

SCIENTIFIC GAMES CORP  
Form 10-Q/A  
June 10, 2002

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**UNITED STATES  
SECURITIES AND EXCHANGE COMMISSION**

WASHINGTON, D. C. 20549

**FORM 10-Q/A**

{Mark One}

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

For the quarterly period ended March 31, 2002

OR

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

Commission File number: 0-13063

**SCIENTIFIC GAMES CORPORATION**

(Exact name of registrant as specified in its charter)

**Delaware**

(State or other jurisdiction of  
incorporation or organization)

**81-0422894**

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

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

(Address of principal executive offices)

(Zip Code)

**(212) 754-2233**

(Registrant's telephone number, including area code)

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

**APPLICABLE ONLY TO CORPORATE ISSUERS:**

Indicate the number of shares outstanding of each of the issuer's classes of common stock as of May 10, 2002:

Class A Common Stock: 43,056,007

Class B Common Stock: None

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SCIENTIFIC GAMES CORPORATION AND SUBSIDIARIES

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AND OTHER INFORMATION

THREE MONTHS ENDED MARCH 31, 2002

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SCIENTIFIC GAMES CORPORATION AND SUBSIDIARIES

CONSOLIDATED BALANCE SHEETS

(In thousands, except per share amounts)

	<u>December 31, 2001</u>	<u>March 31, 2002</u>
	(Audited)	(Unaudited)
<b>ASSETS</b>		
Current assets:		
Cash and cash equivalents	\$ 12,649	5,016
Restricted cash	708	740
Accounts receivable, net of allowance for doubtful accounts	50,410	52,554
Inventories	19,547	19,450
Prepaid expenses, deposits and other current assets	14,829	16,752
	<u>98,143</u>	<u>94,512</u>
Total current assets	98,143	94,512

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	December 31, 2001	March 31, 2002
Property and equipment, at cost	364,837	370,754
Less accumulated depreciation	168,049	176,033
Net property and equipment	196,788	194,721
Goodwill, net	195,255	198,425
Other intangible assets, net	60,154	56,812
Other assets and investments	51,612	52,658
Total assets	\$ 601,952	597,128
<b>LIABILITIES AND STOCKHOLDERS' EQUITY</b>		
Current liabilities:		
Current installments of long-term debt	\$ 9,437	10,174
Accounts payable	26,632	23,760
Accrued liabilities	51,118	45,993
Interest payable	8,381	3,823
Total current liabilities	95,568	83,750
Deferred income taxes	28,568	25,598
Other long-term liabilities	23,440	22,404
Long-term debt, excluding current installments	430,298	431,633
Total liabilities	577,874	563,385
Commitments and contingencies		
Stockholders' equity:		
Convertible preferred stock, par value \$1.00 per share, 2,000 shares authorized, 1,220 and 1,237 shares outstanding at December 31, 2001 and March 31, 2002, respectively	1,220	1,237
Class A common stock, par value \$0.01 per share, 99,300 shares authorized, 41,203 and 42,986 shares outstanding at December 31, 2001 and March 31, 2002, respectively	412	430
Class B non-voting common stock, par value \$0.01 per share, 700 shares authorized, none outstanding		
Additional paid-in capital	275,510	278,525
Accumulated losses	(242,545)	(237,143)
Treasury stock, at cost	(135)	(135)
Accumulated other comprehensive loss	(10,384)	(9,171)
Total stockholders' equity	24,078	33,743
Total liabilities and stockholders' equity	\$ 601,952	597,128

See accompanying notes to consolidated financial statements.

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CONSOLIDATED STATEMENTS OF OPERATIONS

Three Months Ended March 31, 2001 and 2002  
(Unaudited, in thousands, except per share amounts)

	2001	2002
Operating revenues:		
Services	\$ 88,040	92,516
Sales	24,068	14,456
	<u>112,108</u>	<u>106,972</u>
Operating expenses (exclusive of depreciation and amortization shown below):		
Services	58,113	53,262
Sales	14,707	9,225
Amortization of service contract software (note 1)	892	1,209
	<u>73,712</u>	<u>63,696</u>
Total gross profit	38,396	43,276
Selling, general and administrative expenses	14,625	14,360
Depreciation and amortization	12,716	9,197
	<u>11,055</u>	<u>19,719</u>
Operating income	11,055	19,719
Other deductions:		
Interest expense	13,580	11,451
Other (income) expense	244	(68)
	<u>13,824</u>	<u>11,383</u>
Income (loss) before income tax expense (benefit)	(2,769)	8,336
Income tax expense (benefit)	(332)	1,131
	<u>(2,437)</u>	<u>7,205</u>
Net income (loss)	(2,437)	7,205
Convertible preferred stock paid-in-kind dividend	1,699	1,803
	<u>(4,136)</u>	<u>5,402</u>
Net income (loss) available to common stockholders	\$ (4,136)	5,402
Basic and diluted net income (loss) per share:		
Basic net income (loss) available to common stockholders	\$ (0.10)	0.13
	<u>(0.10)</u>	<u>0.10</u>
Diluted net income (loss) available to common stockholders	\$ (0.10)	0.10
	<u>(0.10)</u>	<u>0.10</u>
Weighted average number of shares used in per share calculations:		
Basic shares	40,163	42,067
	<u>40,163</u>	<u>71,725</u>
Diluted shares	40,163	71,725
	<u>40,163</u>	<u>71,725</u>

See accompanying notes to consolidated financial statements.

## SCIENTIFIC GAMES CORPORATION AND SUBSIDIARIES

## CONSOLIDATED STATEMENTS OF CASH FLOWS

Three Months Ended March 31, 2001 and 2002  
(Unaudited, in thousands)

	2001	2002
	<u>          </u>	<u>          </u>
Cash flows from operating activities:		
Net income (loss)	\$ (2,437)	7,205
	<u>          </u>	<u>          </u>
Adjustments to reconcile net income (loss) to cash provided by operating activities:		
Depreciation and amortization	13,608	10,406
Non-cash interest expense	585	612
Changes in operating assets and liabilities	(1,338)	(16,463)
Other	(164)	(272)
	<u>          </u>	<u>          </u>
Total adjustments	12,691	(5,717)
	<u>          </u>	<u>          </u>
Net cash provided by operating activities	10,254	1,488
	<u>          </u>	<u>          </u>
Cash flows from investing activities:		
Capital expenditures	(1,034)	(1,828)
Wagering systems expenditures	(8,316)	(5,006)
Increase in other assets and liabilities	(1,592)	(5,124)
	<u>          </u>	<u>          </u>
Net cash used in investing activities	(10,942)	(11,958)
	<u>          </u>	<u>          </u>
Cash flows from financing activities:		
Net borrowings under lines of credit	7,000	4,250
Payments on long-term debt	(1,509)	(2,166)
Proceeds from the issuance of common stock	37	1,163
	<u>          </u>	<u>          </u>
Net cash provided by financing activities	5,528	3,247
	<u>          </u>	<u>          </u>
Effect of exchange rate changes on cash	(974)	(410)
	<u>          </u>	<u>          </u>
Increase (decrease) in cash and cash equivalents	3,866	(7,633)
Cash and cash equivalents, beginning of period	6,488	12,649
	<u>          </u>	<u>          </u>
Cash and cash equivalents, end of period	\$ 10,354	5,016
	<u>          </u>	<u>          </u>
Supplemental disclosure of cash flow information:		
Cash paid (recovered) during the period for:		
Interest paid	\$ 17,647	15,397
	<u>          </u>	<u>          </u>
Net income taxes (recovered) paid	\$ (999)	992

	2001	2002
	_____	_____
	_____	_____

Non-cash financing activity during the period:

Convertible preferred stock paid-in-kind dividends	\$ 1,699	1,803
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See accompanying notes to consolidated financial statements.

