

ALLIANCE GAMING CORP  
Form 10-Q  
November 09, 2004

**UNITED STATES**  
**SECURITIES AND EXCHANGE COMMISSION**

Washington, D.C. 20549

**FORM 10-Q**

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

**For the quarterly period ended September 30, 2004**

**OR**

o

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

**For the transition period from      to**

**Commission File Number 0-4281**

**ALLIANCE GAMING CORPORATION**

(Exact name of registrant as specified in its charter)

**NEVADA**  
(State or other jurisdiction of  
incorporation or organization)

**88-0104066**  
(I.R.S. Employer  
Identification No.)

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**6601 S. Bermuda Rd.**  
**Las Vegas, Nevada**  
(Address of principal executive offices)

**89119**  
(Zip Code)

Registrant's telephone number: **(702) 270-7600**

**Registrant's internet: [www.alliancegaming.com](http://www.alliancegaming.com)**

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

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  No

The number of shares of Common Stock, \$0.10 par value, outstanding as of October 1, 2004, according to the records of the registrant's registrar and transfer agent was 51,044,000.

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## PART I

## ALLIANCE GAMING CORPORATION AND SUBSIDIARIES

## UNAUDITED CONDENSED CONSOLIDATED BALANCE SHEETS

(In 000s except share amounts)

|  | June 30,           |            |
|--|--------------------|------------|
|  | September 30, 2004 | 2004       |
| <b>ASSETS</b>  |                    |            |
| Current assets:  |                    |            |
| Cash and cash equivalents  | \$ 43,229          | \$ 172,726 |
| Accounts and notes receivable, net of allowance for doubtful accounts of \$12,342 and \$9,722                                    | 110,100            | 129,779    |
| Inventories, net of reserves of \$7,086 and \$4,914  | 81,466             | 61,135     |
| Deferred tax assets, net   | 20,053             | 20,054     |
| Other current assets   | 22,264             | 12,420     |
| Total current assets   | 277,112            | 396,114    |
| Long-term investments (restricted)   | 4,676              | 2,528      |
| Long-term receivables, net   | 21,340             | 12,518     |
| Net investment in leases   | 8,308              | 5,614      |
| Leased gaming equipment, net of accumulated depreciation of \$36,081 and \$31,105  | 47,138             | 46,634     |
| Property, plant and equipment, net of accumulated depreciation and amortization of \$27,371 and \$23,127                         | 76,694             | 75,838     |
| Goodwill, net  | 136,764            | 136,989    |
| Intangible assets, net of accumulated amortization of \$14,532 and \$12,489  | 61,990             | 63,623     |
| Assets of discontinued operations held for sale  | 4,432              | 4,442      |
| Other assets, net  | 6,365              | 6,354      |
| Total assets   | \$ 644,819         | \$ 750,654 |
| <b>LIABILITIES AND STOCKHOLDERS EQUITY</b>   |                    |            |
| Current liabilities:   |                    |            |
| Accounts payable   | \$ 46,654          | \$ 37,515  |
| Accrued liabilities  | 61,487             | 51,469     |
| Jackpot liabilities  | 9,447              | 12,075     |
| Income taxes payable   | 420                | 7,233      |
| Current maturities of long-term debt   | 14,662             | 5,866      |
| Liabilities of discontinued operations held for sale   | 1,229              | 4,337      |
| Total current liabilities  | 133,899            | 118,495    |
| Long-term debt, net  | 311,195            | 423,089    |
| Deferred tax liabilities   | 850                | 849        |
| Other liabilities  | 7,029              | 6,092      |
| Minority interest  | 1,298              | 1,326      |
| Total liabilities  | 454,271            | 549,851    |
| Commitments and contingencies  |                    |            |
| Stockholders' equity:  |                    |            |
| Special stock, 10,000,000 shares authorized; Series E, \$100 liquidation value; 115 shares and 115 shares issued and outstanding | 12                 | 12         |
| Common stock, \$.10 par value; 100,000,000 shares authorized; 51,530,000 and 51,426,000 shares issued                            | 5,156              | 5,145      |
| Treasury stock at cost, 536,900 and 525,000 shares   | (665)              | (501)      |
| Deferred compensation (restricted stock units)   | (6,500)            | (6,500)    |
| Additional paid-in capital   | 194,902            | 194,040    |
| Accumulated other comprehensive income   | 1,356              | 1,524      |
| Retained earnings (accumulated deficit)  | (3,713)            | 7,083      |
| Total stockholders' equity   | 190,548            | 200,803    |
| Total liabilities and stockholders' equity   | \$ 644,819         | \$ 750,654 |

See accompanying notes to unaudited condensed consolidated financial statements.

## ALLIANCE GAMING CORPORATION AND SUBSIDIARIES

## UNAUDITED CONDENSED CONSOLIDATED STATEMENTS OF OPERATIONS

(In 000s, except per share amounts)

|  | Three Months Ended September 30, |           |
|--|----------------------------------|-----------|
|  | 2004                             | 2003      |
| <b>Revenues:</b>   |                                  |           |
| Gaming equipment and systems                                     | \$ 104,077                       | \$ 88,468 |
| Casino operations  | 12,836                           | 12,755    |
|  | 116,913                          | 101,223   |
| <b>Costs and expenses:</b>                                       |                                  |           |
| Cost of gaming equipment and systems                             | 50,836                           | 33,237    |
| Cost of casino operations  | 4,802                            | 5,003     |
| Selling, general and administrative                              | 43,655                           | 29,065    |
| Research and development costs                                   | 11,772                           | 5,963     |
| Restructuring charge   | 1,435                            |           |
| Depreciation and amortization                                    | 10,841                           | 6,022     |
|  | 123,341                          | 79,290    |
| Operating income (loss)  | (6,428)                          | 21,933    |
| <b>Other income (expense):</b>                                   |                                  |           |
| Interest income  | 480                              | 43        |
| Interest expense   | (3,962)                          | (5,729)   |
| Minority interest  | (499)                            | (486)     |
| Refinancing charge   |                                  | (12,293)  |
| Other, net   | 153                              | (354)     |
| Income (loss) from continuing operations before income taxes     | (10,256)                         | 3,114     |
| Income tax expense (benefit)                                     | (3,851)                          | 1,266     |
| Income (loss) from continuing operations                         | (6,405)                          | 1,848     |
| <b>Discontinued operations:</b>                                  |                                  |           |
| Income (loss) from discontinued operations of Nevada Route, net  | (4,701)                          | 3,132     |
| Income from discontinued operations of Louisiana Route, net      | 310                              | 310       |
| Income from discontinued operations of Rail City Casino, net     |                                  | 738       |
| Income (loss) from discontinued operations                       | (4,391)                          | 4,180     |
| Net income (loss)  | \$ (10,796)                      | \$ 6,028  |
| <b>Basic earnings (loss) per share:</b>                          |                                  |           |
| Continuing operations  | \$ (0.13)                        | \$ 0.04   |
| Discontinued operations  | (0.08)                           | 0.08      |
|  | \$ (0.21)                        | \$ 0.12   |
| <b>Diluted earnings (loss) per share</b>                         |                                  |           |
| Continuing operations  | \$ (0.13)                        | \$ 0.04   |
| Discontinued operations  | (0.08)                           | 0.08      |
| Total  | \$ (0.21)                        | \$ 0.12   |
| Weighted average common shares outstanding                       | 50,966                           | 49,579    |
| Weighted average common and common share equivalents outstanding | 50,966                           | 50,687    |

See accompanying notes to unaudited condensed consolidated financial statements.



## ALLIANCE GAMING CORPORATION AND SUBSIDIARIES

## UNAUDITED CONDENSED CONSOLIDATED STATEMENTS OF STOCKHOLDERS EQUITY

(In 000s)

|   | Common Stock |          | Series E<br>Special<br>Stock | Treasury<br>Stock | Deferred<br>Comp. | Additional<br>Paid-in<br>Capital | Accum.<br>Other<br>Comprehensive<br>Income (loss) | Retained<br>Earnings<br>(Accum.<br>Deficit) | Total<br>Stockholders<br>Equity |
|---|--------------|----------|------------------------------|-------------------|-------------------|----------------------------------|---|---|---------------------------------|
|   | Shares       | Dollars  |                              |                   |                   |                                  |   |   |                                 |
| Balances at June 30,<br>2004                        | 51,426       | \$ 5,145 | 12                           | (501)             | (6,500)           | 194,040                          | 1,524   | 7,083                                       | 200,803                         |
| Net loss  |              |          |                              |                   |                   |                                  |   | (10,796)                                    | (10,796)                        |
| Foreign currency<br>translation adjustment          |              |          |                              |                   |                   |                                  | (168)   |   | (168)                           |
| Total comprehensive<br>income                       |              |          |                              |                   |                   |                                  |   |   | (10,964)                        |
| Repurchase of common<br>stock for treasury          |              |          |                              | (164)             |                   |                                  |   |   | (164)                           |
| Shares issued upon<br>exercise of options           | 104          | 11       |                              |                   |                   | 626                              |   |   | 637                             |
| Tax benefit of<br>employee stock option<br>exercise |              |          |                              |                   |                   | 236                              |   |   | 236                             |
| Balances at September<br>30, 2004                   | 51,530       | \$ 5,156 | 12                           | (665)             | (6,500)           | 194,902                          | 1,356   | (3,713)                                     | 190,548                         |

See accompanying notes to unaudited condensed consolidated financial statements.

## ALLIANCE GAMING CORPORATION AND SUBSIDIARIES

## UNAUDITED CONDENSED CONSOLIDATED STATEMENTS OF CASH FLOWS

(In 000s)

|   | Three Months Ended September 30, |           |
|---|----------------------------------|-----------|
|   | 2004                             | 2003      |
| Cash flows from operating activities of continuing operations:  |                                  |           |
| Net income (loss)   | \$ (10,796)                      | \$ 6,028  |
| Adjustments to reconcile net income (loss) to net cash provided by (used in) operating activities of continuing operations: |                                  |           |
| (Income) loss from discontinued operations  | 4,391                            | (4,180)   |
| Depreciation and amortization   | 10,841                           | 6,022     |
| Refinancing charge  |                                  | 12,293    |
| Deferred income taxes   | 2                                | 1,277     |
| Provision for losses on receivables   | 2,717                            | 933       |
| Inventory write down  | 3,582                            | 40        |
| Other   | (2,227)                          | (1,574)   |
| Change in operating assets and liabilities:   |                                  |           |
| Accounts and notes receivable   | 5,587                            | (5,581)   |
| Inventories   | (22,596)                         | (5,347)   |
| Other current assets  | (6,831)                          | (480)     |
| Accounts payable  | 9,139                            | 2,616     |
| Accrued liabilities and jackpot liabilities   | (9,350)                          | (8,290)   |
| Net cash provided by (used in) operating activities of continuing operations  | (15,541)                         | 3,757     |
| Cash flows from investing activities of continuing operations:  |                                  |           |
| Additions to property, plant and equipment  | (3,200)                          | (1,659)   |
| Additions to leased gaming equipment  | (8,192)                          | (5,004)   |
| Additions to other long-term assets   | (588)                            | (6,431)   |
| Proceeds from sale of discontinued operations   |                                  | 16,500    |
| Net cash provided by (used in) investing activities of continuing operations  | (11,980)                         | 3,406     |
| Cash flows from financing activities of continuing operations:  |                                  |           |
| Capitalized debt issuance costs   |                                  | (5,686)   |
| Proceeds from issuance of long-term debt  |                                  | 275,000   |
| Payoff of debt from refinancing   |                                  | (337,625) |
| Payoff of debt due to sale of net assets of discontinued operations   | (101,618)                        |           |
| Reduction of long-term debt   | (1,511)                          | (879)     |
| Re-purchase of common stock for treasury  | (164)                            |           |
| Net change in revolving credit facility   |                                  | 70,000    |
| Premium paid on early redemption of debt  |                                  | (5,399)   |
| Proceeds from exercise of stock options and warrants  | 873                              | 1,460     |
| Net cash used in financing activities of continuing operations  | (102,420)                        | (3,129)   |
| Effect of exchange rate changes on cash   | 47                               | (21)      |
| Cash provided by discontinued operations  | 397                              | 637       |
| Cash and cash equivalents:  |                                  |           |
| Increase (decrease) for period  | (129,497)                        | 4,650     |
| Balance, beginning of period  | 172,726                          | 38,884    |
| Balance, end of period  | \$ 43,229                        | \$ 43,534 |

See accompanying notes to unaudited condensed consolidated financial statements.



