VICOR CORP
Form 10-K
March 19, 2008

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UNITED STATES SECURITIES AND EXCHANGE COMMISSION
Washington, D.C. 20549
Form 10-K

þ **ANNUAL REPORT PURSUANT TO SECTION 13 OR 15(d) OF THE SECURITIES EXCHANGE ACT OF 1934**
For the fiscal year ended December 31, 2007

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 0-18277
VICOR CORPORATION
(Exact name of registrant as specified in its charter)

Delaware *(State or other jurisdiction of incorporation or organization)*	**04-2742817** *(IRS employer identification no.)*
25 Frontage Road, Andover, Massachusetts *(Address of principal executive offices)*	**01810** *(Zip code)*

Registrant s telephone number, including area code:
(978) 470-2900

Securities registered pursuant to Section 12(b) of the Act:

Common Stock, $.01 par Value	**The NASDAQ Stock Market, LLC**
(Title of Class)	*(Name of Each Exchange on Which Registered)*

Securities registered pursuant to Section 12(g) of the Act:
None

Indicate by check mark if the registrant is a well-known seasoned issuer, as defined in Rule 405 of the Securities Act. Yes o No þ

Indicate by check mark if the registrant is not required to file reports pursuant to Section 13 or Section 15(d) of the Act. Yes o No þ

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 þ No o

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

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

Large accelerated filer o	Accelerated filer þ	Non-accelerated filer o (Do not check if a smaller reporting company)	Smaller Reporting company o

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

The aggregate market value of the voting stock held by non-affiliates of the registrant was approximately $260,538,271 as of June 30, 2007.

On February 29, 2008, there were 29,851,286 shares of Common Stock outstanding and 11,785,052 shares of Class B Common Stock outstanding.

DOCUMENTS INCORPORATED BY REFERENCE

Portions of the Company s definitive proxy statement (the Definitive Proxy Statement) to be filed with the Securities and Exchange Commission pursuant to Regulation 14A and relating to the Company s 2008 annual meeting of stockholders are incorporated by reference into Part III.

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PART I

This Annual Report on Form 10-K contains forward-looking statements within the meaning of Section 27A of the Securities Act of 1933, as amended, and Section 21E of the Securities Exchange Act of 1934, as amended. The words believes, expects, anticipates, intend, estimate, plans, assumes, may, will, would, should, cor project, and other similar expressions identify forward-looking statements. Forward-looking statements also include statements regarding the derivation of a substantial portion of the Company s sales in each quarter from orders booked in the same quarter, the Company s plans to invest in research and development and manufacturing equipment, the Company s belief regarding market risk being mitigated because of limited foreign exchange fluctuation exposure, the Company s continued success depending in part on its ability to attract and retain qualified personnel, the Company s belief that cash generated from operations and the total of its cash and cash equivalents and short-term investments will be sufficient for the foreseeable future, the Company s intention regarding protecting its rights under its patents and the Company s expectation that no current litigation or claims will have a material adverse impact on its financial position or results of operations. These statements are based upon the Company s current expectations and estimates as to the prospective events and circumstances which may or may not be within the Company s control and as to which there can be no assurance. Actual results could differ materially from those projected in the forward-looking statements as a result of various factors, including our ability to develop and market new products and technologies cost effectively, to leverage design wins into increased product sales, to continue to make progress with key customers and prospects, to decrease manufacturing costs, to enter into licensing agreements that amplify the market opportunity and accelerate market penetration, to realize significant royalties under license agreements, to achieve a sustainable increased bookings rate over a longer period, to hire key personnel and to continue to build our three business units, to successfully enforce our intellectual property rights, to successfully defend outstanding litigation, to successfully leverage the V*I Chips in standard products to promote market acceptance of Factorized Power, to develop or maintain an effective system of internal controls, to obtain required financial information for certain investments on a timely basis, and factors impacting the Company s various end markets, the impact of write-downs in the value of assets, the effects of equity accounting with respect to certain affiliates, the failure of auction rate securities to sell at their reset dates as well as those factors described in the risk factors set forth in this Annual Report on Form 10-K under Part I, Item I Business, Competition, Patents, and Licensing, under Part I, Item 1A Risk Factors, Item 3 Legal Proceedings, and under Part II, Item 7 Management s Discussion and Analysis of Financial Condition and Results of Operations. The risk factors contained in this report may not be exhaustive. Therefore, the information contained in this report should be read together with other reports and documents that the Company files with the Securities and Exchange Commission from time to time, including Forms 10-Q, and 8-K, which may supplement, modify, supersede or update those risk factors. The Company does not undertake any obligation to update any forward-looking statements as a result of future events or developments.

ITEM 1 *BUSINESS*

The Company

Vicor Corporation was incorporated in Delaware in 1981. Unless the context indicates otherwise, the term Company or Vicor mean Vicor Corporation and its consolidated subsidiaries. The Company designs, develops, manufactures and markets modular power components and complete power systems, many of which use an innovative, high frequency electronic power conversion technology called zero current and zero voltage switching. In April 2003, the Company announced the introduction of a new power system architecture based on an array of proprietary power conversion technologies called Factorized Power Architecture (FPA). The Company believes FPA will provide power system designers with enhanced performance at a lower cost than attained with conventional Distributed Power Architecture (DPA). The Company s principal product lines are covered by one or more United States and foreign patents. Power systems, a central element in any electronic system, convert power from a primary power source (e.g., a wall outlet or battery source) into the stable DC voltages that are required by most contemporary electronic circuits.

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In 1986, the Company formed Westcor Corporation (Westcor). During 1990, Westcor was merged into the Company and became a division. Westcor manufactures configurable products at its location in Sunnyvale, California. In 1987, the Company formed VLT Corporation as its licensing subsidiary. During 2000, the Company reincorporated VLT Corporation in California by merging it with and into VLT, Inc., a wholly owned subsidiary of the Company. In 1990, the Company established a Technical Support Center in Germany. In 1995, the Company established Technical Support Centers in France, Italy, Hong Kong, and England. Also in 1995, the Company established Vicor Integration Architects (VIAs), most of which are majority-owned subsidiaries. VIAs provide customers with local design and manufacturing services for turnkey custom power solutions. At December 31, 2007 there were six (6) VIAs operating in the United States. In 1996, the Company established Vicor B.V., a Netherlands company, which serves as a European Distribution Center. In 1998, the Company acquired the principal assets of the switching power supply businesses owned by the Japan Tobacco, Inc. group and established a direct presence in Japan through a new subsidiary called Vicor Japan Company, Ltd. (VJCL). VJCL markets and sells the Company s products and provides customer support in Japan. In 2001, the Company established Picor Corporation (Picor), a subsidiary which designs, develops and markets Power Management Integrated Circuits and related products for use in a variety of power system applications. Picor develops these products to be sold as part of Vicor s products or to third parties for separate applications. In 2007, the Company established V*I Chip Corporation as a wholly-owned subsidiary of Vicor which designs, develops, manufactures and markets the Company s FPA products. The Company s Common Stock became publicly traded on the NASDAQ National Market System in April 1990. All of the above named entities are consolidated in the Company s financial statements.

The Company maintains a website with the address www.vicorpower.com. We make available free of charge through our website our Annual Reports on Form 10-K, Quarterly Reports on Form 10-Q and Current Reports on Form 8-K, and amendments to these reports filed or furnished pursuant to Section 13(a) or 15(d) of the Exchange Act, as soon as reasonably practicable after we electronically file such material with, or furnish such material to, the Securities and Exchange Commission. The information contained on our website is not a part of, or incorporated by reference into, this Annual Report on Form 10-K.

The Products

Power systems are incorporated into virtually all electronic products, such as computers and telecommunications equipment, to convert electric power from a primary source, for example a wall outlet or battery source, into the stable DC voltages required by electronic circuits. Because power systems are arranged in a myriad of application-specific configurations, the Company s basic strategy is to exploit the density and performance advantages of its technology by offering comprehensive families of economical, component-level building blocks which can be used to configure a power system specific to a user s needs. In addition to component-level power converters, which serve as modular power system building blocks, the Company also manufactures and sells complete configurable power systems, accessory products, and custom power solutions. The Company has organized its business segments according to its key product lines. The Brick Business Unit segment (BBU or Brick) designs, develops, manufactures and markets the Company s modular power converters and configurable products, and includes the operations of the Company s Westcor division, VIAs and VJCL. The V*I Chip segment consists of V*I Chip Corporation, a wholly owned subsidiary which designs, develops, manufactures and markets the Company s FPA products. The Picor segment consists of Picor Corporation, a majority-owned subsidiary of Vicor, which designs, develops, manufactures and markets Power Management Integrated Circuits and related products for use in a variety of power system applications. Picor develops these products to be sold as part of Vicor s products or to third parties for separate applications. The Company s principal product lines include:

Brick Products

Modular Power Converters

The Company currently offers seven families of component-level DC-DC power converters: the VI-200, VI-J00, MI-200, MI-J00, Maxi, Mini and Micro families. Designed to be mounted directly on a printed circuit board assembly and soldered in place using contemporary manufacturing processes, each family comprises a

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comprehensive set of products which are offered in a wide range of input voltage, output voltage and power ratings. This allows end users to select products appropriate to their individual applications. The product families differ in maximum power ratings, performance characteristics, package size and, in certain cases, in target market.

Since 1998, the Company has introduced four input series of its high power density, component-level DC-DC converters in three standard packages: the full size (Maxi), the half size (Mini) and the quarter size (Micro), along with military-commercial-off-the-shelf (MIL-COTS) products. In 1998, the 48 Volt input series was introduced, which was designed for the telecommunications market as well as for distributed power systems. Output power levels from 50 to 500 Watts are covered by these products. In 1999, this was followed by two additional series: a 300 Volt input for off-line (rectified 115 or 230 Volt ac) and distributed power applications, and a 375 Volt input specifically designed for use in power factor corrected systems. This latter series increased the power available to 600 Watts. In 2001, a 24 Volt input series was added to the standard product line to address additional telecommunications, industrial and defense market opportunities. The Company has undergone a process of converting these products to the new FasTrak platform that was completed in the first quarter of 2006. The conversion to FasTrak has resulted in lower unit costs, improved manufacturing yields, improved field reliability and improved gross margins.

The Vicor Design Assistance Computer (VDAC), a core component of the Vicor PowerBench tool suite, was introduced for general use in 2000 and is a proprietary system, which enables Vicor s customers to specify on-line, and verify in real time, the performance and attributes of its Maxi, Mini, Micro and MIL-COTS DC-DC converters. Using patented technology, VDAC enables the design of DC-DC converters with any output voltage between 2 and 48 Volts and with any input voltage from 18 to 425 Volts, with an input voltage range of up to 2.1:1, available in all of the Vicor established brick standards, full-, half- and quarter-size. Output power is selectable over a continuous range of 20 to 500 Watts per module and modules can be configured in fault-tolerant arrays capable of delivering several kilowatts.

Configurable Products

Utilizing its standard converters as core elements, the Company has developed several product families, which provide complete power solutions configured to a customer s specific needs. These products exploit the benefits of the component-level approach to offer higher performance, higher power densities, lower costs, greater flexibility and faster delivery than traditional competitive offerings.

Most process control, information technology (IT) and industrial electronic products operate directly off of AC lines. Off-line power systems require front end circuitry to convert AC line voltage into DC voltage for the core converters. The Company s off-line AC-DC products incorporate a set of modular front-end subassemblies to offer a complete power solution from AC line input to highly regulated DC output. The product selection includes a low-profile modular design in various sizes and power levels, and a choice of alternatives to conventional box switchers, high power, off-line bulk supplies in industry-standard packages. Voltage and power levels can be either factory or field configurable.

Many telecommunications, defense and transportation electronic products are powered from central DC sources (battery plants or generators). The Company s DC-DC power system choices include a low-profile modular design similar to the corresponding AC-DC system and a rugged, compact assembly for chassis-mounted, bulk power applications.

In February 2001, the Company introduced the VIPAC family of power systems, a class of user defined, modular power solutions. VIPAC is a type of integrated power system leveraging the latest advances in Maxi, Mini, and Micro DC-DC converter technology and modular front ends. VIPAC combines application specific front end units, a choice of chassis styles and, in AC input versions, remotely located hold-up capacitors to provide fast, flexible and highly reliable power solutions for a wide range of demanding applications.

The web-based Vicor Computer Aided Design tool, also a component of Vicor PowerBench, can be utilized by the customer to specify and verify, in real time, that customer s desired VIPAC configuration. The

Vicor PowerBench system enables the design of a custom configured VIPAC product from all available combinations of inputs, outputs, chassis and optional features.

Accessory Power System Components

Accessory power system components, used with the Company s component-level power converters, integrate other important functions of the power system, facilitating the design of complete power systems by interconnecting several modules. In general, accessory products are used to condition the inputs and outputs of the Company s modular power components.

VI-HAMs (Harmonic Attenuator Modules) are universal-AC-input, power-factor-correcting front ends for use with compatible power converters. VI-AIMs (AC Input Modules) provide input filtering, transient protection and rectification of the AC line. VI-IAMs (Input Attenuator Modules) provide the DC input filtering and transient protection required in industrial and telecommunications markets. VI-RAMs (Ripple Attenuator Modules) condition converter module outputs for extremely low noise systems. In 1998, the Company doubled the power capability of its component-level AC front end, the VI-ARM (AC Rectifier Module). This front end product is packaged in the same Micro package and includes a microcontroller that tracks the AC line to ensure correct operation for domestic or international line voltages. In addition, two accessory products for the 48 Volt input Maxi, Mini, and Micro family were introduced in 1999: the FiltMod for input filtering and the IAM48 for transient and spike protection. In 2000, the FARM and FIAM were introduced. The FARM combines autoranging AC input capability with filtering to simplify the design of AC-DC systems. The FIAM combines filtering and transient suppression for 48 volt input applications. In 2005, the High-Boost HAM was introduced. This product can be combined with standard Maxi, Mini and Micro DC-DC converters, greatly improving power density and cost effectiveness in AC-DC designs.

Customer Specific Products

Since its inception, the Company has accepted a certain amount of custom power supply business. In most cases, the customer was unable to obtain a conventional solution that could achieve the desired level of performance in the available space. By utilizing its component-level power products as core elements in developing most of these products, the Company was able to meet the customer s needs with a reliable, high power density, total solution. However, in keeping with the Company s strategy of focusing on sales of standard families of component-level power building blocks, custom product sales have not been directly pursued. The Company has traditionally pursued these custom opportunities through Value-Added-Resellers (VARs) and a network of VIAs (see Part I, Item 1 Business The Company). Most of the VIAs are majority owned by the Company, while VARs are independent businesses. Both VIAs and VARs are distributed geographically and are in close proximity to many of their customers.

V*I Chip Products

In April 2003, the Company announced the introduction of a new power system architecture based on an array of proprietary power conversion technologies called Factorized Power Architecture (FPA). The Company believes FPA will provide power system designers with enhanced performance at a lower cost than attained with conventional DPA. Factorized Power maximizes the competitiveness of a power system with a high degree of systems flexibility, power density, conversion efficiency, transient responsiveness, noise performance and reliability. FPA is enabled by power conversion components called V*I Chips or VICs . V*I Chips deliver up to 320 Watts of power in a surface-mount (SMD) J-lead package occupying less than 0.3 cubic-inch of space, with power densities up to 1,100 Watts per cubic-inch, which represents a seven to eight times improvement over the Company s Maxi, Mini and Micro products.

In May 2003, the Company introduced the first family of products based on this new technology, 48 Volt to 12 Volt Bus Converter Modules (BCM) for conventional Intermediate Bus Architecture applications. In July 2003, the

Company introduced its first V*I Chip[tm] Voltage Transformation Module (VTM). VTMs are designed to meet the demands of advanced Digital Signal Processors (DSP), Field Programmable Gate Arrays (FPGA), Application Specific Integrated Circuits (ASIC), processor cores and microprocessor

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applications at the point of load (POL) while providing isolation from input to output. They may be paralleled to deliver hundreds of Amperes. In January 2004, the Company announced the availability of the first members of its 48 Volt Intermediate Bus Converter Modules (IBCs). Offered in standard 1/4 brick format and operating from a 38-55 Volt DC input, the IBC family consists of ten fixed ratio standard models with nominal outputs from 3 to 48 Volt DC delivering up to 100 Amperes or 600 Watts. Additional VTM and BCM products were introduced throughout 2004.

In 2005, the Company completed the matrix of 48 Volt V*I Chips: the 36-75 Volt input Pre-Regulator Module (PRM), which can operate from the wide DC input voltages normally encountered in telecommunications systems and the complete line of VTMs compatible with this PRM. With these devices, 48 Volt FPA systems can be implemented with regulated and isolated outputs between 0.8-55 Volt DC. In addition, several V I Chip specialty products were designed for and delivered to specific customers for them to evaluate for use in potential applications where V I Chips can enable significant market advantages. High voltage (380 volts) BCM products were introduced to provide power factor correction to processor down conversion. MIL COTS rated products for defense applications were qualified and released for production in 2007.

