MULTIMEDIA GAMES INC
Form 10-K
December 14, 2004

UNITED STATES

SECURITIES AND EXCHANGE COMMISSION

Washington, DC 20549

Form 10-K

(Mark One)

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

For the fiscal year ended: September 30, 2004

¨ TRANSITION REPORT UNDER 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)	**(I.R.S. Employer Identification No.)**
206 Wild Basin Road, Building B, Fourth Floor	
Austin, Texas	**78746**
(Address of principal executive offices)	**(Zip Code)**

Registrant s telephone number, including area code: (512) 334-7500

Registrant s website: www.multimediagames.com

Securities Registered Pursuant to Section 12(b) of the Exchange Act:

None

Securities Registered Pursuant to Section 12(g) of the Exchange Act:

Common Stock, $0.01 par value

Preferred Share Purchase Rights

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 if disclosure of delinquent filers pursuant to Item 405 of Regulation S-K is not contained herein, and will not be contained, to the best of Registrant s knowledge, in definitive proxy or information statements incorporated by reference in Part III of this Form 10-K or any amendment to this Form 10-K ¨

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

The aggregate market value of voting stock held by non-affiliates of the Registrant as of December 8, 2004 was approximately $357.6 million based upon the last sales price reported for such date on the NASDAQ National Market System. For purposes of this disclosure, shares of common stock held by officers and directors of the Registrant have been excluded because such persons may be deemed to be affiliates. This determination is not necessarily conclusive.

As of December 8, 2004, the Registrant had 27,961,680 outstanding shares of common stock.

DOCUMENTS INCORPORATED BY REFERENCE

Portions of the Proxy Statement for the Registrant s 2005 Annual Meeting of Shareholders are incorporated by reference into Items 10, 11, 12, 13 and 14 of Part III of this Form 10-K.

Document	**Form 10-K Reference**
Portions of the Definitive Proxy Statement for the Registrant s 2005 Annual Meeting of Shareholders	Items 10, 11, 12, 13 and 14 of Part III

This Annual Report on Form 10-K contains forward-looking statements reflecting our current forecast of certain aspects of our future. It is based on current information that we have assessed but which by its nature is dynamic and subject to rapid, and even abrupt changes. Forward-looking statements include statements regarding future operating results, liquidity, capital expenditures, product development and enhancements, numbers of personnel, customer and strategic relationships with third parties, our strategy, legal and regulatory uncertainties, including outcomes of pending or new litigation by the Department of Justice, the effects of such outcomes upon our business, changes in existing laws and regulations or in the interpretation of such laws and regulations, the effects of competition in the Class II market by games that we believe are non-Class II games, and the effect of uneven enforcement policies by the National Indian Gaming Commission in challenging such non-Class II games. The forward-looking statements are generally accompanied by words such as plan, estimate, expect, intend, believe, should, would, could, anticipate, or other words that convey uncertainty of future events or outcomes. Our actual results could differ materially from those stated or implied by our forward-looking statements, due to risks and uncertainties associated with our business. These risks are described throughout this Annual Report on Form 10-K, which you should read carefully. We particularly refer you to the section under the heading Risk Factors for an extended discussion of certain of the risks confronting our business. The forward-looking statements in this Annual Report on Form 10-K should be considered in the context of these risk factors.

PART I

ITEM 1. ***Business***

General

We are a supplier of complex, mission-critical systems to the gaming segment of the entertainment industry. We design and develop linked, interactive, electronic gaming systems and related products that are marketed primarily to operators of Native American, charity and commercial gaming facilities, and to operators and/or regulators of domestic and international lotteries.

All of the segments of the gaming industry are highly regulated and we may be affected by expected and/or unforeseen changes in dynamic political, regulatory, socioeconomic, competitive and technological environments.

We specialize in server-based gaming systems commonly known as central determinant systems. We provide these systems for use by Native American gaming operators in both Class II and Class III facilities, operators of charity gaming facilities and for use in domestic lottery jurisdictions. We also provide Point-of-Sale Terminals, or POSTs, for central determinant video lottery systems, and player terminals for bingo

systems.

We provide proprietary content that has been designed and developed by us for our gaming systems. We also market game themes it has licensed from others.

We market ancillary products such as back office systems, player tracking systems, slot accounting systems, slot management systems and slot monitoring systems to gaming operators, domestic and international lotteries and regulators. In addition, we market certain proprietary and non-proprietary hardware products that are used in conjunction with our systems.

Our gaming systems typically operate across proprietary local-area and wide-area broadband networks. We provide linked interactive Class II gaming to our tribal customers via nationwide, broadband telecommunications network. Player terminals in the Class II gaming market are typically interconnected within a gaming facility and to other facilities via fiber optic and telephonic networks, thereby enabling players to simultaneously participate in the same game and to compete against one another to win common pooled prizes. In the charity bingo market, player

terminals are typically only interconnected within the gaming facility where the player terminals are located. With the exception of linked progressives, both Class III Native American casinos and traditional commercial casinos normally operate only intra facility gaming.

Our gaming systems are typically provided to customers under revenue-sharing arrangements, although sales models are common in some markets, for example, the Native American Class III market in Washington State, where POSTs and other products are typically sold for an up-front purchase price. Historically, we have primarily focused our development and marketing efforts on Class II gaming systems for use by Native American tribes throughout the U.S., and Class III video lottery systems for use by Native American tribes under compact with the state of Washington. We have recently focused our marketing efforts on the emerging charity markets in the U.S. and on domestic and international video lottery markets.

Native American Gaming. The Native American gaming market is a highly fragmented segment of the overall gaming industry in the United States. Though not all of the over 562 federally recognized Native American tribes offer gaming, there are over 356 Class II and Class III gaming facilities throughout the United States, with the majority of tribes operating only one facility.

Native American gaming is governed by the Indian Gaming Regulatory Act of 1988, or IGRA, which also established the National Indian Gaming Commission, or the NIGC, and granted the NIGC regulatory powers over certain aspects of Native American gaming. IGRA classifies games that may be played on Native American lands into three categories, each of which is subject to different regulations as follows:

> ***Class I Gaming.*** Class I gaming includes traditional Native American social and ceremonial games. Class I gaming is regulated exclusively at the Native American tribal level.
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> ***Class II Gaming.*** Class II gaming includes bingo and, if played at the same location where bingo is offered, pull tabs and other games similar to bingo. Class II gaming is regulated by individual Native American tribes, with the NIGC having oversight of the tribal regulatory process. States that allow bingo and games similar to bingo to be conducted by any other entity or for any other purpose, such as bingo at charities or schools, may not regulate Class II gaming, and therefore receive no tax revenues from income the tribes derive from Class II gaming.
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> ***Class III Gaming.*** Class III gaming includes all other forms of gaming that are not included in either Class I or Class II, including slot machines and most table games. Class III gaming may be conducted only pursuant to contracts called compacts that are negotiated between individual states and individual Native American tribes located within that state and subsequently approved by the U.S. Bureau of Indian Affairs. The compacts typically include provisions entitling the state to receive revenues at mutually agreed rates from the income a tribe derives from Class III gaming activities.

We believe that all of our Class II games, electronic player terminals, and gaming systems are designed and operated to meet the requirements of Class II gaming as defined by IGRA, and that all of our Class III games, POSTs, and gaming systems meet the requirements of the appropriate tribal/state compacts. For a more in-depth discussion of these regulations, see the section under the heading Governmental Regulation.

We deliver our Class II games to our Native American customers nationwide through a broadband telecommunications network, which links player terminals located both within and among Class II gaming facilities, enabling players to compete against one another in the same game to win pooled prizes. We design and develop all of the hardware, software, networks and content to provide our Native American customers with complete, comprehensive gaming systems.

We currently offer our Class II customers two gaming systems, our Legacy system and our New Generation system. In our Class II gaming markets, we typically provide player terminals to our customers on a participation basis, and receive revenue based on a percentage of the hold per day generated by each player terminal. As of September 30, 2004, we had 10,651 Class II player terminals installed in 83 Native American gaming facilities in 10 states, an increase of approximately 4% from the 10,259 player terminals installed as of September 30, 2003.

We offer intra facility linked Class III video lottery systems and POSTs to Native American customers in Washington State. The majority of our Class III POSTs are sold for an up-front purchase price, and we also receive back-office fees based on a percentage of the hold per day generated by each terminal. In addition, we offer Class III POSTs under both rental and lease-purchase programs. As of September 30, 2004, we had 3,583 Class III POSTs

running on our central determinant system, an increase of approximately 26% from the 2,851 Class III POSTs installed as of September 30, 2003. As of September 30, 2004, our Class III POSTs were located in 13 gaming facilities in Washington State.

In December 2003, we installed the first POSTs for our new Tribal Instant Lottery Game, or TILG, in California. The new one-touch game is based on a simulated scratch-off lottery ticket, and employs our central determinant system technology.

Charity Gaming. We design, develop and in some cases may operate gaming systems for charity gaming. Charity bingo and other forms of charity gaming are operated by or for the benefit of non-profit organizations for charitable, educational and other lawful purposes. This and other forms of non-Native American gaming are not currently subject to a federal regulatory system such as the one created by IGRA to regulate Native American gaming. Regulation of charity gaming is vested with each individual state, and in some states, regulatory authority is delegated to county or municipal governmental units. In addition, certain federal laws relating to gaming, such as the Johnson Act and the Wire Act, which regulate inter-state gaming and the inter-state transportation or illegal operation of slot machines and similar gambling devices, also apply to new video lottery jurisdictions, absent the passage of enabling legislation of constitutional amendments by a state.

We provide linked interactive electronic bingo systems and player terminals to charitable bingo operations in Alabama. During January 2004, we began placing player terminals in Alabama, and as of September 30, 2004, we had 2,059 player terminals at three facilities. The Attorney General of Alabama has recently completed a review of the gaming within the state. He concluded that the games that we were operating in Alabama were a legal form of bingo. He also concluded that two of the facilities are operating under a valid constitutional amendment, authorizing the facilities the ability to play electronic bingo. The third facility is operating under a constitutional amendment that was flawed in its ratification. The Attorney General and his staff have indicated they will file a declaratory judgment action asking the courts to invalidate this amendment as improperly ratified.

Video Lottery Gaming for State Regulated Jurisdictions. We designed and developed a central determinant system for the emerging state video lottery market. Our central determinant system includes all software, hardware and networks required to provide outcomes to, remotely manage, and to provide accounting reports for video lottery gaming conducted on POSTs at multiple locations. Beginning in January 2004, we began the first operation of our central determinant system for the video lottery POST network that the New York Lottery operates at licensed New York State racino racetracks. Our central determinant system is able to interface with, provide outcomes to and manage POSTs provided by Bally Gaming Inc., International Game Technology, Sierra Design Group, and Spielo Gaming International. As payment for providing and maintaining the central determinant system, we receive a small portion of the network-wide hold per day. We believe that we will be able to achieve future growth in the domestic and international video lottery market by leveraging our experience in the states of California, Washington and New York, our leadership in technologically advanced game and system design, and our ability to rapidly adapt game and system technology to satisfy emerging regulatory requirements.

The following table sets forth our end-of-period installed player terminals and POSTs base by quarter and by product line for each of the five most recent fiscal quarters:

Quarter Ended	Reel Time Bingo	MegaNanza	Legacy	Total Class II Units	Class III Washington State	Other Gaming Units
9/30/2004	9,805		846	10,651	3,583	2,753
6/30/2004	8,686		1,009	9,695	3,180	1,996
3/31/2004	8,862		1,171	10,033	3,074	1,573
12/31/2003	8,842		1,290	10,132	3,005	589
9/30/2003	8,473	288	1,498	10,259	2,851	

Through the Investor Relations link on our website, www.multimediagames.com, we make available free of charge, as soon as reasonably practicable after such information has been filed with the SEC, our annual report on Form 10-K, quarterly reports on Form 10-Q, current reports on Form 8-K, and amendments to those reports furnished pursuant to Section 13 or 15(d) of the Securities Exchange Act.

Multimedia Games, Inc. was incorporated in Texas on August 30, 1991. Unless the context otherwise requires, the terms Company, MGAM, we, us, and our include Multimedia Games, Inc., and its subsidiaries MegaBingo, Inc., MGAM Systems, Inc, and Multimedia Services, LLC. Our executive offices are located at 206 Wild Basin Rd. Bldg. B, Fourth Floor, Austin, Texas, 78746, and our telephone number is (512) 334-7500.

Our Strategy

Our strategy is to leverage our position as a dominant supplier of central determinant driven, online gaming systems and an operator of linked, interactive electronic gaming systems and content to place systems and player terminals in the rapidly evolving and growing Native American, charity, video lottery and other domestic and international gaming markets. By doing so we will increase our revenues, diversify our revenue sources and expand the number of jurisdictions in which we conduct business. In addition, we plan to use our expertise and technology to develop new products and expand into other new markets for interactive gaming. Our strategies include the following:

Expand our installed base with new and existing customers, and enhance our customer relationships and market position through joint development efforts. We seek to continue our growth in our customer base and to place units with new customers to expand our installed base of linked terminals through development agreements. Pursuant to these agreements, we advance funds for the construction of new gaming facilities or for the expansion of existing facilities. These agreements provide for repayment of some or all of the amounts advanced. In return, we receive certain contractual commitments regarding the placement of player terminals at the gaming facility. As of September 30, 2004, five facilities covered under our development agreements were operating, and had signed agreements which covered an additional six facilities for an aggregate outstanding commitment to advance approximately $42.5 million.

