale of the assets of Hollywood Park during 2005.
- We anticipate that cash flows from operations over the next twelve months will be adequate to fund our business operations and capital expenditures.

## Recently Issued Accounting Pronouncements

In July of 2006, the Financial Accounting Standards Board (the “FASB”) issued FASB Interpretation No. 48, “Accounting for Uncertainty in Income Taxes - an interpretation of FASB Statement 109” (“FIN 48”). FIN 48 establishes, among other things, that a tax benefit from an uncertain position may only be recognized if it is “more likely than not” that the position is sustainable based on its technical merits. The tax benefit of a qualifying position will be measured by calculating the largest amount of tax benefit that is greater than 50 percent likely of being realized upon ultimate settlement with a taxing authority having full knowledge of all relevant information. The assessment of the recognition threshold and the measurement of the associated tax benefit might change as new information becomes available. Unrecognized tax benefits will be recognized in the period that the position reaches the recognition threshold, which might occur prior to absolute finality of the matter. Similarly, recognized tax benefits will be derecognized in the period in which the position falls below the threshold. FIN 48 also requires qualitative and quantitative disclosures, including discussion of reasonably possible changes that might occur in the recognized tax benefits over the next twelve months, a description of open tax years by major jurisdictions and a roll-forward of all unrecognized tax benefits, presented as a reconciliation of the beginning and ending balances of the unrecognized tax benefits on a worldwide aggregated basis. FIN 48 is effective for the Company as of January 1, 2007. The change in net assets, if any, that results from the application of FIN 48 will be recorded as an adjustment to retained earnings. Management has not yet determined the impact that the adoption of FIN 48 will have on our consolidated financial position, results of operations and earnings per common share.

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

No material changes have occurred in our exposures to market risk during the first nine months of 2006.

Return to Index

## ITEM 4. CONTROLS AND PROCEDURES

(a) Evaluation of Disclosure Controls and Procedures

As of the end of the period covered by the report, the Company carried out an evaluation under the supervision and with the participation of the Company's Disclosure Committee and management, including the President and Chief Executive Officer ("CEO") and the Chief Financial Officer ("CFO"), of the effectiveness of the design and operation of our disclosure controls and procedures pursuant to Exchange Act Rule 13a-15(b). Based upon this evaluation, the CEO and the CFO concluded that our disclosure controls and procedures were effective as of September 30, 2006.

(b) Changes in Internal Control over Financial Reporting

Management of the Company has evaluated, with the participation of our CEO and CFO, changes in the Company's internal control over financial reporting (as defined in Rules 13a-15(f) and 15d-15(f) of the Exchange Act) during the third quarter of 2006. There have not been any changes in the Company's internal control over financial reporting (as defined in Rules 13a-15(f) and 15d-15(f) of the Exchange Act) that occurred during the quarter ended September 30, 2006 that have materially affected, or are reasonably likely to materially affect, the Company's internal control over financial reporting.

Return to Index

**PART II.** **OTHER INFORMATION**

**ITEM 1.** **LEGAL PROCEEDINGS**

Not applicable.

**ITEM 1A.** **RISK FACTORS**

Information regarding risk factors appears in Part I - Item 1A of the Company's Annual Report on Form 10-K for the year ended December 31, 2005. Other than described below, there have been no material changes from the risk factors previously disclosed in the Company's Annual Report on Form 10-K.

Potential Changes in Legislation and Regulation of Our Operations

Our gaming operations exist at the discretion of the states where we conduct business. Certain aspects of our gaming operations are also subject to federal statutes or regulations. All of our pari-mutuel wagering operations are contingent upon continued governmental approval of those operations as forms of legalized gaming. Legislation to limit or prohibit gaming (pari-mutuel or non-pari-mutuel) may be introduced in the future. Any restriction on or prohibition of gaming operations could have a material, adverse impact on our business, financial condition and results of operations. In addition, any expansion of our gaming operations into alternative gaming, such as slot machines, video lottery terminals and other forms of non-pari-mutuel gaming, will likely require various additional licenses, registrations, permits and approvals. The approval process can be time-consuming and costly, and there is no assurance of success. We have and continue to seek legal authority to offer alternative gaming at our racetracks where alternative gaming is not currently permitted.

We authorize third party account wagering providers to accept pari-mutuel wagers from subscribers residing in states that expressly authorize or do not expressly prohibit account wagering. We receive host fees and source market fees from this activity. In the past, certain state attorneys general, district attorneys and other law enforcement officials have expressed concern over the legality of interstate account wagering. In December 2000, legislation was enacted in the United States that amends the Interstate Horseracing Act of 1978. We believe that this amendment clarifies that inter-track simulcasting, off-track betting and account wagering, when conducted in accordance with the IHA are authorized under U.S. federal law. The amendment may not be interpreted in this manner by all concerned, however, and there may be challenges to these activities by both state and federal law enforcement authorities, which could have a material, adverse impact on our business, financial condition and results of operations. In addition, if any proceedings were brought by governmental or private litigants who disagree with our interpretation of the applicable laws, the adverse publicity, cost of such litigation and diversion of our management's focus and time away from our business operations may have a material, adverse impact on our business, financial condition and results of operations.