Picor Products

In 2002, the MicroRAM (µRAM) was introduced. This product, designed by the Company s Picor subsidiary, performs a function similar to the VI-RAM product in a smaller package at a lower price. In 2003, Picor introduced two new families of products, the QPO (QuietPower^{tm} Output Ripple Attenuation SiP) and QPI (QuietPower^{tm} 12 Amp Active EMI Filter for DC-DC Converters). The QPO performs a similar function to the µRAM in a smaller, lower cost surface mount package. Different QPO models allow customers to solve unique output noise problems. The QPI filters unwanted Electro-Magnetic Interference (EMI) from the input supply bus. The product is targeted at the telecom market and the emerging Advanced Telecommunication Computing Architecture (ATCA) segment. In 2004, Picor expanded its QPI product offerings to include several new products targeted at 24 Volt industrial and military COTS voltage bus supplies. In 2005, Picor introduced the QPI-8, the industry s first System-in-a-Package (SiP) device designed to integrate the total hot-swap function with an active EMI filter. This integrated device enables live insertion of plug-in cards and simultaneous EMI noise suppression for DC-DC converter applications.

Sales and Marketing

The Company sells its products through a network of 28 independent sales representative organizations in North and South America and internationally, through 36 independent distributors. Sales activities are managed by a staff of Area Directors and Regional and National Account Sales Managers and sales personnel based at the Company s world headquarters in Andover, Massachusetts, its Westcor division in Sunnyvale, California, a Technical Support Center in Lombard, Illinois, a VIA location in Oceanside, California, in its Technical Support Center subsidiaries in Munich, Germany; Camberley Surrey, England; Milan, Italy; Paris, France; Hong Kong and in its subsidiary in Tokyo, Japan.

Export sales, as a percentage of total net revenues, were approximately 37% in 2007 and 2006, and 42%, in 2005, respectively.

Because of the technical nature of the Company s product lines, the Company engages a staff of Field Applications Engineers to support the Company s sales activities. Field Application Engineers provide direct technical sales support worldwide to existing and potential customers by reviewing new applications and technical matters with existing and potential customers. Product Specialists (Product Line Engineers) located in Andover , Massachusetts support field application engineers assigned to all company locations. The Company generally warrants its products for a period of two years.

The Company also sells directly to customers through Vicor Express, an in-house distribution group. Through advertising and periodic mailing of its catalogs, Vicor Express generally offers customers rapid delivery on small quantities of many standard products. The Company, through Vicor B.V., has Vicor Express operations in Germany, France, Italy and England.

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Customers and Applications

The Company s customer base is comprised of large Original Equipment Manufacturers (OEMs) and smaller, lower-volume users that are broadly distributed across several major market areas.

Some examples of the diverse applications of the Company s products are:

Telecommunications:
Central Office Systems
Fiber Optic Systems
Cellular Telecommunications
Microwave Communications
ATM Switches
Paging Equipment
Broadcast Equipment
Remote Telemetry Equipment
Cable Head End Equipment
Power Amplifiers

Industrial:
Process Control Equipment
Medical Equipment
Seismic Equipment
Test Equipment
Transportation Systems
Agricultural Equipment
Material Handling Equipment
Marine Products
Commercial Avionics

Military/Defense:
Secure Communications Equipment
Unmanned Airborne/Remotely Piloted Vehicles
Aircraft/Weapons Test Equipment
Ruggedized Computers
Electronic Warfare Equipment
Reconnaissance/Targeting Systems
Global Positioning Systems
Missile Defense Systems
Radio/Telemetry Systems
NBC Detection Equipment

Information Technology:
RAID Systems
Parallel Processors
Data Storage Systems
Network Servers
Enterprise Servers
File Servers
Optical Switches

For the years ended December 31, 2007, 2006 and 2005, no single customer accounted for more than 10% of net revenues.

Backlog

As of December 31, 2007, the Company had a backlog of approximately $46.7 million compared to $36.4 million at December 31, 2006. Backlog is comprised of orders for products, which have a scheduled shipment date within the next 12 months. The Company believes that a substantial portion of sales in each quarter is, and will continue to be, derived from orders booked in the same quarter.

Research and Development

As a basic element of its long-term strategy, the Company is committed to the continued advancement of power conversion technology and power component product development. The Company s research and development efforts are focused in four areas: continued enhancement of the Company s patented technology; expansion of the Company s families of component level DC-DC converter products; development of the new FPA products and power management integrated circuits; and continued development of configurable products based upon market opportunities. The Company invested approximately $30.4 million, $31.4 million and $29.5 million in research and development in 2007, 2006 and 2005, respectively. Investment in research and development represented 15.5%, 16.3% and 16.4% of net revenues in 2007, 2006 and 2005, respectively. The Company plans to continue to invest a significant percentage of revenues into research and development.

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Manufacturing

The Company s principal manufacturing processes consist of assembly of electronic components onto printed circuit boards, automatic testing of components, wave, reflow and infrared soldering of assembled components, encapsulation of converter subassemblies, final environmental stress screening of certain products and product test using automatic test equipment.

The Company continues to pursue a strategy based upon the phased acquisition and/or fabrication, qualification and integration of automated manufacturing equipment to reduce manufacturing costs, increase product quality and reliability and enable rapid and effective expansion of capacity, as needed. The Company plans to make continuing investments in manufacturing equipment, particularly for the Company s new FPA products (see Part I, Item I The Products Factorized Power Architecture) and replacement of aging manufacturing equipment utilized by the Brick Business Unit.

Components used in the Company s products are purchased from a variety of vendors. Most of the components are available from multiple sources. In instances of single source items, the Company maintains levels of inventories it considers to be appropriate to enable it to meet delivery requirements of customers. Incoming components, assemblies and other parts are subjected to several levels of inspection procedures.

Compliance by the Company with applicable environmental laws has not had a material effect on the financial condition or results of operations of the Company.

Competition

The power conversion industry is highly competitive. Many power supply manufacturers target markets similar to those of the Company. Representative examples of these manufacturers are: Lambda Electronics, a subsidiary of TDK Corporation; Lineage Power (formerly Tyco Electronics Power Systems, now owned by the Gores Group); Artesyn Technologies and Astec Power, subsidiaries of Emerson Electric Co., Power-One, Inc., and Murata Power Solutions, a subsidiary of Murata Manufacturing Co. Although certain of the Company s competitors have significantly greater financial and marketing resources and longer operating histories than the Company, the Company believes that it has a strong competitive position, particularly with customers who need small, high density power system solutions requiring a variety of input-output configurations. The Company bases its competitive strategy on technical innovation, product performance, service and technical support, and in offering a broad product line. The principal methods of competition in the markets in which the Company s products compete are price, performance and the level of service and technical support offered.

Patents

The Company believes that its patents afford advantages by building fundamental and multilayered barriers to competitive encroachment upon key features and performance benefits of its principal product families. The Company s patents cover the fundamental conversion topologies used to achieve the performance attributes of its converter product lines; converter array architectures which are the basis of the products parallelability ; product packaging design; product construction; high frequency magnetic structures; and automated equipment and methods for circuit and product assembly.

The Company has been issued 105 patents in the United States (which expire between 2008 and 2025), and 2 in Far East (which expire in 2008). The Company also has a number of patent applications pending in the United States, Europe and the Far East. The Company intends to vigorously protect its rights under its patents. Although the Company believes that patents are an effective way of protecting its technology, there can be no assurances that the

Company s patents will prove to be enforceable (see, e.g., Part I, Item 3 Legal Proceedings). While some of the Company s patents are deemed materially important to the Company s operations, the Company believes that no one patent is essential to the success of the Company.

Licensing

In addition to generating revenue from product sales, licensing is an element of the Company s strategy for building worldwide product and technology acceptance and market share. In granting licenses, the

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Company generally retains the right to use its patented technologies, and manufacture and sell its products, in all licensed geographic areas and fields of use. Licenses are granted and administered through the Company s wholly-owned subsidiary, VLT, Inc., which owns the Company s patents. Revenues from licensing arrangements have not exceeded 10% of the Company s consolidated revenues in any of the last three fiscal years.

Employees

As of December 31, 2007, the Company employed approximately 1,036 full time and 78 part time people. The Company believes that its continued success depends, in part, on its ability to attract and retain qualified personnel. Although there is strong demand for qualified technical personnel, the Company has not to date experienced difficulty in attracting and retaining sufficient engineering and technical personnel to meet its needs (see Part I, Item IA Risk Factors).

None of the Company s employees are subject to a collective bargaining agreement.

ITEM 1A *RISK FACTORS*

This Annual Report on Form 10-K contains 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. Actual results could differ materially from those projected in the forward-looking statements as a result of, among other factors, the risk factors set forth below.

Our future operating results are subject to fluctuations.

Our future operating results may be materially affected by a number of factors, including the level of orders and demand from customers, the timing of new product announcements or introductions by us or our competitors, the ability to achieve and/or maintain yield improvements and cost reductions particularly with Maxi, Mini, Micro and FPA products, achieving increased sales of FPA products, changes in the product mix, and changes in economic conditions in the United States and international markets. As a result of these and other factors, we cannot assure you that we will not experience significant fluctuations in future operating results on a quarterly or annual basis.

Our future success depends upon our ability to develop and market leading-edge, cost effective products.

The power supply industry and the industries in which many of our customers operate are characterized by intense competition, rapid technological change, product obsolescence and price erosion for mature products, each of which could have an adverse effect on our results of operations. If we fail to continue to develop and commercialize leading-edge technologies and products that are cost effective and maintain high standards of quality, our competitive position and results of operations could be materially adversely affected. Specifically, we may not be successful in leveraging the V*I Chips in standard products to promote market acceptance of Factorized Power.

Our future operating results are dependent on the growth in our customers businesses.

We manufacture modular power components and power systems that are incorporated into our customers electronic products. Our growth is therefore dependent on the growth in the sales of our customers products as well as the development by our customers of new products. If we fail to anticipate changes in our customers businesses and their changing product needs, our results of operations and financial position could be negatively impacted.

If we were unable to use our manufacturing facility in Andover, Massachusetts, we would not be able to manufacture for an extended period of time.

All modular power components, whether for direct sale to customers or for sale to our subsidiaries for incorporation into their respective products, are manufactured at our Andover, Massachusetts production facility. Damage to this facility due to fire, natural disaster, power loss or other events could cause us to cease

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manufacturing. Any prolonged inability to utilize all or a significant portion of this facility could have a material adverse effect on our results of operations.

We may not be able to procure necessary key components for our products, or we may purchase too much inventory or the wrong inventory.

The power supply industry, and the electronics industry as a whole, can be subject to business cycles. During periods of growth, key components required to build our products may become unavailable in the timeframe required for us to meet our customers demands. Our inability to secure sufficient components to build products for our customers could negatively impact our sales and operating results. We may choose to mitigate this risk by increasing the levels of inventory for certain key components. Increased inventory levels can increase the potential risk for excess and obsolescence should our forecasts fail to materialize or if there are negative factors impacting our customers end markets. If we purchase too much inventory or the wrong inventory, we may have to record additional inventory reserves or write-off the inventory, which could have a material adverse effect on our gross margins and on our results of operations.

Our revenues may not increase enough to offset the expense of additional capacity.

We have made significant additions to our manufacturing equipment and capacity over the past several years, including equipment for FPA products and the FasTrak platform. If overall revenue levels do not increase enough to offset the increased fixed costs, or significant revenues do not materialize for the FPA products or if there is deterioration in our business, our future operating results could be adversely affected. In addition, asset values could be impaired if the additional capacity is underutilized for an extended period of time resulting in a material adverse effect on our financial position and results of operations.

We rely on third-party suppliers and subcontractors for components and assemblies and, therefore, cannot control their availability or quality.

We depend on third party suppliers and subcontractors to provide components and assemblies used in our products, some of which are sole-sourced. If suppliers or subcontractors cannot provide their products or services on time or to our specifications, we may not be able to meet the demand for our products and our delivery times may be negatively affected. In addition, we cannot directly control the quality of the products and services provided by third parties. In order to grow, we may need to find new or change existing suppliers and subcontractors. This could cause disruptions in production, delays in the shipping of product or increases in prices paid to third-parties.

We are exposed to economic, political and other risks through our foreign sales and distributors.

International sales have been and are expected to be a significant component of total sales. Dependence on foreign third parties for sales and distribution is subject to special risks, such as foreign economic and political instability, foreign currency controls and market fluctuations, trade barriers and tariffs, foreign regulations and exchange rates. Sudden or unexpected changes in the foregoing could have a material adverse effect on our results of operations.

Our ability to successfully implement our business strategy may be limited if we do not retain our key personnel and attract and retain skilled and experienced personnel.

Our success depends on our ability to retain the services of our executive officers. The loss of one or more members of senior management could materially adversely affect our business and financial results. In particular, we are dependent on the services of Dr. Patrizio Vinciarelli, our founder, Chairman, President and Chief Executive Officer. The loss of the services of Dr. Vinciarelli could have a material adverse effect on our development of new products and on our results of operations. In addition, we depend on highly skilled engineers and other personnel with technical skills that are in high demand and are difficult to replace. Our continued operations and growth depend on our ability to attract and retain skilled and experienced personnel in a very competitive employment market. If we are unable to attract and retain these employees, our ability to successfully implement our business strategy may be harmed.

We may be unable to adequately protect our proprietary rights, which may limit our ability to compete effectively.

We operate in an industry in which the ability to compete depends on the development or acquisition of proprietary technologies which must be protected to preserve the exclusive use of such technologies. We devote substantial resources to establish and protect our patents and proprietary rights, and we rely on patent and intellectual property law to protect such rights. This protection, however, may not prevent competitors from independently developing products similar or superior to our products. We may be unable to protect or enforce current patents, may rely on unpatented technology that competitors could restrict, or may be unable to acquire patents in the future, and this may have a material adverse affect on our competitive position. In addition, the intellectual property laws of foreign countries may not protect our rights to the same extent as those of the United States. We have been and may need to continue to defend or challenge patents. We have incurred and expect to incur significant costs in and devote significant resources to these efforts which, if unsuccessful, may have a material adverse effect on our results of operations and financial position.

We may face intellectual property infringement claims that could be costly to resolve.

We may in the future receive communications from third parties asserting that our products or manufacturing processes infringe on a third party s patent or other intellectual property rights. In the event a third party makes a valid intellectual property claim against us and a license is not available to us on commercially reasonable terms, or at all, we could be forced to either redesign or stop production of products incorporating that technology, and our operating results could be materially and adversely affected. In addition, litigation may be necessary to defend us against claims of infringement, and this litigation could be costly and divert the attention of key personnel. An adverse outcome in these types of matters could have a material adverse impact on the results of our operations and financial condition.

We may face legal claims and litigation that could be costly to resolve.

We may in the future encounter legal action from customers, vendors or others concerning product warranty or other claims. We have ongoing litigation with several customers and vendors over product warranty matters, which are fully described in Part I, Item 3 Legal Proceedings . Such litigation is costly and diverts the attention of key personnel. An adverse outcome in these current or future matters could have a material adverse impact on the results of our operations and financial condition.

If we fail to develop or maintain an effective system of internal controls, we may not be able to accurately report our financial results or prevent fraud or to ensure that information required to be disclosed by the Company in the reports it files or submits under the Exchange Act is recorded, processed, summarized and reported within the time periods specified.

Our management determined that we did not maintain effective internal control over financial reporting as of December 31, 2007 and 2006 because a material weakness in internal control over financial reporting existed. A material weakness is a control deficiency, or combination of control deficiencies, that results in more than a remote likelihood that a material misstatement of the annual or interim financial statements will not be prevented or detected. Specifically, we determined that our accounting department did not have sufficient experienced personnel and resources with the requisite technical skills to address complex and judgmental accounting, tax and financial reporting matters within the financial statement close process, including accounting for the Company s related-party investment in Great Wall Semiconductor Corporation, accounting for income taxes, accounting for complex revenue transactions, and accounting for judgmental accrued liabilities.

Our plans to improve the effectiveness of our internal controls and processes are in process. We cannot assure you that the measures we have taken to date or any future measures will remediate the material

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weaknesses reported by our management. Further, additional deficiencies in our internal controls may be discovered in the future. If we fail to achieve and maintain an effective system of internal controls over financial reporting, we may be unable to accurately report our financial results, prevent or detect fraud, or provide timely and reliable financial information, which could have a material adverse effect on our business, results of operations or financial condition. In fact, the Company did not file its June 30, 2007 and September 30, 2007 quarterly reports on Form 10-Q within the time period specified under the Exchange Act. In addition, in December 2007, the Company s former Chief Financial Officer transitioned to the position of Vice President of Treasury Services. The Company s Vice President, Chief Accounting Officer has assumed the role of Interim Chief Financial Officer. The Company is in the process of a search for a new Chief Financial Officer. However, we cannot assure you if or when a new Chief Financial Officer will be hired. Ineffective internal controls could also cause investors to lose confidence in our reported financial information, which would likely have a negative effect on the trading price of our common stock.