Exploit the potential expansion of additional domestic video lottery jurisdictions. We currently provide video lottery technologies to Native American tribes in the states of Washington and California. There are also ongoing legislative initiatives in a number of other states that, if successful, would permit the play of video lottery games in new jurisdictions. For example, New York adopted legislation authorizing the placement of POSTs at eight race tracks located in New York State. In May 2002, the New York Lottery notified us that we had been selected as the winning vendor to provide the central operating system for its video lottery system; currently, four of the eight tracks are now in operation. We believe we were selected over our competition primarily on the basis of our system s technological attributes, as well as its flexibility and cost effectiveness. As a result, we anticipate that we will be able to achieve future growth in the video lottery market by leveraging our experience in the states of Washington, California and New York, our leadership in technologically advanced game and system design, and our ability to rapidly adapt our game and system technology to satisfy emerging regulatory requirements.

Continue expansion in the charity gaming market. There are ongoing legislative initiatives in a number of jurisdictions that, if successful, we believe would allow the use of our technology in charity gaming facilities in those jurisdictions. We currently supply systems and/or player terminals to charity operators in Alabama and Louisiana that are authorized to conduct bingo games on behalf of certain non-profit organizations. As of September 30, 2004, we had installed a total of 2,237 player terminals in the charity gaming market. If similar legislative initiatives are successful in other markets, we believe we will be able to expand into new and evolving markets by building upon our existing gaming system and bingo gaming technology, infrastructure, product base and regulatory expertise.

Develop new products for emerging international markets for charity and commercial interactive, player-against-player gaming. Bingo or similar forms of player-against-player gaming is authorized in more than 100 countries. In a number of these jurisdictions, government regulators and/or legislators are considering expanding the types and forms of authorized gaming.We plan to leverage our success as a system provider and operator of player-against-player gaming in Class II Native American and domestic charity gaming to enter these evolving international markets.

Develop new products for emerging markets for interactive and conventional gaming for commercial and Native American Class III Casinos. We plan to market a variety of new gaming platforms, new proprietary content, and new innovative gaming systems as well as proprietary stand-alone gaming terminals to both the Native American Class III casinos and the conventional casino markets.

Develop new system-based products for domestic and international operators and regulators of lotteries. As a result of the expansion of gaming and as new forms of gaming are approved in new jurisdictions, regulators and

governmental agencies are procuring new systems and tools to facilitate the control and/or monitoring of gaming operations. We plan to leverage our core systems, accounting, database, encrypted communication, interoperability, data center, network operation center and gaming system operations capabilities to develop proprietary products to facilitate the regulators performing their oversight responsibilities.

Our Competitive Strengths

We intend to execute our strategy by leveraging on our competitive strengths, which include:

Years of experience and success as a proven operator of mission-critical, high-availability, large-scale transactional processing gaming systems. We have been operating central determinant driven, cashless payment systems, player-against-player gaming systems since 1989. Utilizing data centers and network operation centers at multiple locations, we currently operate and/or support seven different gaming systems facilitating gaming operations at over a hundred different facilities. We believe that our long-term experience as an operator of various types of gaming systems is unmatched by any other service provider in the gaming industry and plan to leverage on this valuable experience to obtain new contracts to operate additional gaming systems in new jurisdictions.

Experience providing server-based central determinant games. Since our inception, we have focused on a type of gaming that has come to be known within the gaming industry as server-based central determinant gaming. Many industry leading gaming companies have now recognized the power of this type of gaming system architecture and many knowledgeable industry specialist believe that we are the technology leader in this form of gaming system architecture.

Leader in network enabled gaming. We were one of the first operators of gaming systems to recognize the advantages of networked gaming and to embrace the use of both local area networks and wide area networks to enhance the entertainment value of the gaming experience. We currently operate the largest network of inter-facility interactive central determinant gaming in North America. We believe that our experience in operating networked gaming will help us enter new markets in the future.

The technological flexibility of our gaming systems allows us to place player terminals, or POSTs, in multiple geographic locations, add new locations to our network without disrupting play on the network, and to provide a satisfying entertainment and gaming experience to the end user.

Superior technology, products, systems and services. Our technology-driven approach to our business has yielded what we believe are the most flexible and innovative gaming systems in the North American gaming industry. The advanced architecture of our gaming systems enable us to regularly launch new games that we believe appeal to the entertainment and gaming preferences of our end users. Our standard product offerings also include richly featured back-office systems, cashless payment systems, player tracking systems, accounting systems for gaming system and slot/video lottery floor management systems. We believe that our investment in and focus on the use of emerging technologies will help us procure additional non-commodity priced business in the future.

We continually upgrade our existing hardware, communication network infrastructure, and systems and application software to incorporate state-of-the-art architecture. We systematically upgrade the components contained in the player terminals located at our customers facilities so that the player terminals can use our most up-to-date technology, and so we can enhance the gaming and entertainment experience of our end users by offering games that play at high speed and use the new technology to offer advanced graphics and sounds in all of the gaming markets that we serve.

Extensive and flexible content library. We currently offer our own proprietary game themes in our Class II and Class III libraries and game themes developed through third-party license agreements. Through these agreements, we have access to a significant number of additional game themes with proven acceptance in a variety of gaming jurisdictions, and which we may use in both our Class II and Class III markets.

Our license agreements with WMS Gaming Inc., or WMS, Bally Gaming Inc., or Bally, Mikohn Gaming Corporation, or Mikohn, and Sigma Games, Inc., or Sigma, allow us to use some of their most popular game themes, which have player-tested acceptance in other gaming markets. These games are offered in a variety of pay tables, prize distributions and currency denominations.

Utilizing our advanced game development tools and our software driven architecture, our team of game technology specialists can quickly and cost effectively adapt these game themes to the Class II, Class III, charity, video lottery and other gaming markets and to respond quickly to changing end-user preferences as well as changes in the requirements of applicable regulatory agencies.

Advanced tools for the gaming operator. Our technology embraces the development of new tools to enable the gaming operator to collect and mine data that will empower the operator to optimize the earnings of a gaming facility.

Ongoing revenue from existing installed base. We derive most of our revenues from participation arrangements with our customers, through which we receive a percentage of the hold per day generated by each of our player terminals. Therefore, our interests are closely aligned with the interests of our customers, as a substantial portion of our revenues is dependent on the revenues they generate.

Our Products and Services

Class II Games and Systems. We provide the Class II Native American gaming market with linked, interactive electronic games and related online systems and player terminals. These games, systems and player terminals include:

- Flexible gaming systems that enable us to regularly launch new game engines;
- Flexible gaming systems that enable us to operate games efficiently;
- Flexible game engines that enable us to display the same underlying bingo game utilizing various game themes;
- High-speed, interactive Class II bingo games and game themes we designed and developed that provide our end users with an entertaining gaming experience;
- Player terminals linked via nationwide, broadband telecommunications network, thereby enabling us to rapidly build quorums and broaden participation in games run throughout the country and monitor the performance of our network in real time;
- Information services that allow our customers to monitor their gaming activities and to improve service to end users; and
- Back office, accounting and player tracking systems that help our customers optimize their earnings.

To take advantage of advances in technology that increase the capability of our systems, improve the end-user experience, broaden participation in the games and thereby increase revenues, we regularly introduce new high-speed, interactive Class II bingo games. Our historical growth in revenue is the result of the increase in our installed base of player terminals and the technological advances we have developed and implemented. These advances have enabled us to dramatically increase the frequency and the number of games played on our system over any given period of time.

From 1989 through April, 2003, we produced MegaBingo, a live bingo game that was broadcast via satellite into participating facilities and utilized a live ball draw. MegaBingo was televised a couple of times per week at multiple bingo facilities throughout the U.S. The game enabled players to simultaneously view the live ball draw on television monitors located in the facility, and compete with players in other facilities in the same live game to win a large jackpot prize. We may resume play of a revised game that is similar in concept to MegaBingo.

In May 1996, we introduced our Legacy gaming system and its related family of game engines with the launch of MegaMania, the first online, interactive bingo game played on player terminals linked within a single facility; shortly thereafter, we began linking multiple facilities with one another via nationwide, broadband telecommunications network. When first introduced, a game of MegaMania took approximately two minutes to play. We used rotating shifts of teams of employees, working twenty-four hours per day, seven days a week, to manually draw bingo ball numbers from a bingo ball blower. The drawn numbers were then keyed into the network to appear simultaneously on multiple player terminals linked to the network and logged onto that game. Today, a game of MegaMania takes about one minute to play. In place of a bingo ball blower, we now use an electronic ball draw that randomly determines bingo numbers, which are instantly communicated over the network to player

terminals. This new method has significantly increased the speed and reliability of the game, improved security and significantly reduced overhead.

In January 2001, we introduced our New Generation gaming system and its related family of game engines with the launch of MegaNanza, a bonanza-style bingo game where the bingo numbers are drawn before the bingo cards are purchased. We believe the faster pace facilitated by our New Generation gaming system enhances the entertainment and gaming experience of our end users, resulting in an overall increase in the number of end users playing our games.

In June 2002, we introduced Reel Time Bingo, a high-speed, standard-sequence bingo game, in which the cards are purchased before the balls are drawn, played on our New Generation system. As of October 27, 2003, we had converted all of our MegaNanza games to some version of Reel Time Bingo, both in response to the settlement agreement reached between us and the NIGC, and to take advantage of improved technologies.

We continually strive to improve the capabilities of our core gaming system. In November 2003, we introduced and began deploying our Gen4 gaming system, which enables us to operate games with complex bonus rounds, to operate real-time, inter-hall progressives and to provide better inter operability between gaming systems. Furthermore, our Gen 4 gaming system allows us to operate multiple gaming engines within a single facility. This will be especially beneficial in certain Oklahoma facilities where the operators have decided to continue offering Class II games after they begin offering the new Class III games that are permitted under the compact.

We currently offer a variety of Class II player terminal models. Each Class II player terminal has a screen that always displays the bingo cards being played as well as a flashboard that displays bingo numbers that have been drawn. Depending upon the end user s entertainment preference, an additional display can be selected that minimizes the size of the bingo card display and shows other graphics that can take many forms, including graphics that simulate spinning reels similar to slot machines or video lottery games. In addition to our proprietary titles, some of our player terminals also use displays adapted from game themes we license from WMS, Bally, Sigma and Mikohn. The screen also serves as a touch pad that allows end users to communicate, interactively, decisions that influence the play of the game. Such actions may include initiating play, dropping bingo cards from play, daubing or covering numbers drawn, claiming a prize or ending play. Player terminals vary according to height, width and depth (to accommodate, in part, the differing space needs of our customers facilities), screen size and other features affecting appearance and the visual appeal to end users.

Our Class II games are linked via nationwide, broadband telecommunications network, which provides several important benefits to us, our customers and our end users:

- A large number of potential players are available to rapidly build quorums for individual games.
- For certain game designs, larger numbers of end users can compete in a single game, which increases the size of the prize pool.
- Class II gaming requires there to be more than one end user participating in a game. Our network enables end users to link with each other more quickly, thereby increasing the number of games played during a given period.
- We are able to introduce technological enhancements via our network without the need for location-by-location down time, thereby avoiding lost revenues for our customers.

We are able to monitor network performance in real time, which allows us to quickly identify and respond to network problems and avoid significant down time.

With our ability to launch new games broadly over a large number of player terminals, the chance that any new game will become popular with end users is increased, since the frequency of prizes and its related effect upon the popularity of a game depend in part on the total number of end users participating in the same game.

In addition, our back-office system provides accounting, management and information services to our customers, who are able to monitor all aspects of their gaming activities by player terminal, by game and by gaming facility. Our back-office system normally includes a database server that archives details of distribution and sales, as well as end-user information used by the gaming facilities for marketing and player tracking, and a management terminal that can monitor game system operation and generate system reports. Our player tracking system allows us to track

the playing preferences of those individual end users who have elected to participate in our player tracking program, thereby gaining potentially valuable design insight into game features that appeal to end users. It also serves as a marketing tool for our customers, who are made aware, in real time, of end users playing in their facility.

We continuously monitor our network from our network operations center, headquartered in Austin, Texas, which enables us to identify disruptions or less than optimum network performance, as well as to gather valuable data regarding the playing habits and preferences of end users and this data is then utilized in our game design efforts.

Class III Games and Systems. We sell, rent or lease Class III POSTs to Native American customers in the state of Washington and receive back-office fees based on a share of the hold per day generated by the POSTs. Class III video lottery gaming in the state of Washington is allowed pursuant to a compact between the state and certain Native American tribes in that state. The compacts contain the specifications for permissible video lottery systems in the state, including:

- Only those POSTs within the same gaming facility may be linked with one another;
- The system must be cashless ; and
- All system components and software and the implementation of each game must be approved by an independent gaming laboratory as well as by the gaming laboratory operated by Washington State.

An end user who wishes to play our Class III POSTs in the state of Washington must open an account with the cashier in the facility and receive a card encoded with an account number and a personal identification number. The end user can then use the card to buy an electronic ticket at a POST, add money to the account at a point of sale terminal, or cash out the account.