**ALLIANCE GAMING CORPORATION AND SUBSIDIARIES**

**NOTES TO UNAUDITED CONDENSED CONSOLIDATED FINANCIAL STATEMENTS**

**1. BASIS OF PRESENTATION**

*Principles of presentation and consolidation*

The accompanying unaudited interim condensed consolidated financial statements reflect all adjustments, consisting of normal recurring adjustments, which management believes are necessary to present fairly the financial position, results of operations and cash flows of Alliance Gaming Corporation and subsidiaries ( Alliance or the Company ) for the respective periods presented. The results of operations for an interim period are not necessarily indicative of the results that may be expected for any other interim period or for the year as a whole. The accompanying unaudited interim condensed consolidated financial statements should be read in conjunction with the consolidated financial statements and notes in the Company's annual report on Form 10-K for the year ended June 30, 2004.

We completed the sale of Rail City Casino in May 2004 and the sale of United Coin Machine Co. ( UCMC ) in June 2004. As a result of the sale of these assets, the terms of our bank loan agreement required the use of approximately 50% of the net proceeds (as defined in the agreement) to reduce the term loan and revolver principal balances on a pro rata basis. Accordingly, in August 2004 the Company reduced its term loan by \$31.6 million and its revolver by \$11.3 million.

The accompanying consolidated financial statements include the accounts of Alliance Gaming Corporation, and its wholly owned and partially owned, controlled subsidiaries. The Company consolidates RCVP and records minority interest expense to reflect the portion of the earnings of RCVP attributable to the minority shareholders. The Company owns 100% of the voting stock and was entitled to receive 71% of dividends declared by VSI, if any, at such time that dividends were declared.

The Company is the general partner of Rainbow Casino Vicksburg Partnership ( RCVP ) the partnership that operates the Rainbow Casino. Pursuant to transactions consummated in March 1995, the Rainbow Corporation, which was the former general partner of RCVP became a limited partner entitled to receive 10% of the net available cash flows after debt service and other items, as defined (which amount increases to 20% of such amount when annual revenues exceed \$35.0 million but only on such incremental amount), payable quarterly through December 31, 2010. The Company holds the remaining economic interest in the partnership.

All significant intercompany accounts and transactions have been eliminated in consolidation. Certain reclassifications have been made to prior year financial statements to conform to the current year presentation, and to present Rail City as discontinued operations for all periods presented.

**2. STOCK-BASED COMPENSATION**

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The Company accounts for its stock-based employee compensation awards in accordance with Accounting Principles Board Opinion No. 25, Accounting for Stock Issued to Employees ( APB 25 ). Under APB 25, because the exercise price of the Company's employee stock options equals or exceeds the market price on date of grant, no compensation expense is recognized.

As provided under Financial Accounting Standards Board No. 123 Accounting for Stock-Based Compensation ( FASB No. 123 ), companies may continue to account for employee stock-based compensation under APB 25, but are required to disclose historical pro-forma net income and earnings per share that would have resulted from the use of the fair value method described in FASB No. 123.

In December 2002, the FASB issued FASB No.148, Accounting for Stock-Based Compensation-Transition and Disclosure . This Statement amends FASB No. 123, to provide alternative methods of transition for a voluntary change to the fair value based method of accounting for stock-based employee compensation. In addition, this Statement amends the disclosure requirements of FASB No. 123 and APB Opinion No. 28 Interim Financial Reporting to require prominent disclosures in both annual and interim financial statements about the method of accounting for stock-based employee compensation and the effect of the method used on reported results. Under fair value method, compensation costs are measured using an options pricing model and

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are amortized over the estimated life of the option, which is generally three to ten years, with option forfeitures accounted for at the time of the forfeiture, and all amounts are reflected net of tax. The historical and pro forma net income (assuming an after-tax charge for stock-based compensation) and related per share data are as follows (in 000s, except per share data):

|   |             | <b>Three Months Ended September 30,</b> |             |
|---|-------------|---|-------------|
|   |             | <b>2004</b>                             | <b>2003</b> |
| <b>Net income (loss)</b>                                |             |   |             |
| As reported   |             | \$ (10,796)                             | \$ 6,028    |
| Stock-based compensation under FASB No. 123, net of tax |             | (1,580)                                 | (1,837)     |
| Pro forma net income (loss)                             |             | \$ (12,376)                             | \$ 4,191    |
| <b>Earnings per share:</b>                              |             |   |             |
| Basic and diluted                                       | As reported | \$ (0.21)                               | \$ 0.12     |
| Basic and diluted                                       | Pro forma   | \$ (0.24)                               | \$ 0.08     |

On the date of grant using the Black-Scholes option-pricing model, the following assumptions were used to estimate the grant-date fair value of the options in the periods indicated:

|  | <b>Three Months Ended September 30,</b> |             |
|--|---|-------------|
|  | <b>2004</b>                             | <b>2003</b> |
| Risk-free interest rate (weighted average) | 2.5%                                    | 3.5%        |
| Expected volatility                        | 0.26                                    | 0.26        |
| Expected dividend yield                    | 0%                                      | 0%          |
| Expected life                              | 3-10 years                              | 3-10 years  |

The resulting fair values applied to the options granted were \$5.67 and \$9.36 per share for the three month periods ended September 30, 2004 and September 30, 2003, respectively.

### 3. DISCONTINUED OPERATIONS

We have completed several divestitures in accordance with our plan to sell our non-core businesses, which was a strategy we announced in July 2003. In July 2003, we completed the sale of Bally Wulff to a private equity investor. Since the net assets of Bally Wulff were written down to the estimated sell price in June 2003, no additional gain or loss was recorded upon the closing of the sale. In May 2004, we completed the sale of Rail City Casino to The Sands Resort. On June 30, 2004, we completed the sale of United Coin Machine Co. ( UCMC ).

On October 15, 2004 the Company completed the sale of its interest in VSI to Churchill Downs Incorporated. We received approximately \$2.0 million.

The results of these discontinued operations are presented net of applicable income taxes within income from discontinued operations in the accompanying consolidated statements of operations. The net assets of VSI are classified as assets held for sale in the accompanying condensed consolidated balance sheets.

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Operating results for the discontinued operations for the quarter ended September 30, 2004 include VSI and UCMC, while the results for the quarter ended September 30, 2003 include UCMC, VSI, and Rail City. Summary operating results are as follows (in 000s):

|   | Three Months Ended September 30, |           |
|---|----------------------------------|-----------|
|   | 2004                             | 2003      |
| Net revenues                                | \$ 3,955                         | \$ 60,012 |
| Operating income                            | 487                              | 6,467     |
| Loss on litigation settlement, Nevada Route | (7,356)                          |           |
| Income tax expense (benefit)                | (2,478)                          | 2,287     |
| Income (loss) from discontinued operations  | \$ (4,391)                       | \$ 4,180  |

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During the quarter ended September 30, 2004, a Federal District Court jury reached a verdict in a patent infringement case filed by Action Gaming, Inc. and International Game Technology, Inc. ( plaintiffs ). The jury awarded the plaintiffs approximately \$7.4 million (or \$4.7 million after tax) in damages related to a single, optional feature offered in certain multi-hand poker games provided solely by UCMC. This charge is included in the UCMC discontinued operations in the table above.

The following schedule reflects the net assets held for sale, included in the accompanying consolidated balance sheets consisting of VSI as of September 30, 2004 and June 30, 2004 (in 000s):

|  | Sept 30,<br>2004 | June 30,<br>2004 |
|--|------------------|------------------|
| Cash and cash equivalents                    | \$ 3,562         | \$ 3,543         |
| Other assets                                 | 870              | 899              |
| <b>Total assets</b>                          | <b>4,432</b>     | <b>4,442</b>     |
| <b>Current liabilities</b>                   | <b>1,213</b>     | <b>4,321</b>     |
| Long-term liabilities                        | 16               | 16               |
| <b>Total liabilities</b>                     | <b>\$ 1,229</b>  | <b>4,337</b>     |
| <b>Net assets of discontinued operations</b> | <b>\$ 3,203</b>  | <b>\$ 105</b>    |

#### 4. OTHER CURRENT ASSETS

Other current assets consist of the following (in 000s):

|   | Sept 30,<br>2004 | June 30,<br>2004 |
|---|------------------|------------------|
| Prepaid taxes                           | \$ 1,117         | \$ 814           |
| Prepaid royalty                         | 3,344            | 2,623            |
| Refundable deposits                     | 7,587            | 3,229            |
| Games on trial                          | 2,474            | 2,608            |
| Deferred cost of revenue                | 2,956            | 208              |
| Prepaid licensing and intellectual fees | 1,102            | 1,001            |
| Prepaid insurance                       | 873              | 592              |
| Prepaid other expense                   | 2,811            | 1,345            |
| <b>Total accrued liabilities</b>        | <b>\$ 22,264</b> | <b>\$ 12,420</b> |

The increase in refundable deposits of \$4.4 million is a result of units purchased from other manufacturers. The increase in deferred costs of \$2.7 million is due to shipments of games to the European market which will not be installed until the second quarter of fiscal year 2005.

#### 5. INVENTORIES

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Inventories are stated at the lower of cost, determined on a first-in, first-out basis, or market. Cost elements included for work-in-process and finished goods include raw materials, freight, direct labor and manufacturing overhead. Inventories, net of valuation reserves, consist of the following (in 000s):

|                 | <b>Sept 30,<br/>2004</b> |    | <b>June 30,<br/>2004</b> |
|-----------------|--------------------------|----|--------------------------|
| Raw materials   | \$ 43,780                | \$ | 26,050                   |
| Work-in-process | 5,172                    |    | 3,324                    |
| Finished goods  | 32,514                   |    | 31,761                   |
| Total           | \$ 81,466                | \$ | 61,135                   |

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During the quarter ended September 30, 2004, the Company recorded an inventory write down of \$3.0 million for recently discontinued legacy video products and used games which have been identified for accelerated disposal.

### 6. PROPERTY, PLANT AND EQUIPMENT AND LEASED GAMING EQUIPMENT

Property, plant and equipment is stated at cost and depreciated over the estimated useful lives or lease term, if less, using the straight line method as follows: buildings and improvements, 28-40 years; gaming equipment, 4-7 years; furniture, fixtures and equipment, 3-7 years; and leasehold improvements, 5-10 years. Leased gaming equipment is stated at cost and depreciated over estimated useful life ranging from 3-4 years.

Significant replacements and improvements are capitalized; other maintenance and repairs are expensed. The cost and accumulated depreciation of assets retired or otherwise disposed of are eliminated from the accounts and any resulting gain or loss is credited or charged to income as appropriate.

Property, plant and equipment consist of the following (in 000s):

|  | Sept 30,<br>2004 | June 30,<br>2004 |
|--|------------------|------------------|
| Land and land improvements                     | \$ 19,086        | \$ 19,086        |
| Buildings and leasehold improvements           | 30,700           | 29,937           |
| Gaming equipment                               | 32,166           | 29,121           |
| Furniture, fixtures and equipment              | 22,113           | 20,821           |
| Less accumulated depreciation and amortization | (27,371)         | (23,127)         |
| Total property, plant and equipment, net       | \$ 76,694        | \$ 75,838        |
| Leased gaming equipment                        | \$ 83,219        | \$ 77,739        |
| Less accumulated depreciation                  | (36,081)         | (31,105)         |
| Total leased gaming equipment, net             | \$ 47,138        | \$ 46,634        |

### 7. INTANGIBLE ASSETS AND GOODWILL

In July 2001, the Company adopted FASB No. 142 *Goodwill and Other Intangible Assets*, which requires companies to cease amortizing goodwill and certain intangible assets with indefinite useful lives. Instead, goodwill and intangible assets deemed to have indefinite useful lives are to be reviewed for impairment annually at the reporting unit level (Gaming equipment and systems, and casino operations). There was no impairment of goodwill upon adoption of FASB No. 142. No impairment was charged to goodwill in the three months ended September 30, 2004 or during fiscal 2004.