If we are unable to obtain required financial information for certain investments on a timely basis, we may not be able to accurately report our financial results in the reports we file or submit under the Exchange Act, within the time periods specified.

The Company is required to account for an investment under the equity method of accounting. The Company has developed processes and controls to ensure proper accounting and reporting for the investment. We cannot assure you that those procedures, processes and controls will be adequate to ensure that we obtain the required information in order to properly account for this investment under the equity method of accounting and allow us to file our reports under the Exchange Act on a timely basis. The lack of timely filing could prevent continued listing of the Company s common stock on the Nasdaq Global Select Market and could have a significant impact on the trading price of our Common Stock.

The failure of auction rate securities to sell at their reset dates could impact the liquidity of the investment and could negatively impact the carrying value of the investment.

The Company s short-term investments consist mainly of municipal and corporate debt securities in which a significant portion are invested in auction rate securities, the significant majority of which are student loan backed securities. Auction rate securities are securities that are structured with short-term interest rate reset dates of generally less than ninety days but with longer contractual maturities that range, for our holdings, from 13 to 39 years. At the end of each reset period, investors can typically sell at auction or continue to hold the securities at par. These securities are subject to fluctuations in fair value depending on the supply and demand at each auction. Through March 14, 2008, auctions held for the Company s auction rate securities with a total aggregate value of approximately $38.0 million failed. As of March 14, 2008, the Company was holding a total of approximately $43.0 million in auction rate securities. While these debt securities are all highly-rated investments, generally with AAA/Aaa ratings, continued failure to sell at their reset dates could impact the liquidity of the investment which in turn could negatively impact the liquidity requirements of the Company. In addition, continued failure to sell at their reset dates could also negatively impact the carrying value of the investment which could lead to impairment charges in future periods should a decline in the value of those securities be other than temporary, which could have a material adverse effect on our financial position and results of operations.

ITEM 1B *UNRESOLVED STAFF COMMENTS*

The Company has not received written comments from the Securities and Exchange Commission regarding its periodic or current reports under the Securities Exchange Act of 1934, as amended, that were received 180 days or more before December 31, 2007 and remain unresolved. There are no unresolved comments from the Securities and Exchange Commission as of December 31, 2007.

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ITEM 2 *PROPERTIES*

The Company s corporate headquarters building, which the Company owns and which is located in Andover, Massachusetts, provides approximately 90,000 square feet of office space for its sales, marketing, engineering and administration personnel.

The Company also owns a building of approximately 230,000 square feet in Andover, Massachusetts, which houses all Massachusetts manufacturing activities.

The Company s Westcor division owns and occupies a building of approximately 31,000 square feet in Sunnyvale, California.

ITEM 3 *LEGAL PROCEEDINGS*

Vicor and VLT, Inc. (VLT), a wholly owned subsidiary of the Company, had been pursuing Reset Patent infringement claims directly against Artesyn Technologies (Artesyn), Lucent Technologies and Tyco Electronics Power Systems, Inc. (Lucent / Tyco) in the United States District Court in Boston, Massachusetts. The lawsuit against Lucent was filed in May 2000 and in April 2001, the Company added Tyco Electronics as a defendant in that lawsuit. The lawsuit against Artesyn was filed in February 2001. In the second quarter of 2007, the Company entered into separate settlement agreements with Artesyn and Lucent/Tyco, under which the Company received payments of $1,770,000 in full settlement of the Company s Patent infringement claims against Lucent/Tyco and Artesyn, and which settled the lawsuits that the Company had filed against Lucent/Tyco in May 2000 and in April 2001, and the lawsuit that the Company had filed against Artesyn in February 2001. The full amount of the payment, net of a $177,000 contingency fee accrued by the Company for its litigation counsel, has been included in (Gain) loss from litigation-related settlements, net in the accompanying condensed consolidated statement of operations.

On February 22, 2007, the Company announced that it had reached an agreement in principle with Ericsson, Inc., to settle a lawsuit brought by Ericsson against the Company in California state court. Under the terms of the settlement agreement entered into on March 29, 2007, after a Court ordered mediation, the Company paid $50.0 million to Ericsson, of which $12.8 million was paid by the Company s insurance carriers. Accordingly, the Company recorded a net loss of $37.2 million from the litigation-related settlements in the fourth quarter of 2006. The Company is seeking further recoveries from the insurance carriers. The Company s decision to enter into the settlement followed an adverse ruling by the Court in January, 2007 in connection with a settlement between Ericsson and co-defendants Exar Corporation (Exar) and Rohm Device USA, LLC (Rohm), two of the Company s component suppliers prior to 2002. The Company s writ of mandate appeal of this ruling was denied in April, 2007. In September 2007, the Company filed a notice of appeal of the Court s decision upholding the Ericsson-Exar-Rohm settlement, which is pending. In December 2007, the Court awarded Exar and Rohm amounts for certain statutory and discovery costs associated with this ruling. Since this matter was outstanding as of June 30, 2007, the Company accrued $240,000 in the second quarter of 2007 as a result of the Court s decision, which is included in Accrual for litigation settlements in the condensed consolidated balance sheet and in (Gain) loss from litigation-related settlements, net in the condensed consolidated statement of operations.

On August 18, 2005, the Company filed an action in The Superior Court of the Commonwealth of Massachusetts, County of Essex (the Massachusetts Court) against Concurrent Computer Corporation (Concurrent) in response to a demand made by Concurrent in connection with breach of contract and breach of product warranty claims against the Company. On August 1, 2007, the Company reached an agreement in principle to settle the lawsuit with Concurrent for $2,350,000, all of which would be paid by the Company s insurance carriers. The settlement agreement was finalized effective August 28, 2007, upon which the Company made the settlement payment of $2,350,000 to Concurrent and in turn received payment for that same amount from its insurance carriers. There was no impact on the consolidated statement of operations for the year ended December 31, 2007 as a result of the settlement.

In addition, the Company is involved in certain other litigation and claims incidental to the conduct of its business. While the outcome of lawsuits and claims against the Company cannot be predicted with certainty,

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management does not expect any current litigation or claims to have a material adverse impact on the Company s financial position or results of operations.

ITEM 4 *SUBMISSION OF MATTERS TO A VOTE OF SECURITY HOLDERS*

None.

PART II

ITEM 5 *MARKET FOR REGISTRANT S COMMON EQUITY AND RELATED STOCKHOLDER MATTERS*

The Common Stock of the Company is listed on The Nasdaq Stock Market under the trading symbol VICR. The Class B Common Stock of the Company is not traded on any market and is subject to restrictions on transfer under the Company s Restated Certificate of Incorporation, as amended.

The following table sets forth the quarterly high and low sales prices for the Common Stock as reported by The Nasdaq Stock Market for the periods indicated:

2007	**High**	**Low**
First Quarter	$ 11.62	$ 8.78
Second Quarter	13.54	9.06
Third Quarter	14.99	10.81
Fourth Quarter	15.60	12.05

2006	**High**	**Low**
First Quarter	$ 20.50	$ 15.09
Second Quarter	23.38	14.80
Third Quarter	16.70	9.54
Fourth Quarter	13.29	10.79

As of February 29, 2008, there were approximately 274 holders of record of the Company s Common Stock and approximately 17 holders of record of the Company s Class B Common Stock. These numbers do not reflect persons or entities that hold their stock in nominee or street name through various brokerage firms.

Dividend Policy

Dividends are declared at the discretion of the Company s Board of Directors and depend on actual cash from operations, the Company s financial condition and capital requirements and any other factors the Company s Board of Directors may consider relevant.

On February 4, 2006, the Company s Board of Directors approved a cash dividend of $.12 per of the Company s stock. The total dividend of approximately $5,030,000 was paid on March 20, 2006 to shareholders of record at the close of business on February 28, 2006.

On June 23, 2006, the Company s Board of Directors approved a cash dividend of $.15 per share of the Company s stock. The total dividend of approximately $6,313,000 was paid on August 7, 2006 to shareholders of record at the close of business on July 17, 2006.

On February 16, 2007 the Company s Board of Directors approved a cash dividend of $.15 per share of the Company s stock. The total dividend of approximately $6,235,000 was paid on March 27, 2007 to shareholders of record at the close of business on March 9, 2007.

On July 25, 2007, the Company s Board of Directors approved a cash dividend of $.15 per share of the Company s stock. The total dividend of approximately $6,242,000 was paid on August 30, 2007 to shareholders of record at the close of business on August 14, 2007.

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During the second quarter of 2007, two subsidiaries paid a total of $180,000 in dividends, of which $92,000 was paid to outside shareholders.

On March 14, 2008, the Company s Board of Directors approved a cash dividend of $.15 per share of the Company s stock. The total dividend of approximately $6,245,000 will be paid on April 18, 2008 to shareholders of record at the close of business on April 2, 2008.

Issuer Purchases of Equity Securities

Period	Total Number of Shares (or Units) Purchased	Average Price Paid per Share (or Unit)	Total Number of Shares (or Units) Purchased as Part of Publicly Announced Plans or Programs	Maximum Number (or Approximate Dollar Value) of Shares (or Units) that May Yet be Purchased Under the Plans or Programs
October 1 31, 2007		$		$ 8,541,000
November 1 30, 2007				8,541,000
December 1 31, 2007				8,541,000
Total		$		$ 8,541,000

In November 2000, the Board of Directors of the Company authorized the repurchase of up to $30,000,000 of the Company s Common Stock.

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Stockholder Return Performance Graph

The graph set forth below presents the cumulative, five-year stockholder return for each of the Corporation s Common Stock, the Standard & Poor s 500 Index (S&P 500 Index) and an index of peer group companies selected by the Company (the Peer Group). The Peer Group consists of the following ten (10) publicly-traded companies in the specialty electronic component industry: Analog Devices Incorporated; Intel Corporation; Linear Technology Corporation; LSI Logic Corporation; Xilinx Incorporated; Maxim Integrated Products, Inc.; Semtech Corporation; Intersil Corporation; RF Micro Devices, Inc. and Altera Corporation.

The graph assumes an investment of $100 on December 31, 2002 in each of the Company s Common Stock, the S&P 500 Index and the Peer Group, and assumes reinvestment of all dividends. The peer group indices used in the graph are market capitalization-weighted. The historical information set forth below is not necessarily indicative of future performance.

Comparison of Five Year Cumulative Return
Among Vicor Corporation, S&P 500 Index
and Peer Group Companies

	2002	2003	2004	2005	2006	2007
Vicor Corporation	$ 100.00	$ 138.32	$ 158.93	$ 191.67	$ 136.45	$ 196.83
S&P 500 Index	$ 100.00	$ 128.68	$ 142.67	$ 149.65	$ 173.28	$ 182.81
Peer Group Companies	$ 100.00	$ 196.12	$ 149.03	$ 154.87	$ 132.97	$ 161.85

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ITEM 6 *SELECTED FINANCIAL DATA*

The following selected consolidated financial data with respect to the Company s statements of operations for the years ended December 31, 2007, 2006 and 2005 and with respect to the Company s balance sheets as of December 31, 2007 and 2006 are derived from the Company s consolidated financial statements, which appear elsewhere in this report and which have been audited by Ernst & Young LLP, the Company s independent registered public accounting firm. The following selected consolidated financial data with respect to the Company s statements of operations for the years ended December 31, 2005 and 2004 and with respect to the Company s balance sheets as of December 31, 2005, 2004 and 2003 are derived from the Company s consolidated financial statements, which are not included herein. As described in Note 7. in the Notes to the Consolidated Financial Statements, due to an additional investment in Great Wall Semiconductor Corporation (GWS) in May 2007, the Company changed its method of accounting for its investment in GWS from the cost method to the equity method of accounting. As a result, the financial statements for years ended December 31, 2003, 2004, 2005 and 2006 have been retroactively restated to reflect the equity method of accounting, in accordance with Accounting Principles Board Opinion No. 18, The Equity Method of Accounting for Investments in Common Stock . The data should be read in conjunction with the consolidated financial statements, related notes and other financial information included herein.

	Year Ended December 31,				
Statement of Operations Data	2007	2006 (restated)	2005 (restated)	2004 (restated)	2003 (restated)
	(In thousands except per share data)				
Net revenues	$ 195,827	$ 192,047	$ 179,351	$ 171,580	$ 151,421
Income (loss) from operations	1,071	(33,182)	3,380	(4,035)	(25,703)
Net income (loss)	5,335	(29,059)	3,493	(4,692)	(19,996)
Net income (loss) per share basic	.13	(.69)	.08	(.11)	(.48)
Net income (loss) per share diluted	.13	(.69)	.08	(.11)	(.48)
Weighted average shares basic	41,597	41,839	41,923	42,022	41,896
Weighted average shares diluted	41,687	41,839	42,089	42,022	41,896
Cash dividends per share	$ .30	$ .27	$ .12	$ .08	$

	At December 31,				
Balance Sheet Data	2007	2006 (restated)	2005 (restated)	2004 (restated)	2003 (restated)
	(In thousands)				
Working capital	$ 115,924	$ 123,467	$ 150,385	$ 148,419	$ 141,547
Total assets	192,458	247,461	243,902	243,452	251,003
Long-term debt					
Total liabilities	28,018	77,289	28,965	24,259	24,806
Stockholders equity	164,440	170,172	214,937	219,193	226,197

ITEM 7 *MANAGEMENT S DISCUSSION AND ANALYSIS OF FINANCIAL CONDITION AND RESULTS OF OPERATIONS*

Overview

Vicor Corporation designs, develops, manufactures and markets modular power components and complete power systems based upon a portfolio of patented technologies. The Company sells its products primarily to the telecommunications, electronic data processing, industrial control and military electronics markets, through a network of 28 independent sales representative organizations in North and South America and, internationally, through 36 independent distributors. Export sales as a percentage of total revenues were approximately 37% in 2007 and 2006 and 42% in 2005, respectively. The Company has organized its business segments according to its key product lines. The Brick Business Unit segment (BBU or Brick) designs, develops, manufactures and markets the Company s modular power converters and configurable products, and includes the operations of the Company s Westcor division, Vicor Integration Architects (VIAs) and Vicor Japan

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Company, Ltd. (VJCL). The V*I Chip segment consists of V*I Chip Corporation, a wholly owned subsidiary which designs, develops, manufactures and markets the Company s Factorized Power Architecture (FPA) products. The Picor segment consists of Picor Corporation, a majority-owned subsidiary of Vicor, which designs, develops, manufactures and markets Power Management Integrated Circuits and related products for use in a variety of power system applications. Picor develops these products to be sold as part of Vicor s products or to third parties for separate applications.

For the year ended December 31, 2007 revenues increased to $195,827,000 from $192,047,000 in 2006. The Company had income before taxes of $5,459,000 in 2007 as compared to a loss before taxes of $28,090,000 in 2006. The Company reported net income in 2007 of $5,335,000 as compared to a net loss of $29,059,000 in 2006, and a diluted income per share of $.13 in 2007 as compared with diluted loss per share of $.69 in 2006. The net loss in 2006 was primarily due to a loss from a litigation-related settlement described below.

The book to bill ratio for the third and fourth quarters of 2007 was 1.17:1 and 0.96:1, respectively. The book to bill ratio for the year ended December 31, 2007 was 1.05:1 compared with 0.99:1 in 2006. In light of the fact that bookings and sales can vary significantly from quarter to quarter, the Company does not believe that this quarterly and annual change in the book to bill ratio is indicative of a trend at this time. The Company ended 2007 with approximately $46.7 million in backlog compared to $36.4 million at the end of 2006.

The gross margin for 2007 decreased to 40.3% compared with 42.6% in 2006. The primary components of the decrease in gross margin dollars and percentage were due to product mix and an issue with certain product returns and warranty expense.

As described in Note 7. in the Notes to the Consolidated Financial Statements, the Company changed its method of accounting for its investment in GWS from the cost method to the equity method of accounting. As a result, the financial statements for the years ended December 31, 2006, 2005 and 2004 have been retroactively restated to reflect the equity method of accounting, in accordance with APB 18. Loss from equity method investment (net of tax) increased $818,000 to $1,139,000 from $321,000 for 2006. This was principally due to the equity method investment in GWS being adjusted for a decline in value judged to be other than temporary of $620,000 in the second quarter and due to higher equity method investment losses allocated to the Company. Additionally, the Company made an additional $1,000,000 investment in GWS in February 2008. The Company expects that it will take an impairment charge of approximately $700,000 in the first quarter of 2008 due to the additional investment.