On September 29, 2006, the United States Congress passed the Safe Port Act ("HR 4954"). An amendment to this act incorporated the Internet Gambling Enforcement Act ("HR 4411"). The act prohibits those involved in the business of betting or wagering from accepting any financial instrument, electronic or otherwise, for deposit that is intended to be utilized for unlawful Internet gambling. The definition of unlawful Internet gambling specifically excludes all activities which are legal under the Interstate Horseracing Act. The act also contains a "Sense of Congress" which explicitly states that the act is not intended to criminalize any activity currently permitted by federal law. The Secretary of the Treasury is directed to promulgate regulations to enforce the provisions of this act within 270 days. The Secretary is further directed to ensure the regulations do not prohibit any activity which is excluded from the definition of unlawful Internet gambling, including those activities legal under the Interstate Horseracing Act. President Bush signed the bill in to law on October 13, 2006

In 2003, the country of Antigua filed a formal complaint against the United States with the WTO, challenging the United States' ability to enforce certain Federal gaming laws against foreign companies that were accepting Internet wagers from United States residents. At issue was whether the United States' enforcement of the Acts against foreign companies violated the GATS. In November of 2004, a WTO panel ruled that the United States, as a signatory of GATS, could not enforce the Acts against foreign companies that were accepting Internet wagers from United States residents. The United States

Return to Index

appealed the ruling and, in April of 2005, the WTO's appellate body ruled that the United States had demonstrated that the Acts were measures necessary to protect public morals or maintain public order, but that the United States did not enforce the Acts consistently between domestic companies and foreign companies as required by GATS. The WTO's appellate body specifically referenced the IHA, which appeared to authorize domestic companies to accept Internet wagers on horseracing, as being inconsistent with the United States' stated policy against Internet wagering. In arguments and briefs before the WTO's appellate body, the United States argued that the Acts, specifically the Wire Act, applies equally to domestic companies and foreign companies and the IHA does not create an exception for domestic companies to accept Internet wagering on horseracing. The WTO's appellate body did not rule on whether an exception for domestic U.S. companies was created under the IHA, but recommended that the WTO's Dispute Settlement Body request the United States to bring measures found to be inconsistent with GATS into conformity with its obligations under GATS. The United States was given until April 3, 2006 to bring its policies in line with the ruling, assuming it believed any changes were necessary. On April 10, 2006, the United States delegation to the WTO submitted a brief report to the Chairman of the Dispute Settlement Body (“U.S. Report”) stating that no changes are necessary to bring U.S. policies in line with the ruling. In support of its position, the United States delegation informed the Dispute Settlement Body that on April 5, 2006, the United States Department of Justice confirmed the United States Government position regarding remote wagering on horseracing in testimony before a subcommittee of the United States House of Representatives. According to the U.S. Report, in that testimony, the Department of Justice stated its view that regardless of the IHA, existing criminal statutes prohibit the interstate transmission of bets or wagers, including wagers on horseracing, and informed the subcommittee that it is currently undertaking a civil investigation relating to a potential violation of law regarding this activity. Antigua has not indicated what actions, if any, it will take in response to the U.S. Report and the United States' position relative to interstate wagering on horseracing. The effect of the WTO ruling on the ability of domestic companies to accept Internet wagers and other account wagers on horseracing remains unclear. While the WTO decision does not affect any existing federal or state law, we cannot predict what actions, if any, the U.S. government will take in response to the request of the WTO in light of the appellate body report of the WTO and in light of the U.S. Report and what impact, if any, the appellate body report and the U.S. Report will have on our business and operations. One of the options available to Congress and the White House is to prohibit or restrict substantially the conduct of interstate simulcast wagering or account wagering. If the U.S. government elects to take such an approach (including through any action by the Department of Justice), it will have a material, adverse impact on our business, financial condition and results of operations.

The Indiana horse racing industry currently receives a subsidy from riverboat casinos. Currently the subsidy is distributed as follows: 40% for purse expenses, 20% for breed development and 40% for the two existing racetrack operators, which is divided equally. During March of 2006, the IHRC approved “Integrity ’06,” a program designed to improve the integrity of horse racing in Indiana that is effective April 1, 2006. The estimated cost of complying with the rules and regulations created by “Integrity ‘06” will be financed by the two existing racetrack operators in Indiana using the subsidy paid by riverboat casinos, which is estimated to be 2% of the total subsidy. As a result, beginning April 1, 2006, the subsidy will be distributed as follows: 39.2% for purse expenses, 19.6% for breed development and 41.2% for the two existing racetrack operators, which is divided equally. Any change in this arrangement could adversely impact our operations in Indiana and the value of this operation.