**SCIENTIFIC GAMES CORPORATION AND SUBSIDIARIES**

**NOTES TO CONSOLIDATED FINANCIAL STATEMENTS**

**(Unaudited, in thousands, except per share amounts)**

**(1) Consolidated Financial Statements**

*Basis of Presentation*

The consolidated balance sheet as of March 31, 2002 and the consolidated statements of operations for the three months ended March 31, 2001 and 2002, and the consolidated statements of cash flows for the three months then ended, have been prepared by the Company without audit. In the opinion of management, all adjustments necessary to present fairly the financial position of the Company at March 31, 2002 and the results of its operations for the three months ended March 31, 2001 and 2002 and its cash flows for the three months ended March 31, 2001 and 2002 have been made.

Certain information and footnote disclosures normally included in financial statements prepared in accordance with accounting principles generally accepted in the United States of America have been condensed or omitted. These consolidated financial statements should be read in conjunction with the financial statements and notes thereto included in the Company's 2001 Annual Report on Form 10-K. The results of operations for the period ended March 31, 2002 are not necessarily indicative of the operating results for the full year.

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

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

The following represents a reconciliation of the numerator and denominator used in computing basic and diluted net income (loss) per share for the three months ended March 31, 2001 and 2002:

	<b>Three Months Ended March 31,</b>	
	2001	2002
	_____	_____
<b>Income (loss) (numerator)</b>		
Net income (loss)	\$ (2,437)	7,205
Convertible preferred stock paid-in-kind dividend	1,699	1,803
	_____	_____
Net income (loss) available to common stockholders basic	(4,136)	5,402
Add back convertible preferred stock paid-in-kind dividend(1)		1,803
	_____	_____
Net income (loss) available to common stockholders diluted	\$ (4,136)	7,205
	_____	_____

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	Three Months Ended March 31,	
<b>Shares (denominator)</b>		
Basic weighted average common shares outstanding	40,163	42,067
Effect of diluted securities-stock options, warrants, convertible preferred shares and deferred shares(2)		29,658
Diluted weighted average common shares outstanding	40,163	71,725
<b>Basic and diluted per share amount</b>		
Basic net income (loss) available to common stockholders	\$ (0.10)	0.13
Diluted net income (loss) available to common stockholders(2)	\$ (0.10)	0.10

- (1) Convertible preferred stock paid-in-kind dividend is not included in the calculation of diluted net income per share in the three months ended March 31, 2002 since the preferred stock is assumed to have been converted.
- (2) Potential common shares are not included in the calculation of dilutive net loss per share in the three months ended March 31, 2001 since the inclusion would be anti-dilutive.

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At March 31, 2001 and 2002, the Company had outstanding stock options, warrants, Performance Accelerated Restricted Stock Units, convertible preferred stock and deferred shares, which could potentially dilute basic earnings per share in the future. (See Notes 13 and 14 to the Consolidated Financial Statements for the year ended December 31, 2001 in the Company's 2001 Annual Report on Form 10-K.)

**(2) Business Segments**

The following tables represent revenues, profits, depreciation and capital expenditures for the three months ended March 31, 2001 and 2002 and assets at March 31, 2001 and 2002, by business segment. Corporate expenses, interest expense and other (income) deductions are not allocated to business segments.

**Three Months Ended March 31, 2001**

	Lottery Group	Pari-Mutuel Group	Venue Management Group	Telecom- munications Products Group	Totals
(unaudited, in thousands)					
Service revenues	\$ 53,203	19,333	15,504		88,040
Sales revenues	2,914	9,674		11,480	24,068
<b>Total revenues</b>	<b>56,117</b>	<b>29,007</b>	<b>15,504</b>	<b>11,480</b>	<b>112,108</b>
Cost of service	35,715	11,375	11,023		58,113
Cost of sales	2,126	6,000		6,581	14,707
Amortization of service contract software (note 1)	339	553			892

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Three Months Ended March 31, 2001

Total operating expenses	38,180	17,928	11,023	6,581	73,712
Gross profit	17,937	11,079	4,481	4,899	38,396
Selling, general and administrative expenses	6,893	2,693	682	1,370	11,638
Depreciation and amortization	8,244	3,218	655	523	12,640
Segment operating income	2,800	5,168	3,144	3,006	14,118
Unallocated corporate expense					3,063
Consolidated operating income	\$				11,055
Assets at March 31, 2001	\$ 329,104	232,992	33,827	34,108	630,031
Assets at December 31, 2001	\$ 306,127	226,650	32,977	36,198	601,952
Capital and wagering systems expenditures	\$ 7,469	975	363	543	9,350

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Three Months Ended March 31, 2002

	Lottery Group	Pari-Mutuel Group	Venue Management Group	Telecommunications Products Group	Totals
(unaudited, in thousands)					
Service revenues	\$ 58,078	19,637	14,801		92,516
Sales revenues	1,941	1,397	343	10,775	14,456
Total revenues	60,019	21,034	15,144	10,775	106,972
Cost of service	32,164	10,888	10,209		53,261
Cost of sales	1,483	389	332	7,022	9,226
Amortization of service contract software (note 1)	583	626			1,209
Total operating expenses	34,230	11,903	10,541	7,022	63,696
Gross profit	25,789	9,131	4,603	3,753	43,276
Selling, general and administrative expenses	6,483	1,838	629	1,148	10,098
Depreciation and amortization	5,405	2,809	420	475	9,109
Segment operating income	13,901	4,484	3,554	2,130	24,069
Unallocated corporate expense					4,350
Consolidated operating income	\$				19,719



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Three Months Ended March 31, 2002

Assets at March 31, 2002	\$ 306,823	220,661	34,642	35,002	597,128
Capital and wagering systems expenditures	\$ 4,645	1,341	164	684	6,834

The following table provides a reconciliation of consolidated operating income to the consolidated income (loss) before income tax expense (benefit) and extraordinary items for each period:

	Three Months Ended March 31,	
	2001	2002
Reportable consolidated operating income	\$ 11,055	19,719
Interest expense	13,580	11,451
Other (income) expense	244	(68)
Income (loss) before income tax expense (benefit)	\$ (2,769)	8,336

**(3) Comprehensive Income (Loss)**

*Interest Rate Agreements*

Statement of Financial Accounting Standards No. 133, *Accounting for Derivative Instruments and Hedging Activities* ("SFAS 133"), as amended by SFAS 138, establishes accounting and reporting standards for derivative instruments and hedging activities. It requires entities to record all derivative instruments on the balance sheet at fair value. Changes in the fair value of derivatives are recorded in

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each period in current operations or other comprehensive income (loss), based on whether a derivative is designated as part of a hedge transaction and the type of hedge transaction. The ineffective portion of all hedges is recognized in operations.

Pursuant to the terms of the Company's credit facility, the Company is required to maintain interest rate hedges for a notional amount of not less than \$140,000 for a period of not less than two years. In satisfaction of this requirement, the Company entered into three interest rate swap agreements in November 2000 which obligate the Company to pay a fixed LIBOR rate and entitle the Company to receive a variable LIBOR rate on an aggregate \$140,000 notional amount of debt. The Company has structured these interest rate swap agreements and intends to structure all such future agreements to qualify for hedge accounting pursuant to the provisions of SFAS 133. Accumulated other comprehensive losses resulting from the changes in fair value of the interest rate hedge instruments were \$7,249 and \$5,388 at December 31, 2001 and March 31, 2002, respectively. For the three month periods ended March 31, 2001 and 2002, the Company recorded a \$2,806 charge and a \$1,861 credit, respectively, to other comprehensive income (loss) for the change in fair value of the interest rate hedge instruments.