In 2007, depreciation and amortization was $11.6 million, a decrease of approximately $2.5 million from 2006, and capital additions were $9.9 million, an increase of approximately $4.3 million from 2006. Due to assets which either are now or will be fully depreciated in 2008, the Company expects depreciation and amortization to be less in 2008 than 2007.

Inventories increased by approximately $1.1 million or 4.9% to $23.1 million as compared with $22.0 million at the end of 2006, primarily to meet the increased demand.

On February 22, 2007, the Company announced that it had reached an agreement in principle with Ericsson, Inc., to settle a lawsuit brought by Ericsson against the Company in California state court. Under the terms of the settlement agreement entered into on March 29, 2007, after a Court ordered mediation, the Company paid $50.0 million to Ericsson, of which $12.8 million was paid by the Company s insurance carriers. Accordingly, the Company recorded a net loss of $37.2 million from the litigation-related settlements in the fourth quarter of 2006.

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The following table sets forth certain items of selected consolidated financial information as a percentage of net revenues for the periods indicated. This table and the subsequent discussion should be read in conjunction with the selected financial data and the Consolidated Financial Statements and related footnotes of the Company contained elsewhere in this report.

	Year Ended December 31,		
	2007	2006	2005
Net revenues	100.0%	100.0%	100.0%
Gross margin	40.3%	42.6%	39.8%
Selling, general and administrative expenses	25.0%	24.2%	22.8%
Research and development expenses	15.5%	16.3%	16.4%
Income (loss) before income taxes (as restated)	2.8%	(14.6)%	2.7%

Critical Accounting Policies and Estimates

Management s Discussion and Analysis of Financial Condition and Results of Operations discusses the Company s consolidated financial statements, which have been prepared in accordance with accounting principles generally accepted in the United States. The preparation of these financial statements requires management to make estimates and assumptions that affect the reported amounts of assets, liabilities, revenues and expenses, and related disclosure of contingent assets and liabilities. On an ongoing basis, management evaluates its estimates and judgments, including those related to revenue recognition, allowance for doubtful accounts, inventories, investments, intangible assets, income taxes, impairment of long-lived assets, contingencies and litigation. Management bases its estimates and judgments on historical experience, knowledge of current conditions and on various other factors that are believed to be reasonable under the circumstances, the results of which form the basis for making judgments about the carrying value of assets and liabilities that are not readily apparent from other sources. Actual results may differ from these estimates under different assumptions or conditions. Management believes the following accounting policies involve its more significant judgments and estimates used in the preparation of its consolidated financial statements.

Allowance for Doubtful Accounts

The Company maintains allowances for doubtful accounts for estimated losses resulting from the inability of its customers to make required payments, based on assessments of customers credit-risk profiles and payment histories. If the financial condition of the Company s customers were to deteriorate, resulting in an impairment of their ability to make payments, additional allowances may be required.

Inventories

The Company employs a variety of methodologies to estimate allowances for its inventory for estimated obsolescence or unmarketable inventory, based upon its known backlog and historical usage, and assumptions about future demand and market conditions. For the Company s brick products produced at the Andover location, its principal manufacturing location, the model used is based upon a comparison of on-hand quantities to projected demand, such that amounts on hand in excess of three-year projected usage are fully reserved for inventories of those products. Since V*I Chip products are at a relatively early stage, a one-year projected usage assumption is used. While we have used our best efforts and believe we have used the best available information to estimate future demand, due to uncertainty in the economy and our business and the inherent difficulty in predicting future demand, it is possible that actual demand for our products will differ from our estimates. If actual future demand or market conditions are less favorable than those projected by management, additional inventory reserves for existing inventories may need to be recorded in future periods.

Short-term and long-term investments

The Company s short-term and long-term investments are classified as available-for-sale securities and are recorded at fair value, with the unrealized gains and losses, net of tax, reported in a separate component of stockholders equity. The amortized cost of debt securities is adjusted for amortization of premiums and accretion of discounts to maturity. Such amortization, along with interest and realized gains and losses, are included in other income (expense), net. The Company has no trading securities or held-to-maturity securities.

Through March 14, 2008, auctions held for the Company s auction rate securities with a total aggregate value of approximately $38.0 million failed. As of March 14, 2008, the Company was holding a total of approximately $43.0 million in auction rate securities, the significant majority of which are student loan backed securities. These municipal and corporate debt securities have their interest rates reset at auction at regular intervals ranging from seven to ninety days. Because of these short term intervals between interest reset dates, the Company monitors the auctions to ensure they are successful, which provides evidence that the recorded values of these investments approximate their fair values. As discussed above, auctions related to substantially all our auction rate securities have failed and if auctions continue to fail such that the securities were deemed to be not liquid, the Company would need to seek other alternatives to determine the fair value of these securities, which may not be based on the quoted market transaction. In addition, due to the Company s inability to quickly liquidate these investments, the Company may reclassify those investments with failed auctions as long-term assets in its consolidated balance sheet.

Other Investments

The accounting for investment transactions is reviewed for compliance with Accounting Principles Board Opinion No. 18, The Equity Method for Accounting for Investments in Common Stock (APB 18) and/or FASB Interpretation No. 46 Revised (FIN 46R), Consolidation of Variable Interest Entities . As discussed in Note 7. in the Notes to Consolidated Financial Statements, the Company previously accounted for the investment in Great Wall Semiconductor Corporation (GWS) under APB 18 as a cost method investment as management believed it did not have significant influence over GWS. An additional investment in GWS in May 2007 resulted in the Company owning approximately 24% of GWS which management believes, along with other qualitative factors considered, gives the Company significant influence over GWS. As a result of the additional investment, the Company is required to account for the investment in GWS under the equity method of accounting and to retroactively restate its previously issued consolidated financial statements to reflect the equity method of accounting, in accordance with APB 18.

The Company periodically evaluates the investment in GWS to determine if there are any events or circumstances that are likely to have a significant adverse effect on the fair value of the investment, including the net book value of acquired intangible assets and goodwill. Examples of such impairment indicators include, but are not limited to: GWS actual results of operations, actual results of operations compared to forecast, working capital requirements, additional third-party equity investment, if any, and other considerations. If we identify an impairment indicator, we will estimate the fair value of the investment and compare it to its carrying value. If the fair value of the investment is less than its carrying value, the investment is impaired and we make a determination as to whether the impairment is other-than-temporary. For other-than-temporary impairments, we recognize an impairment loss equal to the difference between an investment s carrying value and its fair value. In the second quarter of 2007, the investment was adjusted for a decline in value judged to be other than temporary of $620,000. Deterioration or changes in GWS business in the future could lead to such impairment adjustments in future periods and the impairment adjustments may be material. In fact, the Company made an additional $1,000,000 investment in GWS in February 2008, which will increase its ownership in GWS to approximately 30%, for which the Company expects that it will take an impairment charge of approximately $700,000 in the first quarter of 2008.

Long-Lived Assets

Management evaluates the recoverability of the Company s identifiable intangible assets, goodwill and other long-lived assets in accordance with Statement of Financial Accounting Standards No. 142, Goodwill and Other Intangible Assets (FAS 142) and Statement of Financial Accounting Standards No. 144, Accounting for the Impairment or Disposal of Long-Lived Assets (FAS 144), which generally requires that the recoverability of these assets be assessed when events or circumstances indicate a potential impairment. The Company periodically assesses the remaining use of fixed assets based upon operating results and cash flows

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from operations. Equipment has been written-down as a result of these assessments as necessary. Goodwill is tested for potential impairment at least annually at the reporting unit level.

Stock-Based Compensation

The Company accounts for stock-based compensation in accordance with Statement of Financial Accounting Standards No. 123 (revised 2004), Share Based Payment (FAS 123R), which requires that stock-based compensation expense associated with stock options and related awards be recognized in the statement of income. Determining the amount of stock-based compensation requires us to develop estimates to be used in calculating the grant-date fair value of stock options. We calculate the grant-date fair values using the Black-Scholes valuation model. The use of this model requires us to make estimates for the following assumptions: expected volatility, expected term, risk-free interest rate, expected dividend yield and forfeiture rate. Changes in any of these assumptions may have an impact on the amount of stock-based compensation recorded.

Product Warranties

The Company generally warrants its products for a period of two years. Vicor maintains allowances for estimated product returns under warranty based upon a review of known or potential product failures in the field and upon historical patterns of product returns. If unforeseen product issues arise or product returns increase above expected rates, additional allowances may be required.

Income Taxes

The Company accounts for income taxes in accordance with Statement of Financial Accounting Standards No. 109, Accounting for Income Taxes (FAS 109), which requires that deferred tax assets and liabilities be recognized using enacted rates for the effect of temporary differences between the book and tax bases of recorded assets and liabilities. FAS 109 also requires that deferred tax assets be reduced by a valuation allowance if it is more likely than not that some portion or all of the deferred tax assets will not be realized. The Company has assessed the need for a valuation allowance against these deferred tax assets and concluded that a valuation allowance for a significant portion of the deferred tax assets is warranted at December 31, 2007. In reaching this conclusion, the Company evaluated all relevant criteria including the existence of significant temporary differences reversing in the carryforward period, primarily depreciation. The valuation allowance against these deferred tax assets may require adjustment in the future based on changes in the mix of temporary differences, changes in tax laws, and operating performance. In addition, the assessment of the valuation allowance requires the Company to make estimates of future taxable income and to estimate reversals of temporary differences. Changes in the assumptions or other circumstances may require additional valuation allowances if actual reversals of temporary differences differ from those estimates.

The Company adopted FASB Interpretation No. 48, Accounting for Uncertainty in Income Taxes (FIN 48), on January 1, 2007. FIN 48 clarifies the accounting for uncertainty in income taxes recognized in an enterprise s financial statements in accordance with FASB Statement No. 109, Accounting for Income Taxes . FIN 48 prescribes a two-step process to determine the amount of tax benefit to recognize. First, the tax position must be evaluated to determine the likelihood that it will be sustained upon examination by a tax authority. If the tax position is deemed more-likely-than-not to be sustained, the tax position is then assessed to determine the amount of benefit to recognize in the financial statements. The amount of the benefit that may be recognized is the largest amount that has a greater than 50 percent likelihood of being realized upon ultimate settlement. If the tax position does not meet the more-likely-than-not threshold then it is not recognized in the financial statements. In accordance with FIN 48, the Company accrues interest and penalties, if any, related to unrecognized tax benefits as a component of income tax expense. The Company s adoption of FIN 48 as of January 1, 2007 did not have a material impact on the Company s financial position or results of operations.

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Contingencies

From time to time, we receive notices for product failure claims or that our products or manufacturing processes may be infringing the patent or intellectual property rights of others or for other matters. We periodically assess each matter to determine if a contingent liability should be recorded in accordance with Statement of Financial Accounting Standards No. 5, Accounting for Contingencies (FAS 5). In making this assessment, we may, depending on the nature of the matter, consult with external legal counsel and technical experts. Based on the information we obtain, combined with our judgment regarding all the facts and circumstances of each matter, we determine whether it is probable that a contingent loss may be incurred and whether the amount of such loss can be reasonably estimated. Should a loss be probable and reasonably estimable, we record a loss in accordance with FAS 5. In determining the amount of the loss, we consider advice received from experts in the specific matter, current status of legal proceedings, if any, prior case history and other factors. Should the judgments and estimates made by us be incorrect, we may need to record additional contingent losses that could materially adversely impact our results of operations and financial position.

Year Ended December 31, 2007 compared to Year Ended December 31, 2006

Net revenues for fiscal 2007 were $195,827,000, an increase of $3,780,000, or 2.0%, as compared to $192,047,000 for the same period a year ago. The increase in net revenues from the prior year resulted primarily from an increase in V*I Chip revenues of $6,099,000 and Picor revenues of $340,000, partially offset by decreases in Brick segment shipments of standard and custom products of $2,657,000. Orders for fiscal year 2007 increased by 8.5% compared with 2006. Subject to continuing demand, the Company expects modest growth in revenues in 2008. The book-to-bill ratio for 2007 was 1.05:1 as compared to 0.99:1 for 2006.

Gross margin for fiscal 2007 decreased $2,827,000, or 3.5%, to $79,009,000 from $81,836,000 in 2006 and decreased as a percentage of net revenues to 40.3% from 42.6%. The primary components of the decrease in gross margin dollars and percentage were due to the product mix and an issue with certain product returns and warranty expense. During the year ended 2007, the Company replaced certain products and established reserves for future replacements of these products, which were manufactured with a purchased component that exhibited an unacceptable failure rate. As a result, gross margin in the year ended December 31, 2007 were negatively impacted by approximately $980,000 from a combination of product returns which affected net revenues and charges to cost of revenues for warranty costs. In addition, cost of revenues increased approximately $713,000 due to the allocation of a portion of Picor non-recurring engineering charges being charged to cost of revenues in 2007 and not research and development.

Selling, general and administrative expenses were $48,919,000 for 2007, an increase of $2,482,000, or 5.3%, over the same period in 2006. As a percentage of net revenues, selling, general and administrative expenses increased to 25.0% from 24.2%. The principal components of the $2,482,000 increase were $1,666,000, or 8.6.%, of increased compensation expense primarily due to annual compensation adjustments in May 2007, $689,000, or 60.1%, of increased audit and tax expenses, $546,000, or 44.6%, of increased travel expenses, $271,000, or 5.8%, of increased commissions due to the increase in net revenues and due to changes in the mix of revenues subject to commissions, $193,000, or 57.3%, of increased outside services and $130,000, or 6.1%, in increased legal fees due to the litigation with Ericsson Wireless Communications, Inc., Exar Corporation and Rohm Device USA, LLC, and Concurrent Computer Corporation (Concurrent), which were partially offset by a $718,000 reimbursement payment from its insurance carriers received in the fourth quarter of 2007 in connection with the Concurrent litigation (see Part II Item 1 Legal Proceedings). The principal components partially offsetting the above increases were $424,000, or 10.5%, of decreased depreciation and amortization costs, $295,000, or 10.6%, of decreased advertising costs, $151,000, or 35.4%, in decreased employment recruiting expenses and $115,000, or 9.2%, of decreased training expenses.

Research and development expenses decreased $1,009,000, or 3.2%, to $30,372,000 in 2007 from $31,381,000 in 2006 and decreased as a percentage of net revenues to 15.5% from 16.3%. The principal components of the $1,009,000 decrease were $713,000, or 100%, of decreased costs due to the allocation of a portion of Picor non-recurring engineering charges being charged to cost of revenues and not research and development, $425,000, or 16.8%, of decreased costs associated with the VIAs, $155,000, or 8.7%, of decreased facility costs, $119,000, or 7.9%, of decreased depreciation and amortization costs, and $64,000, or 26.6%, of decreased travel expenses. The principal component partially offsetting the above decreases was $529,000, or 2.7%, in increased compensation expense primarily due to annual compensation adjustments in May 2007. The decreased costs associated with the VIAs was primarily due to $397,000 of decreased sub-contract labor costs.

In the second quarter of 2007, the Company entered into separate settlement agreements with Artesyn and Lucent/Tyco, under which, the Company received total payments of $1,770,000 in full settlement of the Company s Patent infringement claims against Lucent/Tyco and Artesyn, and which settled the lawsuits that the Company had filed against Lucent/Tyco in May 2000 and in April 2001, and the lawsuit that the Company had filed against Artesyn in February 2001. The full amount of the payments, net of a $177,000 contingency fee accrued by the Company for its litigation counsel, has been included in (Gain) loss from litigation-related settlements, net in the accompanying condensed consolidated statement of operations. In December 2007, the Court awarded Exar and Rohm amounts for certain statutory and discovery costs associated with this ruling. The Company accrued $240,000 in the second quarter of 2007 as a result of the Court s decision, which is included in (Gain) loss from litigation-related settlement, net in the accompanying condensed consolidated statement of operations.

On February 22, 2007, the Company announced that it had reached an agreement in principle with Ericsson, Inc., to settle a lawsuit brought by Ericsson against the Company in California state court. Under the terms of the settlement agreement entered into on March 29, 2007, after a Court ordered mediation, the Company paid $50.0 million to Ericsson, of which $12.8 million was paid by the Company s insurance carriers. Accordingly, the Company recorded a net loss of $37.2 million from the litigation-related settlements in the fourth quarter of 2006.

The changes in the major components of other income (expense), net were as follows (in thousands):

	2007	2006 (As restated)	Increase (Decrease)
Interest income	$ 4,484	$ 5,389	$ (905)
Minority interest in net income of subsidiaries	(539)	(562)	23
Foreign currency gains	186	139	47
Gain on disposal of equipment	129	67	62
Other	128	59	69
	$ 4,388	$ 5,092	$ (704)

The decrease in interest income is due to lower average balances on the Company s cash equivalents and short-term investments, principally due to the $37,200,000 net payment to Ericsson made at the end of March 2007 (see Part II Item 3- Legal Proceedings). The increase in foreign currency gains is due to favorable exchange rates in 2007 as compared to 2006. The Company s exposure to market risk for fluctuations in foreign currency exchange rates relates primarily to the operations of Vicor Japan Co. Ltd. (VJCL) and changes in the dollar/yen exchange rate. In addition, the functional currency of the Company s subsidiaries in Europe and Hong Kong is the U.S. dollar.