The Company evaluates the carrying value of goodwill for impairment annually during the fourth quarter or whenever events or changes in circumstances indicate that the carrying value of goodwill may not be recoverable. Indicators that could trigger an impairment review include changes in legal, regulatory, or economic factors, market conditions or operational performance. Impairment is measured as the difference between the carrying amount and the fair value of the intangible assets and is recognized as a component of income from operations.



*Intangibles*

Intangible assets excluding discontinued operations consist of the following (in 000s):

|  | Wt. Avg<br>Useful<br>Life<br>(Years) | September 30, 2004          |                             |                           | June 30, 2004               |                             |                           |
|--|--------------------------------------|-----------------------------|-----------------------------|---------------------------|-----------------------------|-----------------------------|---------------------------|
|  |                                      | Gross<br>Carrying<br>Amount | Accumulated<br>Amortization | Net<br>Carrying<br>Amount | Gross<br>Carrying<br>Amount | Accumulated<br>Amortization | Net<br>Carrying<br>Amount |
| Computer software                        | 3                                    | \$ 8,866                    | \$ (2,260)                  | \$ 6,606                  | \$ 8,963                    | \$ (1,498)                  | \$ 7,465                  |
| Computer software<br>acquisitions        | 9                                    | 11,700                      | (3,705)                     | 7,995                     | 11,700                      | (3,380)                     | 8,320                     |
| License Rights                           | 3-5                                  | 3,101                       | (2,228)                     | 873                       | 2,745                       | (1,979)                     | 766                       |
| Capitalized regulatory<br>approval costs | 3                                    | 4,885                       | (1,172)                     | 3,713                     | 4,767                       | (833)                       | 3,934                     |
| CRM Project                              | 5                                    | 3,290                       | (963)                       | 2,327                     | 3,039                       | (1,046)                     | 1,993                     |
| PLM Project                              | 5                                    | 1,800                       |                             | 1,800                     | 1,585                       |                             | 1,585                     |
| Trademarks                               | 5                                    | 6,688                       | (309)                       | 6,379                     | 6,688                       | (288)                       | 6,400                     |
| Patents                                  | 13                                   | 9,470                       | (538)                       | 8,932                     | 9,470                       | (307)                       | 9,163                     |
| Non-Compete<br>Agreements                | 6                                    | 275                         |                             | 275                       | 275                         |                             | 275                       |
| Customer Relationships                   | 5                                    | 740                         |                             | 740                       | 740                         |                             | 740                       |
| Core Technology                          | 8                                    | 5,445                       | (395)                       | 5,050                     | 5,445                       | (227)                       | 5,218                     |
| Deferred Financing<br>Costs              | 6                                    | 6,911                       | (1,333)                     | 5,578                     | 6,910                       | (1,017)                     | 5,893                     |
| Contracts                                | 10                                   | 12,100                      | (714)                       | 11,386                    | 12,100                      | (411)                       | 11,689                    |
| Other Intangibles                        | 7                                    | 1,255                       | (919)                       | 336                       | 1,685                       | (1,503)                     | 182                       |
| <b>Total</b>                             |                                      | <b>\$ 76,526</b>            | <b>\$ (14,536)</b>          | <b>\$ 61,990</b>          | <b>\$ 76,112</b>            | <b>\$ (12,489)</b>          | <b>\$ 63,623</b>          |

Amortization expense totaled \$2.0 million and \$1.3 million for the three months ended September 30, 2004 and 2003, respectively. Computer software amortization expense totaled \$0.5 million for the three months ended September 30, 2004 and 2003.

Future amortization of intangible assets is scheduled as follows (in 000s):

**Periods and Years ending June 30,**

|              |           |               |
|--------------|-----------|---------------|
| 2005         | \$        | 7,796         |
| 2006         |           | 8,636         |
| 2007         |           | 6,778         |
| 2008         |           | 5,509         |
| 2009         |           | 4,882         |
| Thereafter   |           | 28,389        |
| <b>Total</b> | <b>\$</b> | <b>61,990</b> |

*Goodwill*

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The changes in the carrying amount of goodwill are as follows (in 000s):

|   |    |         |
|---|----|---------|
| Balance as of June 30, 2004             | \$ | 136,989 |
| Foreign currency translation adjustment |    | (225)   |
| Balance as of September 30, 2004        | \$ | 136,764 |

The purchase agreements for two recent acquisitions, Sierra Design Group ( SDG ) and MindPlay LLC, call for future contingent consideration ( earnouts ) to be paid to the former principals of these companies, as more fully described in footnote 14. The MindPlay earnout is payable based on future revenues and gross margins from the sale of MindPlay products, while the SDG earnout is payable based on Adjusted EBITDA (as that term is defined in the purchase agreement) and revenues generated from the SDG related business division over the three year period ended June 30, 2007. Any earnout payments made under either agreement will be treated as additional purchase consideration, which would result in increases in goodwill.

**8. ACCRUED AND JACKPOT LIABILITIES**

Accrued liabilities consist of the following (in 000s):

|   | Sept 30,<br>2004 | June 30,<br>2004 |
|---|------------------|------------------|
| Payroll and related costs               | \$ 10,600        | \$ 11,905        |
| Interest                                | 898              | 1,265            |
| Professional and consulting fees        | 3,548            | 3,102            |
| Deferred revenues, sales and use taxes  | 7,359            | 5,113            |
| Regulatory approval cost accruals       | 690              | 652              |
| Royalties, rebates, direct mail coupons | 8,146            | 6,607            |
| Customer deposits                       | 11,670           | 9,896            |
| Acquisition related accruals            | 3,714            | 3,806            |
| Divestiture related accruals            | 560              | 4,377            |
| Litigation accruals                     | 8,581            |                  |
| Severance accruals                      | 1,353            |                  |
| Other                                   | 4,368            | 4,746            |
| Subtotal                                | 61,487           | 51,469           |
| Jackpots accrued not yet awarded        | 9,447            | 12,075           |
| Total accrued liabilities               | \$ 70,934        | \$ 63,544        |

The Company recognizes liability for jackpot expense for the cost to fund these jackpots in the future. Generally winners may elect to receive a single lump sum payment or may opt to receive payments in equal installments over a specified period of time. The most recent history pattern indicates that approximately 85% of winners will elect the single payment option.

The Company funds jackpot installment payments through qualifying U.S. government or agency securities. The present value of the outstanding progressive jackpot liabilities is computed based upon the payment stream discounted at the applicable discount rate.

The increase in litigation accruals of \$8.6 million is a result of the patent litigation discussed in Note 3 and consists of the damage award of \$7.4 million and related litigation costs.

**9. LONG-TERM DEBT**

Long-term debt consisted of the following (in 000s):

| Sept 30,<br>2004 | June 30,<br>2004 |
|------------------|------------------|
|------------------|------------------|

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|   |    |         |    |         |
|---|----|---------|----|---------|
| Term Loan facility                      | \$ | 317,507 | \$ | 350,000 |
| Revolving credit facility               |    |         |    | 70,000  |
| Other, generally unsecured              |    | 8,350   |    | 8,955   |
|   |    | 325,857 |    | 428,955 |
| Less current maturities                 |    | 14,662  |    | 5,866   |
| Long-term debt, less current maturities | \$ | 311,195 | \$ | 423,089 |

The Company's debt structure at September 30, 2004 consists primarily of a term loan facility with an original balance of \$350 million and a \$125 million revolving credit facility. The term loan which is due on September 4, 2009, has an interest rate of LIBOR plus 2.25% or 3.8% at September 30, 2004, and has required quarterly principal reductions of approximately 1% per annum.

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We completed the sale of Rail City in May 2004 and the sale of UCMC in June 2004. As a result of the sale of these assets, the terms of our bank loan agreement required the use of approximately 50% of the net proceeds (as defined in the agreement) to reduce the term loan and revolver principal balances on a pro rata basis, no later than 180 days after the close of the sales. Accordingly, in August 2004 the Company made an initial reduction in the term loan of \$31.6 million and the revolver of \$11.3 million and will be required to make additional term loan reduction currently estimated to be approximately \$10.0 million by December 31, 2004. In August 2004 the Company made additional revolver paydown totaling \$58.7 million, which reduced the revolver to zero. The Company has the ability to borrow approximately \$10.0 million on the revolver as of September 30, 2004.

The Company's bank credit agreement contains several covenants including maximum leverage ratio, minimum cash flow (as that term is defined in the agreement) and fixed charge coverage ratio. The credit agreement also contains a number of maintenance covenants and other significant covenants that, among other things, restrict the ability of the Company certain of its subsidiaries to dispose of assets, incur additional indebtedness and issue preferred stock, pay dividends or make other distributions, enter into certain acquisitions, repurchase equity interests or subordinated indebtedness, issue or sell equity interests of the Company's subsidiaries, engage in mergers or acquisitions, or engage in certain transactions with subsidiaries and affiliates, and that otherwise restrict corporate activities. As of September 30, 2004, the Company is in compliance with the financial covenants.

The other debt totaling approximately \$8.4 million as of September 30, 2004, consists primarily of the debt owed to the former principals of MCC, MindPlay, and CMS totaling \$2.5 million, \$4.0 million and \$0.4 million respectively. The loans are due at various dates between 2005 and 2006 and bear rates of interest between LIBOR plus 2% (3.8% as of September 30, 2004) and 6%, and are generally unsecured.

### 10. EARNINGS PER SHARE

The following computation of basic and diluted earnings (loss) per share from continuing operations, and income (loss) applicable to common shares are as follows (in 000s except per share amounts):

|   | <b>Three Months Ended September 30,</b> |             |
|---|---|-------------|
|   | <b>2004</b>                             | <b>2003</b> |
| Net income (loss) from continuing operations            | \$ (6,405)                              | \$ 1,848    |
| Net income (loss) from discontinued operations          | (4,391)                                 | 4,180       |
| Net income (loss)                                       | \$ (10,796)                             | \$ 6,028    |
| Weighted average common shares outstanding              | 50,966                                  | 49,579      |
| Effect of dilutive securities                           |   | 1,108       |
| Weighted average common and dilutive shares outstanding | 50,966                                  | 50,687      |
| <b>Earnings (loss) per basic share:</b>                 |   |             |
| Income (loss) from continued operations                 | \$ (0.13)                               | \$ 0.04     |
| Income (loss) from discontinued operations              | (0.08)                                  | 0.08        |
|   | \$ (0.21)                               | \$ 0.12     |
| <b>Earnings (loss) per diluted share:</b>               |   |             |
| Income (loss) from continued operations                 | \$ (0.13)                               | \$ 0.04     |
| Income (loss) from discontinued operations              | (0.08)                                  | 0.08        |
|   | \$ (0.21)                               | \$ 0.12     |



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Diluted earnings per share represents the potential dilution that could occur if all dilutive securities outstanding were exercised. Certain securities do not have dilutive effect because their exercise price exceeds the fair market value of the underlying stock. Such securities are excluded from the diluted earnings per share calculation and consist of the following (in 000s):

|                        | <b>Three Months Ended September 30,</b> |             |
|------------------------|---|-------------|
|                        | <b>2004</b>                             | <b>2003</b> |
| Stock options          | 2,004                                   | 672         |
| Restricted stock units | 377                                     |             |
| Warrants               | 100                                     |             |
|                        | 2,481                                   | 672         |

For the quarter ended September 30, 2004, a total of 2.2 million in-the-money options were also excluded from the dilutive earnings per share calculation as they are also antidilutive.

A total of 377,030 RSU s were granted on June 30, 2004, as part of the employment agreement of the Company s new Chief Executive Officer. The RSU s granted were treated as deferred compensation which will be amortized over the three year term of Mr. Haddrill s employment agreement which began October 1, 2004.