The following presents a reconciliation of net income (loss) to comprehensive income (loss) for the three months ended March 31, 2001 and 2002:

	Three Months Ended March 31,	
	2001	2002
Net income (loss)	\$ (2,437)	7,205
Other comprehensive income (loss):		
Foreign currency translation	(1,480)	(1,003)

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	<b>Three Months Ended March 31,</b>	
	<u>          </u>	<u>          </u>
Unrealized gain on investments	575	355
Unrealized gain (loss) on interest rate swap agreements	(2,806)	1,861
	<u>          </u>	<u>          </u>
Other comprehensive income (loss)	(3,711)	1,213
	<u>          </u>	<u>          </u>
Comprehensive income (loss)	<b>\$ (6,148)</b>	<b>8,418</b>
	<u>          </u>	<u>          </u>

**(4) Inventories**

Inventories consist of the following:

	<b>December 31, 2001</b>	<b>March 31, 2002</b>
	<u>          </u>	<u>          </u>
Parts and work-in-process	\$ 10,130	9,532
Finished goods	9,417	9,918
	<u>          </u>	<u>          </u>
	<b>\$ 19,547</b>	<b>19,450</b>
	<u>          </u>	<u>          </u>

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

**(5) Debt**

At March 31, 2002, the Company had approximately \$26,664 available for borrowing under the Company's revolving credit facility (the "Facility"). There were approximately \$19,000 of borrowings outstanding under the Facility and approximately \$19,336 in letters of credit were issued under the Facility at March 31, 2002. At December 31, 2001, Scientific Games' available borrowing capacity under the Facility was \$30,960.

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

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

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

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

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We had unamortized goodwill of approximately \$195,255 and unamortized identifiable intangible assets in the amount of approximately \$60,154 at December 31, 2001, all of which were subject to the transition provisions of SFAS 141 and SFAS 142. In connection with the adoption of SFAS 142, we evaluated our intangible assets and determined that our right to operate our Connecticut OTBs and our trade name with net carrying amounts of approximately \$11,681 and \$30,093, respectively, at December 31, 2001, have indefinite useful lives and, accordingly, we ceased amortization as of January 1, 2002. In addition, as required by SFAS 142, we reclassified our employee work force intangible asset with a net carrying value of approximately \$3,170, net of related deferred tax liabilities, to goodwill effective January 1, 2002. Amortization expense of these intangible assets and goodwill was approximately \$15,909 for the year ended December 31, 2001. We also evaluated the remaining useful lives of our intangible assets that will continue to be amortized and have determined that no revision to the useful lives will be required. We completed our initial impairment review of intangible assets with indefinite useful lives during the first quarter of 2002 with no material adjustments to the December 31, 2001 balances for these assets. We expect to complete our initial impairment review of goodwill by the end of the second quarter 2002. Because of the extensive effort needed to comply with adopting SFAS 142, it is not practicable to reasonably estimate whether any transitional impairment losses associated with our goodwill will be required to be recognized.

SFAS 144 addresses financial accounting and reporting for the impairment or disposal of long-lived assets and supersedes Statement No. 121, *Accounting for the Impairment of Long-Lived Assets and for Long-Lived Assets to Be Disposed Of* ("SFAS 121"). However, SFAS 144 retains the fundamental provisions of SFAS 121 for (a) recognition and measurement of the impairment of long-lived assets to be held and used and (b) measurement of long-lived assets to be disposed of by sale. SFAS 144 supersedes the accounting and reporting provisions of APB Opinion No. 30, *Reporting the Results of Operations - Reporting the Effects of Disposal of a Segment of a Business, and Extraordinary, Unusual and Infrequently Occurring Events and Transactions*, for the disposal of a segment of a business. However, SFAS 144 retains the requirement of Opinion 30 to report discontinued operations separately from continuing operations and extends that reporting to a component of an entity that either has been disposed of (by sale, by abandonment, or in distribution to owners) or is classified as held for sale. SFAS 144 also amends ARB No. 51, *Consolidated Financial Statements*, to eliminate the exception to consolidation for a temporarily controlled subsidiary. We adopted SFAS 144 effective January 1, 2002. The adoption of SFAS 144 for long-lived assets held for sale had no material impact on our consolidated financial statements for the first quarter of 2002 because the impairment assessment under SFAS 144 is largely unchanged from SFAS 121. The provisions of this statement for assets held for sale or other disposal generally are required to be applied prospectively after the adoption date to newly initiated disposal activities and therefore, will depend on future actions initiated by management. As a result, we cannot determine the potential effects that adoption of SFAS 144 will have on our financial statements with respect to future disposal decisions, if any.

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

Intangible Assets	Weighted Average Amortization Period	Gross Carrying Amount	Accumulated Amortization	Net Balance
<b>Balance at December 31, 2001</b>				
Amortizable intangible assets:				
Patents	15	\$ 900	79	821
Customer lists	14	14,600	2,324	12,276
Employee work force	5	7,200	1,917	5,283

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Intangible Assets	Weighted Average Amortization Period	Gross Carrying Amount	Accumulated Amortization	Net Balance
Trade name	20	32,200	2,107	30,093
Connecticut off-track betting system operating rights	20	20,000	8,319	11,681
Total intangible assets		\$ 74,900	14,746	60,154
<b>Balance at March 31, 2002</b>				
Amortizable intangible assets:				
Patents	15	\$ 900	94	806
Customer lists	14	14,600	2,695	11,905
		15,500	2,789	12,711
Non-amortizable intangible assets:				
Trade name		32,200	2,107	30,093
Connecticut off-track betting system operating right		22,327	8,319	14,008
		54,527	10,426	44,101
Total intangible assets		\$ 70,027	13,215	56,812

The aggregate intangible amortization expense for the three-month period ended March 31, 2002 was approximately \$386. The estimated intangible asset amortization expense for the year ending December 31, 2002 and for each of the subsequent four years ending December 31, 2006 are \$1,765, \$1,765, \$1,480, \$732 and \$445, respectively.

The table below reconciles the change in the carrying amount of goodwill, by operating segment, for the period from December 31, 2001 to March 31, 2002. The Company recorded a \$3,170 increase in goodwill at January 1, 2002 in connection with the reclassification of employee work force intangible

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assets of \$5,283 less related deferred tax liability of \$2,113 acquired prior to July 1, 2001 that did not meet the criteria for recognition apart from goodwill under SFAS 141.

Goodwill	Lottery Group	Pari-Mutuel Group	Venue Management Group	Telecommunications Products Group	Totals
Balance at December 31, 2001	\$ 192,658	2,597			195,255
Effect of adoption of SFAS 141 and SFAS 142:					
Reclassification of employee workforce intangible asset, net of tax	3,170				3,170
Balance at March 31, 2002	\$ 195,828	2,597			198,425

The following table compares pro forma net income (loss) available to common stockholders for the three months ended March 31, 2001, adjusted to reflect the adoption of SFAS 142 on January 1, 2001, to the reported net income for the three months March 31, 2002:

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	Three Months Ended March 31,	
	2001	2002
	Pro Forma	As Reported
Reported net income (loss)	\$ (2,437)	7,205
Convertible preferred stock paid-in-kind dividend	1,699	1,803
Reported net income (loss) available to common stockholders	(4,136)	5,402
Add back:		
Goodwill and related intangible amortization, net of tax benefit of \$305	2,816	
Adjusted net income (loss) available to common stockholders	\$ (1,320)	5,402
Basic and diluted net income (loss) per share available to common stockholders:		
Basic reported net income (loss) per share	\$ (0.10)	0.13
Diluted reported net income (loss) per share	(0.10)	0.10
Add back:		
Goodwill and related intangible amortization, net of tax benefit	0.07	
Adjusted basic net income (loss) per share	\$ (0.03)	0.13
Adjusted diluted net income (loss) per share	\$ (0.03)	0.10
Weighted average basic shares used in per share calculations	40,163	42,067
Weighted average diluted shares used in per share calculations	40,163	71,725

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**(7) Recent Developments**

On March 19, 2002, we executed a letter of intent to purchase 65% of the equity of Serigrafica Chilena S.A., or SERCHI. The purchase price will be \$3.9 million in cash payable at closing and up to \$4.4 million in cash or stock payable upon the achievement of certain financial performance levels of SERCHI over the next four years. The closing of the transaction is subject to certain conditions, including execution of definitive agreements and completion of due diligence.