Income before income taxes was $5,459,000 in 2007 compared to a loss before income taxes of $28,090,000 for 2006.

The benefit for income taxes totaled $(1,015,000) in 2007 as compared to a provision of $648,000 in 2006. The Company s effective tax rate was (18.6%) and 2.3% in 2007 and 2006, respectively. In 2007, the tax provision includes estimated federal, state and foreign income taxes on the Company s pre-tax income, estimated federal and state income taxes for certain minority-owned subsidiaries that are not part of the Company s consolidated income tax returns, and increases in accrued interest for potential liabilities, offset by the expected utilization of foreign net operating loss carryforwards and the release of certain valuation allowances related to temporary book versus tax differences. During the second quarter of 2007 and year ended December 31, 2007, the Company reversed approximately $300,000 of previously unidentified excess tax reserves identified during the quarter. The impact on the second quarter of 2007 and the year ended December 31, 2007, as well as on prior periods, was not material. The expense was also offset by a discrete item of $169,000 representing refunds of interest received and recorded as a benefit during the first quarter of 2007 as final settlement related to the audit of the Company s federal tax returns for tax years 1994 though 2002 by the Internal Revenue Service and the reduction in the tax reserves discussed below. In 2006, the tax provision included estimated federal, state and foreign income taxes on the Company s projected annual pre-tax income, estimated federal and state income taxes for certain minority-owned subsidiaries that are not part of the Company s consolidated income tax returns, offset by the expected utilization of remaining net operating loss carryforwards and certain tax credit carryforwards. For the year ended December 31, 2007 and 2006, the Company reduced its tax reserves by $1,517,000 and $468,000, respectively, due to closing tax periods in certain jurisdictions and other tax reserves no longer considered necessary. The decreases in 2007 and 2006 were partially offset by increases in reserves during the year of approximately $205,000 and $133,000, respectively.

Loss from equity method investment (net of tax) for fiscal year 2007 increased $818,000 to $1,139,000 from $321,000 for 2006. This was principally due to the equity method investment in GWS being adjusted for a decline in value judged to be other than temporary of $620,000 in the second quarter and due to higher equity method investment losses allocated to the Company. As described in Note 7. in the Notes to the Consolidated Financial Statements, the Company changed its method of accounting for its investment in GWS from the cost method to the equity method of accounting. As a result, the financial statements for the years ended December 31, 2006 and December 31, 2005 have been retroactively restated to reflect the equity method of accounting, in accordance with APB 18. The Company made an additional $1,000,000 investment in GWS in February 2008. The Company expects that it will take an impairment charge of approximately $700,000 in the first quarter of 2008 due to the additional investment.

Basic and diluted loss per share was $0.13 for the year ended December 31, 2007, compared to basic and diluted loss per share of $0.69 for the year ended December 31, 2006.

Year Ended December 31, 2006 compared to Year Ended December 31, 2005

Net revenues for fiscal 2006 were $192,047,000, an increase of $12,696,000, or 7.1%, as compared to $179,351,000 for the same period a year ago. The increase in net revenues resulted primarily from an increase in Brick segment shipments of standard and custom products of $11,018,000, along with increases in V*I Chip and Picor revenues of $1,376,000 and $299,000, respectively. Orders for fiscal year 2006 increased by 4.6% compared with 2005. The book-to-bill ratio for 2006 was 0.99:1 as compared to 1.01:1 for 2005.

Gross margin for fiscal 2006 increased $10,429,000, or 14.6%, to $81,836,000 from $71,407,000 in 2005 and increased as a percentage of net revenues from 39.8% to 42.6%. The primary components of the increase in gross margin dollars and percentage were due to the increase in net revenues, an increase in manufacturing efficiencies resulting in lower average unit costs and significant inventory reserves recorded in 2005. During the second quarter of 2005, the Company provided additional reserves of approximately $1,600,000 for potential obsolete inventory arising primarily from the European Union RoHS initiative and the conversion of Maxi, Mini, Micro and MIL-COTS product families to the FasTrak platform. In addition, the Company identified other slow-moving and potential obsolete inventory of approximately $1,200,000, of which $300,000 was related to raw material inventory in support of pilot production of V*I Chips.

Selling, general and administrative expenses were $46,437,000 for 2006, an increase of $5,626,000, or 13.8%, over the same period in 2005. As a percentage of net revenues, selling, general and administrative expenses increased to 24.2% from 22.8%. The principal components of the $5,626,000 increase were $1,550,000, or 8.7%, of increased compensation primarily due to annual compensation adjustments in May 2006 and increases in headcount, $982,000 or 88.0% of increased legal fees due to litigation with Ericsson Wireless Communications, Inc. (See Part I, Item 3

Legal Proceedings), $725,000, or 39.2%, of increased depreciation and amortization expense principally due to the accelerated amortization for and the write-off of certain patent costs, $698,000, or 17.8%, increase in commissions due to the increase in net revenues, $323,000, or 306.1%, increase in employment advertising, recruiting and relocation expense, $256,000, or

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12.2%, in increased advertising expense, and a $216,000, or 177.3%, increase in outside services expense. The increase in compensation expense also includes $385,000 of non-cash stock-based compensation recorded under FAS 123(R). See Note 3 to the consolidated financial statements for further discussion.

Research and development expenses increased $1,915,000, or 6.5%, to $31,381,000 in 2006 from $29,466,000 in 2005 but decreased as a percentage of net revenues to 16.3% from 16.4%. The principal components of the $1,915,000 increase were $1,676,000, or 9.4%, of increased compensation expense primarily due to annual compensation adjustments in May 2006 and increases in headcount, $224,000, or 15.5%, of increased expenses related to the Vicor Integration Architects (VIAs), $162,000, or 10.1%, of increased facilities costs and $152,000, or 110.9%, in increased industrial gas costs. These items were partially offset by a decrease in production materials of $542,000, or 13.5%. The increase in compensation expense also includes $281,000 of non-cash stock-based compensation recorded under FAS 123(R). See Note 3 to the consolidated financial statements for further discussion.

On February 22, 2007, the Company announced that it has reached an agreement in principle with Ericsson, Inc., to settle a lawsuit brought by Ericsson against the Company in California state court. Under the terms of the settlement agreement, reached on February 16, 2007 after a Court ordered mediation, the Company agreed to pay $50.0 million to Ericsson, of which $12.8 million will be paid by the Company s insurance carriers. Accordingly, the Company recorded a net loss of $37.2 million from litigation-related settlement in the fourth quarter of 2006.

In the second quarter of 2005, the Company entered into a settlement agreement with Lambda Americas, Inc., successor to Lambda Electronics, Inc., under which the Company received a payment of $2,500,000 in full settlement of the Company s Reset Patent claims against Lambda and which settled the lawsuit that the Company had filed against Lambda in June 2001. The full amount of the payment, net of a $250,000 contingency fee paid by the Company to its litigation counsel, has been included in gain from litigation-related settlement, net in the accompanying condensed consolidated statement of operations.

The changes in the major components of other income (expense), net were as follows (in thousands):

	2006 (As restated)	2005	Increase (Decrease)
Interest income	$ 5,389	$ 3,124	$ 2,265
Minority interest in net income of subsidiaries	(562)	(807)	245
Foreign currency gains (losses)	139	(771)	910
Gain (loss) on disposal of equipment	67	(41)	108
Other	59	(5)	64
	$ 5,092	$ 1,500	$ 3,592

The increase in interest income is due to higher interest rates and higher average balances on the Company s cash equivalents, short-term and long-term investments. The increase in foreign currency gains is due to the favorable exchange rates in 2006 as compared to 2005. The Company s exposure to market risk for fluctuations in foreign currency exchange rates relates primarily to the operations of Vicor Japan Co. Ltd. (VJCL) and changes in the dollar/yen exchange rate. In addition, the functional currency of the Company s subsidiaries in Europe and Hong Kong is the U.S. dollar. The decrease in minority interest in the net income of subsidiaries was due to lower income at certain minority interest entities.

Loss before income taxes was $28,090,000 in 2006 compared to income before income taxes of $4,880,000 for 2005.

The provision for income taxes totaled $648,000 in 2006 as compared to a provision of $964,000 in 2005. The Company s effective tax rate was 2.3% and 19.8% for 2006 and 2005, respectively. Tax provisions in 2006 and 2005 have been provided for federal and state taxes for certain minority-owned subsidiaries that are not part of the Company s consolidated income tax returns, for the federal alternative minimum tax and for estimated income taxes due in various state and international taxing jurisdictions. In the third quarter of 2006 and 2005, the Company reduced its tax reserves by $468,000 and $770,000, respectively, due to closing tax periods in certain jurisdictions and other tax reserves no longer considered necessary. The decreases in 2006

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and 2005 were partially offset by increases in reserves during the year of approximately $133,000 and $412,000, respectively, for potential liabilities.

Loss from equity method investment (net of tax) for fiscal year 2006 decreased $102,000 to $321,000 from $423,000 for 2005. This was principally due lower equity method investment losses allocated to the Company. As described in Note 7. in the Notes to the Consolidated Financial Statements, the Company changed its method of accounting for its investment in GWS from the cost method to the equity method of accounting. As a result, the financial statements for the years ended December 31, 2006 and December 31, 2005 have been retroactively restated to reflect the equity method of accounting, in accordance with APB 18. The Company made an additional $1,000,000 investment in GWS in February 2008. The Company expects that it will take an impairment charge of approximately $700,000 in the first quarter of 2008 due to the additional investment.

Basic and diluted loss per share was $0.69 for the year ended December 31, 2006, compared to basic and diluted income per share of $0.08 for the year ended December 31, 2005.

LIQUIDITY AND CAPITAL RESOURCES

At December 31, 2007 the Company had $20,017,000 in unrestricted cash and cash equivalents. The ratio of current assets to current liabilities was 6.5:1 at December 31, 2007 compared to 2.9:1 at December 31, 2006. Working capital decreased $7,543,000, from $123,467,000 at December 31, 2006 to $115,924,000 at December 31, 2007. The primary factors affecting the working capital decrease was a decrease in cash and cash equivalents and short-term investments of $40,034,000, a decrease in insurance receivable for a litigation payment of $12,800,000, and a decrease in deferred tax assets of $2,961,000. The decreases were partially offset by a decrease in total current liabilities of $45,693,000, which was primarily due to the decrease in accrual for litigation settlement of $50,000,000, an increase in accounts receivable of $1,655,000 and an increase in inventories of $1,077,000. The decrease in cash and cash equivalents and short-term investments was principally due to a net payment of $37,200,000 related to the Ericsson litigation settlement, which had been accrued for as of December 31, 2006. The primary source of cash for the year ended December 31, 2007 were $24,656,000 in net sales of short-term investments and $19,381,000 of net cash provided by operating activities (after adjusting for the net payment for litigation settlement of $37,200,000). The primary uses of cash for the twelve months ended December 31, 2007 were $37,200,000, net, for the litigation settlement, $12,569,000 for the payments of dividends, $9,856,000 for the purchase of equipment and $1,000,000 invested in GWS.

In November 2000, the Board of Directors of the Company authorized the repurchase of up to $30,000,000 of the Company s Common Stock (the November 2000 Plan). The November 2000 Plan authorizes the Company to make such repurchases from time to time in the open market or through privately negotiated transactions. The timing and amounts of stock repurchases are at the discretion of management based on its view of economic and financial market conditions. The Company did not repurchase shares of Common Stock during the year ended December 31, 2007. As of December 31, 2007, the Company had approximately $8,541,000 remaining under the plan.

On July 25, 2007, the Company s Board of Directors approved a cash dividend of $.15 per share of the Company s stock. The total dividend of approximately $6,242,000 was paid on August 30, 2007 to shareholders of record at the close of business on August 14, 2007. On February 16, 2007, the Company s Board of Directors approved a cash dividend of $.15 per share of the Company s stock. The total dividend of approximately $6,235,000 was paid on March 27, 2007 to shareholders of record at the close of business on March 9, 2007. On March 14, 2008, the Company s Board of Directors approved a cash dividend of $.15 per share of the Company s stock. The total dividend of approximately $6,245,000 will be paid on April 18, 2008 to shareholders of record at the close of business on April 2, 2008. The Board of Directors anticipates reviewing its dividend policy on a semi-annual basis.

During the second quarter of 2007, two subsidiaries paid a total of $180,000 in dividends, of which $92,000 was paid to outside shareholders.

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The table below summarizes the Company s contractual obligations as of December 31, 2007 (in thousands):

	Payments Due by Period				
Contractual Obligations	Total	Less than 1 Year	Years 2 & 3	Years 4 & 5	More Than 5 Years
Operating lease obligations	$ 3,861	$ 1,398	$ 1,453	$ 239	$ 771
Purchase obligations	2,248	291	600	624	733
Total	$ 6,109	$ 1,689	$ 2,053	$ 863	$ 1,504

In addition to the amounts shown in the table above, approximately $511,000 of unrecognized tax benefits have been recorded as liabilities in accordance with FIN 48, and we are uncertain as to if or when such amounts may be settled. Related to these unrecognized tax benefits, we have also recorded a liability for potential interest and penalties of approximately $833,000 at December 31, 2007.

The Company s primary liquidity needs are for making continuing investments in manufacturing equipment, particularly equipment for the Company s new FPA products and replacement of aging manufacturing equipment utilized by the Brick Business Unit. The Company believes that cash generated from operations and the total of its cash and cash equivalents and short-term investments will be sufficient to fund planned operations and capital equipment purchases for the foreseeable future. During the quarter ended June 30, 2007, the Company made an additional investment of $1,000,000 in GWS and agreed to a further investment of $1,000,000 if certain conditions were met by November 2007. Those conditions were not met by November 2007. However, the Company did make the additional $1,000,000 investment in February 2008. The additional $1,000,000 investment was approved by the Audit Committee of the Company s Board of Directors. Additionally, the Company had approximately $2,047,000 of capital expenditure commitments, principally for manufacturing equipment as of December 31, 2007.

Through March 14, 2008, auctions held the Company s auction rate securities with a total aggregate value of approximately $38.0 million failed. As of March 14, 2008, the Company was holding a total of approximately $43.0 million in auction rate securities, the significant majority of which are student loan backed securities. These municipal and corporate debt securities have their interest rates reset at auction at regular intervals ranging from seven to ninety days. The funds associated with our auction rate securities that fail auction may not be accessible until a successful auction occurs, a buyer is found outside of the auction process, the security is called, or the underlying securities have matured. Based on our ability to access our cash and other short-term investments and our expected operating cash flows, we do not anticipate the current lack of liquidity will affect our ability to execute our current operating plan.

The Company does not consider the impact of inflation and changing prices on its business activities or fluctuations in the exchange rates for foreign currency transactions to have been material during the last three fiscal years.

ITEM 7A *QUALITATIVE AND QUANTITATIVE DISCLOSURE ABOUT MARKET RISK*

The Company is exposed to a variety of market risks, including changes in interest rates affecting the return on its cash and cash equivalents and short-term investments and fluctuations in foreign currency exchange rates.

As the Company s cash and cash equivalents consist principally of money market securities, which are short-term in nature, the Company s exposure to market risk on interest rate fluctuations for these investments is not significant. The Company s short-term investments consist mainly of municipal and corporate debt securities, in which a significant portion are invested in auction rate securities, the significant majority of which are student loan backed securities. These auction rate securities have interest rates reset at auction at regular intervals. Through March 14, 2008, auctions held for the Company s auction rate securities with a total aggregate value of approximately $38.0 million failed. As of March 14, 2008, the Company was holding a total of approximately $43.0 million in auction rate securities. While those debt securities are all highly rated investments, generally with AAA/Aaa ratings, continued failure to sell at their reset dates could negatively

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impact the carrying value of the investment which could lead to impairment charges in future periods, should a decline in the value of these securities be other than temporary. The Company does not believe there was any impairment to these investments as of December 31, 2007. Our annual interest income would change by approximately $600,000 in 2007 for each 100 basis point increase or decrease in interest rates.

The Company s exposure to market risk for fluctuations in foreign currency exchange rates relates primarily to the operations of Vicor Japan Company, Ltd. (VJCL) and changes in the dollar/yen exchange rate. In addition, the functional currency of the Company s subsidiaries in Europe and Hong Kong is the U.S. Dollar. Therefore, the Company believes that market risk is mitigated since these operations are not materially exposed to foreign exchange fluctuations. Relative to foreign currency exposure against the yen existing at December 31, 2007, a 10% unfavorable movement in the dollar/yen exchange rate would increase foreign currency loss by approximately $200,000.