Electronic replicas of scratch tickets are shown on the POSTs, with the results of the wager displayed in a variety of graphical game formats that entertain the end user with motion and sound before revealing the value of the scratch ticket. We have license agreements with WMS and Bally that allow us to use several of their popular game themes in the state of Washington. Our Class III POSTs are available in a variety of freestanding and bar-top styles having a look and feel that is consistent with traditional video slot machines.

Our Class III systems in Washington State comprise all the software and hardware necessary for operation, and are designed to be readily adaptable to the video lottery requirements of jurisdictions outside that state. Our hardware includes multiple servers that generate sets of electronic lottery tickets, and distribute them on demand to end users sitting at terminals networked throughout a casino. As with our Class II gaming systems, our Class III back-office system allows us to maintain details of ticket manufacture, distribution and sales, and end-user information, and monitor game system operation and generate system reports.

In December 2003, we installed the first POSTs for our new Tribal Instant Lottery Game, or TILG, in California. The new one-touch game is based on a simulated scratch-off lottery ticket, and employs our central determinant system technology. Our customers in the state of California believe that the operation of the video lottery system is permitted under their compact; however, the Office of the Governor of the state of California has notified both the tribes and us that they do not believe that this system can be operated unless it is part of the 2000 device limit outlined in the compact.

Charity and Commercial Bingo Games and Systems

Video Lottery Central Systems. We designed and developed a central determinant system for the emerging domestic and international video lottery market. Our central system encompasses all software, hardware and networks required to provide outcomes and accounting for video lottery gaming conducted at multiple locations. 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 racino racetracks. Our central system is able to interface with and manage POSTs provided by Bally Gaming Inc., International Game Technology, Sierra Design Group, and Spielo Gaming International. As payment for providing and maintaining the central determinant system, we receive a small portion of the network-wide hold per day. We believe that we will be able to achieve future growth in the domestic and international video lottery market by leveraging our experience in the states of California, Washington and New York, our leadership in technologically advanced game and system design, and our ability to rapidly adapt game and system technology to satisfy emerging regulatory requirements.

Research and Development

Our research and development activities primarily focus on the development of new gaming systems, gaming engines, player tracking systems, casino data management systems, central video lottery systems, gaming platforms and content, and enhancements to our existing product lines. We believe our investments in product development are necessary to deliver differentiated products and solutions to the marketplace. Research and development costs consist primarily of salaries and benefits, consulting fees, and an allocation of corporate facilities costs related to these activities. Once the technological feasibility of a project has been established, the project is transferred from research to development, and capitalization begins.

Research and development expenses increased by 35.1% to $3.4 million for the three months ended September 30, 2004, from $2.5 million for the comparable period in the prior fiscal year. For the year ended September 30, 2004, research and development expenses increased by 23.3% to $12.3 million, from $10.0 million for the same period of 2003. This increase primarily resulted from an increased headcount in our development group as we have focused our internal efforts on developing new gaming systems and game themes. We expect our research and development expenses to grow over the upcoming periods as we continue focusing on product development and adding development staff.

Gaming Contracts

Generally, all of our Class II and Class III gaming revenues are derived through contracts with our Native American customers. Our contracts typically run over multiple years, and can be terminated earlier under certain specified conditions. The contracts specify the quantity and type of player terminals to be installed and the terms of the rental or participation arrangement. There is also a limited waiver of sovereign immunity by each tribe that typically provides for the arbitration of any dispute under the contract, and the right to enforce any decision of the arbitrator by application to a federal or state court having jurisdiction. Under these contracts, we are also granted the right to enter the land of the Native American tribe for the purpose of removing our property under certain circumstances. See Risk Factors We do not rely upon the term of our customer contracts to retain the business of our customers, and - Enforcement of remedies or contracts against Native American tribes could be difficult. Furthermore, the National Indian Gaming commission has recently expressed concern that some of our form of contract may violate the spirit of the sole proprietary interest concept that is required to be written into all tribal gaming regulations.

Marketing, Advertising and Promotion

In addition, we use a variety of focused advertising and promotion methods, including direct mailings in localities near our customers facilities, discount coupons for new players, advertising in specialized bingo newsletters, and other promotions unique to each facility.

While we consult with our customers on advertising and pro motion, we pay most of the costs.

Intellectual Property

We rely to a limited extent upon patent, copyright, trademark and trade secret laws, license agreements and employee nondisclosure agreements to protect our proprietary rights and technology. Since these laws and contractual provisions provide only limited protection, we rely more upon proprietary know-how and continuing technological innovation to develop and maintain our competitive position. Insofar as we rely on trade secrets, unpatented know-how, and innovation, there is no assurance that others will not independently develop similar technology or that

secrecy will not be breached.

Patents, Trademarks and Tradenames. We have patents issued and patents pending in the U.S. We also have patents pending overseas corresponding to some of our U.S. patents and pending U.S. patent applications. Our trademarks and tradenames include: Players Passport®, Reel Time Bingo®, MegaNanza® MegaBingo®, and MegaMania®. All references herein to those trademarks and tradenames are deemed to include the applicable tradename or trademark designation. See Risk Factors We may not be successful in protecting our intellectual property rights, or avoiding claims that we are infringing upon the intellectual property rights of others.

Licenses

We are licensed by the state of Washington to conduct Class III gaming in that state, and we are licensed by the states of Texas, Louisiana, and Mississippi as a manufacturer of charitable gaming equipment. For Class II gaming, we are licensed by all of the relevant Native American gaming commissions that grant licenses pursuant to their gaming ordinances. We have sought and obtained determinations that our New Generation games are Class II gaming from each tribe s gaming commission prior to the installation of the games in their facilities. We are also licensed by the state of New York for the purpose of providing the central determinant driven video lottery system operated at certain racetracks.

Competition

We currently compete in Native American Class II gaming markets with companies that are both larger and smaller than we are. In this market, we also compete with vendors of paper and electronic pull tabs, paper bingo and card minders. We compete with other Class II vendors for customers, primarily on the basis of the amount of profit our gaming products generate for our customers in relation to other vendors gaming products. We believe that the most important factor influencing our customers product selection is the appeal of those products to end users. This appeal has a direct effect on the volume of play by end users, and drives the amount of revenue generated for and by our customers. Our ability to remain competitive depends primarily on our ability to continuously develop new game themes and systems that appeal to end users, and to introduce those game themes and systems in a timely manner. See Risk Factors Our future performance will depend on our ability to develop and introduce new gaming systems and to enhance existing games that are widely accepted and played. We may not be able to continue to develop and introduce appealing new game themes and systems that meet the emerging requirements of Class II gaming in a timely manner, or at all. In addition, others may independently develop games similar to our Class II games, and competitors may introduce non-Class II games that unfairly compete in the Class II market due to uneven regulatory enforcement policies.

We believe continued developments in the Class II market that alleviate or clarify the legal and regulatory uncertainties of that market will result in increased competition in the interactive electronic Class II gaming market, including the entrance of new competitors with significant gaming experience and financial resources. We believe the increased competition will intensify pressure on our pricing model. In the future, gaming providers will compete on the basis of price as well as the entertainment value and technological superiority of their products. While we will continue to compete by regularly introducing new and faster games, with technological enhancements that we believe will appeal to end users, we believe that the net revenue retained by our customers from their installed base of player terminals will become a more significant factor, one that may require us to change the terms of our participation arrangements with customers to remain competitive.

Employees

At September 30, 2004, we had 444 full-time and part-time employees, including 221 engaged in field operations and business development, 152 in system and game development, 23 in sales and marketing activities, 21 in accounting functions, and 27 in other general administrative and executive functions. We do not have a collective bargaining agreement with any of our employees. We believe our relationship with our current employees is good.

Governmental Regulation

General. We are subject to federal, state and Native American laws and regulations that affect both our general commercial relationships with our Native American tribal customers as well as the products and services provided to them. We also offer products for charity bingo markets that are subject to state and local regulation. The following is only a summary of the more material aspects of these laws and regulations, and is

not a complete recitation of all applicable law.

Federal Regulation. The most important pieces of federal legislation affecting our business are the Indian Gaming Regulatory Act of 1988, or IGRA, and the Johnson Act.

Indian Gaming Regulatory Act. Most of our business relates to gaming activities on Native American lands. The operation of gaming on Native American lands is subject to IGRA which created the National Indian Gaming Commission, or NIGC, to promulgate regulations to enforce certain aspects of IGRA.

IGRA classifies games that may be played on Native American land into three categories: Class I gaming includes traditional Native American social and ceremonial games, and is regulated only by the tribes. Class II gaming includes bingo and, if played at the same location where bingo is played, pull tabs, lotto, punch boards, tip jars, instant bingo, certain card games played under limited circumstances, and other games similar to bingo. Class III gaming consists of all forms of gaming that are not Class I or Class II, such as video lottery games, slot machines, most table games and keno.

IGRA allows Native American tribes to legally engage in Class II gaming on Native American lands in any state where the state permits such gaming by any person for any purpose. For example, if a state permits churches to hold charity bingo nights, then IGRA would allow tribes to engage in bingo on Native American lands located in that state as a Class II gaming activity, free of any interference, regulation or taxation by that state.

IGRA also regulates the terms of gaming management contracts with Native Americans, which must be approved by the NIGC before taking effect, and requires the Native American tribe to have the sole proprietary interest in the gaming operation. Historically, the NIGC has determined that the agreements pursuant to which we provide our Class II games, equipment and services are service agreements and not management contracts, thereby allowing us to obtain terms that might otherwise not be permitted. Under existing regulations, management contracts can have a maximum term of seven years, and limit the amount payable to the manager to 30% of the net revenue from the related gaming activity. On occasion, however, as a condition of its approval of a management contract, the NIGC has required that managers accept both a shorter term and a reduced percentage of the net revenue.

On April 23, 2004, we reported that the acting General Counsel of the NIGC had issued a letter to us and one of our tribal customers opining that the our development agreement regarding the WinStar Casino in Thackerville, Oklahoma constituted a management contract. The authority of the NIGC to review and approve gaming related contracts is limited to management contracts and related collateral agreements. According to the acting General Counsel, the performance of any planning, organizing, directing, coordinating or controlling with respect to any part of a gaming operation constitutes management for purposes of determining whether an agreement for any of these activities is a management contract. We have expressed our disagreement with this interpretation by the acting General Counsel, and our belief that her view of management is broader than was intended by Congress. We also believe that the acting General Counsel s opinion may have been based in part on collateral agreements we provided to the NIGC in error and that are not presently in effect. We, along with certain tribal customers, submitted additional information and documents related to the development agreements for review by the NIGC.

On December 1, 2004 we received a series of letters from the NIGC expressing the commission s concern that certain of our agreements violate the requirements of IGRA and tribal gaming regulations, which state that the Native American tribes hold the sole proprietary interest in the tribe s gaming operations. In particular, the NIGC is concerned that our development agreements, whereby we advance development funds to our tribal customers in exchange for allocated floor space and a share of gaming revenue, create a proprietary interest of ours in the tribe s gaming operations. As a result of its concern, the NIGC has requested we and our tribal customers provide a written justification for the percentage of shared revenue specified in the subject agreements, which in the view of the NIGC exceeds the level permissible under a management agreement. The NIGC has also asked that we and our tribal customers provide an explanation why our arrangements do not result in our holding a proprietary interest in our tribal customer s gaming operations. In addition, on December 1, 2004, we received a letter from the NIGC expressing the commission s concern that an Integrated Electronic Gaming Services Agreement, dated January 2000 with one of our customers, covering one of our Legacy games constituted a management agreement. According to the acting general counsel, the performance of any planning, organizing, directing, coordinating or controlling, with respect to any part of a gaming operation, constitutes management for purposes of determining whether an agreement is a management contract, which requires NIGC approval. We are currently preparing our response to the NIGC s requests.

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

Johnson Act. The Johnson Act broadly defines an illegal gambling device as any machine or mechanical device designed and manufactured primarily for use in connection with gambling and that, when operated, delivers money or other property to a player as the result of the application of an element of chance. Courts that have considered the scope of the Johnson Act in relation to IGRA have generally determined that the Johnson Act does not prohibit the use of electronic and technological aids to bingo that operate to broaden the participation of players to play against one another rather than against a machine.

Class II gaming is defined by IGRA as including the game of chance commonly known as bingo (whether or not electronic, computer or other technological aids are used in connection therewith). However, IGRA s definition of Class II gaming expressly excludes electronic or electromechanical facsimiles of any game of chance or slot machines of any kind. Prior to June 17, 2002, regulations adopted by the NIGC defined electronic or electromechanical facsimiles of any game of chance or slot machines of any kind as being equivalent to gambling devices, as defined and prohibited by the Johnson Act.

On June 17, 2002, the NIGC published new regulations, effective July 16, 2002, defining the terms electronic, computer or other technological aids that can legally be used in Class II gaming, and electronic or electromechanical facsimiles of a game of chance that may not be legally used in Class II gaming. The NIGC essentially did away with using the Johnson Act definition of gambling device as the method of determining what constituted an illegal electronic or electromechanical facsimile of a game of chance, and relied instead upon existing court cases which have held that legal technological aids permitted by IGRA are aids that broaden the participation levels of players in the same game, facilitate communication between and among gaming facilities, and allow players to play a game with or against other players rather than with or against a machine. Under these court decisions, any devices that accomplish these objectives are not gambling devices prohibited by the Johnson Act.