### 11. SEGMENTS AND GEOGRAPHICAL INFORMATION

The Company currently operates in two business segments (exclusive of the business segments included in discontinued operations): (i) Gaming Equipment and Systems which designs, manufactures and distributes gaming machines and computerized monitoring systems for gaming machines, and (ii) Casino Operations which currently owns and operates a casino in Vicksburg, Mississippi. The accounting policies of these segments are consistent with Company s policies for the Consolidated Financial Statements.

The table below presents information as to the Company s revenues and operating income by segment (in 000s):

|                                 | <b>Three Months Ended</b> |             |
|---------------------------------|---------------------------|-------------|
|                                 | <b>September 30,</b>      |             |
|                                 | <b>2004</b>               | <b>2003</b> |
| <b>Revenues:</b>                |                           |             |
| Gaming Equipment and Systems    | \$ 104,077                | \$ 88,468   |
| Casino Operations               | 12,836                    | 12,755      |
| Total revenues                  | \$ 116,913                | \$ 101,223  |
| <b>Intersegment revenues:</b>   |                           |             |
| Gaming Equipment and Systems    | \$ 172                    | \$ 93       |
| Casino Operations               |                           |             |
| Total intersegment revenues     | \$ 172                    | \$ 93       |
| <b>Operating income (loss):</b> |                           |             |
| Gaming Equipment and Systems    | \$ (4,487)                | \$ 21,358   |
| Casino Operations               | 3,796                     | 4,014       |

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|                               |    |         |    |         |
|-------------------------------|----|---------|----|---------|
| Corporate/other               |    | (5,737) |    | (3,439) |
| Total operating income (loss) | \$ | (6,428) | \$ | 21,933  |

The Company has operations based primarily in the United States with sales and distribution offices in Europe and South America.

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The table below presents information as to the Company's revenues, operating income, identifiable assets capital expenditures and depreciation and amortization by geographic region (in 000s):

|                                      | Three Months Ended<br>September 30, |                   |
|--------------------------------------|-------------------------------------|-------------------|
|                                      | 2004                                | 2003              |
| <b>Revenues:</b>                     |                                     |                   |
| United States                        | \$ 111,682                          | \$ 92,612         |
| Germany                              | 1,176                               | 6,032             |
| Other foreign                        | 4,055                               | 2,579             |
| <b>Total revenues</b>                | <b>\$ 116,913</b>                   | <b>\$ 101,223</b> |
| <b>Operating income (loss):</b>      |                                     |                   |
| United States                        | \$ (5,515)                          | \$ 21,159         |
| Germany                              | (401)                               | 1,024             |
| Other foreign                        | (512)                               | (250)             |
| <b>Total operating income (loss)</b> | <b>\$ (6,428)</b>                   | <b>\$ 21,933</b>  |

### 12. SUPPLEMENTAL CASH FLOW INFORMATION

The following supplemental information is related to the consolidated statements of cash flows (in 000s).

|   | Three Months Ended<br>September 30, |           |
|---|-------------------------------------|-----------|
|   | 2004                                | 2003      |
| Cash paid for interest                                | \$ 3,311                            | \$ 11,695 |
| Cash paid for income taxes                            | 3,057                               | 1,239     |
| <b>Non-cash investing and financing transactions:</b> |                                     |           |
| Reclassify property, plant and equipment to inventory | \$ 1,193                            | \$ 799    |
| Unfavorable translation rate adjustment               | 215                                 | 732       |

### 13. RESTRUCTURING CHARGE

During the quarter ended September 30, 2004, the Company undertook an extensive review of its operations and accordingly reduced its workforce which resulted in a restructuring charge and accrual totaling \$1.4 million, of this charge, \$0.9 million was recorded at the gaming equipment and systems segment and \$0.5 million was recorded at corporate segment. No further costs will be incurred in connection with this restructuring, as all employees subject to this have been terminated from the Company as of September 30, 2004; however future restructuring charges may be incurred if the Company initiates future reduction in its workforce.

### 14. COMMITMENTS AND CONTINGENCIES

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The Company is also a party to various lawsuits relating to routine matters incidental to its business. Management does not believe that the outcome of such litigation, in the aggregate, will have a material adverse effect on the Company.

In June and July 2004, purported class actions were filed against Alliance Gaming Corporation and its officers, Robert Miodunski (the Company's former Chief Executive Officer), Robert Saxton, Mark Lerner, and Steven Des Champs, in the Federal District Court for the District of Nevada. The nearly identical complaints allege violations of the Securities Exchange Act of 1934 stemming from the revision of earnings guidance, and declines in the stock price. At the plaintiffs' request, the district court consolidated the cases and appointed a lead plaintiff and counsel, as is customary in such cases. The next step is for the plaintiffs to file a consolidated complaint. We believe the lawsuits are without merit and the Company intends to vigorously defend the action. In addition, in July 2004 two derivative lawsuits were filed in Nevada state court against the members of the board of directors and the officers

listed above. The Company is named as a nominal defendant in the derivative lawsuits as the claims are purportedly asserted for the benefit of the Company. These lawsuits assert claims for breach of fiduciary duty and waste of corporate assets arising out of the same events as those giving rise to the class actions described above. These two cases have also been consolidated, and a consolidated complaint has been filed.

On February 19, 2004, the Company completed the acquisition of MindPlay. The Company purchased substantially all of the assets and liabilities of MindPlay for consideration of \$11.0 million in cash, a promissory note in the amount of \$4.0 million and a warrant to purchase 100,000 shares of Alliance Common Stock, plus transaction fees and expense resulting in total consideration of \$15.9 million. Additional consideration may become payable in cash over the next 13 years upon the MindPlay business unit achieving certain significant revenue and gross margin targets. The additional consideration that may become payable will be recorded as an additional cost of the acquired entity.

Additionally, on March 2, 2004, the Company completed the acquisition of SDG. The Company purchased 100 percent of the outstanding shares of SDG for consideration of approximately \$29.8 million in cash and 662,000 shares of Alliance Common Stock. In addition, the Company assumed approximately \$80 million of debt plus transaction fees and expenses, resulting in total initial consideration of \$126.4 million. Additional contingent consideration of up to \$95.6 million may become payable, in equal portions of cash and stock, over the next three fiscal years upon the SDG business unit achieving certain significant revenue and EBITDA (as that term is defined in the purchase agreement) targets. The additional consideration that may become payable will be recorded as an additional cost of the acquired entity.

Management believes that cash flows from current operating activities and the limited availability under the revolving credit facility will provide the Company with sufficient capital resources and liquidity. At September 30, 2004 we had no material commitments for capital expenditures.

## 15. UNAUDITED CONSOLIDATING FINANCIAL STATEMENTS

The following unaudited condensed consolidating financial statements are presented to provide certain financial information regarding guaranteeing and non-guaranteeing subsidiaries in relation to the Company's new bank credit agreement. The financial information presented includes Alliance Gaming Corporation (the Parent), its wholly-owned guaranteeing subsidiaries (Guaranteeing Subsidiaries), and the non-guaranteeing subsidiaries Video Services, Inc., the Rainbow Casino Vicksburg Partnership, L.P. (dba Rainbow Casino) and the Company's non-domestic subsidiaries (together the Non-Guaranteeing Subsidiaries). The notes to the unaudited consolidating financial statements should be read in conjunction with these unaudited consolidating financial statements.

## UNAUDITED CONSOLIDATING BALANCE SHEETS

September 30, 2004

(In 000s)

|  | Parent     | Guaranteeing<br>Subsidiaries | Non-<br>Guaranteeing<br>Subsidiaries | Reclass-<br>ifications<br>and<br>Elimina-<br>tions | Alliance<br>Gaming<br>Corporation<br>and<br>Subsidiaries |
|--|------------|------------------------------|--------------------------------------|--|--|
| <b>ASSETS</b>                                      |            |                              |                                      |  |  |
| Current assets:                                    |            |                              |                                      |  |  |
| Cash and cash equivalents                          | \$ 27,839  | \$ 6,405                     | \$ 8,985                             | \$   | \$ 43,229  |
| Accounts and notes receivable,<br>net              | 2,070      | 93,081                       | 15,754                               | (805)  | 110,100  |
| Inventories, net                                   |            | 74,033                       | 7,773                                | (340)  | 81,466   |
| Deferred tax assets, net                           | 1,461      | 18,592                       |                                      |  | 20,053   |
| Other current assets                               | 1,240      | 18,725                       | 2,299                                |  | 22,264   |
| Total current assets                               | 32,610     | 210,836                      | 34,811                               | (1,145)  | 277,112  |
| Long-term investment<br>(restricted)               |            | 4,676                        |                                      |  | 4,676  |
| Long-term receivables, net                         | 259,355    | 18,777                       | 22                                   | (256,814)  | 21,340   |
| Net investment in leases                           |            | 8,308                        |                                      |  | 8,308  |
| Leased gaming equipment, net                       |            | 51,424                       | (4,286)                              |  | 47,138   |
| Property, plant and equipment,<br>net              | 77         | 33,693                       | 42,924                               |  | 76,694   |
| Goodwill, net                                      | (900)      | 119,715                      | 17,949                               |  | 136,764  |
| Intangible assets, net                             | 5,582      | 51,932                       | 4,476                                |  | 61,990   |
| Investments in subsidiaries                        | 338,335    | 75,203                       |                                      | (413,538)  |  |
| Deferred tax assets, net                           | 5,342      |                              |                                      | (5,342)  |  |
| Assets of discontinued<br>operations held for sale | 39         |                              | 4,393                                |  | 4,432  |
| Other assets, net                                  | (110,570)  | 133,173                      | (16,190)                             | (48)   | 6,365  |
|  | \$ 529,870 | \$ 707,737                   | \$ 84,099                            | \$ (676,887)                                       | \$ 644,819   |
| <b>LIABILITIES AND<br/>STOCKHOLDERS EQUITY</b>     |            |                              |                                      |  |  |
| Current liabilities:                               |            |                              |                                      |  |  |
| Accounts payable                                   | \$ 971     | \$ 44,535                    | \$ 1,148                             | \$   | \$ 46,654  |
| Accrued liabilities                                | 12,922     | 44,687                       | 4,743                                | (865)  | 61,487   |
| Jackpot liabilities                                |            | 9,301                        | 146                                  |  | 9,447  |
| Taxes payable                                      |            | 420                          |                                      |  | 420  |
| Current maturities of long-term<br>debt            | 12,388     | 2,274                        |                                      |  | 14,662   |
| Liabilities of disc operations<br>held for sale    |            |                              | 1,229                                |  | 1,229  |
| Total current liabilities                          | 26,281     | 101,217                      | 7,266                                | (865)  | 133,899  |
| Long term debt, net                                | 309,119    | 258,724                      |                                      | (256,648)  | 311,195  |
| Deferred tax liabilities                           |            | 4,557                        | 1,635                                | (5,342)  | 850  |
| Other liabilities                                  | 2,624      | 4,405                        |                                      |  | 7,029  |
| Minority interest                                  | 1,298      |                              |                                      |  | 1,298  |
| Total liabilities                                  | 339,322    | 368,903                      | 8,901                                | (262,855)  | 454,271  |
| Commitments and<br>contingencies                   |            |                              |                                      |  |  |
| Stockholders' equity:                              |            |                              |                                      |  |  |
| Special stock series E                             | 12         |                              |                                      |  | 12   |

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|   |            |            |           |              |            |
|---|------------|------------|-----------|--------------|------------|
| Common stock                                  | 5,156      | 109        | 1,027     | (1,136)      | 5,156      |
| Treasury stock                                | (665)      |            |           |              | (665)      |
| Deferred compensation                         | (6,500)    |            |           |              | (6,500)    |
| Additional paid-in capital                    | 194,902    | 260,813    | 33,415    | (294,228)    | 194,902    |
| Accumulated other comprehensive income (loss) | 1,356      | 1,359      | 2,688     | (4,047)      | 1,356      |
| Retained earnings (accumulated deficit)       | (3,713)    | 76,553     | 38,068    | (114,621)    | (3,713)    |
| Total stockholders equity                     | 190,548    | 338,834    | 75,198    | (414,032)    | 190,548    |
|   | \$ 529,870 | \$ 707,737 | \$ 84,099 | \$ (676,887) | \$ 644,819 |

See accompanying unaudited notes.