On February 26, 2002, the Company executed a letter of intent to acquire MDI Entertainment, Inc. in a stock-for-stock transaction valued at approximately \$26,000. On February 28, 2002, a class action suit on behalf of MDI's public stockholders was filed against multiple parties, including the Company and MDI, to enjoin the proposed acquisition on the grounds that the value of MDI's common stock is in excess of the amount provided for in the Company's letter of intent. On May 8, 2002, the Company and MDI announced that they had mutually and amicably terminated negotiations with respect to that contemplated acquisition. The announcement followed MDI's announcement that it had received a proposal from a third party to acquire a majority interest in MDI for \$3.30 per share in cash. In light of this development, the Company believes that the lawsuit currently pending relating to the now terminated transaction is subject to dismissal.

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

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

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Presented below is condensed consolidating financial information for (i) Scientific Games Corporation (the "Parent Company"), which includes the activities of Scientific Games Management Corporation, (ii) the Guarantor Subsidiaries and (iii) the wholly owned foreign subsidiaries and the non-wholly owned domestic and foreign subsidiaries (the "Non-Guarantor Subsidiaries") as of December 31, 2001 and March 31, 2002 and for the three months ended March 31, 2001 and 2002. The condensed consolidating financial information has been presented to show the nature of assets held, results of operations and cash flows of the Parent Company, Guarantor Subsidiaries and Non-Guarantor Subsidiaries assuming the guarantee structure of the Notes was in effect at the beginning of the periods presented. Separate financial statements for Guarantor Subsidiaries are not presented based on management's determination that they would not provide additional information that is material to investors.

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

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SCIENTIFIC GAMES CORPORATION AND SUBSIDIARIES

SUPPLEMENTAL CONDENSED CONSOLIDATING BALANCE SHEET

December 31, 2001  
(in thousands)

	Parent Company	Guarantor Subsidiaries	Non-Guarantor Subsidiaries	Eliminating Entries	Consolidated
<b>ASSETS</b>					
Cash and cash equivalents	\$ 7,612	(415)	5,452		12,649
Accounts receivable, net		34,322	16,088		50,410
Inventories		16,524	3,558	(535)	19,547
Other current assets	973	9,344	5,190	30	15,537
Property and equipment, net	2,159	156,224	38,822	(417)	196,788
Investment in subsidiaries	265,521			(265,521)	
Goodwill	183	192,658	2,414		195,255
Intangible assets		54,913	5,241		60,154
Other assets	20,378	44,071	6,487	(19,324)	51,612
<b>Total assets</b>	<b>\$ 296,826</b>	<b>507,641</b>	<b>83,252</b>	<b>(285,767)</b>	<b>601,952</b>
<b>LIABILITIES AND STOCKHOLDERS' EQUITY</b>					
Current installments of long-term debt	\$ 9,018	9	410		9,437
Current liabilities	14,999	50,672	19,661	799	86,131
Long-term debt, excluding current installments	429,917	10	371		430,298
Other non-current liabilities	14,221	32,702	4,356	729	52,008
Intercompany balances	(195,407)	169,896	27,154	(1,643)	
Stockholders' equity	24,078	254,352	31,300	(285,652)	24,078
<b>Total liabilities and stockholders' equity</b>	<b>\$ 296,826</b>	<b>507,641</b>	<b>83,252</b>	<b>(285,767)</b>	<b>601,952</b>

SCIENTIFIC GAMES CORPORATION AND SUBSIDIARIES

SUPPLEMENTAL CONDENSED CONSOLIDATING BALANCE SHEET

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March 31, 2002  
(unaudited, in thousands)

	Parent Company	Guarantor Subsidiaries	Non-Guarantor Subsidiaries	Eliminating Entries	Consolidated
<b>ASSETS</b>					
Cash and cash equivalents	\$ 2,443	(1,951)	4,524		5,016
Accounts receivable, net		37,794	14,760		52,554
Inventories		16,143	3,862	(555)	19,450
Other current assets	1,283	10,231	5,948	30	17,492
Property and equipment, net	2,068	154,339	38,730	(416)	194,721
Investment in subsidiaries	287,898			(287,898)	
Goodwill	183	195,828	2,414		198,425
Intangible assets		53,180	3,632		56,812
Other assets	21,805	41,757	5,656	(16,560)	52,658
<b>Total assets</b>	<b>\$ 315,680</b>	<b>507,321</b>	<b>79,526</b>	<b>(305,399)</b>	<b>597,128</b>
<b>LIABILITIES AND STOCKHOLDERS' EQUITY</b>					
Current installments of long-term debt	\$ 9,770	9	395		10,174
Current liabilities	10,127	42,636	19,866	947	73,576
Long-term debt, excluding current installments	431,351	8	274		431,633
Other non-current liabilities	13,765	29,627	4,410	200	48,002
Intercompany balances	(183,076)	163,116	21,751	(1,791)	
Stockholders' equity	33,743	271,925	32,830	(304,755)	33,743
<b>Total liabilities and stockholders' equity</b>	<b>\$ 315,680</b>	<b>507,321</b>	<b>79,526</b>	<b>(305,399)</b>	<b>597,128</b>

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SCIENTIFIC GAMES CORPORATION AND SUBSIDIARIES

SUPPLEMENTAL CONDENSED STATEMENT OF OPERATIONS

Three Months Ended March 31, 2001  
(unaudited, in thousands)

	Parent Company	Guarantor Subsidiaries	Non-Guarantor Subsidiaries	Eliminating Entries	Consolidated
Operating revenues	\$	85,262	31,810	(4,964)	112,108
Operating expenses		54,832	22,908	(4,920)	72,820
Amortization of service contract software (note 1)		892			892
Gross profit		29,538	8,902	(44)	38,396
Selling, general and administrative expenses	2,987	8,476	3,165	(3)	14,625
Depreciation and amortization	76	11,164	1,511	(35)	12,716
<b>Operating income (loss)</b>	<b>(3,063)</b>	<b>9,898</b>	<b>4,226</b>	<b>(6)</b>	<b>11,055</b>
Interest expense	13,556	4	592	(572)	13,580

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	Parent Company	Guarantor Subsidiaries	Non-Guarantor Subsidiaries	Eliminating Entries	Consolidated
Other (income) expense	(49)	(587)	256	624	244
Income (loss) before equity in income of subsidiaries and income taxes	(16,570)	10,481	3,378	(58)	(2,769)
Equity in income of subsidiaries	13,508			(13,508)	
Income tax expense (benefit)	(625)	(836)	1,129		(332)
Net income (loss)	\$ (2,437)	11,317	2,249	(13,566)	(2,437)

SCIENTIFIC GAMES CORPORATION AND SUBSIDIARIES

SUPPLEMENTAL CONDENSED STATEMENT OF OPERATIONS

Three Months Ended March 31, 2002  
(unaudited, in thousands)