These new NIGC regulations are not binding upon the DOJ, which is the federal agency charged with enforcing the Johnson Act. The DOJ has asserted in the past and, as described below, continues to assert their position, that any electronic or mechanical device used in gaming, such as the electronic player terminals used to play our Class II games, are illegal gambling devices, and thus in violation of the Johnson Act.

In a decision of the United States Court of Appeals for the Tenth Circuit (*Seneca-Cayuga Tribe of Oklahoma, et al. vs. National Indian Gaming Commission, et al.*, decided April 17, 2003), a federal circuit court considered the applicability of the Johnson Act to Class II gaming. The opinion of the court was in line with several previous court opinions (including the Ninth and Tenth Circuit opinions on our MegaMania games) that found that the Johnson Act did not prohibit the use of technological aids to Class II gaming on Native American land. The court also noted that their opinion was in line with the new NIGC regulations. In another recent decision from the United States Court of Appeals for the Eighth Circuit (*United States of America vs. Santee Sioux Tribe of Nebraska,* decided March 20, 2003), a circuit court found for the first time that the Johnson Act does apply to Class II technological aids, although the court also found that the pull-tab player terminals at issue in that case were not Johnson Act devices. That court also went on to cite the fact that the NIGC has adopted new regulations and that those regulations would permit Class II technological aids under IGRA.

On November 21, 2003, the 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 seeks review of *United States of America v. Santee Sioux Tribe of Nebraska, a federally recognized Indian Tribe*, on Petition for a Writ of Certiorari to the United States 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 United States Court of Appeals for the Tenth Circuit. In the petitions, the DOJ asserts 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 our machines were not the subject of the lawsuits, the DOJ s arguments and reasoning appeared to encompass the machines offered by us for the Class II market. Since the Supreme Court declined to accept these cases for review, the lower court s decisions affirming the right of the tribes to offer games such as those manufactured and sold by

us, as legal electronic aids to bingo for the Class II market, will continue to stand. We believe that for the immediate future, significant legal uncertainty has been eliminated concerning our ability to continue to offer Class II games played with the assistance of technological aids in our principal market. However, the elimination of this legal uncertainty may have contributed to increased competition from vendors currently in the Class III market who we believe have avoided entry into the Class II market due to the legal uncertainties described above.

Game Classification Standards. The NIGC has expressed concern that accelerated changes in gaming technology threatens to obscure the statutory distinction between permissible Class II technologic aids and Class III electronic facsimiles and slot machines. As a result, earlier this year the NIGC began a process to develop regulations that the NIGC believes will result in clear, precise, objective and verifiable standards distinguishing technologic aids from electronic facsimiles and slot machines.

On March 30, 2004, the NIGC established a Tribal Advisory Committee made up of tribal gaming operators and regulators nominated by tribal leaders. The purpose of the Committee is to solicit their input on the various working drafts of the Class II game classification standards prepared by NIGC staff.

On September 30, 2004, the NIGC released its third draft of the game classification standards on its web site and for the first time invited comment by all interested parties, including tribal leaders, gaming operators and regulators, states, gaming vendors and manufacturers, in order to help the NIGC formulate the standards. Public comments were due on November 12, 2004, but that date was later extended to November 29, 2004.

According to the Chairman of the NIGC, all received comments are to be shared and discussed with the Tribal Advisory Committee and NIGC staff in developing subsequent preliminary drafts and formulating the Class II technical classification standards and procedures for publication in the Federal Register as a proposed NIGC rule. After the proposed rule is published in the Federal Register, there will be a 60-day review and comment period for all tribes, as well as gaming manufacturers, and suppliers, and other interested persons. The final NIGC rule will be formulated and published in the Federal Register and take effect only after all submitted tribal and public comments on the proposed rule are considered by the NIGC and its Tribal Advisory Committee.

During the 60-day comment period on the proposed rule, the NIGC intends to conduct one or more public hearings to receive public comments from tribal leaders and representatives and other interested persons regarding the merits of the proposed Class II technical standards and procedures set forth in the proposed rule.

It is anticipated that the proposed rule will be prepared and published in the Federal Register on or about January 26, 2005. After completion of the 60-day comment period and all public hearing(s) on the proposed rule, the NIGC plans to consult further with the Tribal Advisory Committee and other tribal leaders to complete formulation of the final rule. Under the current NIGC time-line, the NIGC expects the final rule to be published in the Federal Register and take effect in late June 2005.

Tribal-State Compacts. Native American tribes cannot offer Class III gaming unless, among other things, they are parties to compacts, with the states in which they operate. The tribal-state compacts typically include provisions entitling the state to receive revenues from the income a tribe derives from Class III gaming activities. Although compacts are intended to document the agreement between the state and a tribe relative to permitted Class III gaming operations, they are agreements and can be subject to interpretive and other ambiguity and disputes. Currently, we operate in three states where compacts significantly affect our business: California, Oklahoma, and Washington.

California. In December 2003, we began to offer TILG POSTs to tribal customers in California who are parties to compacts with the state. In November 2004, two of our tribal customers opened expanded facilities which increased the number of TILG POSTs substantially. In part, these compacts permit each tribe to offer gaming facilities with up to 2,000 gambling devices, and separately, permit the play of any video lottery machine that the state of California could legally offer. The state and our tribal customers are currently involved in a dispute over our TILG games, wherein the state asserts, among other things, that the TILG POSTs should be counted for purposes of determining that the tribe is offering only 2,000 machines in its facility. As a result of this dispute, we may be required to modify or remove our machines from the tribal facilities, among other risks to our business.

In California, our TILG POSTs are the subject of a dispute between the state of California and our tribal customers, which may result in significant modification or discontinuance of the play of these games.

Oklahoma. In May 2004, the Oklahoma Legislature passed legislation authorizing certain forms of gaming at racetracks and additional types of games at tribal gaming facilities pursuant to a tribal-state compact. This

legislation was subject to approval in a statewide referendum, which was subsequently obtained in the November 2004 elections. The Oklahoma gaming legislation will allow the tribes to sign a compact with the state of Oklahoma to operate an unlimited number of electronic instant Bingo games, electronic bonanza-style bingo games, electronic skill games and non-house banked blackjack games. In addition, certain horse tracks in Oklahoma will be allowed to operate a limited number of instant and bonanza style bingo games and skill games. Three tribes and the state must sign the compact and the Bureau of Indian Affairs must approve the compact before the compact becomes effective. The compact could be effective and the tribes could begin operating the compacted games as soon as December 2004. All vendors placing games under the compact will ultimately be required to be licensed by the state of Oklahoma.

We believe the recently adopted Oklahoma legislation significantly clarifies and expands the types of gaming permitted by Native America tribes in that state. We currently expect continued intensified competition from vendors currently operating in Oklahoma as well as new market entrants. As a result, we anticipate further pressure on our market and revenue share percentages in Oklahoma. In addition, in the immediate future, we expect continued regulatory uncertainty in Oklahoma. In particular, although we and other vendors may not begin to offer games enabled by the new legislation until state and tribal regulations, rules and specifications adopted pursuant to that legislation become final, certain other vendors and tribes may begin to offer new games prior to that time. It is unclear what, if any, regulatory enforcement action could or would be taken against tribes and vendors offering games not authorized by existing law but permitted under the newly adopted, but not yet effective, legislation.

Washington. In Washington State, the Company offers video lottery POSTs operated in conjunction with local central determinant systems, pursuant to compacts between the state and certain Native American tribes in that state. These compacts are recognized by IGRA to permit Class III gaming, which would otherwise be illegal.

Native American Regulation of Gaming. IGRA requires that Native American tribes adopt and submit for NIGC approval, gaming ordinances that regulate tribes conduct of gaming. While these ordinances vary from tribe to tribe, they commonly provide for the following:

- Native American ownership of the gaming operation;
- Establishment of an independent tribal gaming commission;
- Use of gaming net revenues for Native American government, economic development, health, education, housing or related purposes;
- Independent audits, including specific audits of all contracts for amounts greater than $25,000;
- Native American background investigations and licenses;
- Adequate safeguards for the environment and the public health and safety; and
- Dispute resolution procedures.

Pursuant to IGRA, our tribal customers have adopted regulations requiring the tribe to have the sole proprietary interest in its gaming activities. We and certain of our customers have recently received correspondence from the NIGC expressing concern that our agreements with these customers create a proprietary interest in the tribe s gaming operations. We are preparing a response to the NIGC addressing this issue. See Governmental Regulation Federal Regulation Indian Gaming Regulatory Act.

Charity Gaming. Charity bingo facilities are generally operated by non-profit organizations for charitable, educational and other lawful purposes. Charity bingo is not currently subject to a nationwide regulatory system such as the one created by IGRA to regulate Native American gaming, so regulation is on a state-by-state, and sometimes a county-by-county basis. We currently offer charity bingo gaming systems in the state of Alabama pursuant to state and county regulations. We also offer games to certain operators in Louisiana.

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.

RISK FACTORS

The following risk factors should be carefully considered in connection with the other information and financial statements contained in this Annual Report, including Item 7. Management s Discussion and Analysis of Financial Condition and Results of Operations. If any of these risks actually occur, our business, financial condition and results of operations could be seriously and materially harmed, and the trading price of our common stock could decline.

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

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

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

Native American gaming activities involving our games and systems are also subject to regulation by state and local authorities, to the extent such gaming activities constitute, or are perceived to constitute, Class III gaming. Class III gaming is illegal in most states unless conducted by a tribe pursuant to a compact between a tribe and the state in which the tribe is located. The Class III video lottery systems we offer, such as the systems and POSTs operating in Washington State, are subject to regulation by authorities in that state and to the terms of the compacts between the tribes offering such games and Washington State. Gaming activities under the new tribal-state compact in Oklahoma, when effective, will be subject to the terms of compacts between such tribes and the state of Oklahoma. In addition, the state of California has recently notified us that the state has determined that our TILG units constitute Class III gaming devices that are not permitted by the compacts between the state and tribes. California also asserts we may be obligated to cooperate with the state in removing or otherwise stopping the play of these games in California tribal facilities. We are currently working with our tribal customers in California and plan to communicate with California gaming authorities to attempt to resolve the current regulatory uncertainty in that state. Regulatory interpretations and enforcement actions by state regulators, including without limitation, actions by California authorities regarding our TILG product, could have significant and immediate adverse impacts on our business and operating results.

In addition to federal, state and local regulation, all Native American tribes are required by IGRA to adopt ordinances regulating gaming as a condition of their right to conduct gaming on Native American lands. These ordinances often include the establishment of tribal gaming commissions that make their own judgment about

whether an activity is Class II or Class III gaming. Normally, we will not introduce a new Class II game in a customer s gaming facility unless the tribe s gaming commission has made its own independent determination that the game is Class II gaming. Adverse regulatory decisions by tribal gaming commissions could adversely affect our business.

We also face risks from a lack of regulatory or judicial enforcement action. In particular, we believe we have lost market share to competitors who offer games that do not appear to comply with published regulatory restrictions on Class II games, and thereby offer features not available in our products. As a consequence of recently adopted gaming legislation in Oklahoma, we believe vendors with whom we compete and some tribes operating gaming facilities in Oklahoma may increase deployment of these games in advance of final regulations required under the new legislation. To the extent tribes offer these games rather than ours, our market share, revenue and operating results may suffer.

The NIGC has recently determined that the Players Club/Players Account card system, employed by Native American gaming operations using the gaming system that we developed, is an account access card system as defined in the NIGC s Minimum Internal Control Standards regulation, thereby triggering certain recordkeeping requirements. An account access card is defined as an instrument to access customer accounts for wagering at a gaming machine. Account access cards are used in connection with a computerized database.

On October 7, 2004, the NIGC issued a Proposed Notice of Violation to a tribe for, among other things, a violation of the recordkeeping requirements applicable to account access cards. According to the Proposed Notice of Violation, the cashiers were not obtaining signatures from the customers on our receipts when cashing out. The NIGC is also of the opinion that the Bank Secrecy Act recordkeeping requirements apply to account access cards.

We have been working with our legal counsel and tribal customers, exploring ways to modify the Players Club card system to eliminate the account aspect of the system so that the card system operates like script or a bearer instrument.

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

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

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

We face intensified competition in the Class II markets that have historically provided the substantial majority of our revenue and earnings. Moreover, the apparent trend in regulatory developments suggests that Class II gaming may diminish as a percentage of overall gaming activity in the United States. We believe it is imperative that we successfully diversify our operations to include gaming opportunities in markets other

than our historical Class II jurisdictions. If we are unable to effectively develop and operate within these new markets, then our business, operating results and financial condition would be impaired.

Our growth strategy includes selling and/or licensing our systems, games and technology into segments of the gaming industry other than Native American gaming, principally the charity and commercial bingo markets and new jurisdictions authorizing video lottery systems. These and other non-Native American gaming opportunities are not currently subject to a nationwide regulatory system such as the one created by IGRA to regulate Native American gaming, so regulation is on a state-by-state, and sometimes a county-by-county basis. In addition, federal laws

relating to gaming, such as the Johnson Act, which regulates slot machines and similar gambling devices, apply to new video lottery jurisdictions, absent authorized state law exemptions.