## UNAUDITED CONSOLIDATING BALANCE SHEETS

June 30, 2004

(In 000s)

|  | Parent     | Guaranteeing<br>Subsidiaries | Non-<br>Guaranteeing<br>Subsidiaries | Reclass-<br>ifications<br>and<br>Elimina-<br>tions | Alliance<br>Gaming<br>Corporation<br>and<br>Subsidiaries |
|--|------------|------------------------------|--------------------------------------|--|--|
| <b>ASSETS</b>                                      |            |                              |                                      |  |  |
| Current assets:                                    |            |                              |                                      |  |  |
| Cash and cash equivalents                          | \$ 155,347 | \$ 7,742                     | \$ 9,637                             | \$   | \$ 172,726   |
| Accounts and notes receivable, net                 | 1,806      | 110,693                      | 17,984                               | (704)  | 129,779  |
| Inventories, net                                   |            | 55,125                       | 6,161                                | (151)  | 61,135   |
| Deferred tax assets, net                           | 1,461      | 18,593                       |                                      |  | 20,054   |
| Other current assets                               | 744        | 10,531                       | 1,145                                |  | 12,420   |
| Total current assets                               | 159,358    | 202,684                      | 34,927                               | (855)  | 396,114  |
| Long-term investment (restricted)                  |            | 2,528                        |                                      |  | 2,528  |
| Long-term receivables, net                         | 254,862    | 9,789                        | 22                                   | (252,155)  | 12,518   |
| Net investment in leases                           |            | 5,614                        |                                      |  | 5,614  |
| Leased gaming equipment, net                       |            | 50,664                       | (4,030)                              |  | 46,634   |
| Property, plant and equipment, net                 | 70         | 33,299                       | 42,469                               |  | 75,838   |
| Goodwill, net                                      | (900)      | 119,715                      | 18,174                               |  | 136,989  |
| Intangible assets, net                             | 5,899      | 52,958                       | 4,766                                |  | 63,623   |
| Investments in subsidiaries                        | 345,560    | 74,234                       |                                      | (419,794)  |  |
| Deferred tax assets, net                           | 5,342      |                              |                                      | (5,342)  |  |
| Assets of discontinued operations held<br>for sale | 39         |                              | 4,403                                |  | 4,442  |
| Other assets, net                                  | (122,036)  | 143,833                      | (15,443)                             |  | 6,354  |
|  | \$ 648,194 | \$ 695,318                   | \$ 85,288                            | \$ (678,146)                                       | \$ 750,654   |
| <b>LIABILITIES AND<br/>STOCKHOLDERS EQUITY</b>     |            |                              |                                      |  |  |
| Current liabilities:                               |            |                              |                                      |  |  |
| Accounts payable                                   | \$ 974     | \$ 34,017                    | \$ 2,524                             | \$   | \$ 37,515  |
| Accrued liabilities                                | 9,744      | 37,391                       | 5,052                                | (718)  | 51,469   |
| Jackpot liabilities                                |            | 11,934                       | 141                                  |  | 12,075   |
| Taxes payable                                      | 5,538      | 1,140                        | 555                                  |  | 7,233  |
| Current maturities of long-term debt               | 3,313      | 2,553                        |                                      |  | 5,866  |
| Liabilities of disc operations held for<br>sale    | 3,185      |                              | 1,152                                |  | 4,337  |
| Total current liabilities                          | 22,754     | 87,035                       | 9,424                                | (718)  | 118,495  |
| Long term debt, net                                | 420,687    | 254,391                      |                                      | (251,989)  | 423,089  |
| Deferred tax liabilities                           |            | 4,556                        | 1,635                                | (5,342)  | 849  |
| Other liabilities                                  | 2,624      | 3,468                        |                                      |  | 6,092  |
| Minority interest                                  | 1,326      |                              |                                      |  | 1,326  |
| Total liabilities                                  | 447,391    | 349,450                      | 11,059                               | (258,049)  | 549,851  |
| Commitments and contingencies                      |            |                              |                                      |  |  |
| Stockholders equity:                               |            |                              |                                      |  |  |
| Special stock series E                             | 12         |                              |                                      |  | 12   |
| Common stock                                       | 5,145      | 109                          | 1,027                                | (1,136)  | 5,145  |
| Treasury stock                                     | (501)      |                              |                                      |  | (501)  |
| Deferred compensation                              | (6,500)    |                              |                                      |  | (6,500)  |
| Additional paid-in capital                         | 194,040    | 260,813                      | 33,415                               | (294,228)  | 194,040  |
|  | 1,524      | 1,527                        | 2,713                                | (4,240)  | 1,524  |

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Accumulated other comprehensive  
income (loss)

|   |            |            |           |              |            |
|---|------------|------------|-----------|--------------|------------|
| Retained earnings (accumulated deficit) | 7,083      | 83,419     | 37,074    | (120,493)    | 7,083      |
| Total stockholders equity               | 200,803    | 345,868    | 74,229    | (420,097)    | 200,803    |
|   | \$ 648,194 | \$ 695,318 | \$ 85,288 | \$ (678,146) | \$ 750,654 |

See accompanying unaudited notes.

## UNAUDITED CONSOLIDATING STATEMENTS OF OPERATIONS

Three Months Ended September 30, 2004

(In 000s)

|   | Parent      | Guaranteeing<br>Subsidiaries | Non-<br>Guaranteeing<br>Subsidiaries | Reclass-<br>ifications<br>and<br>Elimina-<br>tions | Alliance<br>Gaming<br>Corporation<br>and<br>Subsidiaries |
|---|-------------|------------------------------|--------------------------------------|--|--|
| <b>Revenues:</b>  |             |                              |                                      |  |  |
| Gaming equipment and systems                                    | \$          | \$ 103,094                   | \$ 5,231                             | \$ (4,248)   | \$ 104,077   |
| Casino operations   |             |                              | 14,258                               | (1,422)  | 12,836   |
|   |             | 103,094                      | 19,489                               | (5,670)  | 116,913  |
| <b>Costs and expenses:</b>                                      |             |                              |                                      |  |  |
| Cost of gaming equipment and systems                            |             | 52,202                       | 2,693                                | (4,059)  | 50,836   |
| Cost of casino operations                                       |             |                              | 4,802                                |  | 4,802  |
| Selling, general and administrative                             | 3,979       | 33,139                       | 7,959                                | (1,422)  | 43,655   |
| Research and development costs                                  |             | 11,669                       | 103                                  |  | 11,772   |
| Restructuring charge  | 1,435       |                              |                                      |  | 1,435  |
| Depreciation and amortization                                   | 323         | 9,469                        | 1,049                                |  | 10,841   |
|   | 5,737       | 106,479                      | 16,606                               | (5,481)  | 123,341  |
| Operating income (loss)   | (5,737)     | (3,385)                      | 2,883                                | (189)  | (6,428)  |
| Earnings in consolidated subsidiaries                           | (6,600)     | 1,449                        |                                      | 5,151  |  |
| <b>Other income (expense):</b>                                  |             |                              |                                      |  |  |
| Interest income   | 5,007       | 8                            | 124                                  | (4,659)  | 480  |
| Interest expense  | (3,885)     | (4,733)                      | (3)                                  | 4,659  | (3,962)  |
| Rainbow royalty   | 1,613       |                              | (1,613)                              |  |  |
| Minority interest   | (499)       |                              |                                      |  | (499)  |
| Other, net  | 140         | (44)                         | 57                                   |  | 153  |
| Income (loss) from continuing operations<br>before income taxes | (9,961)     | (6,705)                      | 1,448                                | 4,962  | (10,256)   |
| Income tax expense (benefit)                                    | (3,556)     | (294)                        | (1)                                  |  | (3,851)  |
| Net income (loss) from continuing operations                    | (6,405)     | (6,411)                      | 1,449                                | 4,962  | (6,405)  |
| <b>Discontinued Operations:</b>                                 |             |                              |                                      |  |  |
| Income from disc. ops. of Nevada Route, net                     | (4,701)     |                              |                                      |  | (4,701)  |
| Income from disc. ops. of Louisiana Route, net                  |             |                              | 310                                  |  | 310  |
| Earnings from consolidated discontinued<br>operations           | 310         | 310                          |                                      | (620)  |  |
| Income (loss) from discontinued operations                      | (4,391)     | 310                          | 310                                  | (620)  | (4,391)  |
| Net income (loss)   | \$ (10,796) | \$ (6,101)                   | \$ 1,759                             | \$ 4,342   | \$ (10,796)  |

See accompanying unaudited notes.



## UNAUDITED CONSOLIDATING STATEMENTS OF OPERATIONS

Three Months Ended September 30, 2003

(In 000s)

|   | Parent   | Guaranteeing<br>Subsidiaries | Non-<br>Guaranteeing<br>Subsidiaries | Reclass-<br>ifications<br>and<br>Elimina-<br>tions | Alliance<br>Gaming<br>Corporation<br>and<br>Subsidiaries |
|---|----------|------------------------------|--------------------------------------|--|--|
| <b>Revenues:</b>  |          |                              |                                      |  |  |
| Gaming equipment and systems  | \$       | \$ 85,009                    | \$ 8,612                             | \$ (5,153)   | \$ 88,468  |
| Casino operations   |          |                              | 14,239                               | (1,484)  | 12,755   |
|   |          | 85,009                       | 22,851                               | (6,637)  | 101,223  |
| <b>Costs and expenses:</b>  |          |                              |                                      |  |  |
| Cost of gaming equipment and systems                                |          | 32,688                       | 5,585                                | (5,036)  | 33,237   |
| Cost of casino operations   |          |                              | 5,003                                |  | 5,003  |
| Selling, general and administrative                                 | 2,933    | 21,212                       | 6,404                                | (1,484)  | 29,065   |
| Research and development costs                                      |          | 5,741                        | 222                                  |  | 5,963  |
| Depreciation and amortization                                       | 506      | 4,669                        | 847                                  |  | 6,022  |
|   | 3,439    | 64,310                       | 18,061                               | (6,520)  | 79,290   |
| Operating income (loss)   | (3,439)  | 20,699                       | 4,790                                | (117)  | 21,933   |
| <b>Earnings in consolidated subsidiaries</b>                        |          |                              |                                      |  |  |
|   | 19,752   | 2,569                        |                                      | (22,321)   |  |
| <b>Other income (expense):</b>                                      |          |                              |                                      |  |  |
| Interest income   | 3,070    |                              | 5                                    | (3,032)  | 43   |
| Interest expense  | (5,661)  | (3,084)                      | (16)                                 | 3,032  | (5,729)  |
| Rainbow royalty   | 1,593    |                              | (1,593)                              |  |  |
| Minority interest   | (486)    |                              |                                      |  | (486)  |
| Refinancing charge  | (12,293) |                              |                                      |  | (12,293)   |
| Other, net  | 109      | (197)                        | (266)                                |  | (354)  |
| <b>Income (loss) from continuing operations before income taxes</b> |          |                              |                                      |  |  |
|   | 2,645    | 19,987                       | 2,920                                | (22,438)   | 3,114  |
| Income tax expense  | (797)    | (118)                        | (351)                                |  | (1,266)  |
| Net income (loss) from continuing operations                        | 1,848    | 19,869                       | 2,569                                | (22,438)   | 1,848  |
| <b>Discontinued Operations:</b>                                     |          |                              |                                      |  |  |
| Income from disc. ops. of Nevada Route, net                         |          | 3,132                        |                                      |  | 3,132  |
| Income from disc. ops. of Louisiana Route, net                      |          |                              | 310                                  |  | 310  |
| Income from disc. ops. of Rail City, net                            |          | 738                          |                                      |  | 738  |
| Earnings from consolidated discontinued operations                  | 4,180    | 310                          |                                      | (4,490)  |  |
| Income (loss) from discontinued operations                          | 4,180    | 4,180                        | 310                                  | (4,490)  | 4,180  |
| Net income (loss)   | \$ 6,028 | \$ 24,049                    | \$ 2,879                             | \$ (26,928)  | \$ 6,028   |

See accompanying unaudited notes.