In Illinois, the IRB has the authority to designate racetracks as "host track" for the purpose of receiving host track revenues generated during periods when no racetrack is conducting live races. Racetracks that are designated as "host track" obtain and distribute out of state simulcast signals for the State of Illinois. Under Illinois law, the "host track" is entitled to a larger portion of commissions on the related pari-mutuel wagering. Failure to designate Arlington Park as "host track" during this period could have a material, adverse impact on our business, financial condition and results of operations. In addition, Arlington Park is statutorily entitled to recapture as revenues monies that are otherwise payable to Arlington Park's purse account. The right to recapture these revenues is subject to change every legislative session.

These statutory or regulatory established revenue sources in Indiana and Illinois are subject to change every legislative session. The reduction or elimination of any one of them could have a material, adverse impact on our results of operations. In addition, certain revenue sources are dedicated by legislation or regulation and may be subject to change.

Return to Index

The passage of legislation permitting alternative gaming at racetracks can be a long and uncertain process. As a result, there can be no assurance that (1) jurisdictions in which we own or operate racetracks will pass legislation permitting alternative gaming, (2) if jurisdictions pass such legislation, it will be permitted at our racetracks, and (3) if alternative gaming is permitted at our racetracks, it will be on economically viable terms. If alternative gaming legislation is enacted in any jurisdiction where we own or operate a racetrack and we proceed to conduct alternative gaming, there may be significant costs and other resources to be expended and there will be significant risks involved, including the risk of changes in the enabling legislation, that racetrack's business, financial condition and results of operations.

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

Not applicable.

## ITEM 3. DEFAULTS UPON SENIOR SECURITIES

Not applicable.

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

Not applicable.

## ITEM 5. OTHER INFORMATION

Not applicable.

## ITEM 6. EXHIBITS

See exhibit index.

Return to Index

**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.

| | |
|---|---|
| | **CHURCHILL DOWNS INCORPORATED** |
| November 7, 2006 | /s/Robert L. Evans<br>Robert L. Evans<br>President and Chief Executive Officer<br>(Principal Executive Officer) |
| November 7, 2006 | /s/Michael E. Miller<br>Michael E. Miller<br>Executive Vice President and<br>Chief Financial Officer<br>(Principal Financial and Accounting Officer) |

Return to Index

## EXHIBIT INDEX

| Numbers | Description | By Reference To |
| --- | --- | --- |
| 10(a) | First Amendment to Employment Agreement, as Amended and Restated as of December 31, 2005 by and between Thomas H. Meeker and Churchill Downs Incorporated | Exhibit 10.1 to Report on Form 8-K dated July 18, 2006 |
| 10(b) | Employment Agreement dated as of July 18, 2006 by and between Churchill Downs Incorporated and Robert L. Evans * | Report on Form 10-Q for the Fiscal Quarter ended September 30, 2006 |
| 10(c) | Churchill Downs Incorporated Restricted Stock Agreement for 65,000 Shares made as of July 18, 2006 by and between Robert L. Evans and Churchill Downs Incorporated * | Report on Form 10-Q for the Fiscal Quarter ended September 30, 2006 |
| 10(d) | Churchill Downs Incorporated Restricted Stock Agreement for 90,000 Shares made as of July 18, 2006 by and between Robert L. Evans and Churchill Downs Incorporated * | Report on Form 10-Q for the Fiscal Quarter ended September 30, 2006 |
| 10(e) | Churchill Downs Incorporated Restricted Stock Units Agreement for 65,000 Units made as of July 18, 2006 by and between Robert L. Evans and Churchill Downs Incorporated | Report on Form 10-Q for the Fiscal Quarter ended September 30, 2006 |
| 10(f) | Churchill Downs Incorporated Stock Option Agreement for 130,000 Options made as of July 18, 2006 by and between Churchill Downs Incorporated and Robert L. Evans | Report on Form 10-Q for the Fiscal Quarter ended September 30, 2006 |
| 10(g) | Offer Letter to Vernon Niven, III accepted as of September 12, 2006 * | Report on Form 10-Q for the Fiscal Quarter ended September 30, 2006 |
| 10(h) | Description of Special Recognition Bonus for Thomas H. Meeker | Report on Form 8-K dated August 11, 2006 |
| 31(i)(a) | Certification of Chief Executive Officer Pursuant to Section 302 of the | Report on Form 10-Q for the fiscal quarter ended September 30, 2006 |

| | | |
|---|---|---|
| | Sarbanes-Oxley Act of 2002 | |
| 31(i)(b) | Certification of Chief Financial Officer Pursuant to Section 302 of the Sarbanes-Oxley Act of 2002 | Report on Form 10-Q for the fiscal quarter ended September 30, 2006 |
| 32 | Certification of CEO and CFO Pursuant to 18 U.S.C. Section 1350, As Adopted Pursuant to Section 906 of the Sarbanes-Oxley Act of 2002 (furnished pursuant to Rule 13a - 14(b)) | Report on Form 10-Q for the fiscal quarter ended September 30, 2006 |

* Portions of these exhibits have been redacted pursuant to a confidential treatment request filed with the Securities Exchange Commission. Such redacted portions have been marked with an asterisk.