As we expand into new markets, we expect to encounter business, legal and regulatory uncertainties similar to those we face in our Native American gaming business. Our strategy is to attempt to be an early entrant into new and evolving markets where the legal and regulatory environment may not be well settled or well understood. As a result, we may encounter legal and regulatory challenges that are difficult or impossible to foresee and which could result in unforeseen adverse impact on planned revenues or costs associated with the new market opportunity. For example, we face business and legal risks in connection with a charity gaming project, in part due to uncertainty related to the state authorization of charity gaming in that jurisdiction. In California, our TILG POSTs are the subject of a dispute between the state of California and our tribal customers, which may result in significant modification or discontinuance of the play of those games.

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

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

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

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 racino racetracks. As payment for providing and maintaining the central determinant system, we receive a small portion of the network-wide hold per day. To date, we have realized substantially less revenue than anticipated from our New York Lottery operations, in significant part due to delays in the opening of racino operations at several of the planned racetracks. We are nevertheless required to incur ongoing expenses associated with development and maintenance of the New York video lottery system, and we do not currently expect to have profitable operations there at least through 2005. Delays in the anticipated development of the New York video lottery system and other emerging market opportunities may continue to adversely affect our revenue and operating results.

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

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

Our historical revenue growth has been driven primarily by technological innovations to our gaming systems, and the increased size and use of our installed base of player terminals in the Class II market. Our future performance will depend primarily on our ability to successfully and cost-effectively enter new gaming markets and develop and introduce new and enhanced gaming systems and content that will be widely accepted both by our customers and their end users. We believe our business requires us to continually offer games and technology that play quickly and provide more entertaining value than those our competitors offer. However, consumer preferences can be difficult to predict, and we may offer new games or technologies that do not achieve market acceptance. In addition, we may experience future delays in game development, or we may not be successful in developing, introducing, and

marketing new games or game enhancements on a timely and cost-effective basis. Furthermore, our new games may be subject to challenge by the NIGC, the DOJ, or some other regulatory or law enforcement agencies applicable to that particular game.

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

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

For the year ended September 30, 2004, two tribes in Oklahoma accounted for approximately 34% and 10% of our gaming revenues. Approximately 68% of our gaming revenues for the year ended September 30, 2004 were from Native American tribes located in Oklahoma. The significant concentration of our customers in Oklahoma means that local economic changes may adversely affect our customers, and therefore our business, disproportionately to changes in national economic conditions, including more sudden adverse economic declines or slower economic recovery from prior declines. The loss of any of our Oklahoma tribes as customers would have a material and adverse effect upon our financial condition and results of operations. In addition, the pending legislation allowing tribal-state compacts in Oklahoma could result in increased competition from other vendors, who we believe have avoided entry into the Class II market due to its uncertain and ambiguous legal environment. The new legislation allows for other types of gaming, both at tribal gaming facilities and at Oklahoma s racetracks. The loss of significant market share to these new gaming opportunities or our competitors products in Oklahoma could also have a material adverse effect upon our financial condition and results of operations.

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

The majority of our revenue is generated from the placement of Class II gaming systems with tribal customers who are not parties to any state compact that would permit them to offer Class III games. If any of our Class II tribal customers were to enter compacts with the states in which they operate, allowing the tribes to offer Class III games, we believe the number of our game machine placements in those customers facilities would decline significantly, and our operating results would be materially adversely affected.

In May 2004, the Oklahoma Legislature passed legislation authorizing certain forms of gaming at racetracks and additional types of games at tribal gaming facilities, pursuant to a tribal-state compact. This legislation was subject to approval in a statewide referendum, which was subsequently obtained in the November 2004 elections. The Oklahoma gaming legislation will allow the tribes to sign a compact with the state of Oklahoma to operate an unlimited number of electronic instant bingo games, electronic bonanza-style bingo games, electronic skill games and non-house-banked blackjack games. In addition, certain horse tracks in Oklahoma will be allowed to operate a limited number of instant and bonanza style bingo games and skill games. Three tribes and the state must sign the compact and the Bureau of Indian Affairs must approve the compact before it becomes effective. The compact could be effective and the tribes could begin operating the compacted games as soon as December 2004. All vendors placing games under the compact will ultimately be required to be licensed by the state of Oklahoma.

The majority of our revenue is generated from the placement of Class II gaming systems with tribal customers who are not currently parties to any state compact that would permit them to offer Class III games. We believe the recently adopted Oklahoma legislation significantly clarifies and expands the types of gaming permitted by Native America tribes in that state. We also expect the new legislation will bring intensified competition into the Oklahoma market, including new competition from credible gaming industry participants that to date have only had a limited presence in that market. In addition, we are experiencing an extended period of uncertainty relative to enforcement of existing restrictions on non-Class II devices, which is forcing us to continue to compete against games that do not appear to comply with published

regulatory restrictions on Class II games. As a result of this increased competition in Oklahoma, we have and may continue to experience pressure on our pricing model. New opportunities in the Oklahoma market resulting from the recent legislation may not develop as we anticipate, or may take longer to develop than we expected. Further, we may offer games similar to those games that do not appear to comply with published regulatory restrictions on Class II games in an effort to compete on an equal footing. These games may be the subject of enforcement actions against us.

We believe the establishment of a state compact depends on a number of political, social, and economic factors which are inherently difficult to ascertain. Accordingly, although we attempt to closely monitor state legislative developments that could affect our business, we may not be able to timely predict when or if a compact could be entered into by one or more of our tribal customers. Moreover, our business requires that we provide support for the economic interests of our tribal customers, and we may therefore not only be restricted from taking political action or positions in opposition to the adoption of a compact but also from supporting the compact.

We are seeking to expand our business by lending money to new and existing Native American customers to develop or expand gaming facilities primarily in the State of Oklahoma, and we are jointly developing or expanding gaming and related facilities with some of these customers. We have limited experience with these activities and may not realize a satisfactory return, if any, on our investment, and we could lose some or all of our investment.

To date, we have entered into development agreements to jointly develop and provide financing to construct and or remodel eleven tribal gaming facilities in the state of Oklahoma. Under our development agreements, we secure a long-term revenue share percentage and a guaranteed percentage of the tribal gaming facilities available floor space in exchange for development and construction funding. Certain of the agreements contain performance standards for our player terminals that could allow the facility to reduce a portion of our guaranteed floor space. In connection with these advances, we could face liquidity pressure or a complete loss of our investment if a tribe does not timely pay any amounts owed to us from such funding. In addition, future NIGC decisions could affect our ability to place our games with these tribes. See Certain Risk Factors Enforcement of remedies or contracts against Native American tribes could be difficult. In addition, the NIGC has recently expressed its view that our development agreements violate the requirements of IGRA and tribal gaming regulations, which state that the Native American tribes must hold the sole proprietary interest in the tribes gaming operations, which presents additional risks for our business. See Certain Risk Factors Changes in regulation or regulatory interpretations could require us to modify the terms of our contracts with customers.

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

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

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

We compete with other vendors for customers, primarily on the basis of the amount of profit our gaming products generate for our customers in relation to other vendors gaming products. We believe that the most important factor influencing our customers product selection is the appeal of those products to end users. This appeal has a direct effect on the volume of play by end users, and drives the amount of revenues generated for and by our customers. Our ability to remain competitive depends primarily on our ability to continuously develop new game themes and systems that appeal to end users, and to introduce those game themes and systems in a timely manner. See Certain Risk Factors Our future performance will depend on our ability to develop and introduce new games and enhancements to existing games that are widely accepted and played. We may not be able to continue to develop and introduce appealing new game themes and systems that meet the emerging requirements in a timely manner, or at all. In addition, others may independently develop games similar to our games, and competitors may introduce non-compliant games that unfairly compete in certain markets due to uneven regulatory enforcement policies. In addition, we have lost certain end-users based upon our decision not to place pre-drawn games in the field that would be covered under the Oklahoma compact, but in advance of the effective date of the compact. After we are able to place the compacted games, it may take some time, if at all, to regain the players that we previously

lost.

We believe continued developments in the Class II market that alleviate or clarify the legal and regulatory uncertainties of that market will result in increased competition in the interactive electronic Class II gaming market,

including the entrance of new competitors with significant gaming experience and financial resources. Specifically, three of the largest manufacturers of gaming equipment have expressed an interest in the Class II market. We believe the increased competition will intensify pressure on our pricing model. In the future, gaming providers will compete on the basis of price as well as the entertainment value and technological superiority of their products. While we will continue to compete by regularly introducing new and faster games, with technological enhancements that we believe will appeal to end users, we believe that the net revenue our customers retain from their installed base of player terminals will become a more significant factor, one that may require us to change the terms of our participation arrangements with customers to remain competitive. Consequently, we believe that a simple business model based upon a relationship between the average hold per player terminal per day and the installed base of player terminals will become less relevant in predicting our performance, as the totality and the mix of our participation arrangements with customers become less standardized and more complex.

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

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

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

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

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

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

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

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

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

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

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

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

The NIGC has recently determined that the Players Club/Players Account card system, employed by Native American gaming operations using the gaming system developed by us, is an account access card system as defined in the NIGC s Minimum Internal Control Standards regulation, thereby triggering certain recordkeeping requirements. An account access card is defined as an instrument to access customer accounts for wagering at a gaming machine. Account access cards are used in connection with a computerized database.

On October 7, 2004, the NIGC issued a Proposed Notice of Violation to a tribe for, among other things, a violation of the recordkeeping requirements applicable to account access cards. According to the Proposed Notice of Violation, the cashiers were not obtaining signatures from the customers on our receipts when cashing out. The NIGC is also of the opinion that the Bank Secrecy Act recordkeeping requirements apply to account access cards.

We have been working with our legal counsel and tribal customers, exploring ways to modify the Players Club card system to eliminate the account aspect of the system so that the card system operates like script or a bearer instrument

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

On April 23, 2004, we reported that the acting General Counsel of the NIGC had issued a letter to us and one of our tribal customers opining that our development agreement regarding the WinStar Casino in Thackerville, Oklahoma constituted a management contract. The authority of the NIGC to review and approve gaming related contracts is limited to management contracts and related collateral agreements. According to the

acting General Counsel, the performance of any planning, organizing, directing, coordinating or controlling with respect to any part of a gaming operation constitutes management for purposes of determining whether an agreement for any of these activities is a management contract. We have expressed our disagreement with this interpretation by the acting General Counsel, and our belief that her view of management is broader than was intended by Congress. We also believe that the acting General Counsel s opinion may have been based in part on collateral agreements we provided to the NIGC in error and that are not presently in effect. We, along with certain tribal customers, submitted additional information and documents related to the development agreements for review by the NIGC.

On December 1, 2004 we received a series of letters from the NIGC expressing the commission s concern that certain of our agreements violate the requirements of IGRA and tribal gaming regulations, which state that the Native American tribes hold the sole proprietary interest in the tribe s gaming operations. In particular, the NIGC is concerned that our development agreements, whereby we advance development funds to our tribal customers in exchange for allocated floor space and a share of gaming revenue, create a proprietary interest of ours in the

tribe s gaming operations. As a result of its concern, the NIGC has requested we and our tribal customers provide a written justification for the percentage of shared revenue specified in the subject agreements, which in the view of the NIGC exceeds the level permissible under a management agreement. The NIGC has also asked that we and our tribal customers provide an explanation why our arrangements do not result in our holding a proprietary interest in our tribal customer s gaming operations. In addition, on December 1, 2004, we received a letter from the NIGC expressing the commission s concern that an Integrated Electronic Gaming Services Agreement, dated January 2000 with one of our customers, covering one of our Legacy games constituted a management agreement. According to the acting general counsel, the performance of any planning, organizing, directing, coordinating or controlling, with respect to any part of a gaming operation, constitutes management for purposes of determining whether an agreement is a management contract, which requires NIGC approval. We are currently preparing our response to the NIGC s requests.

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

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

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

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

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

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

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

Sovereign Immunity; Applicable Courts. Native American tribes generally enjoy sovereign immunity from suit similar to that of the individual states and the United States. In order to sue a Native American tribe (or an agency or instrumentality of a Native American tribe), the tribe must

have effectively waived its sovereign immunity with respect to the matter in dispute.

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

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

We may incur prize payouts in excess of game revenues.

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

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

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

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

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

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

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

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

Worsening economic conditions may adversely affect our business.

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

ITEM 2. ***Properties***

We do not own any real property. As of September 30, 2004, we are under contract for the following leases:

	Square Feet	Monthly Rent	Expiration Date
Austin, Texas			
Corporate Offices	67,761	$ 89,273	July 2010
Assembly and Warehouse Facilities	30,500	10,980	June 2005
Tulsa, Oklahoma			
Operations and Sales Offices	7,445	8,376	February 2005
Warehouse	77,000	12,835	May 2005
Plano, Texas			
Technology Offices	5,010	8,350	March 2008
Kent, Washington			
Warehouse	9,453	4,000	July 2005
Albany, New York			
Office Space	2,708	2935	December 2009
Schenectady, New York			
System Operations	1,690	1,775	September 2009

The aggregate annual rentals under these operating leases are approximately $1.3 million. We believe that these leases will be renewed as they expire, or that alternative properties can be leased on acceptable terms. Specifically, we are reviewing our leases in Tulsa, Oklahoma and Kent, Washington to determine our plans to renew these leases.