ITEM 8 *FINANCIAL STATEMENTS AND SUPPLEMENTARY DATA*

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FINANCIAL STATEMENTS

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REPORT OF INDEPENDENT REGISTERED PUBLIC ACCOUNTING FIRM

Board of Directors and Stockholders
Vicor Corporation

We have audited the accompanying consolidated balance sheets of Vicor Corporation as of December 31, 2007 and 2006, and the related consolidated statements of operations, stockholders equity, and cash flows for each of the three years in the period ended December 31, 2007. Our audits also included the financial statement schedule listed in the Index at Item 15(a)(2). These financial statements and schedule are the responsibility of the Company s management. Our responsibility is to express an opinion on these financial statements and schedule based on our audits.

We conducted our audits in accordance with the standards of the Public Company Accounting Oversight Board (United States). Those standards require that we plan and perform the audit to obtain reasonable assurance about whether the financial statements are free of material misstatement. An audit includes examining, on a test basis, evidence supporting the amounts and disclosures in the financial statements. An audit also includes assessing the accounting principles used and significant estimates made by management, as well as evaluating the overall financial statement presentation. We believe that our audits provide a reasonable basis for our opinion.

In our opinion, the consolidated financial statements referred to above present fairly, in all material respects, the consolidated financial position of Vicor Corporation at December 31, 2007 and 2006, and the consolidated results of its operations and its cash flows for each of the three years in the period ended December 31, 2007, in conformity with U.S. generally accepted accounting principles. Also, in our opinion, the related financial statement schedule, when considered in relation to the basic financial statements taken as a whole, presents fairly in all material respects the information set forth therein.

As discussed in Notes 2 and 7 to the consolidated financial statements, in 2007, the Company changed its method of accounting for its related-party investment in Great Wall Semiconductor Corporation. As discussed in Notes 2 and 12 to the consolidated financial statements, on January 1, 2007, the Company adopted the provisions of Financial Accounting Standards Board Interpretation No. 48, *Accounting for Uncertainty in Income Taxes*. As discussed in Notes 2 and 3 to the consolidated financial statements, on January 1, 2006, the Company adopted the provisions of Statement of Financial Accounting Standards No. 123(R), *Share-Based Payment*.

We also have audited, in accordance with the standards of the Public Company Accounting Oversight Board (United States), the effectiveness of Vicor Corporation s internal control over financial reporting as of December 31, 2007, based on criteria established in Internal Control Integrated Framework issued by the Committee of Sponsoring Organizations of the Treadway Commission and our report dated March 14, 2008 expressed an adverse opinion thereon.

/s/ Ernst & Young LLP

Boston, Massachusetts
March 14, 2008

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VICOR CORPORATION

CONSOLIDATED BALANCE SHEETS
December 31, 2007 and 2006

	2007	2006
	(In thousands, except share data)	
ASSETS		
Current assets:		
Cash and cash equivalents	$ 20,017	$ 35,860
Restricted cash and short-term investments	952	1,045
Short-term investments	57,490	81,681
Accounts receivable, less allowance of $398 in 2007 and $583 in 2006	32,054	30,399
Insurance receivable for litigation settlements		12,800
Inventories, net	23,078	22,001
Deferred tax assets	741	3,702
Other current assets	2,629	2,709
Total current assets	136,961	190,197
Property, plant and equipment, net	50,257	51,573
Other assets	5,240	5,691
	$ 192,458	$ 247,461
LIABILITIES AND STOCKHOLDERS EQUITY		
Current liabilities:		
Accounts payable	$ 10,062	$ 7,273
Accrued compensation and benefits	6,003	5,192
Accrued expenses	3,471	4,189
Accrual for litigation settlements	240	50,000
Income taxes payable	278	
Deferred revenue	983	76
Total current liabilities	21,037	66,730
Long-term income taxes payable	1,344	2,577
Deferred income taxes	1,597	4,389
Minority interests	4,040	3,593
Stockholders equity:		
Preferred Stock, $.01 par value, 1,000,000 shares authorized; no shares issued or outstanding in 2007 and 2006		
Class B Common Stock: 10 votes per share, $.01 par value, 14,000,000 shares authorized, 11,824,952 shares issued and outstanding (11,854,952 shares issued and outstanding in 2006)	118	119
Common Stock: 1 vote per share, $.01 par value, 62,000,000 shares authorized, 38,209,486 shares issued and 29,811,088 shares outstanding (38,106,377 shares	384	382

issued and 29,707,979 shares outstanding in 2006)		
Additional paid-in capital	159,332	158,021
Retained earnings	126,263	133,405
Accumulated other comprehensive income (loss)	170	72
Treasury stock at cost: 8,398,398 shares in 2007 and 2006	(121,827)	(121,827)
Total stockholders equity	164,440	170,172
	$ 192,458	$ 247,461

See accompanying notes

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VICOR CORPORATION

CONSOLIDATED STATEMENTS OF OPERATIONS
Years ended December 31, 2007, 2006 and 2005

	2007	2006 (As restated)	2005 (As restated)
	(In thousands, except per share amounts)		
Net revenues	$ 195,827	$ 192,047	$ 179,351
Cost of revenues	116,818	110,211	107,944
Gross margin	79,009	81,836	71,407
Operating expenses:			
Selling, general and administrative	48,919	46,437	40,811
Research and development	30,372	31,381	29,466
(Gain) loss from litigation-related settlements, net	(1,353)	37,200	(2,250)
Total operating expenses	77,938	115,018	68,027
Income (loss) from operations	1,071	(33,182)	3,380
Other income (expense), net	4,388	5,092	1,500
Income (loss) before income taxes	5,459	(28,090)	4,880
(Benefit) provision for income taxes	(1,015)	648	964
Loss from equity method investment (net of tax)	1,139	321	423
Net income (loss)	$ 5,335	$ (29,059)	$ 3,493
Net income (loss) per common share:			
Basic	$ .13	$ (.69)	$ .08
Diluted	$ .13	$ (.69)	$ .08
Shares used to compute net income (loss) per share:			
Basic	41,597	41,839	41,923
Diluted	41,687	41,839	42,089
Cash dividends per share	$ .30	$ .27	$ .12

See accompanying notes

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VICOR CORPORATION

CONSOLIDATED STATEMENTS OF CASH FLOWS
Years ended December 31, 2007, 2006 and 2005

	2007	2006 (As restated)	2005 (As restated)
		(In thousands)	
Operating activities:			
Net income (loss)	$ 5,335	$ (29,059)	$ 3,493
Adjustments to reconcile net income (loss) to net cash (used in) provided by operating activities:			
Depreciation and amortization	11,619	14,158	17,082
Loss from equity method investment (net of tax)	1,139	321	423
Loss on litigation related settlement		37,200	
Stock compensation expense	667	751	
Minority interest in net income of subsidiaries	539	562	807
(Accretion) amortization of bond (discount) premium	(465)	(167)	573
Deferred income taxes	104	86	(133)
(Gain) loss on disposal of equipment	(129)	(67)	41
Change in assets and liabilities, net	(36,628)	(9,455)	6,985
Net cash (used by) provided by operating activities	(17,819)	14,330	29,271
Investing activities:			
Purchases of investments	(138,642)	(189,683)	(116,114)
Sales and maturities of investments	163,298	199,901	100,746
Additions to property, plant and equipment	(9,856)	(5,603)	(8,944)
Proceeds from sale of equipment	129	88	
Purchase of equity method investment	(1,000)		
Increase in other assets	(120)	(176)	(573)
Decrease (increase) in restricted cash and short term investments	93	(139)	210
Net cash provided by (used in) investing activities	13,902	4,388	(24,675)
Financing activities:			
Proceeds from exercise of stock options	645	5,577	3,578
Dividends paid	(12,569)	(11,343)	(5,025)
Acquisitions of treasury stock		(10,835)	(5,544)
Net cash used in financing activities	(11,924)	(16,601)	(6,991)
Effect of foreign exchange rates on cash	(2)	40	170
Net (decrease) increase in cash and cash equivalents	(15,843)	2,157	(2,225)
Cash and cash equivalents at beginning of year	35,860	33,703	35,928
Cash and cash equivalents at end of year	$ 20,017	$ 35,860	$ 33,703

Change in assets and liabilities:			
Accounts receivable	$ (1,546)	$ (2,363)	$ (4,941)
Insurance receivable for litigation	12,800		
Inventories, net	(997)	(4,854)	8,913
Other current assets	83	395	(279)
Accounts payable and accrued liabilities	2,840	303	3,545
Accrual for litigation settlement	(49,760)		
Income taxes payable	(955)	(2,869)	(90)
Deferred revenue	907	(67)	(163)
	$ (36,628)	$ (9,455)	$ 6,985
Supplemental disclosures:			
Cash paid during the year for income taxes, net of refunds	$ (380)	$ 3,590	$ 1,085

See accompanying notes

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VICOR CORPORATION

CONSOLIDATED STATEMENTS OF STOCKHOLDERS EQUITY
Years ended December 31, 2007, 2006 and 2005

	Class B Common Stock	Common Stock	Additional Paid-In Capital	Retained Earnings (as restated)	Accumulated Other Comprehensive Income (Loss)	Treasury Stock	Total Stockholders Equity
				(In thousands)			
Balance at December 31, 2004 (as restated)	$ 119	$ 373	$ 148,821	$ 175,339	$ (11)	$ (105,448)	$ 219,193
Sales of Common Stock		4	3,574				3,578
Conversion of Class B Common Stock to Common Stock							
Purchase of treasury stock						(5,544)	(5,544)
Common stock dividends				(5,025)			(5,025)
Minority interest adjustment			(697)				(697)
Net income for 2005 (as restated)				3,493			3,493
Unrealized gain on investments					33		33
Currency translation adjustments					(94)		(94)
Comprehensive income (as restated)							3,432
Balance at December 31, 2005 (as restated)	119	377	151,698	173,807	(72)	(110,992)	214,937
Sales of Common Stock		5	5,572				5,577
Purchase of treasury stock						(10,835)	(10,835)
Common stock dividends				(11,343)			(11,343)
Stock-based compensation expense			751				751
Net loss for 2006 (as restated)				(29,059)			(29,059)
Unrealized gain on investments					164		164
Currency translation adjustments					(20)		(20)
							(28,915)

Comprehensive loss (as restated)							
Balance at December 31, 2006 (as restated)	119	382	158,021	133,405	72	(121,827)	170,172
Sales of Common Stock		1	644				645
Conversion of Class B Common Stock to Common Stock	(1)	1					
Purchase of treasury stock							
Common stock dividends				(12,477)			(12,477)
Stock-based compensation expense			667				667
Net income for 2007				5,335			5,335
Unrealized gain on investments					5		5
Currency translation adjustments					93		93
Comprehensive income							5,433
Balance at December 31, 2007	$ 118	$ 384	$ 159,332	$ 126,263	$ 170	$ (121,827)	$ 164,440

See accompanying notes

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VICOR CORPORATION

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

1. DESCRIPTION OF BUSINESS

Vicor Corporation (the Company or Vicor) designs, develops, manufactures and markets modular power converters, power system components, and power systems using a patented, high frequency power conversion technology designated zero current switching. The Company also licenses certain rights to its technology in return for ongoing royalties. The principal markets for the power converters and systems are large Original Equipment Manufacturers and smaller, lower volume users which are broadly distributed across several major market areas.

2. SIGNIFICANT ACCOUNTING POLICIES

Principles of consolidation

The consolidated financial statements include the accounts of the Company and its subsidiaries. All intercompany transactions and balances have been eliminated upon consolidation. Certain of the Company s Vicor Integration Architects (VIAs) are not majority owned by the Company. These entities are consolidated by the Company as management believes that the Company has the ability to exercise control over their activities and operations. During 2005, the Company increased the minority interests balance by $697,000, with a corresponding offset to additional paid-in capital, to adjust the balance to reflect the minority interest ownership percentage in the net equity of these subsidiaries.

Basis of presentation

As described in Note 7., due to an additional investment in Great Wall Semiconductor Corporation (GWS) in May 2007, the Company changed its method of accounting for its investment in GWS from the cost method to the equity method of accounting. As a result, the financial statements for the year ended December 31, 2006 and December 31, 2005 have been retroactively restated to reflect the equity method of accounting, in accordance with Accounting Principles Board Opinion No. 18, The Equity Method of Accounting for Investments in Common Stock .

Revenue recognition

Product revenue is recognized in the period when persuasive evidence of an arrangement with a customer exists, the products are shipped and title has transferred to the customer, the price is fixed or determinable, and collection is considered probable. License fees are recognized as earned. The Company recognizes revenue on such arrangements only when the contract is signed, the license term has begun, all obligations have been delivered to the customer, and collection is probable. The Company evaluates revenue arrangements with potential multi-element deliverables in accordance with Emerging Issues Task Force (EITF) Issue No. 00-21 Revenue Arrangements with Multiple Deliverables (EITF 00-21).

Foreign currency translation

The financial statements of Vicor Japan Company, Ltd. (VJCL), for which the functional currency is the Japanese yen, have been translated into U.S. dollars in accordance with FASB Statement No. 52, Foreign Currency Translation. All balance sheet accounts have been translated using the exchange rate in effect at the balance sheet date. Income statement amounts have been translated at the average exchange rates in effect during the year. The gains and losses resulting from the changes in exchange rates from year to year have been reported in other comprehensive income.

Transaction gains and losses, and translation gains (losses) resulting from the remeasurement of foreign currency denominated assets and liabilities of the Company s foreign subsidiaries where the functional currency is the U.S. dollar are included in other income (expense), net. Foreign currency gains (losses), included in other income (expense), net, were approximately $186,000, $139,000, and ($771,000) in 2007, 2006 and 2005, respectively.

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VICOR CORPORATION

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)

2. SIGNIFICANT ACCOUNTING POLICIES (Continued)

Cash and cash equivalents

Cash and cash equivalents include funds held in checking and money market accounts with banks, certificates of deposit and debt securities with maturities of less than three months when purchased and money market securities. Cash and cash equivalents are valued at cost which approximates market value. The Company s money market securities, which are classified as cash equivalents on the balance sheet, are purchased and redeemed at par. The estimated fair value is equal to the cost of the securities and due to the nature of the securities there are no unrealized gains or losses at the balance sheet dates.

Restricted cash and short-term investments

Restricted cash and short-term investments represent the amount of cash and short-term investments required to be set aside as a guarantee for certain foreign letters of credit. Restricted cash and short-term investments of $1,045,000 as of December 31, 2006, and $906,000 as of December 31, 2005, respectively, were reclassified to conform to the 2007 presentation.

Short-term and long-term investments

The Company s short-term and long-term investments are classified as available-for-sale securities and are recorded at fair value, with the unrealized gains and losses, net of tax, reported in a separate component of stockholders equity. The amortized cost of debt securities is adjusted for amortization of premiums and accretion of discounts to maturity. Such amortization, along with interest and realized gains and losses, are included in other income (expense), net. The Company has no trading securities or held-to-maturity securities.

Through March 14, 2008, auctions held for the Company s auction rate securities with a total aggregate value of approximately $38.0 million failed. As of March 14, 2008, the Company was holding a total of approximately $43.0 million in auction rate securities, the significant majority of which are student loan backed securities. These municipal and corporate debt securities have their interest rates reset at auction at regular intervals ranging from seven to ninety days. Because of these short term intervals between interest reset dates, the Company monitors the auctions to ensure they are successful, which provides evidence that the recorded values of these investments approximate their fair values. As discussed above, auctions related to substantially all our auction rate securities have failed and if auctions continue to fail such that the securities were deemed to be not liquid, the Company would need to seek other alternatives to determine the fair value of these securities, which may not be based on the quoted market transaction. In addition, due to the Company s inability to quickly liquidate these investments, the Company may reclassify those investments with failed auctions as long-term assets in its consolidated balance sheet.

Allowance for doubtful accounts

The Company maintains allowances for doubtful accounts for estimated losses resulting from the inability of its customers to make required payments, based on assessments of customers credit-risk profiles and payment histories. If the financial condition of the Company s customers were to deteriorate, resulting in an impairment of their ability to make payments, additional allowances may be required.

Inventories

Inventories are valued at the lower of cost (determined using the first-in, first-out method) or market. The Company provides reserves for inventories estimated to be excess, obsolete or unmarketable. The Company s estimation process for such reserves is based upon its known backlog, projected future demand and expected market conditions. If the Company s estimated demand and or market expectation were to change or if product sales were to decline, the Company s estimation process may cause larger inventory reserves to be recorded, resulting in larger charges to cost of revenues.

