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

SECURITIES AND EXCHANGE COMMISSION

Washington, D.C. 20549

Form 10-Q

(Mark One)

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

OR

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

Commission File Number: 001-14551

Multimedia Games, Inc.

(Exact name of Registrant as specified in its charter)

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

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

(512) 334-7500

(Registrant s telephone number, including area code)

Registrant s website: www.multimediagames.com

None

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

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

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

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

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

APPLICABLE ONLY TO CORPORATE ISSUERS:

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

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PART I

FINANCIAL INFORMATION

Item 1. Financial Statements

MULTIMEDIA GAMES, INC.

CONSOLIDATED BALANCE SHEETS

As of December 31, 2006 and September 30, 2006

(In thousands, except shares)

(Unaudited)

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

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

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MULTIMEDIA GAMES, INC.

CONSOLIDATED BALANCE SHEETS (Continued)

As of December 31, 2006 and September 30, 2006

(In thousands, except shares)

(Unaudited)

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

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

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MULTIMEDIA GAMES, INC.

CONSOLIDATED STATEMENTS OF OPERATIONS

For the Three Months Ended December 31, 2006 and 2005

(In thousands, except per-share amounts)

(Unaudited)

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

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

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MULTIMEDIA GAMES, INC.

CONSOLIDATED STATEMENTS OF CASH FLOWS

For the Three Months Ended December 31, 2006 and 2005

(In thousands)

(Unaudited)

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

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

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

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1. SIGNIFICANT ACCOUNTING POLICIES

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

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

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

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

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

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

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

2. Development Agreements

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

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

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

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

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

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

3. Property and Equipment and Leased Gaming Equipment

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

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

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

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4. Intangible Assets

The Company s intangible assets consisted of the following:

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

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

5. Notes Receivable.

The Company s notes receivable consisted of the following:

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

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

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

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

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

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

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

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

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

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

7. Earnings Per Common Share.

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

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

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

8. COMMITMENTS AND CONTINGENCIES

Litigation

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

9. Related Party Transactions

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

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

Overview

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

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

Class II Market

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

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

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

Oklahoma Compact Market

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

Charity Market

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

All Other Gaming Markets.

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

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

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

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

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

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Promotional Sweepstakes Market

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

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

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

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

Development Agreements

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

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

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

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

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

Recent Developments

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

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

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

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RESULTS OF OPERATIONS

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

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

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

(1) Other gaming terminals include charity and Mexico.

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

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

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

Gaming Revenue Class II

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

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

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

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

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Gaming Revenue Oklahoma Compact

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

Gaming Revenue Charity

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

Gaming Revenue All Other

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

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