ITEM 3. Legal Proceedings

First American Decision. We were a defendant in a lawsuit filed in the Federal Court for the Western District of Oklahoma, alleging that we had tortuously interfered with a contract between the plaintiff and a Native American tribe that granted the plaintiff the exclusive right to provide gaming machines to the tribe. On September 12, 2003, a jury rendered a verdict in favor of us on all counts in the complaint. The plaintiff has filed an appeal with the Tenth Circuit Court of Appeals. We are not able to make any prediction on the outcome of this appeal given the inherent uncertainties in any litigation.

Diamond Games. We are a defendant in a lawsuit filed in the State Court in Oklahoma City, Oklahoma alleging four causes of action: 1) Deceptive Trade Practices, 2) Unfair competition, 3) Wrongful Interference with Diamond Games, Inc. s Business and 4) Restraint of Trade. All of the theories of recovery arise out of Oklahoma state law. The essence of the case alleges that we offered MegaNanza and Reel Time Bingo to tribes in Oklahoma even though they were both allegedly illegal Class III games which had a severe negative impact on Diamond Games market for their legal pull-tab game, Lucky Tab II. Also, the case alleges that our development agreements unfairly interfere with their ability to

successfully conduct their business. Diamond Games is seeking unspecified damages and injunctive relief; however, we believe the claims of Diamond Games are without merit and intend to defend the case vigorously.

International Game Co. International Gamco, Inc., or Gamco claiming certain rights in United States Patent No. 5,324,035, or the 035 Patent, brought suit against us in the United States District Court, for the Southern District of California, claiming that our central determinant system, as operated in the New York State Lottery, infringes the 035 Patent. We currently sublicense the right to practice the technology stated in the 035 Patent in Native American gaming jurisdictions in the United States pursuant to an agreement between us and Bally. Bally obtained the right to sublicense those rights to us from Oasis Technologies, Inc., or Oasis, a previous owner of the 035 Patent.

In the event that we desire to expand our rights beyond Native American gaming, the agreement provides us the option: (1) to pursue legal remedies to establish our rights independent of the Patent; or (2) to negotiate directly and enter into a separate agreement with Oasis for such rights, paying either a one-time license fee per jurisdiction or a unit fee per gaming machine. Gamco claims to have acquired ownership of Oasis rights to the 035 Patent.

Prior to deployment of our central determinant system in New York, we undertook an analysis of the patent issues to determine whether or not our central determinant system infringed the claims of the 035 Patent. We determined that it did not infringe. Although continuing to assert that it did not infringe, we offered to enter into a license agreement with Gamco, whom refused the offer and filed its complaint seeking injunctive relief, unspecified damages, and attorneys fees. We intend to vigorously defend this matter. Given the inherent uncertainties in any litigation, we are unable to make any prediction as to the outcome.

MegaNanza Litigation and Related NIGC Settlement Proceedings. On April 15, 2002, we received an Advisory Opinion from the Deputy General Counsel of the NIGC, stating that MegaNanza and its related family of games were Class III games as defined by IGRA. On April 18, 2002, we filed a lawsuit against the NIGC in the United States District Court for the Northern District of Oklahoma, seeking a judicial declaration that our MegaNanza family of games are Class II games. On June 14, 2002, the NIGC, represented by and acting through the DOJ, filed a motion to dismiss the case, claiming the Court lacked jurisdiction on various procedural grounds. After the NIGC Commissioner issued a Notice of Violation, or NOV, to our largest customer on June 17, 2002, the court granted us a motion seeking the issuance of a temporary restraining order against the NIGC from taking any enforcement actions against any of our customers for playing MegaNanza. Notwithstanding the existence of the temporary restraining order against the NIGC, as a result of the issuance of the NOV, our largest MegaNanza customer and certain other customers discontinued playing MegaNanza, and requested that we install Reel Time Bingo in place of existing MegaNanza units. As the result of a settlement agreement, we stopped offering MegaNanza during June 2003.

Johnson Act. On November 21, 2003, the 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 American Tribe, on Petition for a Writ of Certiorari to the United States 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 United States 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 our machines were not the subject of the lawsuits, the DOJ s arguments and reasoning appeared to encompass the machines offered by us 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 us as legal electronic aids to bingo for the Class II market will continue to stand. We believe that, for the immediate future, significant legal uncertainty has been eliminated concerning our ability to continue to offer Class II games played with the assistance of technological aids in its principal market. However, the elimination of this legal uncertainty could also result in increased competition from vendors currently in the Class III market who we believe have avoided entry into the Class II market due to the legal uncertainties described above.

Development Agreements. On April 23, 2004 we reported that the acting General Counsel of the NIGC had issued a letter to us and one of our tribal customers opining that our development agreement regarding the WinStar Casino in Thackerville, Oklahoma constitutes a management contract. The authority of the NIGC to review and approve gaming related contracts is limited to management contracts and related collateral agreements. According to the acting General Counsel, the performance of any planning, organizing, directing, coordinating or controlling with respect to any part of a gaming operation constitutes management for purposes of determining whether an agreement for any of these activities is a management contract. We have expressed our disagreement with the acting General Counsel s interpretation, and its belief that her view of management is broader than was intended by Congress. We also believe that the acting General Counsel s opinion may be based in part on collateral agreements that it provided to the NIGC in error and that are not presently in effect.

On December 1, 2004 we received a series of letters from the NIGC expressing the commission s concern that certain of our agreements violate the requirements of IGRA and tribal gaming regulations which state that the Native American tribes hold the sole proprietary interest in the tribe s gaming operations. In particular, the NIGC is concerned that our development agreements, whereby we advance development funds to our tribal customers in

exchange for allocated floor space and a share of gaming revenue, create a proprietary interest of ours in the tribe s gaming operations. As a result of its concern, the NIGC has requested that we and our tribal customers provide a written justification for the percentage of shared revenue specified in the subject agreements, which in the view of the NIGC exceeds the level permissible under a management agreement. The NIGC has also asked that we and our tribal customers provide an explanation why our arrangements do not result in our holding a proprietary interest in our tribal customers gaming operations. In addition, on December 1, 2004, we received a letter from the NIGC expressing the Commission s concern that an Integrated Electronic Gaming Services Agreement, dated January 2000 with one of our customers, covering one of our Legacy games constituted a management agreement. According to the acting General Counsel, the performance of any planning, organizing, directing, coordinating or controlling, with respect to any part of a gaming operation, constitutes management for purposes of determining whether an agreement is a management contract, which requires NIGC approval. We are currently preparing our response to the NIGC s requests.

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

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

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.

ITEM 4. Submission of Matters to a Vote of Securities Holders

No matter was submitted during the fourth quarter of the fiscal year covered by this report to a vote of security holders, through the solicitation of proxies or otherwise.

PART II

ITEM 5. ***Market for Registrant s Common Equity and Related Stockholder Matters***

Our common stock is currently listed on the NASDAQ National Market under the symbol MGAM. Prior to September 27, 2001, we were listed on the NASDAQ Small Cap Market under the same symbol. The following table sets forth the range of the quarterly high and low bid prices for the last two fiscal years, as reported in the Wall Street Journal.

Fiscal Quarter	High	Low
First Quarter 2003	$ 14.25	$ 9.87
Second Quarter 2003	14.05	8.48
Third Quarter 2003	13.50	9.03
Fourth Quarter 2003	18.19	11.04
First Quarter 2004	22.42	17.25
Second Quarter 2004	26.43	19.33
Third Quarter 2004	26.82	21.33
Fourth Quarter 2004	27.58	14.25

There were approximately 67 holders of record of our common stock on December 8, 2004, including shares held in street name by Cede & Co. We believe that the shares held in street name are held for more than 4,200 beneficial owners.

We have never declared or paid any cash dividends on our common stock. We intend to retain our earnings to finance growth and development, and therefore do not anticipate paying any cash dividends on our common stock in the foreseeable future. The declaration and payment of any dividends on the Common Stock would be at the sole discretion of our Board of Directors subject to the terms of our bank credit facility, our financial condition, capital requirements, future prospects and other factors deemed relevant.

Summary of Stock Repurchases

	Total Number of Shares Purchased	Average Price Paid per Share
	(Unaudited)	
July 1, 2004 to July 31, 2004		
August 1, 2004 to August 31, 2004	237,500	$ 16.09
September 1, 2004 to September 30, 2004		
Total	237,500	$ 16.09

For a description of our authorized stock repurchase plans, see Part II Item 7. Management s Discussion and Analysis of Financial Condition and Results of Operations.

Equity Compensation Plan Information

Plan Category[1]	Number of securities to be issued upon exercise of outstanding options, warrants, and rights (#)	Weighted-average exercise price of outstanding options, warrants, and rights ($)	Number of securities remaining available for future issuance under equity compensation plans (excluding securities reflected in the first column) (#)
Equity compensation plans approved by security holders	4,314,372	$ 4.34	2,924,693
Equity compensation plans not approved by security holders	970,050	7.03	
Total	**5,284,422**	**$ 6.31**	**2,924,693**

(1) Stock Plans are discussed in further detailed under Part IV Item 15. Financial Statements Note 8. Stockholders Equity.

ITEM 6. ***Selected Financial Data***

The following selected financial data should be read in conjunction with our Consolidated Financial Statements and Notes thereto and Management s Discussion and Analysis of Financial Condition and Results of Operations contained in Item 7 of this Annual Report. Basic and diluted earnings per share have been restated to reflect the Company s two-for-one stock split in February 2004.

	Years Ended September 30,				
	2004	2003	2002	2001	2000
	(In thousands, except per-share amounts)				
Income Statement Data:					
Revenues	$ 153,675	$ 124,673	$ 94,794	$ 46,157	$ 38,661
Operating income	50,431	50,731	40,406	11,623	4,719
Net income	32,772	31,655	25,265	6,672	2,779
Earnings per share:					
Basic	1.19	1.22	1.01	0.37	0.16
Diluted	1.07	1.08	0.87	0.29	0.15
Balance Sheet Data:					
Working capital (deficit)	249	18,180	11,477	3,476	(587)
Total assets	217,407	143,730	86,190	44,667	28,792
Long-term obligations	14,685	12,795	1,754	2,000	3,012
Stockholders equity	150,147	102,112	65,512	32,368	13,046

ITEM 7. ***Management s Discussion and Analysis of Financial Condition and Results of Operations***

Overview

We are a supplier of complex, mission-critical systems to the gaming segment of the entertainment industry. We design and develop linked, interactive, electronic gaming systems and related products that provide our customers with a comprehensive gaming system and are marketed primarily to operators of Native American, charity and commercial gaming facilities, and to operators and/or regulators of domestic and international lotteries. Historically, we have focused our development and marketing efforts on Class II gaming systems and Class III video lottery systems used primarily by Native American tribes. We have recently focused our marketing efforts on the emerging charity markets in the U.S. and on domestic and international lottery jurisdictions.

We derive the majority of our gaming revenues from the placement of player terminals, POSTs and back office equipment, which we collectively refer to as gaming systems, under participation arrangements, and to a lesser degree from the placement of POSTs, in the Class III market in Washington State under lease-purchase or participation arrangements, and from the 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 POSTs operated by the New York State Division of the Lottery. A significantly smaller portion of our revenues is generated from the sale of POSTs and game licenses 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 POSTs 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 POSTs permitted under prior law.)

Class II Market

We derive our Class II gaming revenues primarily from participation arrangements with our Native American customers. Under participation arrangements, we retain ownership of the player terminals and 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 to end users for prizes and the amounts retained by the facilities for their share of the hold. Our historical revenue growth is a reflection of the increase in our installed base of player terminals in the Class II market, an

1.5% contingent convertible senior notes due 2033
283.9 283.9

Working Capital

Working capital as of March 31, 2006 and December 31, 2005 consisted of the following (dollar amounts in millions):

	Mar. 31, 2006	Dec. 31, 2005	$ Change	% Change
Cash, cash equivalents and short-term investments	$ 598.7	$ 742.5	$ (143.8)	(19.4)%
Accounts receivable, net	50.4	46.7	3.7	7.9%
Inventories, net	15.7	19.1	(3.4)	(17.7)%
Deferred tax assets, net	12.0	12.7	(0.7)	(5.5)%
Other current assets	13.4	12.3	1.1	10.0%
Total current assets	690.2	833.3	(143.1)	(17.2)%
Accounts payable	35.8	57.7	(21.9)	(38.0)%
Short-term contract obligation		27.4	(27.4)	(100.0)%
Income taxes payable	9.2	31.5	(22.3)	(70.8)%
Other current liabilities	30.0	24.2	5.8	24.2%
Total current liabilities	75.0	140.8	(65.8)	(46.7)%
Working capital	$ 615.2	$ 692.5	$ (77.3)	(11.2)%

We had cash, cash equivalents and short-term investments of $598.7 million and working capital of $615.2 million at March 31, 2006, as compared to $742.5 million and $692.5 million, respectively, at December 31, 2005. The decreases were primarily due to a $90.1 million payment to Ipsen related to a development and distribution agreement for the development of Reloxin®, payment of the $27.4 million contingent payment related to the merger with Ascent, and payments of $20.7 million of income taxes during the first quarter of 2006.