VICOR CORPORATION

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)

2. SIGNIFICANT ACCOUNTING POLICIES (Continued)

Concentrations of credit risk

Financial instruments that potentially subject the Company to significant concentrations of credit risk consist principally of cash and cash equivalents, short-term and long-term investments and trade accounts receivable. The Company maintains cash and cash equivalents and certain other financial instruments with various high credit, quality financial institutions. The Company s short-term and long-term investments consist of highly rated (AAA/Aaa) municipal and corporate debt securities in which a significant portion are invested in auction rate securities. As of March 14, 2008, the Company was holding a total of approximately $43.0 million in auction rate securities, the significant majority of which are student loan backed securities. Through March 14, 2008, auctions held for the Company s auction rate securities with a total aggregate value of approximately $38.0 million failed. The funds associated with our auction rate securities that fail auction may not be accessible until a successful auction occurs, a buyer is found outside of the auction process, the security is called, or the underlying securities have matured. If the credit rating of the issuer of any auction rate security held by us deteriorates, we may be required to adjust the carrying value of the investment for an other than temporary decline in value through an impairment charge. The Company s investment policy, approved by the Board of Directors, limits the amount the Company may invest in any issuer, thereby reducing credit risk concentrations. Concentrations of credit risk with respect to trade accounts receivable are limited due to the number of entities comprising the Company s customer base. Credit losses have consistently been within management s expectations.

Goodwill and intangible assets

The Company accounts for its goodwill and other intangible assets in accordance with FASB Statement No. 142, Goodwill and Other Intangible Assets (FAS 142), which resulted in the elimination of goodwill amortization beginning in fiscal 2002. The Company performs a test of goodwill for potential impairment at least annually. Values assigned to patents are amortized using the straight-line method over periods ranging from three to twenty years.

Long-lived assets

In accordance with FASB Statement No. 144, Accounting for the Impairment or Disposal of Long-Lived Assets , long-lived assets such as property, plant and equipment and intangible assets, are included in impairment evaluations when events or circumstances exist that indicate the carrying amount of those assets may not be recoverable. If the impairment evaluation indicates the affected asset is not recoverable, the asset s carrying value would be reduced to fair value. No event has occurred that would suggest any impairment in the value of long-lived assets recorded in the accompanying consolidated financial statements.

Other investments

The accounting for investment transactions is reviewed for compliance with Accounting Principles Board Opinion No. 18, The Equity Method for Accounting for Investments in Common Stock (APB 18) and/or FASB Interpretation No. 46 Revised (FIN 46R), Consolidation of Variable Interest Entities . As discussed in Note 7. the Company previously accounted for the investment in Great Wall Semiconductor Corporation (GWS) under APB 18 as a cost method investment as management believed it did not have significant influence over GWS. An additional investment in GWS in May 2007 resulted in the Company owning approximately 24% of GWS which management believes, along with other qualitative factors considered, gives the Company significant influence over GWS. As a result of the additional investment, the Company is required to account for the investment in GWS under the equity method of accounting and to retroactively restate its previously issued consolidated financial statements to reflect the equity method of accounting, in accordance with APB 18.

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VICOR CORPORATION

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)

2. SIGNIFICANT ACCOUNTING POLICIES (Continued)

Advertising expense

The cost of advertising is expensed as incurred. The Company incurred $2,205,000, $2,473,000 and $1,913,000 in advertising costs during 2007, 2006 and 2005, respectively.

Product warranties

The Company generally offers a two-year warranty for all of its products. The Company provides for the estimated cost of product warranties at the time product revenue is recognized. Factors that affect the Company s warranty reserves include the number of units sold, historical and anticipated rates of warranty returns and the cost per return. The Company periodically assesses the adequacy of the warranty reserves and adjusts the amounts as necessary. Warranty obligations are included in accrued expenses in the accompanying consolidated balance sheets.

Net income (loss) per common share

Basic and diluted income (loss) per share are calculated in accordance with FASB Statement No. 128, Earnings per Share. The following table sets forth the computation of basic and diluted income (loss) per share (in thousands, except per share amounts):

	2007	2006 (as restated)	2005 (as restated)
Numerator:			
Net income (loss)	$ 5,335	$ (29,059)	$ 3,493
Denominator:			
Denominator for basic income (loss) per share weighted average shares	41,597	41,839	41,923
Effect of dilutive securities:			
Employee stock options	90		166
Denominator for diluted income (loss) per share adjusted weighted-average shares	41,687	41,839	42,089
Basic income (loss) per share	$ .13	$ (.69)	$ .08
Diluted income (loss) per share	$ .13	$ (.69)	$ .08

Options to purchase 968,575 and 1,213,679 shares of Common Stock were outstanding in 2007 and 2005, respectively, but were not included in the computation of diluted income per share because the options exercise prices were greater than the average market price of the Common Stock and, therefore, the effect would have been antidilutive. Options to purchase 1,643,629 shares of Common Stock in 2006, respectively, were not included in the calculation of net loss per share as the effect would have been antidilutive.

Income taxes

The Company accounts for income taxes in accordance with FASB Statement No. 109, Accounting for Income Taxes (FAS 109). FAS 109 requires that deferred tax assets and liabilities are determined based on the differences between financial reporting and tax bases of assets and liabilities and are measured using the enacted income tax rates and laws that are expected to be in effect when the temporary differences are expected to reverse. FAS 109 also requires that deferred tax assets be reduced by a valuation allowance if it is more likely than not that some portion or all of the deferred tax assets will not be realized. Additionally,

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VICOR CORPORATION

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)

2. SIGNIFICANT ACCOUNTING POLICIES (Continued)

deferred tax assets and liabilities are separated into current and noncurrent amounts based on the classification of the related assets and liabilities for financial reporting purposes or the expected reversal.

The Company adopted FASB Interpretation No. 48, Accounting for Uncertainty in Income Taxes (FIN 48), on January 1, 2007. FIN 48 clarifies the accounting for uncertainty in income taxes recognized in an enterprise s financial statements in accordance with FASB Statement No. 109, Accounting for Income Taxes . FIN 48 prescribes a two-step process to determine the amount of tax benefit to recognize. First, the tax position must be evaluated to determine the likelihood that it will be sustained upon examination by a tax authority. If the tax position is deemed more-likely-than-not to be sustained, the tax position is then assessed to determine the amount of benefit to recognize in the financial statements. The amount of the benefit that may be recognized is the largest amount that has a greater than 50 percent likelihood of being realized upon ultimate settlement. If the tax position does not meet the more-likely-than-not threshold then it is not recognized in the financial statements. In accordance with FIN 48, the Company accrues interest and penalties, if any, related to unrecognized tax benefits as a component of income tax expense. The Company s adoption of FIN 48 as of January 1, 2007 did not have a material impact on the Company s financial position or results of operations.

Stock-based compensation

On January 1, 2006, the Company adopted FASB statement No. 123 (revised 2004), Share-Based Payment (FAS 123R), which is a revision of FAS No. 123, Accounting for Stock-Based Compensation . FAS 123(R) supersedes APB Opinion No. 25, Accounting for Stock Issued to Employees , and amends SFAS No. 95, Statement of Cash Flows . Generally, the approach in FAS 123(R) is similar to the approach described in FAS 123. However, FAS 123(R) requires all share-based payments to employees, including grants of employee stock options, to be recognized in the income statement based on their fair values at the date of grant. Pro forma disclosure is no longer an alternative.

The Company is using the modified prospective method as permitted under FAS 123(R). Under this transition method, compensation cost recognized in fiscal 2007 and 2006 includes: (a) compensation cost for all share-based payments granted prior to but not yet vested as of December 31, 2005, based on the grant-date fair value estimated in accordance with the provisions of FAS 123, and (b) compensation cost for all share-based payments granted subsequent to December 31, 2005, based on the grant-date fair value estimated in accordance with the provisions of FAS 123(R). In accordance with the modified prospective method of adoption, Vicor s results of operations and financial position for prior periods have not been restated.

Use of estimates

The preparation of the financial statements in conformity with generally accepted accounting principles requires management to make estimates and assumptions that affect the amounts reported in the financial statements and accompanying notes. Actual results could differ from those estimates.

Comprehensive income

The Company reports comprehensive income in accordance with FASB Statement No. 130, Reporting Comprehensive Income (FAS 130). FAS 130 requires the foreign currency translation adjustments related to VJCL and unrealized gains (losses) on short-term and long-term investments to be included in other comprehensive income, net of related income tax effects.

VICOR CORPORATION

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)

2. SIGNIFICANT ACCOUNTING POLICIES (Continued)

Impact of recently issued accounting standards

In September 2006, the FASB issued Statement of Financial Accounting Standards No. 157, Fair Value Measurements (FAS 157), which the Company must adopt for the fiscal year ending December 31, 2008. FAS 157 defines fair value, establishes a framework for measuring fair value in generally accepted accounting principles (GAAP), and expands disclosures about fair value measurements. FAS 157 applies under other accounting pronouncements that require or permit fair value measurements, the FASB having previously concluded in those accounting pronouncements that fair value is the relevant measurement attribute. Accordingly, this Statement does not require any new fair value measurements. However, for some entities, the application of this Statement will change current practice. The Company has not determined the impact, if any, that FAS 157 will have on its financial position or results of operations.

In February 2007, the FASB issued Statement of Financial Accounting Standards No. 159, The Fair Value Option for Financial Assets and Financial Liabilities Including an amendment of FASB Statement No. 115 (FAS 159), which the Company must adopt for the fiscal year ending December 31, 2008. FAS 159 permits entities to choose to measure many financial instruments and certain other items at fair value that are not currently required to be measured at fair value. The Company has not determined the impact, if any, that FAS 159 will have on its financial position or results of operations.

In December 2007, the FASB issued statement of Financial Accounting Standards No. 141 (revised 2007), Business Combinations (FAS 141R). FAS 141R changes accounting for acquisitions that close beginning in 2009. More transactions and events will qualify as business combinations and will be accounted for at fair value under the new standard. FAS 141R promotes greater use of fair values in financial reporting. Some of the changes will introduce more volatility into earnings. FAS 141R is effective for fiscal years beginning on or after December 15, 2008. The Company has not determined the impact, if any, that FAS 141R will have on its financial position or results of operations.

In December 2007, the FASB issued Statement of Financial Accounting Standards No. 160, Noncontrolling Interests in Consolidated Financial Statements (FAS 160), an amendment of ARB No. 51. FAS 160 will change the accounting and reporting for minority interests which will be recharacterized as noncontrolling interests and classified as a component of equity. FAS 160 is effective for fiscal years beginning on or after December 15, 2008. FAS 160 requires retroactive adoption of the presentation and disclosure requirements for existing minority interests. The Company has not determined the impact, if any, that FAS 160 will have on its financial position or results of operations.

3. STOCK-BASED COMPENSATION AND EMPLOYEE BENEFIT PLANS

On January 1, 2006 the Company adopted FASB statement No. 123 (revised 2004), Share-Based Payment (FAS 123R), which is a revision of FAS No. 123, Accounting for Stock-Based Compensation . FAS 123(R) supersedes APB Opinion No. 25, Accounting for Stock Issued to Employees , and amends SFAS No. 95, Statement of Cash Flows . Generally, the approach in FAS 123(R) is similar to the approach described in FAS 123. However, FAS 123(R) requires all share-based payments to employees, including grants of employee stock options, to be recognized in the income statement based on their fair values at the date of grant. Pro forma disclosure is no longer an alternative.

The Company is using the modified prospective method as permitted under FAS 123(R). Under this transition method, compensation cost recognized in fiscal 2007 and 2006 includes: (a) compensation cost for all share-based payments granted prior to but not yet vested as of December 31, 2005, based on the grant-date fair value estimated in accordance with the provisions of FAS 123, and (b) compensation cost for all share-based payments granted subsequent to December 31, 2005, based on the grant-date fair value estimated in

VICOR CORPORATION

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)

3. STOCK-BASED COMPENSATION AND EMPLOYEE BENEFIT PLANS (Continued)

accordance with the provisions of FAS 123(R). In accordance with the modified prospective method of adoption, Vicor s results of operations and financial position for prior periods have not been restated.

Prior to the adoption of FAS 123(R), the Company used the intrinsic value method in accounting for its employee stock options in accordance with Accounting Principles Board Opinion No. 25, Accounting for Stock Issued to Employees (APB 25) and related Interpretations, as permitted under FASB Statement No. 123, Accounting for Stock-Based Compensation (FAS 123) and FASB Statement No. 148, Accounting for Stock-Based Compensation Transition and Disclosure (FAS 148). Under APB 25, because the exercise price of the Company s employee stock options equals the market price of the underlying stock on the date of grant, no compensation expense is recognized.

Vicor currently grants stock options under the following equity compensation plans that are shareholder-approved:

Amended and Restated 2000 Stock Option and Incentive Plan (the 2000 Plan) Under the 2000 Plan, the Board of Directors or the Compensation Committee may grant stock incentive awards based on the Company s Common Stock, including stock options, stock appreciation rights, restricted stock, performance shares, unrestricted stock, deferred stock and dividend equivalent rights. Awards may be granted to employees and other key persons, including non-employee directors. Discretionary awards of stock options to non-employee directors shall be in lieu of any automatic grant of stock options under the Company s 1993 Stock Option Plan (the 1993 Plan) and the Company s 1998 Stock Option and Incentive Plan (the 1998 Plan). Incentive stock options may be granted to employees at a price at least equal to the fair market value per share of the Common Stock on the date of grant, and non-qualified options may be granted to non-employee directors at a price at least equal to 85% of the fair market value of the Common Stock on the date of grant. A total of 4,000,000 shares of Common Stock have been reserved for issuance under the 2000 Plan. The period of time during which an option may be exercised and the vesting periods are determined by the Compensation Committee. The term of each option may not exceed ten years from the date of grant.

1998 Stock Option and Incentive Plan (the 1998 Plan) The 1998 Plan permitted the grant of share options to its employees and other key persons, including non-employee directors for up to 2 million shares of common stock. As a result of the approval of the 2000 Plan, no further grants were made under the 1998 Plan.

1993 Stock Option Plan (the 1993 Plan) The 1993 Plan permitted the grant of share options to its employees and non-employee directors for up to 4,000,000 shares of common stock. As a result of the approval of the 2000 Plan, no further grants were made under the 1993 Plan.

Picor Corporation (Picor), a privately held majority owned subsidiary of Vicor, currently grants stock options under the following equity compensation plan that has been approved by its Board of Directors:

2001 Stock Option and Incentive Plan, as amended (the 2001 Picor Plan) The 2001 Picor Plan permits the grant of share options to its employees and other key persons, including non-employee directors and full or part-time officers, for up to 10,000,000 shares of common stock.

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VICOR CORPORATION

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)

3. STOCK-BASED COMPENSATION AND EMPLOYEE BENEFIT PLANS (Continued)

V*I Chip Corporation (V*I Chip), a privately held wholly owned subsidiary of Vicor, currently grants stock options under the following equity compensation plan that has been approved by its Board of Directors:

*2007 Stock Option and Incentive Plan, as amended (the 2007 V*I Chip Plan)* The 2007 V*I Chip Plan permits the grant of share options to its employees and other key persons, including non-employee directors and full or part-time officers, for up to 12,000,000 shares of common stock.

All option awards are granted at an exercise price equal to or greater than the market price for Vicor at the date of the grant, and are granted at a price equal to or greater than the estimated fair value for both Picor and V*I Chip at the date of grant. Options vest over various periods of up to five years and may be exercised for up to ten years from the date of grant, which is the maximum contractual term. The Company uses the graded attribution method to recognize expense for all stock-based awards in accordance with FAS 123(R).

Stock compensation expense for the years ended December 31, 2007 and 2006 was as follows (in thousands):

	2007	2006
Cost of revenues	$ 47	$ 85
Selling, general and administrative	368	385
Research and development	252	281
Total stock based compensation	$ 667	$ 751

Had expense been recognized using the fair value method described in FAS 123, using the Black-Scholes option pricing model, the following pro forma results of operations would have been reported (in thousands except for per share information):

	Year Ended December 31, 2005
Net income, as restated	$ 3,493
Total stock-based employee compensation expense determined under fair-value based methods for all awards, net of related tax effects	(845)
Pro forma net income	$ 2,648
Net income per share, as restated:	
Basic	$ .08

Diluted	$	.08
Pro forma net income per share:		
Basic	$	.06
Diluted	$	.06

The fair value for the options was estimated at the date of grant using a Black-Scholes option pricing model under all methods with the following weighted-average assumptions:

Vicor:	**2007**	**2006**	**2005**
Risk-free interest rate	4.7%	4.7%	3.9%
Expected dividend yield	1.84%	1.50%	.38%
Expected volatility	.49	.53	.59
Expected lives	3.8 years	3.8 years	4.0 years

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VICOR CORPORATION

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)

3. STOCK-BASED COMPENSATION AND EMPLOYEE BENEFIT PLANS (Continued)

Picor:	**2007**	**2006**	**2005**
Risk-free interest rate	4.7%	5.1%	4.4%
Expected dividend yield			
Expected volatility	.43	.48	.43
Expected lives	6.5 years	6.5 years	6.5 years

V*I Chip:	**2007**
Risk-free interest rate	4.6%
Expected dividend yield	
Expected volatility	.65
Expected lives	6.5 years

Risk-free interest rate:

Vicor The Company uses the yield on zero-coupon U.S. Treasury Strip securities for a period that is commensurate with the expected term assumption for each vesting period.