## UNAUDITED CONSOLIDATING STATEMENTS OF CASH FLOWS

Three Months Ended September 30, 2004

(000s)

|   | Parent      | Guaranteeing<br>Subsidiaries | Non-<br>Guaranteeing<br>Subsidiaries | Reclass-<br>ifications<br>and<br>Elimina-<br>tions | Alliance<br>Gaming<br>Corporation<br>and<br>Subsidiaries |
|---|-------------|------------------------------|--------------------------------------|--|--|
| Cash flows from operating activities of continuing operations:  |             |                              |                                      |  |  |
| Net income (loss)   | \$ (10,796) | \$ (6,101)                   | \$ 1,759                             | \$ 4,342   | \$ (10,796)  |
| Adjustments to reconcile net income (loss) to net cash provided by (used in) operating activities of continuing operations: |             |                              |                                      |  |  |
| (Income) loss from discontinued operations  | 4,391       | (310)                        | (310)                                | 620  | 4,391  |
| Depreciation and amortization   | 323         | 9,469                        | 1,049                                |  | 10,841   |
| Deferred income taxes   |             | 2                            |                                      |  | 2  |
| Provision for losses on receivables   |             | 2,650                        | 67                                   |  | 2,717  |
| Inventory write down  |             | 3,582                        |                                      |  | 3,582  |
| Other   | (29)        | (2,159)                      | (39)                                 |  | (2,227)  |
| Change in operating assets and liabilities:   |             |                              |                                      |  |  |
| Accounts and notes receivable   | (96)        | 3,167                        | 2,415                                | 101  | 5,587  |
| Intercompany accounts   | (13,459)    | 17,817                       | 747                                  | (5,105)  |  |
| Inventories   |             | (21,298)                     | (1,487)                              | 189  | (22,596)   |
| Other current assets  | (272)       | (5,431)                      | (1,128)                              |  | (6,831)  |
| Accounts payable  | (5)         | 10,520                       | (1,376)                              |  | 9,139  |
| Accrued liabilities and jackpot liabilities   | (5,769)     | (2,584)                      | (850)                                | (147)  | (9,350)  |
| Net cash provided by (used in) operating activities of continuing operations  | (25,712)    | 9,324                        | 847                                  |  | (15,541)   |
| Cash flows from investing activities of continuing operations:  |             |                              |                                      |  |  |
| Additions to property, plant and equipment  | (12)        | (2,006)                      | (1,182)                              |  | (3,200)  |
| Additions to leased gaming equipment  |             | (8,192)                      |                                      |  | (8,192)  |
| Additions to other long-term assets   |             | (592)                        | 4                                    |  | (588)  |
| Net cash used in investing activities of continuing operations  | (12)        | (10,790)                     | (1,178)                              |  | (11,980)   |
| Cash flows from financing activities of continuing operations:  |             |                              |                                      |  |  |
| Payoff of debt due to sale of net assets of discontinued operations   | (101,618)   |                              |                                      |  | (101,618)  |
| Reduction of long-term debt   | (875)       | (636)                        |                                      |  | (1,511)  |
| Re-purchase of common stock for treasury  | (164)       |                              |                                      |  | (164)  |
| Proceeds from exercise of stock options and warrants  | 873         |                              |                                      |  | 873  |
| Dividends received (paid)   |             | 765                          | (765)                                |  |  |
| Net cash provided by (used in) financing activities of continuing operations  | (101,784)   | 129                          | (765)                                |  | (102,420)  |
| Effect of exchange rate changes on cash   |             |                              | 47                                   |  | 47   |
| Cash provided by discontinued operations  |             |                              | 397                                  |  | 397  |

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|                              |           |          |          |           |
|------------------------------|-----------|----------|----------|-----------|
| Cash and cash equivalents:   |           |          |          |           |
| Decrease for the period      | (127,508) | (1,337)  | (652)    | (129,497) |
| Balance, beginning of period | 155,347   | 7,742    | 9,637    | 172,726   |
| Balance, end of period       | \$ 27,839 | \$ 6,405 | \$ 8,985 | \$ 43,229 |

See accompanying unaudited notes.

## UNAUDITED CONSOLIDATING STATEMENTS OF CASH FLOWS

Three Months Ended September 30, 2003

(000s)

|   | Parent    | Guaranteeing<br>Subsidiaries | Non-<br>Guaranteeing<br>Subsidiaries | Reclass-<br>ifications<br>and<br>Elimina-<br>tions | Alliance<br>Gaming<br>Corporation<br>and<br>Subsidiaries |
|---|-----------|------------------------------|--------------------------------------|--|--|
| Cash flows from operating activities of continuing operations:  |           |                              |                                      |  |  |
| Net income (loss)   | \$ 6,028  | \$ 24,049                    | \$ 2,879                             | \$ (26,928)  | \$ 6,028   |
| Adjustments to reconcile net income (loss) to net cash provided by (used in) operating activities of continuing operations: |           |                              |                                      |  |  |
| (Income) loss from discontinued operations  | (4,180)   | (4,180)                      | (310)                                | 4,490  | (4,180)  |
| Depreciation and amortization   | 506       | 4,669                        | 847                                  |  | 6,022  |
| Refinancing charge  | 12,293    |                              |                                      |  | 12,293   |
| Deferred income taxes   | 1,275     | 2                            |                                      |  | 1,277  |
| Provision for losses on receivables   |           | 915                          | 18                                   |  | 933  |
| Inventory write down  |           | 40                           |                                      |  | 40   |
| Other   | (159)     | (1,421)                      | 6                                    |  | (1,574)  |
| Change in operating assets and liabilities:   |           |                              |                                      |  |  |
| Accounts and notes receivable   | (1,566)   | (6,658)                      | 2,510                                | 133  | (5,581)  |
| Intercompany accounts   | (10,124)  | (10,010)                     | (2,205)                              | 22,339   |  |
| Inventories   |           | (5,387)                      | (78)                                 | 118  | (5,347)  |
| Other current assets  | (347)     | (129)                        | (4)                                  |  | (480)  |
| Accounts payable  | (540)     | 3,308                        | (152)                                |  | 2,616  |
| Accrued liabilities and jackpot liabilities   | (8,726)   | 921                          | (333)                                | (152)  | (8,290)  |
| Net cash provided by (used in) operating activities of continuing operations  | (5,540)   | 6,119                        | 3,178                                |  | 3,757  |
| Cash flows from investing activities of continuing operations:  |           |                              |                                      |  |  |
| Additions to property, plant and equipment  | (7)       | (1,546)                      | (106)                                |  | (1,659)  |
| Additions to leased gaming equipment  |           | (5,004)                      |                                      |  | (5,004)  |
| Additions to other long-term assets   | (5,633)   | (926)                        | 128                                  |  | (6,431)  |
| Proceeds from sale of discontinued operations   | 16,500    |                              |                                      |  | 16,500   |
| Net cash used in investing activities of continuing operations  | 10,860    | (7,476)                      | 22                                   |  | 3,406  |
| Cash flows from financing activities of continuing operations:  |           |                              |                                      |  |  |
| Capitalized debt issuance costs   | (5,686)   |                              |                                      |  | (5,686)  |
| Proceeds from issuance of long-term debt  | 275,000   |                              |                                      |  | 275,000  |
| Payoff of debt from refinancing   | (337,625) |                              |                                      |  | (337,625)  |
| Reduction of long-term debt   | (495)     | (375)                        | (9)                                  |  | (879)  |
| Net change in revolving credit facility   | 70,000    |                              |                                      |  | 70,000   |
| Premium paid on early redemption of debt  | (5,399)   |                              |                                      |  | (5,399)  |

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|  |           |           |          |           |
|--|-----------|-----------|----------|-----------|
| Proceeds from exercise of stock options                                      | 1,460     |           |          | 1,460     |
| Dividends received (paid)  |           | 3,233     | (3,233)  |           |
| Net cash provided by (used in) financing activities of continuing operations | (2,745)   | 2,858     | (3,242)  | (3,129)   |
| Effect of exchange rate changes on cash                                      |           |           | (21)     | (21)      |
| Cash provided by (used in) discontinued operations                           |           | (157)     | 794      | 637       |
| Cash and cash equivalents:   |           |           |          |           |
| Increase for the period  | 2,575     | 1,344     | 731      | 4,650     |
| Balance, beginning of period   | 12,730    | 18,036    | 8,118    | 38,884    |
| Balance, end of period   | \$ 15,305 | \$ 19,380 | \$ 8,849 | \$ 43,534 |

See accompanying unaudited notes.

**Debt and Revolving Credit Facility**

Long-term debt and lines of credit at September 30, 2004 consist of the following (in 000s):

|   | Parent     | Guaranteeing<br>Subsidiaries | Reclass-<br>ifications<br>and<br>Elimina-<br>tions | Alliance<br>Gaming<br>Corporation<br>and<br>Subsidiaries |
|---|------------|------------------------------|--|--|
| Term Loan Facility                      | \$ 317,507 | \$                           | \$   | \$ 317,507   |
| Intercompany notes payable              |            | 256,648                      | (256,648)  |  |
| Other, generally unsecured              | 4,000      | 4,350                        |  | 8,350  |
|   | 321,507    | 260,998                      | (256,648)  | 325,857  |
| Less current maturities                 | 12,388     | 2,274                        |  | 14,662   |
| Long-term debt, less current maturities | \$ 309,119 | \$ 258,724                   | \$ (256,648)                                       | \$ 311,195   |

Long-term debt and lines of credit at June 30, 2004 consist of the following (in 000s):

|   | Parent     | Guaranteeing<br>Subsidiaries | Reclass-<br>ifications<br>and<br>Elimina-<br>tions | Alliance<br>Gaming<br>Corporation<br>and<br>Subsidiaries |
|---|------------|------------------------------|--|--|
| Term Loan Facility                      | \$ 350,000 |                              |  | \$ 350,000   |
| Revolving credit facility               | 70,000     |                              |  | 70,000   |
| Intercompany notes payable              |            | 251,989                      | (251,989)  |  |
| Other, generally unsecured              | 4,000      | 4,955                        |  | 8,955  |
|   | 424,000    | 256,944                      | (251,989)  | 428,955  |
| Less current maturities                 | 3,313      | 2,553                        |  | 5,866  |
| Long-term debt, less current maturities | \$ 420,687 | \$ 254,391                   | \$ (251,989)                                       | \$ 423,089   |

**ALLIANCE GAMING CORPORATION**

**FORM 10-Q**

**September 30, 2004**

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

**Forward-Looking Statements**

Certain matters in this Form 10-Q and our other filings with the Securities and Exchange Commission, including, without limitation, certain matters discussed in this Management's Discussion and Analysis of Financial Condition and Results of Operations and in Quantitative and Qualitative Disclosures about Market Risk, constitute 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, and are subject to the safe harbor created thereby. Those statements reflect the intent, belief or current expectations of the Company, its directors or its officers with respect to, among other things, future events and financial trends affecting the Company.

Forward-looking statements are typically identified by the words believes, expects, anticipates, and similar expressions. In addition, any statements that refer to expectations or other characterizations of future events or circumstances are forward-looking statements. Readers are cautioned that any such forward-looking statements are not guarantees of future performance and that matters referred to in such forward-looking statements involve known and unknown risks, uncertainties and other factors which may cause actual results, performance or achievements of the Company to be materially different from any future results, performance or achievements expressed or implied by such forward-looking statements. Such factors include, among other things, the impact of competition and uncertainties concerning such matters as the Company's ability to service debt, product development, customer financing, sales to non-traditional gaming markets, foreign operations, dependence on key personnel, the ability to integrate future acquisitions, strict regulation by gaming authorities, the outcome of pending litigation matters including the pending securities class actions, gaming taxes, currency fluctuations and market risk. The Company undertakes no obligation to publicly update or revise these forward-looking statements because of new information, future events or otherwise.