Management believes existing cash and short-term investments, together with funds generated from operations, should be sufficient to meet operating requirements for the foreseeable future. Our cash and short-term investments are available for strategic investments, mergers and acquisitions, and other potential large-scale needs. In addition, we may consider issuing additional debt or equity securities in the future to fund potential acquisitions or investments, to refinance existing debt or for general corporate

Table of Contents

purposes. If a material acquisition or investment is completed, our operating results and financial condition could change materially in future periods. However, no assurance can be given that additional funds will be available on satisfactory terms, or at all, to fund such activities.

We are currently pursuing additional or new headquarter office space to accommodate our expected long-term growth.

Operating Activities

Net cash used in operating activities during the first quarter of 2006 was approximately $111.5 million, compared to cash provided by operating activities of approximately $33.9 million during the first quarter of 2005. The change was primarily attributable to the $90.1 million payment made to Ipsen related to a development and distribution agreement for the development of Reloxin® during the first quarter of 2006 and approximately $16.7 million of professional fees paid related to the termination of the proposed merger with Inamed Corporation. Additionally, approximately $20.7 million of income tax payments were made during the first quarter of 2006, as compared to approximately $8.1 million of income tax payments made during the first quarter of 2005.

Investing Activities

Net cash used in investing activities during the first quarter of 2006 was approximately $88.6 million, compared to net cash provided by investing activities during the first quarter of 2005 of $4.2 million. The change was primarily due to the net purchases or sales of our short-term investments during the respective quarters. In addition, approximately $27.4 million was paid during the first quarter of 2006 for Contingent Payments related to our 2001 merger with Ascent.

Financing Activities

Net cash used in financing activities during the first quarter of 2006 was $1.1 million, compared to net cash used in financing activities of $1.5 million during the first quarter of 2005. Dividends paid during the first quarter of 2006 and the first quarter of 2005 was $1.6 million. Proceeds from the exercise of stock options was $0.6 million during the first quarter of 2006 compared to $0.1 million during the first quarter of 2005.

Contingent Convertible Senior Notes and Other Long-Term Commitments

On August 14, 2003, we exchanged $230.8 million in principal amount of our Old Notes for $283.9 million in principal amount of our New Notes. Holders of Old Notes that accepted the Company s exchange offer received $1,230 in principal amount of New Notes for each $1,000 in principal amount of Old Notes. The terms of the New Notes are similar to the terms of the Old Notes, but have a different interest rate, conversion rate and maturity date. Holders of Old Notes that did not exchange will continue to be subject to the terms of the Old Notes. See Note 9 of Notes to Condensed Consolidated Financial Statements for further discussion.

The New Notes and the Old Notes are unsecured and do not contain any restrictions on the incurrence of additional indebtedness or the repurchase of our securities, and do not contain any financial covenants. The Old Notes do not contain any restrictions on the payment of dividends. The New Notes require an adjustment to the conversion price if the cumulative aggregate of all current and prior dividend increases above $0.025 per share would result in at least a one percent (1%) increase in the conversion price. This threshold has not been reached and no adjustment to the conversion price has been made.

Except for the Old Notes, the New Notes and deferred tax liabilities, we have no long-term liabilities and had only $75.0 million of current liabilities at March 31, 2006. Our other commitments and planned expenditures consist principally of payments we will make in connection with strategic collaborations and research and development expenditures, and we will continue to invest in sales and marketing infrastructure.

Table of Contents

We have made available to BioMarin the ability to draw down on a Convertible Note up to $25.0 million beginning July 1, 2005 (the Convertible Note). The Convertible Note is convertible based on certain terms and conditions including a change of control provision. Money advanced under the Convertible Note is convertible into BioMarin shares at a strike price equal to the BioMarin average closing price for the 20 trading days prior to such advance. The Convertible Note matures on the option purchase date in 2009 as defined in the securities purchase agreement entered into on May 18, 2004 but may be repaid by BioMarin at any time prior to the option purchase date. As of May 9, 2006, BioMarin has not requested any monies to be advanced under the Convertible Note, and no amounts are outstanding.

Dividends

Since July 2003, we have paid quarterly cash dividends aggregating approximately $16.8 million on our common stock. In addition, on March 15, 2006, we declared a cash dividend of $0.03 per issued and outstanding share of common stock payable on April 28, 2006 to our stockholders of record at the close of business on April 3, 2006. Prior to these dividends, we had not paid a cash dividend on our common stock, and we have not adopted a dividend policy. Any future determinations to pay cash dividends will be at the discretion of our Board of Directors and will be dependent upon our financial condition, operating results, capital requirements and other factors that our Board of Directors deems relevant.

Line of Credit

We have a revolving line of credit facility of up to $25.0 million from Wells Fargo Bank, N.A. The facility may be drawn upon by us, at our discretion, and is collateralized by certain short-term investments. Any outstanding balance of the credit facility bears interest at a floating rate of 150 basis points in excess of the 30-day London Interbank Offered Rate and expires in November 2006. The agreement requires us to comply with certain covenants, including covenants relating to our financial condition and results of operation; we are in compliance with such covenants. We have never drawn on this credit facility.

Off-Balance Sheet Arrangements

As of March 31, 2006, we are not involved in any off-balance sheet arrangements, as defined in Item 3(a)(4)(ii) of Securities and Exchange Commission (SEC) Regulation S-K.

Critical Accounting Policies and Estimates

The discussion and analysis of our financial condition and results of operations are based upon our condensed consolidated financial statements, which have been prepared in conformity with U.S. generally accepted accounting principles. The preparation of the condensed consolidated financial statements requires us to make estimates and assumptions that affect the amounts reported in the condensed consolidated financial statements and accompanying notes. On an ongoing basis, we evaluate our estimates related to sales allowances, chargebacks, rebates, returns and other pricing adjustments, depreciation and amortization and other contingencies and litigation. We base our estimates on historical experience and various other factors related to each circumstance. Actual results could differ from those estimates based upon future events, which could include, among other risks, changes in the regulations governing the manner in which we sell our products, changes in the health care environment and managed care consumption patterns. Our significant accounting policies are described in Note 2 to the consolidated financial statements included in our Form 10-K/T for the six-month transition period ended December 31, 2005. We believe the following critical accounting policies affect our most significant estimates and assumptions used in the preparation of our condensed consolidated financial statements and are important in understanding our financial condition and results of operations.

Revenue Recognition

Revenue from our product sales is recognized pursuant to Staff Accounting Bulletin No. 104 (SAB 104), Revenue Recognition in Financial Statements. Accordingly, revenue is recognized when all four of the following criteria are met: (i) persuasive evidence that an arrangement exists; (ii) delivery of the

Table of Contents

products has occurred; (iii) the selling price is both fixed and determinable; and (iv) collectibility is reasonably assured. Our customers consist primarily of large pharmaceutical wholesalers who sell directly into the retail channel.

We do not provide any forms of price protection to our wholesale customers and permit product returns if the product is damaged, or, depending on the customer, if it is returned within six months prior to expiration or up to 12 months after expiration. Our customers consist principally of financially viable wholesalers, and depending on the customer, revenue is recognized based upon shipment (FOB shipping point) or receipt (FOB destination), net of estimated provisions.

We enter into licensing arrangements with other parties whereby we receive contract revenue based on the terms of the agreement. The timing of revenue recognition is dependent on the level of our continuing involvement in the manufacture and delivery of licensed products. If we have continuing involvement, the revenue is deferred and recognized on a straight-line basis over the period of continuing involvement. In addition, if our licensing arrangements require no continuing involvement and payments are merely based on the passage of time, we assess such payments for revenue recognition under the collectibility criteria of SAB 104.

Items Deducted From Gross Revenue

Provisions for estimates for product returns and exchanges, sales discounts, chargebacks, managed care and Medicaid rebates and other adjustments are established as a reduction of product sales revenues at the time such revenues are recognized. These deductions from gross revenue are established by us as our best estimate at the time of sale based on historical experience adjusted to reflect known changes in the factors that impact such reserves. These deductions from gross revenue are generally reflected either as a direct reduction to accounts receivable through an allowance, or as an addition to accrued expenses if the payment is due to a party other than the wholesale or retail customer.

Our accounting policies for revenue recognition have a significant impact on our reported results and rely on certain estimates that require complex and subjective judgment on the part of our management. If the levels of product returns and exchanges, cash discounts, chargebacks, managed care and Medicaid rebates and other adjustments fluctuate significantly and/or if our estimates do not adequately reserve for these reductions of gross product revenues, our reported net product revenues could be negatively affected.

Product Returns and Exchanges

We account for returns and exchanges of product in accordance with SFAS 48, Revenue Recognition When Right of Return Exists, whereby an allowance is established based on our estimate of revenues recorded for which the related products are expected to be returned in the future. We determine our estimate of product returns and exchanges based on historical experience and other qualitative factors that could impact the level of future product returns and exchanges. These factors include estimated shelf life, competitive developments including introductions of generic products, product discontinuations and our introduction of new formulations of our products. Typically, these other factors that influence our allowance for product returns and exchanges do not change significantly from quarter to quarter. Historical experience and the other qualitative factors are assessed on a product-specific basis as part of our compilation of our estimate of future product returns and exchanges. Estimates for returns and exchanges of new products are based on historical experience of new products at various stages of their life cycle.

Our actual experience and the qualitative factors that we use to determine the necessary allowance for future product returns and exchanges are susceptible to change based on unforeseen events and uncertainties. We review our allowance for product returns and exchanges quarterly to assess the trends being considered to estimate the allowance, and make changes to the allowance as necessary.

Table of Contents

Sales Discounts

We offer cash discounts to our customers as an incentive for prompt payment, generally approximately 2% of the sales price. We account for cash discounts by establishing an allowance reducing accounts receivable by the full amount of the discounts expected to be taken by the customers.

Contract Chargebacks

We have agreements for contract pricing with several entities, whereby pricing on products is extended below wholesaler list price. These parties purchase products through wholesalers at the lower contract price, and the wholesalers charge the difference between their acquisition cost and the lower contract price back to us. We account for chargebacks by establishing an allowance reducing accounts receivable based on our estimate of chargeback claims attributable to a sale. We determine our estimate of chargebacks based on historical experience and changes to current contract prices. We also consider our claim processing lag time, and adjust the allowance periodically throughout each quarter to reflect actual experience.

Managed Care and Medicaid Rebates

We establish and maintain reserves for amounts payable by us to managed care organizations and state Medicaid programs for the reimbursement of portions of the retail price of prescriptions filled that are covered by these programs. The amounts estimated to be paid relating to products sold are recognized as deductions from gross revenue and as additions to accrued expenses at the time of sale based on our best estimate of the expected prescription fill rate to these managed care and state Medicaid patients, using historical experience adjusted to reflect known changes in the factors that impact such reserves, including changes in formulary status and contractual pricing.

Other

In addition to the significant items deducted from gross revenue described above, we deduct other items from gross revenue. For example, we offer consumer rebates on many of our products and a consumer loyalty program for our RESTYLANE® dermal filler product. We generally account for these other items deducted from gross revenue by establishing an accrual based on our estimate of the adjustments attributable to a sale. We generally base our estimates for the accrual of these items deducted from gross sales on historical experience and other relevant factors. We adjust our accruals periodically throughout each quarter based on actual experience and changes in other factors, if any.

We believe that our allowances and accruals for items that are deducted from gross revenue are reasonable and appropriate based on current facts and circumstances. However, it is possible that other parties applying reasonable judgment to the same facts and circumstances could develop different allowance and accrual amounts for items that are deducted from gross revenue. Additionally, changes in actual experience or changes in other qualitative factors could cause our allowances and accruals to fluctuate. A five percent change in the expenses related to the allowances and accruals described above would lead to an approximate $5.9 million annual effect on our income before income tax expense, based on the amount of expense we recognized during the year ended June 30, 2005 related to the allowances and accruals described above.

Share-Based Compensation

As part of our adoption of SFAS No. 123R as of July 1, 2005, we are required to recognize the fair value of share-based compensation awards as an expense. We apply the Black-Scholes option-pricing model in order to determine the fair value of stock options on the date of grant, and we apply judgment in estimating key assumptions that are important elements in the model such as the expected stock-price volatility, expected stock option life and expected forfeiture rates. Our estimates of these important assumptions are based on historical data and judgment regarding market trends and factors.

Table of Contents

If actual results are not consistent with our assumptions and judgments used in estimating these factors, we may be required to record additional stock-based compensation expense or income tax expense, which could be material to our results of operations.

Long-lived Assets

We assess the impairment of long-lived assets when events or changes in circumstances indicate that the carrying value of the assets may not be recoverable. Factors that we consider in deciding when to perform an impairment review include significant under-performance of a product line in relation to expectations, significant negative industry or economic trends, and significant changes or planned changes in our use of the assets. Recoverability of assets that will continue to be used in our operations is measured by comparing the carrying amount of the asset grouping to our estimate of the related total future net cash flows. If an asset carrying value is not recoverable through the related cash flows, the asset is considered to be impaired. The impairment is measured by the difference between the asset grouping s carrying amount and its fair value, based on the best information available, including market prices or discounted cash flow analysis.