	Parent Company	Guarantor Subsidiaries	Non-Guarantor Subsidiaries	Eliminating Entries	Consolidated
Operating revenues	\$	84,114	24,927	(2,069)	106,972
Operating expenses		47,567	16,968	(2,048)	62,487
Amortization of service contract software (note 1)		1,209			1,209
Gross profit		35,338	7,959	(21)	43,276
Selling, general and administrative expenses	4,263	7,609	2,491	(3)	14,360
Depreciation and amortization	87	7,223	1,889	(2)	9,197
Operating income (loss)	(4,350)	20,506	3,579	(16)	19,719
Interest expense	11,295	178	309	(331)	11,451
Other (income) expense	(292)	(379)	327	276	(68)
Income (loss) before equity in income of subsidiaries, and income taxes	(15,353)	20,707	2,943	39	8,336
Equity in income of subsidiaries	22,650			(22,650)	
Income tax expense	92	37	1,002		1,131
Net income	\$ 7,205	20,670	1,941	(22,611)	7,205

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SCIENTIFIC GAMES CORPORATION AND SUBSIDIARIES

SUPPLEMENTAL CONDENSED STATEMENT OF CASH FLOWS

Three Months Ended March 31, 2001  
(unaudited, in thousands)

	Parent Company	Guarantor Subsidiaries	Non-Guarantor Subsidiaries	Eliminating Entries	Consolidated
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Net income (loss)	\$ (2,437)	11,317	2,249	(13,566)	(2,437)
Depreciation and amortization	76	12,056	1,511	(35)	13,608
Equity in income of subsidiaries	(13,508)			13,508	
Non-cash interest expense	585				585
Changes in operating assets and liabilities	(6,004)	4,084	(1,148)	1,730	(1,338)
Other non-cash adjustments	66	(354)	124		(164)
Net cash provided by (used in) operating activities	(21,222)	27,103	2,736	1,637	10,254
Cash flows from investing activities:					
Capital and wagering systems expenditures	(23)	(5,970)	(3,639)	282	(9,350)
Other assets and investments	(427)	(2,416)	1,450	(199)	(1,592)
Net cash used in investing activities	(450)	(8,386)	(2,189)	83	(10,942)
Cash flows from financing activities:					
Net borrowing under lines of credit	7,000				7,000
Payments on long-term debt	(1,314)	(3)	(385)	193	(1,509)
Net proceeds from stock issue	37	50	(50)		37
Other, principally intercompany balances	19,023	(17,476)	366	(1,913)	
Net cash provided by (used in) financing activities	24,746	(17,429)	(69)	(1,720)	5,528
Effect of exchange rate changes on cash		(598)	(376)		(974)
Increase in cash and cash equivalents	3,074	690	102		3,866
Cash and cash equivalents, beginning of period	867	(50)	5,671		6,488
Cash and cash equivalents, end of period	\$ 3,941	640	5,773		10,354

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SCIENTIFIC GAMES CORPORATION AND SUBSIDIARIES

SUPPLEMENTAL CONDENSED STATEMENT OF CASH FLOWS

Three Months Ended March 31, 2002  
(unaudited, in thousands)

	Parent Company	Guarantor Subsidiaries	Non-Guarantor Subsidiaries	Eliminating Entries	Consolidated
Net income	\$ 7,205	20,670	1,941	(22,611)	7,205
Depreciation and amortization	87	8,432	1,889	(2)	10,406
Equity in income of subsidiaries	(22,650)			22,650	

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	<u>Parent Company</u>	<u>Guarantor Subsidiaries</u>	<u>Non-Guarantor Subsidiaries</u>	<u>Eliminating Entries</u>	<u>Consolidated</u>
Non-cash interest expense	612				612
Changes in operating assets and liabilities	(5,182)	(11,909)	438	190	(16,463)
Other non-cash adjustments	(306)	(62)	96		(272)
<b>Net cash provided by (used in) operating activities</b>	<b>(20,234)</b>	<b>17,131</b>	<b>4,364</b>	<b>227</b>	<b>1,488</b>
Cash flows from investing activities:					
Capital and wagering systems expenditures	30	(5,061)	(1,803)		(6,834)
Other assets and investments	(269)	(1,941)	379	(3,293)	(5,124)
<b>Net cash used in investing activities</b>	<b>(239)</b>	<b>(7,002)</b>	<b>(1,424)</b>	<b>(3,293)</b>	<b>(11,958)</b>
Cash flows from financing activities:					
Net borrowing under lines of credit	4,250				4,250
Payments on long-term debt	(2,064)	(2)	(100)		(2,166)
Net proceeds from stock issue	1,163	(3,236)		3,236	1,163
Other, principally intercompany balances	11,955	(8,210)	(3,575)	(170)	
<b>Net cash provided by (used in) financing activities</b>	<b>15,304</b>	<b>(11,448)</b>	<b>(3,675)</b>	<b>3,066</b>	<b>3,247</b>
Effect of exchange rate changes on cash		(217)	(193)		(410)
Decrease in cash and cash equivalents	(5,169)	(1,536)	(928)		(7,633)
Cash and cash equivalents, beginning of period	7,612	(415)	5,452		12,649
<b>Cash and cash equivalents, end of period</b>	<b>\$ 2,443</b>	<b>(1,951)</b>	<b>4,524</b>		<b>5,016</b>

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**MANAGEMENT'S DISCUSSION AND ANALYSIS OF FINANCIAL CONDITION  
AND RESULTS OF OPERATIONS FOR  
THE THREE MONTHS ENDED MARCH 31, 2002**

**Background**

Effective April 27, 2001, we changed our corporate name from Autotote Corporation to Scientific Games Corporation. On January 29, 2002 we transferred the listing of our Class A common stock to the Nasdaq National Market from the American Stock Exchange and changed our trading symbol to "SGMS."

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

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

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

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

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

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

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

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

### Results of Operations

#### Three Months Ended March 31, 2002 compared to Three Months Ended March 31, 2001

##### Three Months Ended March 31, 2001

	Lottery Group	Pari-Mutuel Group	Venue Management Group	Telecom- munications Products Group	Totals
	(unaudited, in thousands)				
Service revenues	\$ 53,203	\$ 19,333	\$ 15,504		\$ 88,040
Sales revenues	2,914	9,674		\$ 11,480	24,068
<b>Total revenues</b>	<b>56,117</b>	<b>29,007</b>	<b>15,504</b>	<b>11,480</b>	<b>112,108</b>
Cost of service	35,715	11,375	11,023		58,113
Cost of sales	2,126	6,000		6,581	14,707
Amortization of service contract software	339	553			892

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Three Months Ended March 31, 2001

Total operating expenses	38,180	17,928	11,023	6,581	73,712
Gross profit	17,937	11,079	4,481	4,899	38,396
Selling, general and administrative expenses	6,893	2,693	682	1,370	11,638
Depreciation and amortization	8,244	3,218	655	523	12,640
Segment operating income	\$ 2,800	\$ 5,168	\$ 3,144	\$ 3,006	\$ 14,118
Unallocated corporate selling, general and administrative costs					\$ 3,063
Consolidated operating income					\$ 11,055
Interest expense					\$ 13,580

Three Months Ended March 31, 2002

	Lottery Group	Pari-Mutuel Group	Venue Management Group	Telecommunications Products Group	Totals
(unaudited, in thousands)					
Service revenues	\$ 58,078	\$ 19,637	\$ 14,801		\$ 92,516
Sales revenues	1,941	1,397	343	\$ 10,775	14,456
Total revenues	60,019	21,034	15,144	10,775	106,972
Cost of service	32,164	10,888	10,209		53,261
Cost of sales	1,483	389	332	7,022	9,226
Amortization of service contract software	583	626			1,209
Total operating expenses	34,230	11,903	10,541	7,022	63,696
Gross profit	25,789	9,131	4,603	3,753	43,276
Selling, general and administrative expenses	6,483	1,838	629	1,148	10,098
Depreciation and amortization	5,405	2,809	420	475	9,109
Segment operating income	\$ 13,901	\$ 4,484	\$ 3,554	\$ 2,130	\$ 24,069
Unallocated corporate selling, general and administrative costs					\$ 4,350
Consolidated operating income					\$ 19,719
Interest expense					\$ 11,451

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The tables above reflect the reclassification of "amortization of service contract software" as a component of operating expenses, which amounts had been included in depreciation and amortization in previous filings.