**Introduction**

Operating under the name *Bally Gaming and Systems*, we are a worldwide leader in designing, manufacturing and distributing traditional and nontraditional gaming machines, having marketed over 100,000 gaming machines during the past five years, and computerized monitoring systems for gaming facilities. The Bally Gaming and Systems business unit consists of three divisions: Game sales, System sales and Gaming operations. We also own and operate a dockside casino in Vicksburg, Mississippi, which has approximately 12 table games and approximately 930 gaming devices ( Casino Operations ). Further information about our business units is contained in the notes to the Consolidated Financial Statements ( Segments and Geographical Information ) and in our annual report filed on Form 10-K.

We recognize revenue from the following sources: sales of gaming machines, operation of wide-area progressive systems and lease of gaming machines, sales of computerized monitoring systems and related recurring hardware and software maintenance revenue, and from casino

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operations. We often accept used machines as trade-ins toward the purchase of new gaming equipment. These trade-ins are negotiated at the time of sale for that transaction only, and there are no provisions for rights to future trade-ins contained in the purchase agreement for the new gaming equipment. The traded-in gaming machine is accounted for as a discount to the contracted selling price of a new gaming machine.

Our most significant expenses are (1) cost of sales, (2) research and development expenses, (3) advertising and promotional expenses and (4) administrative expenses. We strive to control these expenses by working closely with division unit leaders and by centralizing functions such as finance, accounting, legal, human resources and management information systems. We also use our market presence and purchasing power to negotiate favorable rates with vendors and suppliers.

Our research and development costs are driven by the development cycle for hardware which varies between a few months for minor revisions to more than a year for major design changes or for changes made by various slot manufacturers with which our product must communicate and be physically integrated. Software development results in (i) periodic product releases that include new features that extend and enhance casino enterprise systems; (ii) periodic maintenance releases that enable casino operators to correct problems or improve the usability of the system; and (iii) documentation needed to install and use the system.

Depreciation and amortization expense for tangible and intangible assets have historically been significant factors in determining our overall profitability. Based on intangible assets currently held by us and the allocation of the aggregate purchase price of acquisitions completed during the year ended June 30, 2004, we expect the total amortization expense incurred will continue to increase.

### Basis of Presentation

Our results include the accounts of Alliance Gaming Corporation, and its wholly-owned and partially-owned, controlled subsidiaries.

### Results of Operations

#### *Bally Gaming and Systems*

Summary financial results and operating statistics (dollars in millions):

|                                     | Three Months Ended |               | 2003    | Increase/<br>(Decrease) | %<br>Change |
|-------------------------------------|--------------------|---------------|---------|-------------------------|-------------|
|                                     | 2004               | September 30, |         |                         |             |
| <b>Revenues</b>                     |                    |               |         |                         |             |
| Game sales                          | \$                 | 51.5          | \$ 42.8 | \$ 8.7                  | 20%         |
| System sales                        |                    | 19.4          | 30.0    | (10.6)                  | (35)%       |
| Gaming operations                   |                    | 33.2          | 15.7    | 17.5                    | 111%        |
| Total revenues                      | \$                 | 104.1         | \$ 88.5 | \$ 15.6                 | 18%         |
| <b>Gross Margin</b>                 |                    |               |         |                         |             |
| Game sales                          | \$                 | 12.9          | \$ 19.6 | \$ (6.7)                | (34)%       |
| System sales                        |                    | 15.9          | 23.9    | (8.0)                   | (33)%       |
| Gaming operations                   |                    | 24.4          | 11.7    | 12.7                    | 109%        |
| Total gross margin                  | \$                 | 53.2          | \$ 55.2 | \$ (2.0)                | (4)%        |
| Selling, general and administrative | \$                 | 36.2          | \$ 23.1 | \$ 13.1                 | 57%         |
| Research and development costs      |                    | 11.8          | 6.0     | 5.8                     | 97%         |
| Depreciation and amortization       |                    | 9.7           | 4.8     | 4.9                     | 102%        |
| Operating income (loss)             | \$                 | (4.5)         | \$ 21.4 | \$ (25.9)               | (121)%      |



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Three Months Ended

|  | 2004    | September 30,<br>2003 | Increase/<br>(Decrease) | %<br>Change |
|--|---------|-----------------------|-------------------------|-------------|
| <b>Operating Statistics:</b>                       |         |                       |                         |             |
| New Gaming Devices Sold                            | 2,740   | 3,330                 | (590)                   | (18)%       |
| Original Equipment Manufacturer ( OEM ) Units Sold | 1,920   | 1,865                 | 55                      | 3%          |
| New Unit average selling price (Excluding OEM) \$  | 10,394  | \$ 8,433              | \$ 1,961                | 23%         |
| Game monitoring units installed base               | 281,000 | 239,000               | 42,000                  | 18%         |
| Casino management systems installed base           | 221     | 197                   | 24                      | 12%         |
| System managed cashless games                      | 97,800  | 34,000                | 63,800                  | 188%        |
| End of period installed base:                      |         |                       |                         |             |
| Wide-area progressive                              | 1,825   | 1,985                 | (160)                   | (8)%        |
| Daily-fee games                                    | 8,259   | 2,995                 | 5,264                   | 176%        |
| Centrally determined games                         | 17,193  |                       | 17,193                  |             |

Total revenues increased due to the following:

Bally game sales revenue increased as a result of the following:

Revenues contributed by SDG in non-traditional gaming jurisdictions offset by lower unit sales in traditional gaming jurisdictions.

Total unit sales declined to 4,660 from 5,195

Average selling price increased 23% to \$10,394

Bally System revenue decreased primarily as a result of:

Decreased hardware sales due to the lack of new property openings in the current quarter.

Recurring hardware and software maintenance revenues increased by 23% to \$6.0 million for the quarter, resulting from the larger base of installed units, which now stands at approximately 281,000 in 221 casinos world-wide.

Gaming Operations revenues increased due to the following:

An increase of 176% in the installed base of daily-fee games deployed to 8,259 units installed primarily driven by the installation relative to the New York Lottery and games such as Monte Carlo and Quarter Millions, as well as the revenues received from centrally-determined games.

Gross margin decreased as a result of the following:

Game sales gross margin declined to 25% from 46% in the prior year quarter resulting from lower margin international sales, lower margins on video games, as well as a \$3.6 million inventory write down charge, which included \$3.0 million for slow-moving recently discontinued legacy video products and used games. We believe the product mix of games sold will cause the gross margin to fluctuate although we believe the gross margin should exceed 40% in the future barring any other unusual charges.

Systems gross margin was 82% compared to 80% in the prior year period.

Gaming operations gross margin was 73% compared to 75% in the prior year quarter, reflecting a slightly higher frequency of WAP jackpots awarded during the current quarter.

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Selling, general and administrative expenses increased in the current quarter over prior year quarter primarily due to:

Increase in headcount related to acquisitions resulted in an increase in payroll.

A one time charge for severance costs of \$0.9 million as a result of the reduction in workforce.

Legal expense as a result of higher patent and litigation costs.

Higher field service related costs due to our increase in the base of installed games under gaming operations.

Increase in the provision for doubtful accounts receivables of \$2.7 million primarily as a result of one specific customer delinquency for which we provided a reserve of \$1.0 million.

Research and development costs increased as a result of the increased investment in the development of the Alpha game platform and related game content, and sustaining development of multiple existing game platforms and systems.

Depreciation and amortization increased as a result of the following:

Acquisition related intangible assets.

Increase in the base of installed recurring revenue games from 4,981 units in the prior year quarter to 9,530 units.

Increase in operating capital expenditures relative to new technology initiatives.

The operating loss from the current period of \$(4.5) million compared to operating income of \$21.4 million in the prior year period, which is a result of the modest increase in revenues and significantly increased level of expenses, as described in the preceding paragraphs.

### *Rainbow Casino Operations*

Summary financial results and operating statistics (dollars in millions):

|                                     | Three Months Ended<br>September 30, |      |      |      | Increase/<br>(Decrease) | %      |
|-------------------------------------|-------------------------------------|------|------|------|-------------------------|--------|
|                                     | 2004                                |      | 2003 |      |                         | Change |
| Revenue                             | \$                                  | 12.8 | \$   | 12.8 | \$                      | 0%     |
| Gross Margin                        |                                     | 8.0  |      | 7.8  | (0.2)                   | (3)%   |
| Selling, general and administrative |                                     | 3.4  |      | 3.1  | 0.3                     | 10%    |
| Depreciation and amortization       |                                     | 0.8  |      | 0.7  | 0.1                     | 14%    |
| Operating income                    | \$                                  | 3.8  | \$   | 4.0  | \$ (0.2)                | (5)%   |

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| Operating Statistics:            |     |     |    |    |
|----------------------------------|-----|-----|----|----|
| Average Number of Gaming Devices | 930 | 905 | 25 | 3% |
| Average Number of Table Games    | 12  | 12  |    | 0% |

Rainbow Casino revenues remained flat compared to the prior year quarter.

Gross margin increased to 62% as a result of decreases in certain operating costs. Cost of casino revenues includes gaming taxes, rental costs and direct labor including payroll taxes and benefits.

The overall selling, general and administrative expenses increased by \$0.3 million primarily due to increases in casino promotional expenses.

Depreciation and amortization expense increased \$0.1 million for the quarter resulting from additional capital improvements made to the Rainbow Casino in fiscal 2004.

Total operating income decreased \$0.2 million reflecting the small improvements in gross margin, offset by higher promotional expenses and slightly higher depreciation.

*Parent Company and other unallocated income (expense)*

Summary financial results (dollars in million):

|                               | Three Months Ended |                       | Increase/<br>(Decrease) | %<br>Change |
|-------------------------------|--------------------|-----------------------|-------------------------|-------------|
|                               | 2004               | September 30,<br>2003 |                         |             |
| General and administrative    | \$ 5.4             | \$ 2.9                | \$ 2.5                  | 86%         |
| Depreciation and amortization | 0.3                | 0.5                   | (0.2)                   | (40)%       |
| Total Parent company expense  | \$ 5.7             | \$ 3.4                | \$ 2.3                  | 68%         |
| Other income (expense):       |                    |                       |                         |             |
| Interest income               | \$ 0.5             | \$ 0.0                | \$ 0.5                  |             |
| Interest expense              | (4.0)              | (5.7)                 | 1.7                     | (30)%       |
| Minority interest             | (0.5)              | (0.5)                 |                         | 0%          |
| Refinancing charge            |                    | (12.3)                | 12.3                    | 100%        |
| Other, net                    | 0.2                | (0.3)                 | 0.5                     | (167)%      |
| Total other income (expense)  | \$ (3.8)           | \$ (18.8)             | \$ 15.0                 | (80)%       |
| Income tax expense (benefit)  | \$ (3.9)           | \$ 1.3                | \$ (5.2)                | (400)%      |

General and administrative expenses increased primarily as a result of:

Increase in severance and relocation costs of approximately \$0.7 million.

Increase in litigation and general legal costs of approximately \$1.2 million relative to protection of our patents and class action law suits.

Increase in professional fees relative to Sarbanes-Oxley implementations, which are expected to continue in fiscal year 2005.

Increase in general liability and director and officer insurance costs. Such increases in insurance costs are expected to continue in fiscal 2005.

Other income (expense) decreased as a result of the prior year refinancing, which resulted in charge of \$12.3 million (consisting of \$5.0 million charge for the early extinguishment of the Subordinated Notes, \$7.0 million for the non-cash write off of deferred financing costs, and \$0.3 million in fees and expenses) and resulted in a reduction in our interest expense relative to lower interest rates achieved in the refinancing of \$1.7 million for the quarter ended September 30, 2004.

Our effective income tax rate for the quarter ended September 30, 2004 was 38% compared to the prior year quarter of 41%.

*Discontinued Operations:*

The current quarter discontinued operations includes VSI, which contributed revenues of \$4.0 million, and operating income of \$0.4 million, as well as a charge of \$7.4 million (or \$4.7 million after tax) for the jury award of damages against UCMC in a patent infringement case.