When we determine that the useful lives of assets are shorter than we had originally estimated, and there are sufficient cash flows to support the carrying value of the assets, we accelerate the rate of amortization charges in order to fully amortize the assets over their new shorter useful lives.

Income Taxes

Income taxes are determined using an annual effective tax rate, which generally differs from the U.S. Federal statutory rate because of state and local income taxes, tax-exempt interest, charitable contribution deductions, nondeductible expenses and research and experimentation tax credits available in the U.S. Our effective tax rate may be subject to fluctuations during the year as new information is obtained which may affect the assumptions we use to estimate our annual effective tax rate, including factors such as our mix of pre-tax earnings in the various tax jurisdictions in which we operate, valuation allowances against deferred tax assets, reserves for tax audit issues and settlements, utilization of research and experimentation tax credits and changes in tax laws in jurisdictions where we conduct operations. We recognize deferred tax assets and liabilities for temporary differences between the financial reporting basis and the tax basis of our assets and liabilities. We record valuation allowances against our deferred tax assets to reduce the net carrying value to an amount that management believes is more likely than not to be realized.

Based on the Company s historical pre-tax earnings, management believes it is more likely than not that the Company will realize the benefit of the existing net deferred tax assets at March 31, 2006. Management believes the existing net deductible temporary differences will reverse during periods in which the Company generates net taxable income; however, there can be no assurance that the Company will generate any earnings or any specific level of continuing earnings in future years. Certain tax planning or other strategies could be implemented, if necessary, to supplement income from operations to fully realize recorded tax benefits.

Research and Development Costs and Accounting for Strategic Collaborations

All research and development costs, including payments related to products under development and research consulting agreements, are expensed as incurred. We may continue to make non-refundable payments to third parties for new technologies and for research and development work that has been completed. These payments may be expensed at the time of payment depending on the nature of the payment made.

Our policy on accounting for costs of strategic collaborations determines the timing of our recognition of certain development costs. In addition, this policy determines whether the cost is classified as development expense or capitalized as an asset. We are required to form judgments with respect to the commercial status of such products in determining whether development costs meet the criteria for immediate expense or capitalization. For example, when we acquire certain products for which there is

Table of Contents

already an ANDA or NDA approval related directly to the product, and there is net realizable value based on projected sales for these products, we capitalize the amount paid as an intangible asset. In addition, if we acquire product rights that are in the development phase and as to which we have no assurance that the third party will successfully complete its developmental milestones, we expense such payments.

Recent Accounting Pronouncements

In November 2005, the FASB issued FSP FAS 115-1 and FAS 124-1, *The Meaning of Other-Than-Temporary Impairment and Its Application to Certain Investments* (FSP 115-1), which provides guidance on determining when investments in certain debt and equity securities are considered impaired, whether that impairment is other-than-temporary, and on measuring such impairment loss. FSP 115-1 also includes accounting considerations subsequent to the recognition of other-than-temporary impairment and requires certain disclosures about unrealized losses that have not been recognized as other-than-temporary impairments. FSP 115-1 is required to be applied to reporting periods beginning after December 15, 2005, and is required to be adopted by us in the first quarter of 2006. We adopted FSP 115-1 beginning on January 1, 2006, and the adoption of FSP 115-1 did not have a material impact on our consolidated results of operations and financial condition.

Table of Contents

Forward Looking Statements

This Quarterly Report on Form 10-Q and other documents we file with the SEC include forward looking statements. These include statements relating to future actions, prospective products or product approvals, future performance or results of current and anticipated products, sales and marketing efforts, expenses, the outcome of contingencies, such as legal proceedings, and financial results. From time to time, we also may make forward-looking statements in press releases or written statements, or in our communications and discussions with investors and analysts in the normal course of business through meetings, webcasts, phone calls, and conference calls. All statements other than statements of historical fact are, or may be deemed to be, forward-looking statements within the meaning of Section 27A of the Securities Act of 1933, as amended, and Section 21E of the Securities Exchange Act of 1934, as amended (the Exchange Act). These statements are based on certain assumptions made by us based on our experience and perception of historical trends, current conditions, expected future developments and other factors we believe are appropriate in the circumstances. We caution you that actual outcomes and results may differ materially from what is expressed, implied, or forecast by our forward-looking statements. Such statements are subject to a number of assumptions, risks and uncertainties, many of which are beyond our control. You can identify these statements by the fact that they do not relate strictly to historical or current facts. They use words such as anticipate, estimate, expect, project, intend, plan, believe, will, should, outlook, could, target, intend, terms of similar meaning in connection with any discussion of future operations or financial performance. Among the factors that could cause actual results to differ materially from our forward-looking statements are the following:

the success of research and development activities and the speed with which regulatory authorizations and product launches may be achieved;

changes in our product mix;

changes in prescription levels and the effect of economic changes in hurricane-effected areas;

manufacturing or supply interruptions;

competitive developments affecting our current growth products, such as the recent FDA approval of HYLAFORM®, HYLAFORM PLUS® and CAPTIQUE®, competitors to RESTYLANE®, a generic form of our DYNACIN® Tablets product and generic forms of our LOPROX® TS and LOPROX® Cream products;

importation of other dermal filler products;

changes in the prescribing or procedural practices of dermatologists, podiatrists and/or plastic surgeons;

the ability to successfully market both new and existing products;

difficulties or delays in manufacturing;

the ability to compete against generic and other branded products;

trends toward managed care and health care cost containment;

our ability to protect our patents and other intellectual property;

possible U.S. legislation or regulatory action affecting, among other things, pharmaceutical pricing and reimbursement, including Medicaid and Medicare and involuntary approval of prescription medicines for over-the-counter use;

Table of Contents

legal defense costs, insurance expenses, settlement costs and the risk of an adverse decision or settlement related to product liability, patent protection, government investigations, and other legal proceedings;

changes in U.S. generally accepted accounting principles;

additional costs related to compliance with changing regulation of corporate governance and public financial disclosure;

any changes in business, political and economic conditions due to the threat of future terrorist activity in the U.S. and other parts of the world;

access to available and feasible financing on a timely basis;

the risks and uncertainties normally incident to the pharmaceutical and medical device industries, including product liability claims;

the risks and uncertainties associated with obtaining necessary FDA approvals;

growth in costs and expenses; and

the impact of acquisitions, divestitures and other significant corporate transactions.

We undertake no obligation to publicly update forward-looking statements, whether as a result of new information, future events or otherwise. You are advised, however, to review any future disclosures contained in the reports that we file with the SEC. Our Transition Report on Form 10-K/T for the six-month period ended December 31, 2005 contains discussions of various risks relating to our business that could cause actual results to differ materially from expected and historical results, which is incorporated herein by reference and which you should review. You should understand that it is not possible to predict or identify all such factors. Consequently, you should not consider any such list or discussion to be a complete set of all potential risks or uncertainties.

Item 3. Quantitative and Qualitative Disclosures About Market Risk

As of March 31, 2006, there were no material changes to the information previously reported under Item 7A in our Transition Report on Form 10-K/T for the six-month period ended December 31, 2005.

Item 4. Controls and Procedures

We maintain disclosure controls and procedures (as defined in Rules 13a-15(e) and 15d-15(e) of the Exchange Act that are designed to ensure that information required to be disclosed in reports filed by us under the Exchange Act is recorded, processed, summarized and reported within the time periods specified in the SEC s rules and forms and that such information is accumulated and communicated to management, including our Chief Executive Officer and Chief Financial Officer, as appropriate, to allow for timely decisions regarding required disclosure. Our Chief Executive Officer and Chief Financial Officer, with the participation of other members of management, evaluated the effectiveness of our disclosure controls and procedures as of March 31, 2006 and have concluded that, as of such date our disclosure controls and procedures were effective to ensure that the information we are required to disclose in reports that we file or submit under the Exchange Act is recorded, processed, summarized and reported within the time periods specified in the SEC s rules and forms.

Although the management of our Company, including the Chief Executive Officer and the Chief Financial Officer, believes that our disclosure controls and internal controls currently provide reasonable assurance that our desired control objectives have been met, management does not expect that our disclosure controls or internal controls will prevent all error and all fraud. A control system, no matter how well conceived and operated, can provide only reasonable, not absolute, assurance that the objectives of the control system are met. Further, the design of a control system must reflect the fact that there are resource

Table of Contents

constraints, and the benefits of controls must be considered relative to their costs. Because of the inherent limitations in all control systems, no evaluation of controls can provide absolute assurance that all control issues and instances of fraud, if any, within our Company have been detected. These inherent limitations include the realities that judgments in decision-making can be faulty, and that breakdowns can occur because of simple error or mistake. Additionally, controls can be circumvented by the individual acts of some persons, by collusion of two or more people, or by management override of the controls. The design of any system of controls is also based in part upon certain assumptions about the likelihood of future events, and there can be no assurance that any design will succeed in achieving its stated goals under all potential future conditions.

During the three months ended March 31, 2006, there was no change in our internal control over financial reporting (as defined in Rules 13a-15(f) and 15d-15(f) of the Exchange Act) that has materially affected, or is reasonably likely to materially affect, our internal control over financial reporting.

Part II. Other Information

Item 1. Legal Proceedings

The government notified us on December 14, 2004, that it is investigating claims that we violated the federal False Claims Act. We are fully cooperating with the government in its investigation, which relates to our marketing and promotion of LOPROX® products to pediatricians prior to our May 2004, disposition of the Company s pediatric sales division. In April 2006, we offered $6.0 million to resolve the government s civil claims contingent on the execution of appropriate releases. The Justice Department countered with a demand of $12.8 million to resolve the civil claims that the government is prepared to pursue. We are continuing to hold settlement discussions with the government in an effort to resolve their claims, and these discussions may or may not result in a monetary settlement with the government. Accordingly, we have accrued a loss contingency of $6.0 million as of March 31, 2006, related to this matter.

On October 27, 2005, we filed suit against Upsher-Smith Laboratories, Inc. of Plymouth, Minnesota and against Prasco Laboratories of Cincinnati, Ohio for infringement of Patent No. 6,905,675 entitled Sulfur Containing Dermatological Compositions and Methods for Reducing Malodors in Dermatological Compositions covering our sodium sulfacetamide/sulfur technology. This intellectual property is related to our PLEXION® Cleanser product. The suit was filed in the U.S. District Court for the District of Arizona, and seeks an award of damages, as well as a preliminary and a permanent injunction. We are in the midst of accelerated discovery. A hearing on our preliminary injunction motion was heard on March 8 and March 9, 2006. The Court has declined to grant a preliminary injunction at this time.

We and certain of our subsidiaries are parties to other actions and proceedings incident to our business, including litigation regarding our intellectual property, challenges to the enforceability or validity of our intellectual property and claims that our products infringe on the intellectual property rights of others. We record contingent liabilities resulting from claims against us when it is probable (as that word is defined in Statement of Financial Accounting Standards No. 5) that a liability has been incurred and the amount of the loss is reasonably estimable. We disclose material contingent liabilities when there is a reasonable possibility that the ultimate loss will exceed the recorded liability. Estimating probable losses requires analysis of multiple factors, in some cases including judgments about the potential actions of third-party claimants and courts. Therefore, actual losses in any future period are inherently uncertain. In all of the cases noted where we are the defendant, we believe we have meritorious defenses to the claims in these actions and resolution of these matters will not have a material adverse effect on our business, financial condition, or results of operation; however, the results of the proceedings are uncertain, and there can be no assurance to that effect.

Item 1A. Risk Factors

There are no material changes from the risk factors previously disclosed in Part I of Item 1A in our Transition Report on Form 10-K/T for the six month period ended December 31, 2005.

Table of Contents

Item 6. Exhibits

Exhibit 10.1+*	Development and Distribution Agreement by and between Aesthetica, Ltd. and Ipsen, Ltd.
Exhibit 10.2+*	Trademark License Agreement by and between Aesthetica, Ltd. and Ipsen, Ltd.
Exhibit 10.3+*	Trademark Assignment Agreement by and between Aesthetica, Ltd. and Ipsen, Ltd.
Exhibit 12+	Computation of Ratios of Earnings to Fixed Charges
Exhibit 31.1+	Certification by the Chief Executive Officer Pursuant to Section 302 of the Sarbanes-Oxley Act of 2002
Exhibit 31.2+	Certification by the Chief Financial Officer Pursuant to Section 302 of the Sarbanes-Oxley Act of 2002
Exhibit 32.1+	Certification by the Chief Executive Officer and the Chief Financial Officer Pursuant to 18 U.S.C. Section 1350, as adopted pursuant to Section 906 of the Sarbanes-Oxley Act of 2002

+ Filed herewith

* Confidential portions omitted and filed separately with the U.S. Securities and Exchange Commission pursuant to Rule 24b-2 promulgated under the Securities and Exchange Act of 1934, as amended.

Table of Contents

SIGNATURES

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

MEDICIS PHARMACEUTICAL CORPORATION

Date: May 10, 2006

By: /s/ Jonah Shacknai

Jonah Shacknai
Chairman of the Board and
Chief Executive Officer
(Principal Executive Officer)

Date: May 10, 2006

By: /s/ Mark A. Prygocki, Sr.

Mark A. Prygocki, Sr.
Executive Vice President
Chief Financial Officer, Corporate
Secretary and Treasurer
(Principal Financial and Accounting Officer)

Table of Contents

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