### *Revenue Analysis*

Lottery Group revenue of \$60.0 million in the three months ended March 31, 2002 improved \$3.9 million from the same period in 2001. A \$4.9 million increase in service revenue is attributable to: an incremental \$4.5 million growth in our on-line lottery business due to the start-up of the on-line lotteries in Maine and Iowa in July 2001 and the start-up of the South Carolina Educational Lottery in January 2002, \$1.2 million growth in our instant ticket lottery business due primarily to the start-up of the South Carolina Educational Lottery in December 2001, and \$1.5 million growth in our cooperative lottery services business. These increases were partially offset by a \$2.3 million decrease resulting from the absence of revenue from the French lottery business that was sold in the second quarter of 2001 and a \$1.0 million reduction in lottery equipment sales.

Pari-mutuel Group service revenue of \$19.6 million in the three months ended March 31, 2002 increased \$0.3 million from the same period in 2001 as revenue improvements in North American racing operations, NASRIN services and simulcasting services were partially offset by lower revenues in the French operations and the effect of the lower revenues in the German racing operations due to lower simulcasting services and the unfavorable impact of Euro exchange rates on revenues. Sales revenue of \$1.4 million in the three months ended March 31, 2002 decreased \$8.3 million from the same period in 2001 due to completion in 2001 of a system and terminals sale to our customer in Turkey and non-recurring sales of terminals in 2001 to other foreign customers.

Venue Management Group service revenue of \$14.8 million in the three months ended March 31, 2002 was \$0.7 million lower than in the same period in 2001, primarily reflecting lower Handle related revenue in the Connecticut OTB operations following the closing of the Milford jai-alai fronton.

Telecommunications Products Group sales revenue of \$10.8 million in the three months ended March 31, 2002 was \$0.7 million lower than in the same period in 2001, reflecting continued competitive price reductions which offset a 23% growth in the volume of tickets produced.

### *Gross Profit Analysis*

Gross profit of \$43.3 million in the three months ended March 31, 2002 increased \$4.9 million from the same period in 2001. This increase included \$9.0 million in improved gross margins in the service businesses that resulted primarily from the new lotteries, and higher cooperative services revenues and North American pari-mutuel revenues. These improvements were partially offset by a \$4.1 million decrease in gross profit reflecting the reduced sales of equipment and systems to foreign customers and the price related margin reductions in the Telecommunications Products Group.

The Lottery Group gross profit of \$25.8 million, or 43% of revenues, increased \$7.9 million in the three months ended March 31, 2002 from \$17.9 million, or 32% of revenues, in the same period in 2001. Gross margin improvements were realized as a result of the additions of the Maine and Iowa on-line lotteries in July 2001 and the start-up of the South Carolina Educational lotteries in December 2001 and January 2002, growth in cooperative services revenues, and cost reductions in instant ticket printing. These margin improvements were partially offset by a reduction in margins due to lower lottery equipment sales and the sale of the French lottery business in the second quarter of 2001.

Pari-mutuel Group gross profit of \$9.1 million, or 43% of revenues, in the three months ended March 31, 2002, decreased \$1.9 million from \$11.1 million, or 38% of revenues, in the same period in 2001. Of such margin reduction, \$2.7 million, primarily attributable to lower systems and equipment

sales to foreign customers, was partially offset by \$0.8 million in margin improvements on continued growth of the North American operations and the benefits from on-going cost reduction programs.

Venue Management Group gross profit of \$4.6 million, or 30% of revenues, in the three months ended March 31, 2002, increased \$0.1 million from \$4.5 million, or 29% of revenues, in the same period in 2001. This improvement primarily reflects the effect of the new operating agreement in The Netherlands, partially offset by Handle-related margin reductions due to the closing of a jai alai fronton in Connecticut.

The Telecommunications Products Group gross profit of \$3.8 million, or 35% of revenues, in the three months ended March 31, 2002 decreased \$1.1 million from \$4.9 million, or 43% of revenues, in the same period in 2001 as a 23% increase in sales volume was offset by

continued competitive price reductions.

#### *Expense Analysis*

Selling, general and administrative expenses of \$14.4 million in the three months ended March 31, 2002 were \$0.2 million lower than in the same period in 2001 primarily as a result of the sale of the French lottery business in the second quarter of 2001.

Depreciation and amortization expense, including amortization of service contract software, of \$10.4 million in the three months ended March 31, 2002 decreased \$3.2 million from \$13.6 million in the same period in 2001. Depreciation expense was \$0.1 million higher in the three months ended March 31, 2002 than in the same period in 2001, primarily as a result of higher depreciation on new computer systems and terminals acquired in connection with the start-up of the new on-line and instant ticket lotteries. Amortization expense was \$3.3 million lower in the three months ended March 31, 2002 than in the same period in 2001, primarily as a result of the adoption of SFAS 141 and SFAS 142 effective January 1, 2002, and the July 1, 2001 reclassifications of previously estimated acquired intangible assets which were made as a result of the finalization of the SGHC purchase price allocation.

Interest expense of \$11.5 million in the three months ended March 31, 2002 decreased \$2.1 million from \$13.6 million in the same period in 2001 as a result of lower average outstanding debt levels and lower average interest rates.

#### *Income Tax Expense (Benefit)*

Income tax expense was \$1.1 million in the three months ended March 31, 2002. The expense primarily reflects foreign and state taxes, partially offset by a \$0.4 million reversal of deferred taxes provided in connection with the acquisition of SGHC. The income tax benefit of \$0.3 million in the three months ended March 31, 2001 primarily reflects a \$1.1 million reversal of deferred taxes provided in connection with the acquisition of SGHC and an anticipated recovery of previously paid federal taxes, partially offset by federal alternative minimum tax, state taxes and foreign taxes. The deferred tax benefit was reduced in the three months ended March 31, 2002, reflecting the above-mentioned changes in accounting for acquired intangible assets. No current tax benefit has been recognized on domestic operating losses in either period.

#### **Liquidity, Capital Resources and Working Capital**

In order to finance the acquisition of SGHC and refinance substantially all of our then existing indebtedness, we conducted a series of financings in September 2000. As a result, our capital structure changed significantly and, among other things, we are a significantly leveraged company. As a result of the acquisition and debt refinancing, we have total indebtedness including capital lease obligations outstanding of approximately \$441.8 million at March 31, 2002 and had total indebtedness of \$439.7 million at December 31, 2001. We have also recorded a substantial increase in 2000 in goodwill

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and other intangible assets in connection with the SGHC acquisition and a corresponding increase in amortization expense through December 31, 2001.

Our financing arrangements impose certain limitations on our and our subsidiaries' operations, including, at March 31, 2002, the maintenance of a Minimum Fixed Charge Coverage Ratio, as defined in the credit agreement governing our senior credit facilities, of 1.40; a Maximum Consolidated Leverage Ratio, as so defined, of 4.50; a Minimum Interest Coverage Ratio, as so defined, of 2.00; and Minimum Consolidated Net Worth, as so defined, of \$42.8 million. Each of these financial tests will become progressively more stringent during the term of the credit agreement. In addition, our financing arrangements also restrict our and certain of our subsidiaries' ability to finance future operations or capital needs or to engage in other business activities, by, among other things, limiting our ability to incur additional indebtedness, pay dividends, redeem capital stock, make certain investments, engage in sale-leaseback transactions, consummate certain asset sales, and create certain liens and other encumbrances on our assets. In March 2001, as a result of the financial performance of SGHC prior to its acquisition by us, certain transitional and operational matters occurring through December 31, 2000, and the timing of certain anticipated capital expenditures and associated borrowings in 2001, management and our lenders amended certain limitations to be less restrictive. Among other changes, the credit facility was modified so that the planned step-downs in fixed charge coverage ratios and leverage ratios were delayed by up to nine months through September 30, 2002. While we were in compliance with these covenants at March 31, 2002 and expect to continue to remain in compliance over the next 12 months, no assurances can be provided that we will be able to do so or that we will be able to continue to meet the covenant requirements beyond 12 months.