On October 15, 2004 the Company completed the sale of our interest in VSI to Churchill Downs Incorporated. The net proceeds we received totaled approximately \$2.0 million. No significant gain or loss on disposition is expected.

For the comparative three month period ended September 30, 2003, UCMC revenues totaled \$50.3 million and operating income totaled \$5.2 million. Rail City revenues totaled \$5.4 million and operating income totaled \$1.5 million.

## Liquidity and Capital Resources

As of September 30, 2004, we had \$43.2 million in cash and cash equivalents. In addition we had net working capital of approximately \$154 million (excluding assets and liabilities of discontinued operations), a decrease of approximately \$138 million from June 30, 2004, which is explained in the working capital section below. Consolidated cash and cash equivalents at September 30, 2004 include approximately \$1.9 million of cash utilized in our Casino Operations that is held in vaults, cages or change banks. Additionally, pursuant to various state gaming regulations, we maintain certain cash accounts to ensure availability of funds to pay wide-area progressive jackpot awards, which totaled approximately \$14.4 million at September 30, 2004. In addition, we purchase U.S. Treasury Strip securities for the benefit of jackpot winners who elect to receive annual or weekly installment payments. These securities are presented as restricted investments in the accompanying consolidated balance sheets, and totaled \$4.7 million and \$2.5 million as of September 30, 2004 and June 30, 2004, respectively.

We completed the sale of Rail City in May 2004 and the sale of UCMC in June 2004. As a result of the sale of these assets, the terms of our bank loan agreement required the use of approximately 50% of the net proceeds (as defined in the agreement) to reduce the term loan and revolver principal balances on a pro rata basis. Accordingly, in August 2004 we made an initial reduction in our term loan of \$31.6 million and the revolver of \$11.3 million and will be required to make additional term loan reductions currently estimated to be \$10.0 million by December 31, 2004.

As of September 30, 2004 our outstanding debt totaled \$325.9 million. The Company's revolving credit facility of \$125 million was undrawn as of September 30, 2004. The Company is currently limited to approximately \$10 million in the borrowing availability under the revolver. The Company is currently in compliance with its financial covenants consisting of leverage ratio, fixed charges coverage ratio and minimum EBITDA (as that term is defined in the credit agreement). The Company may elect to seek modifications of certain of these financial covenants in the future.

Management believes that cash flows from current operating activities and the limited availability under the revolving credit facility will provide the Company with sufficient capital resources and liquidity. At September 30, 2004 we had no material commitments for capital expenditures.

### Working Capital

The following table presents the components of consolidated working capital at September 30, 2004 and June 30, 2004, excluding assets and liabilities of discontinued operations (dollars in 000s):

|                                    | Sept 30,<br>2004 |    | June 30,<br>2004 | Change    |
|------------------------------------|------------------|----|------------------|-----------|
| Cash and cash equivalents          | \$ 43,229        | \$ | 172,726          | (129,497) |
| Accounts and notes receivable, net | 110,100          |    | 129,779          | (19,679)  |
| Inventories, net                   | 81,466           |    | 61,135           | 20,331    |
| Deferred tax assets, net           | 20,053           |    | 20,054           | (1)       |
| Other current assets               | 22,264           |    | 12,420           | 9,844     |
| Total current assets               | 277,112          |    | 396,114          | (119,002) |



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|                                      | Sept 30,<br>2004 |    | June 30,<br>2004 | Change       |
|--------------------------------------|------------------|----|------------------|--------------|
| Accounts payable                     | 46,654           |    | 37,515           | 9,139        |
| Jackpot liabilities                  | 9,447            |    | 12,075           | (2,628)      |
| Accrued liabilities                  | 61,487           |    | 51,469           | 10,018       |
| Taxes payable                        | 420              |    | 7,233            | (6,813)      |
| Current maturities of long-term debt | 14,662           |    | 5,866            | 8,796        |
| Total current liabilities            | 132,670          |    | 114,158          | 18,512       |
| Net working capital                  | \$ 144,442       | \$ | 281,956          | \$ (137,514) |

The primary fluctuations contributing to the increase in working capital were:

Cash and cash equivalents as a result of the following:

\$101.6 million pay down on the term loan and revolver in accordance with the terms of our loan.

\$17.2 million used in current operations for inventory and gaming assets.

A net decrease in accounts and notes receivable resulting from the overall reduction in game and systems sales.

An increase in inventory relative to the production and purchase of game units expected to be deployed in the second and third quarters of fiscal year 2005.

An increase in other assets as a result of the following:

Increases in refundable deposits relative to units purchased from other manufacturers.

Increase in deferred costs due to shipments of games to the European market that will not be installed until the second quarter 2005.

Increase in prepaid royalties.

The impact of foreign exchange fluctuations between the dollar and the euro on all working capital categories.

An increase in accounts payable primarily related to the increase in inventory.

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An increase in accrued liabilities as a result of the following:

Customer deposits and deferred revenue increased due to contractual requirements from customers for deposits in advance of Systems installation.

An accrual of \$7.4 million for damages awarded to Action Gaming and International Game Technology for patent infringement relative to a single optional feature offered in certain multi-hand poker games operated by UCMC.

### *Cash Flow*

During the quarter ended September 30, 2004, cash flows used in operating activities totaled \$15.5 million as a result of:

Increase in inventory of \$20.3 million.

Timing of receivables collections.

Increase in accounts payable and accrued liabilities largely due to the increase in inventory and legal settlement costs.

During the quarter ended September 30, 2004, cash flow used in investing activities totaled \$12.0 million due to the following:

Capital expenditures of \$3.2 million.

Costs incurred to produce participation games totaling \$8.2 million.

Additions to other long-term assets of \$0.6 million.

During the quarter ended September 30, 2004, \$102.4 million cash was used in financing activities of continuing operations resulting from:

Pay down on the term loan and revolver of \$101.6 million.

Principal payments on other long term debt totaling \$1.5 million.

Cash provided from exercise of stock options of \$0.9 million.

#### *Contractual Commitments*

A description of the Company's contractual commitments can be found in Item 7 of the Company's Annual Report on Form 10-K for the year ended June 30, 2004. For a more extensive discussion of the Company's contractual commitments, see note 12 Commitments and Contingencies in the Notes to the Consolidated Financial Statements in the Company's 2004 Annual Report on Form 10-K for the year ended June 30, 2004.

#### **Critical Accounting Policies and Estimates**

We prepare our Consolidated Financial Statements in conformity with accounting principles generally accepted in the United States of America. Certain of our accounting policies, including valuations utilized in asset impairment tests, acquisitions accounting, revenue recognition, allowance for doubtful accounts, capitalized costs, reserves for inventory, and deferred tax reserves require that we apply significant judgment in defining the appropriate assumptions for calculating financial estimates. These judgments are subject to an inherent degree of uncertainty. There can be no assurance that the actual results will not differ from our estimates.

A description of the Company's critical accounting policies and estimates can be found in Item 7 of the Company's Annual Report on Form 10-K for the year ended June 30, 2004. For a more extensive discussion of the Company's accounting policies, see Note 1, Summary of Significant Accounting Policies, in the Notes to the Consolidated Financial Statements in the Company's 2004 Annual Report on Form 10-K for the year ended June 30, 2004.

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

*Currency Rate Fluctuations*

We derive revenues from our non-U.S. subsidiaries, all of which revenues are denominated in their local currencies, and their results are affected by changes in the relative values of non-U.S. currencies and the U.S. dollar. Most of the currencies in countries in which we have foreign operations strengthened versus the U.S. dollar, which resulted in assets and liabilities denominated in local currencies being translated into more dollars. We do not currently utilize hedging instruments.

*Market risks*

During the normal course of our business, we are routinely subjected to a variety of market risks, examples of which include, but are not limited to, interest and currency rate movements, collectibility of accounts and notes receivable, and recoverability of residual values on leased assets. We constantly assess these risks and have established policies and practices designed to protect against the adverse effects of these and other potential exposures. Although we do not anticipate any material losses in these risk areas, no assurances can be made that material losses will not be incurred in these areas in the future.

We have performed a sensitivity analysis of our financial instruments, which consist of our cash and cash equivalents and debt. We have no derivative financial instruments. In performing the sensitivity analysis, we define risk of loss as the hypothetical impact on earnings of changes in the market interest rates or currency exchange rates.

The results of the sensitivity analysis at September 30, 2004, are as follows:

**Interest Rate Risk:**

We had total debt of approximately \$325.9 million, consisting primarily of the new \$317.5 million is outstanding term loan and other debt at approximately \$8.4 million. The bank facility borrowings each have a term of nine months at which time the interest rate is subject to adjustment to the then current rate. If the LIBOR rates were to increase or decrease by 100 basis points, with all other factors remaining constant, earnings would decrease or increase by approximately \$3.3 million annually on a pre-tax basis.

**Foreign Currency Exchange Rate Risk:**

Our foreign subsidiaries generally use their domestic currency as their functional currency. A 10% fluctuation in the exchange rates of these currencies against the U.S. dollar would result in a corresponding change in annual earnings reported in the consolidated group of approximately \$0.1 million net of tax.

**Estimates:**

Our financial statements are prepared using estimates and assumptions that affect the reported amounts of assets and liabilities. Actual results may differ from these estimates either favorably or unfavorably, which may impact future results.

**ITEM 4. DISCLOSURE CONTROLS AND PROCEDURES**

The Company's management, including the Chief Executive Officer and Chief Financial Officer, conducted an evaluation of the effectiveness of the design and operation of the Company's disclosure controls and procedures as defined in Exchange Act Rule 13a-15(e) as described at the end of the period covered by this report. Based on that evaluation, the Chief Executive Officer and Chief Financial Officer concluded that as of the end of the period covered by this report, the Company's disclosure controls and procedures were effective. During the period covered by this report there have been no changes in the Company's internal control over financial reporting that have materially affected, or are reasonably likely to materially affect the Company's internal control over financial reporting.

**PART II**

**ITEM 1. Legal Proceedings**

For a description of our legal proceedings, see note 14 of Notes to Unaudited Condensed Financial Statement, which is incorporated by reference in response to this item.

In September 2004, a federal district court jury entered a \$7.4 million verdict against the Company in a suit filed by Action Gaming, Inc., and IGT. The suit alleged that the multi-hand video poker game deployed by the Company's former subsidiary, United Coin Machine Co., infringed the plaintiffs' patents. The district court had ruled on summary judgment that the game does not infringe the patents. However, the court left to the jury the question whether the use of autohold, a specific, optional feature of the game, caused it to infringe under the doctrine of equivalents, a doctrine of patent law. After a two-week trial, the jury determined that the game with the autohold option enabled did infringe under the doctrine of equivalents and awarded damages accordingly. The feature has been disabled on all affected games in the field, and the decision permits continued deployment of the game as long as the autohold feature is not included. The Company is pursuing various remedies and has posted a bond to stay payment of the judgment pending post-trial motions and appeal.

We are also a party to various lawsuits relating to routine matters incidental to our business. Management does not believe that the outcome of such litigation, including the matters above, in the aggregate, will have a material adverse effect on our financial position.

**ITEM 6. Exhibits**

a. Exhibits

- 31.1 Certification of Chief Executive Officer, pursuant to Rule 13a-14(a) of the Securities Act of 1934, as amended.
- 31.2 Certification of Chief Financial Officer, pursuant to Rule 13a-14(a) of the Securities Act of 1934, as amended.
- 32.1 Certification of Chief Executive Officer, pursuant to 18 U.S.C. Section 1350, as adopted pursuant to section 906 of the Sarbanes-Oxley Act of 2004.
- 32.2 Certification of Chief Financial Officer, pursuant to 18 U.S.C. Section 1350, as adopted pursuant to section 906 of the Sarbanes-Oxley Act of 2004.

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 authorized.

ALLIANCE GAMING CORPORATION  
(Registrant)

Date: November 8, 2004

By /s/ Richard Hadrill  
President and Chief Executive Officer  
(Principal Executive Officer)

By - /s/ Robert L. Saxton  
Executive Vice President, Treasurer and Chief  
Financial  
Officer (Principal Financial and Accounting Officer)