Our contractual obligations and commercial commitments principally include obligations associated with our outstanding indebtedness and future minimum lease obligations, and they have not changed materially since December 31, 2001.

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Our revolving credit facility, which expires in September 2006, provides for borrowings up to \$65.0 million to be used for working capital and general corporate purpose loans and for letters of credit. At March 31, 2002, we had outstanding borrowings of \$19.0 million and outstanding letters of credit of \$19.3 million under this facility leaving us with a total availability of \$26.7 million as compared to \$31.0 million at December 31, 2001. Our ability to continue to borrow under the revolving credit facility will depend on remaining in compliance with the limitations imposed by our lenders, including maintenance of specified financial covenants. Presently, we have not sought and, therefore, do not have any other financing commitments.

Our convertible preferred stock requires dividend payments at a rate of 6% per annum. To date, we have satisfied the dividend requirement using additional shares of preferred stock. The terms of the convertible preferred stock provide us with the flexibility to satisfy the dividend in cash commencing on September 30, 2002, the date of the ninth quarterly dividend, subject to bank approval. We expect that we will continue to make such payments in-kind; accordingly, this obligation has not been reflected in the table above.

Our pari-mutuel wagering and on-line lottery systems service contracts require us to, among other things, maintain the central computing system and related hardware in efficient working order, provide added software functionality upon request, provide on-site computer operators, and furnish necessary supplies. Our primary expenditures associated with these services are personnel and related costs which are expensed as incurred and are included in Operating Expenses Services in the consolidated statements of operations. Historically, the revenues we derive from our service contracts have exceeded the direct costs associated with fulfilling our obligations under these pari-mutuel wagering and lottery systems service contracts. We expect that we will continue to realize positive cash flow and operating income as we extend or renew existing service contracts. We also expect that we will enter into new contracts that are accretive to our cash flow. In addition, through advancements in technology, we are

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continually deploying more efficient and cost effective methods for manufacturing and delivering our products and services to our customers. We expect that technological efficiencies will continue to positively impact our future cash flows and operating results. We are not party to any other material short term or long term obligations or commitments pursuant to these service contracts.

Periodically, we bid on new pari-mutuel and on-line lottery contracts. Once awarded, these contracts generally require significant up-front capital expenditures for terminal assembly, customization of software, software and equipment installation and telecommunications configuration. Historically we have funded these up front costs through cash flows generated from operations, available cash on hand and borrowings under our credit facilities. Our ability to continue to procure new contracts will depend on, among other things, our then present liquidity levels and/or our ability to obtain additional financing at commercially acceptable rates to finance the initial up front costs. Once operational, long term service contracts have been accretive to our operating cash flow. For fiscal 2002, we anticipate that capital expenditures and software expenditures will be approximately \$27 million. However, the actual level of expenditures will ultimately depend on the extent to which we are successful in winning new contracts. The amount of capital expenditures in fiscal 2003 and beyond will largely depend on the extent to which we are successful in winning new contracts. Furthermore, our pari-mutuel wagering network consists of approximately 26,000 wagering terminals. Periodically, we elect to upgrade the technological capabilities of older terminals and replace terminals that have exhausted their useful lives. We presently have no commitments to replace our existing terminal base and our obligation to upgrade the terminals is discretionary. Servicing our installed terminal base requires that we maintain a supply of parts and accessories on hand. We are also required, contractually in some cases, to provide spare parts over an extended period of time, principally in connection with our systems and terminal sale transactions. To meet our contractual obligations and maintain sufficient levels of on-hand inventory quantities to service our installed base, we purchase inventory on an as needed basis. We presently have no inventory purchase obligations. Our terminal and software license sales generally reflect a limited number of large transactions, which do not recur on an annual basis. Consequently, the timing of these transactions could impact our short term liquidity as we acquire inventory in anticipation of fulfilling our orders and collect on the resulting receivables.

At March 31, 2002, our available cash and borrowing capacity totaled \$31.7 million compared to \$43.6 million at December 31, 2001. Our available cash and borrowing capacities fluctuate principally based on the timing of collections from our customers, cash expenditures associated with new and existing pari-mutuel wagering and lottery systems contracts, repayment of our outstanding debt and changes in our working capital position. The decrease in our available cash and borrowing capacity from the levels at December 31, 2001 principally reflects the use of cash on hand to partially fund our wagering systems and other capital expenditures, to reduce accounts payable and accrued liabilities and to make a semi-annual payment of interest accrued on our 12<sup>1</sup>/<sub>2</sub>% Senior Subordinated Notes.

Net cash provided by operating activities was \$1.5 million for the three months ended March 31, 2002. Of this amount, \$7.2 million was provided from operations and \$16.5 million was used as a result of changes in working capital. The working capital changes occurred principally from (i) increases in accounts receivables due to the new on-line and instant ticket lottery customers and the timing of collections as compared to year-end, (ii) decreases in accounts payable and accrued liabilities due to payments related to the new lottery accounts and obligations incurred in connection with the acquisition of SGHC, and (iii) a decrease in accrued interest as the result of the semi-annual interest payment on the 12<sup>1</sup>/<sub>2</sub>% Senior Subordinated Notes. In this period, we invested \$6.8 million for wagering systems and capital expenditures, \$5.1 million in

software expenditures and other investments, and repaid \$2.2 million on long-term debt. These cash expenditures were funded primarily with net cash provided by operating activities, cash on hand, \$4.3 million of borrowings under our revolving credit facility and \$1.2 million proceeds from the issuance of common stock.

A significant portion of our cash flows from operations must be used to pay our interest expense and repay our indebtedness, which will reduce the funds that would otherwise be available to us for our operations and capital expenditures. Interest expense on our outstanding debt was approximately \$11.5 million for the three months ended March 31, 2002 including approximately \$0.6 million of non-cash charges. Approximately one-third of our debt is in variable rate instruments. Consequently, we are exposed to fluctuations in interest rates. The effect of a 0.125% change in the interest rates associated with our unhedged variable rate debt will result in a change of approximately \$187,000 per year in our interest expense assuming no change in our outstanding borrowings. To reduce the risks associated with fluctuations in the market interest rates and in response to the requirements of our credit facility, we entered into three interest rate swap contracts for an aggregate notional amount of \$140 million. These interest rate swaps obligate us to pay a fixed LIBOR rate and entitle us to receive a variable LIBOR rate on an aggregate \$140 million notional amount of debt thereby creating the equivalent of fixed rate debt until May 30, 2003. We have structured these interest rate swap agreements and we intend to structure future interest rate swap agreements to qualify for hedge accounting pursuant to the provisions of SFAS 133. Changes in the fair value of interest rate swaps designated as hedging instruments that effectively offset the variability of cash flows associated with variable rate credit facility obligations are reported as a component of stockholders' equity. These amounts are subsequently reclassified into interest expense as a yield adjustment of the hedged credit facility obligation in the same period in which the related interest affects operations.

We believe that our cash flow from operations, available cash and available borrowing capacity under our revolving credit facility will be sufficient to meet our liquidity needs, including anticipated capital expenditures, for the foreseeable future; however, we cannot assure you that this will be the case. While we are not aware of any particular trends, our lottery contracts periodically renew and we cannot assure you that we will be successful in sustaining our cash flow from operations through renewal of our existing contracts or through the addition of new contracts. In addition, lottery customers in the United States generally require service providers to provide performance bonds in connection with each state contract. Because of financial and economic events that have occurred this past year, such as the September 11 attack, the bond market is experiencing unusual contraction, and we cannot assure you that we will continue to be able to obtain performance bonds on commercially reasonable terms or at all. While we are not aware of any reason to do so, if we need to refinance all or part of our indebtedness, including our 12<sup>1</sup>/<sub>2</sub>% Senior Subordinated Notes, on or before their maturity, or provide letters of credit or cash in lieu of performance bonds, we cannot assure you that we will be able to obtain new financing or to refinance any of our indebtedness, including our revolving credit facility and our 12<sup>1</sup>/<sub>2</sub>% Senior Subordinated Notes, on commercially reasonable terms or at all.

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

Throughout this Quarterly Report on Form 10-Q we make "forward-looking statements" within the meaning of the United States Private Securities Litigation Reform Act of 1995. In some cases, forward-looking statements can be identified by the use of forward-looking terminology such as "may," "will," "estimate," "intend," "continue," "believe," "except" or "anticipate," or the negatives thereof, variations thereon or similar terminology. The forward-looking statements contained in this Quarterly Report on Form 10-Q are generally located in the material set forth under the heading "Management's Discussion and Analysis of Financial Condition and Results of Operations" but may be found in other locations as well. These forward-looking statements generally relate to plans and objectives for future operations and are based upon management's reasonable estimates of future results or trends. Although we believe that the plans and objectives reflected in or suggested by such forward-looking statements are reasonable, such plans or objectives may not be achieved.

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

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



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

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

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

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

an inability to renew or early termination of our contracts;

an inability to engage in future acquisitions;

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

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

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

### Impact of Recently Issued Accounting Standards

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

In April 2002, the FASB issued Statement No. 145, *Rescission of FASB Statements No. 4, 44 and 64, Amendment of FASB Statement No. 13, and Technical Corrections* ("SFAS 145"). SFAS 145 updates, clarifies and simplifies existing accounting pronouncements. SFAS 145 rescinds Statement 4, which required all gains and losses from extinguishment of debt to be aggregated and, if material, classified as an extraordinary item, net of related income tax effect. As a result, the criteria in Opinion 30 will now be used to classify those gains and losses because Statement 4 has been rescinded. Statement 44 was issued to establish accounting requirements for the effects of transition to the provisions of the Motor Carrier Act of 1980. Because the transition has been completed, Statement 44 is no longer necessary.

SFAS 145 amends Statement 13 to require that certain lease modifications that have economic effects similar to sale-leaseback transactions be accounted for in the same manner as sale-leaseback transactions. This amendment is consistent with the FASB's goal of requiring similar accounting treatment for transactions that have similar economic effects. SFAS 145 also makes technical

corrections to existing pronouncements. While those corrections are not substantive in nature, in some instances, they may change accounting practice. We are required to adopt SFAS 145, effective for calendar year 2003. We do not expect the adoption of SFAS 145 to have a material impact on our future consolidated operations or financial position, as we are now constituted.

### Recent Developments

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On June 5, 2002, we completed the purchase of 65% of the equity of Serigrafica Chilena S.A., or SERCHI. The purchase price was \$3.9 million, paid at closing, plus up to \$4.4 million in cash or stock payable upon the achievement of certain financial performance levels of SERCHI over the next four years.

On February 26, 2002, we executed a letter of intent to acquire MDI Entertainment, Inc. in a stock-for-stock transaction valued at approximately \$26 million. On February 28, 2002, a class action suit on behalf of MDI's public stockholders was filed against multiple parties, including us and MDI, to enjoin the proposed acquisition on the grounds that the value of MDI's common stock is in excess of the amount provided for in our letter of intent. On May 8, 2002, we and MDI announced that we had mutually and amicably terminated negotiations with respect to that contemplated acquisition. The announcement followed MDI's announcement that it had received a proposal from a third party to acquire a majority interest in MDI for \$3.30 per share in cash. In light of this development, we believe that the lawsuit currently pending relating to our now terminated transaction is subject to dismissal.

### QUANTITATIVE AND QUALITATIVE DISCLOSURES ABOUT MARKET RISK

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

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

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

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

In the normal course of business, we are exposed to fluctuations in interest rates and equity market risks as we seek debt and equity capital to sustain our operations. At December 31, 2001, approximately one-third of our debt was in fixed rate instruments. We consider the fair value of all financial instruments to be not materially different from their carrying value at year-end. The following

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table provides information about our financial instruments that are sensitive to changes in interest rates. The table presents principal cash flows and related weighted-average interest rates by expected maturity dates.

**Principal Amount By Expected Maturity Average Interest Rate**  
**Expected Maturity Date (Dollars in Thousands)**  
**March 31, 2002**

	<u>2002</u>	<u>2003</u>	<u>2004</u>	<u>2005</u>	<u>2006</u>	<u>There</u> <u>After</u>	<u>Total</u>	<u>Fair</u> <u>Value</u>
Long-term debt:								
Fixed interest rate	\$					150,000	150,000	165,000
Interest rate						12.5%	12.5%	
Variable interest rate	\$	6,900	11,950	14,950	17,200	83,600	155,100	289,700
Average interest rate		5.50%	5.45%	5.41%	5.39%	5.90%	6.27%	6.05%

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In November 2000, to reduce the risks associated with fluctuations in market interest rates and in response to requirements in the Facility (see Note 9 to the Consolidated Financial Statements for the year ended December 31, 2001 in our 2001 Annual Report on Form 10-K), we entered into three interest rate swap contracts for an aggregate notional amount of \$140,000. The following table provides information about our derivative financial instruments. The table presents notional amounts and weighted-average swap rates by contractual maturity dates. We do not hold any market risk instruments for trading purposes.

**Notional Amount By Expected Maturity Average Swap Rate**  
**Expected Maturity Date (Dollars in Thousands)**  
**March 31, 2002**

	<u>2002</u>	<u>2003</u>	<u>2004</u>	<u>2005</u>	<u>2006</u>	<u>There After</u>	<u>Total</u>	<u>Fair Value</u>
Interest rate swaps:								
Fixed to variable	\$	140,000					140,000	134,612
Receive 3-month LIBOR		6.52%					6.52%	

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

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

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## PART II. OTHER INFORMATION

### Item 1. Legal Proceedings

No significant changes have occurred with respect to legal proceedings as disclosed in Part I, Item 3, of our 2001 Annual Report on Form 10-K, except as follows:

On February 26, 2002, the Company executed a letter of intent to acquire MDI Entertainment, Inc. in a stock-for-stock transaction valued at approximately \$26,000. On February 28, 2002, a class action suit on behalf of MDI's public stockholders was filed against multiple parties, including the Company and MDI, to enjoin the proposed acquisition on the grounds that the value of MDI's common stock is in excess of the amount provided for in the Company's letter of intent. On May 8, 2002, the Company and MDI announced that they had mutually and amicably terminated negotiations with respect to that contemplated acquisition. The announcement followed MDI's announcement that it had received a proposal from a third party to acquire a majority interest in MDI for \$3.30 per share in cash. In light of this development, the Company believes that the lawsuit currently pending relating to the now terminated transaction is subject to dismissal.

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

None.

### Item 3. Defaults Upon Senior Securities

None.

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

None.

**Item 5. Other Information**

None.

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

- (a) Exhibits  
None
- (b) Reports on Form 8-K

A current report on Form 8-K was filed on March 4, 2002, regarding the February 26, 2002 letter of intent we executed with MDI Entertainment, Inc. to acquire MDI in a stock-for-stock transaction valued at approximately \$26 million.

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**SIGNATURES**

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

SCIENTIFIC GAMES CORPORATION  
(Registrant)

By: /s/ DEWAYNE E. LAIRD

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

Dated: June 10, 2002

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