Picor The Company uses the yield to maturity of a ten-year treasury bond, since all of Picor s options expire ten years after they are granted.

*V*I Chip* The Company uses the yield to maturity of a ten-year treasury bond, since all of V*I Chip s options expire ten years after they are granted.

Expected dividend yield:

Vicor The Company determines the expected dividend yield by annualizing the most recent prior cash dividends declared by the Company s Board of Directors and dividing that result by the closing stock price on the date of that dividend declaration. Dividends are not paid on options.

Picor Picor has not and does not expect to declare and pay dividends in the foreseeable future. Therefore, the expected dividend yield is not applicable.

*V*I Chip* V*I Chip has not and does not expect to declare and pay dividends in the foreseeable future. Therefore, the expected dividend yield is not applicable.

Expected volatility:

Vicor Under FAS 123, Vicor used historical volatility to estimate the grant-date fair value of the options. Under FAS 123(R), Vicor has elected to continue to use historical volatility, using the expected term for the period over which to calculate the volatility (see below). The Company does not expect its future volatility to differ from its historical volatility. The computation of the Company s volatility is based on a simple average calculation of monthly volatilities over the expected term.

Picor As Picor is a nonpublic entity, historical volatility information is not available. As permitted under FAS 123(R), an industry sector index of approximately 5 publicly traded fabless semiconductor firms was developed for calculating historical volatility for Picor. Historical prices for each of the companies in the index based on the market price of the shares on each day of trading over the expected term were used to determine the historical volatility.

*V*I Chip* As V*I Chip is a nonpublic entity, historical volatility information is not available. As permitted under FAS 123(R), an industry sector index of approximately 5 publicly traded fabless

VICOR CORPORATION

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)

3. STOCK-BASED COMPENSATION AND EMPLOYEE BENEFIT PLANS (Continued)

semiconductor firms was developed for calculating historical volatility for V*I Chip. Historical prices for each of the companies in the index based on the market price of the shares on each day of trading over the expected term were used to determine the historical volatility.

Expected term:

Vicor The Company uses historical employee exercise and option expiration data to estimate the expected term assumption for the Black-Scholes grant-date valuation. The Company believes that this historical data is currently the best estimate of the expected term of options, and that generally all groups of our employees exhibit similar exercise behavior.

Picor Due to the lack of historical information, the simplified method prescribed by the Securities and Exchange Commission s Staff Accounting Bulletin No. 110 was used to determine the expected term.

*V*I Chip* Due to the lack of historical information, the simplified method prescribed by the Securities and Exchange Commission s Staff Accounting Bulletin No. 110 was used to determine the expected term.

Forfeiture rate

The amount of stock-based compensation recognized during a period is based on the value of the portion of the awards that are ultimately expected to vest. FAS 123(R) requires forfeitures to be estimated at the time of grant and revised, if necessary, in subsequent periods if actual forfeitures differ from those estimates. The term forfeitures is distinct from cancellations or expirations and represents only the unvested portion of the surrendered option.

Vicor The Company currently expects that for Vicor options, based on an analysis of its historical forfeitures, that approximately 80% of its options will actually vest, and therefore has applied an annual forfeiture rate of 7.25% to all unvested options as of December 31, 2007. For 2006, the Company expected 84% of its options would actually vest and applied an annual forfeiture rate of 5.75%. This analysis will be re-evaluated quarterly and the forfeiture rate will be adjusted as necessary. Ultimately, the actual expense recognized over the vesting period will only be for those shares that vest.

Picor The Company currently expects that for Picor options, based on an analysis of its historical forfeitures, that approximately 89% of its options will actually vest, and therefore has applied an annual forfeiture rate of 3.75% to all unvested options as of December 31, 2007. Since the compensation expense for year ended December 31, 2006 was immaterial, the Company did not apply an estimated forfeiture rate to the compensation expense. This analysis will be re-evaluated quarterly and the forfeiture rate will be adjusted as necessary. Ultimately, the actual expense recognized over the vesting period will only be for those shares that vest.

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VICOR CORPORATION

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)

3. STOCK-BASED COMPENSATION AND EMPLOYEE BENEFIT PLANS (Continued)

*V*I Chip* Since the compensation expense for year ended December 31, 2007 was immaterial, the Company did not apply an estimated forfeiture rate to the compensation expense.

Vicor Stock Options

A summary of the activity under Vicor s stock option plans as of December 31, 2007 and changes during the year then ended, is presented below (in thousands except for share and weighted-average data):

	Options Outstanding	Weighted-Average Exercise Price	Weighted-Average Remaining Contractual Life in Years	Aggregate Intrinsic Value
Outstanding at December 31, 2004	3,035,350	$ 18.04		
Granted	78,160	$ 14.04		
Forfeited and expired	(475,964)	$ 23.78		
Exercised	(377,298)	$ 9.47		
Outstanding at December 31, 2005	2,260,248	$ 18.14		
Granted	117,860	$ 17.95		
Forfeited and expired	(298,635)	$ 25.84		
Exercised	(435,844)	$ 12.78		
Outstanding at December 31, 2006	1,643,629	$ 18.14		
Granted	48,530	$ 12.06		
Forfeited and expired	(371,349)	$ 18.99		
Exercised	(73,109)	$ 8.88		
Outstanding at December 31, 2007	1,247,701	$ 18.20	2.66	$ 2,417
Exercisable at December 31, 2007	1,086,471	$ 18.71	2.16	$ 2,070
Vested or expected to vest at December 31, 2007(1)	1,230,412	$ 18.24	2.59	$ 2,383

(1) In addition to the vested options, the Company expects a portion of the unvested options to vest at some point in the future. Options expected to vest is calculated by applying an estimated forfeiture rate to the unvested options.

As of December 31, 2006 and 2005 the Company had shares exercisable of 1,418,885 and 1,918,674 respectively, for which the weighted average exercise prices were $18.63 and $19.30, respectively.

During the years ended December 31, 2007, 2006 and 2005 under all plans, the total intrinsic value of Vicor options exercised (i.e. the difference between the market price at exercise and the price paid by the employee to exercise the options) was $292,000, $3,051,000 and $2,027,000, respectively. The total amount of cash received by the Company from exercise of options exercised in 2007 was $645,000. The total grant-date fair value of stock options that vested during the years ended December 31, 2007, 2006 and 2005 was approximately $634,000, $1,421,000, and $3,036,000, respectively.

As of December 31, 2007, there was $554,000 of total unrecognized compensation cost related to unvested share-based awards for Vicor. That cost is expected to be recognized over a weighted-average period of 1.57 years for all Vicor awards. The expense will be recognized as follows: $311,000 in 2008, $154,000 in 2009, $69,000 in 2010, $18,000 in 2011, and $2,000 in 2012.

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VICOR CORPORATION

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)

3. STOCK-BASED COMPENSATION AND EMPLOYEE BENEFIT PLANS (Continued)

The weighted-average fair value of Vicor options granted was $4.37, $6.54 and $7.02 in 2007, 2006 and 2005, respectively. The weighted-average contractual life for Vicor options outstanding as of December 31, 2007 is 2.7 years.

Picor Stock Options

Under the 2001 Picor Plan, the Board of Directors of Picor Corporation (Picor) may grant stock incentive awards based on the Picor Common Stock, including stock options, restricted stock or unrestricted stock. Awards may be granted to employees and other key persons, including non-employee directors and full or part-time officers. Incentive stock options may be granted to employees at a price at least equal to the fair market value per share of the Picor Common Stock, based on judgments made by the Company, on the date of grant. A total of 10,000,000 shares of Picor Common Stock have been reserved for issuance under the 2001 Picor Plan. The period of time during which an option may be exercised and the vesting periods are determined by the Picor Board of Directors. The term of each option may not exceed ten years from the date of grant.

A summary of the activity under the 2001 Picor Plan as of December 31, 2007 and changes during the year then ended, is presented below (in thousands except for share and weighted-average data):

	Options Outstanding	Weighted-Average Exercise Price	Weighted-Average Remaining Contractual Life in Years	Aggregate Intrinsic Value
Outstanding at December 31, 2004	3,290,000	$ 0.43		
Granted	212,000	$ 0.75		
Forfeited and expired	(60,000)	$ 0.25		
Exercised				
Outstanding at December 31, 2005	3,442,000	$ 0.45		
Granted	1,040,500	$ 0.85		
Forfeited and expired	(147,960)	$ 0.31		
Exercised	(30,000)	$ 0.25		
Outstanding at December 31, 2006	4,304,540	$ 0.55		
Granted	114,000	$ 0.74		
Forfeited and expired	(40,000)	$ 0.88		
Exercised		$ 0.00		
Outstanding at December 31, 2007	4,378,540	$ 0.56	5.98	$ 1,280

Exercisable at December 31, 2007	2,918,412	$	0.45	5.16	$	1,160
Vested or expected to vest at December 31, 2007(1)	4,297,575	$	0.55	5.94	$	1,278

(1) In addition to the vested options, Picor expects a portion of the unvested options to vest at some point in the future. Options expected to vest is calculated by applying an estimated forfeiture rate to the unvested options.

As of December 31, 2006 and 2005 Picor had shares exercisable of 2,269,704 and 1,683,280, respectively, for which the weighted average exercise prices were $0.39 and $0.36, respectively.

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VICOR CORPORATION

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)

3. STOCK-BASED COMPENSATION AND EMPLOYEE BENEFIT PLANS (Continued)

For year end December 31, 2007 Picor did not have any options exercised. During the year ended December 31, 2006, the total intrinsic value of Picor options exercised (i.e. the difference between the market price at exercise and the price paid by the employee to exercise the options) was $19,000 (none in 2005 and 2004). The total amount of cash received by the Company from exercise of options exercised in 2006 was $7,000. The total grant-date fair value of stock options that vested during the years ended December 31, 2007, 2006 and 2005 was approximately $37,000, $111,000 and $101,000 respectively.

As of December 31, 2007, there was $381,000 of total unrecognized compensation cost related to unvested share-based awards for Picor. That cost is expected to be recognized over a weighted-average period of 1.58 years for all Picor awards. The expense will be recognized as follows: $152,000 in 2008, $99,000 in 2009, $86,000 in 2010, $43,000 in 2011, and $1,000 in 2012.

The weighted-average fair value of Picor options granted was $.37, $.37 and $.32 in 2007, 2006 and 2005, respectively. The weighted-average contractual life for Picor options outstanding as of December 31, 2007 is 6 years.

<u>V*I Chip Stock Options</u>

Under the 2007 V* I Chip Plan, the Board of Directors of V*I Chip Corporation (V*I Chip) may grant stock incentive awards based on the V*I Chip Common Stock, including stock options, restricted stock or unrestricted stock. Awards may be granted to employees and other key persons, including non-employee directors and full or part-time officers. Incentive stock options may be granted to employees at a price at least equal to the fair market value per share of the V*I Chip Common Stock, based on judgments made by the Company, on the date of grant. A total of 12,000,000 shares of V*I Chip Common Stock have been reserved for issuance under the 2007 V*I Chip Plan. The period of time during which an option may be exercised and the vesting periods are determined by the V*I Chip Board of Directors. The term of each option may not exceed ten years from the date of grant.

A summary of the activity under the 2007 V*I Chip Plan as of December 31, 2007 and changes during the year then ended, is presented below (in thousands except for share and weighted-average data):

	Options Outstanding	Weighted-Average Exercise Price	Weighted-Average Remaining Contractual Life in Years	Aggregate Intrinsic Value
Outstanding at December 31, 2006	0	$ 0		
Granted	6,655,000	$ 1.00		
Forfeited and expired	(65,000)	$ 1.00		
Exercised				

Outstanding at December 31, 2007	6,590,000	$	1.00	9.42	$	0
Exercisable at December 31, 2007			n/a	n/a		n/a
Vested or expected to vest at December 31, 2007(1)	6,590,000		1.00	9.42	$	0

(1) In addition to the vested options, V*I Chip expects a portion of the unvested options to vest at some point in the future. Options expected to vest is calculated by applying an estimated forfeiture rate to the unvested options.

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VICOR CORPORATION

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)

3. STOCK-BASED COMPENSATION AND EMPLOYEE BENEFIT PLANS (Continued)

As of December 31, 2007, there was $586,000 of total unrecognized compensation cost related to unvested share-based awards for V*I Chip. That cost is expected to be recognized over a weighted-average period of 2.4 years for all V*Chip awards. The expense will be recognized as follows: $134,000 in 2008, $133,000 in 2009, $132,000 in 2010, $132,000 in 2011, and $55,000 in 2012.

The weighted-average fair value of V*I Chip options granted were $.10 for 2007. The weighted-average contractual life for V*I Chip options outstanding as of December 31, 2007 is 9 years.

401(k) Plan

The Company sponsors a savings plan available to all domestic employees, which qualifies under Section 401(k) of the Internal Revenue Code. Employees may contribute to the plan from 1% to 20% of their pre-tax salary subject to statutory limitations. The Company matches employee contributions to the plan at a rate of 50% up to the first 3% of an employee s compensation. The Company s matching contributions currently vest at a rate of 20% per year based upon years of service. The Company s contribution to the plan was approximately $694,000, $684,000 and $622,000 in 2007, 2006 and 2005 respectively.

Stock Bonus Plan

Under the Company s 1985 Stock Bonus Plan, as amended, shares of Common Stock may be awarded to employees from time to time as determined by the Board of Directors. At December 31, 2006, 109,964 shares were available for further award. All shares awarded to employees under this plan have vested. No further awards are contemplated under this plan at the present time.

4. SHORT-TERM AND LONG-TERM INVESTMENTS

The following is a summary of available-for-sale securities (in thousands):

	Cost	Gross Unrealized Gains	Gross Unrealized Losses	Estimated Fair Value
December 31, 2007				
U.S. corporate securities	$ 19,150	$	$	$ 19,150
Obligations of states and political subdivisions	36,000			36,000
Certificates of deposit	2,340			2,340
	$ 57,490	$	$	$ 57,490
December 31, 2006				

U.S. corporate securities (as restated)	$	25,933	$		$	(7)	$	25,926
Obligations of states and political subdivisions		54,425				(2)		54,423
Certificates of deposit		1,332						1,332
	$	81,690	$		$	(9)	$	81,681

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VICOR CORPORATION

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)

4. SHORT-TERM AND LONG-TERM INVESTMENTS (Continued)

The amortized cost and estimated fair value of debt securities at December 31, 2007, by contractual maturities, are shown below (in thousands):

	Cost	Estimated Fair Value
Due in one year or less	$ 2,340	$ 2,340
Due in ten to twenty years	7,075	7,075
Due in twenty to forty years	48,075	48,075
	$ 57,490	$ 57,490

Through March 14, 2008, auctions held for the Company s auction rate securities with a total aggregate value of approximately $38.0 million failed. As of March 14, 2008, the Company was holding a total of approximately $43.0 million in auction rate securities, the significant majority of which are student loan backed securities. These municipal and corporate debt securities have their interest rates reset at auction at regular intervals ranging from seven to ninety days. Because of these short term intervals between interest reset dates, the Company monitors the auctions to ensure they are successful, which provides evidence that the recorded values of these investments approximate their fair values. As discussed above, auctions related to substantially all our auction rate securities have failed and if auctions continue to fail such that the securities were deemed to be not liquid, the Company would need to seek other alternatives to determine the fair value of these securities, which may not be based on the quoted market transaction. In addition, due to the Company s inability to quickly liquidate these investments, the Company may reclassify those investments with failed auctions as long-term assets in its consolidated balance sheet.

5. INVENTORIES

Inventories were as follows (in thousands):

	December 31, 2007	December 31, 2006
Raw materials	$ 23,711	$ 23,805
Work-in-process	2,656	2,319
Finished goods	4,357	4,240
	30,724	30,364
Inventory reserves	(7,646)	(8,363)
	$ 23,078	$ 22,001

6. PROPERTY, PLANT AND EQUIPMENT

Property, plant and equipment are stated at cost and are depreciated and amortized over a period of 3 to 31.5 years generally under the straight-line method for financial reporting purposes and accelerated methods for income tax purposes.

VICOR CORPORATION

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)

6. PROPERTY, PLANT AND EQUIPMENT (Continued)

Property, plant and equipment were as follows (in thousands):

	December 31, 2007	December 31, 2006
Land	$ 2,089	$ 2,089
Buildings and improvements	40,868	40,691
Machinery and equipment	180,216	174,570
Furniture and fixtures	5,922	5,571
Construction-in-progress	1,084	391
	230,179	223,312
Less accumulated depreciation and amortization	179,922	171,739
	$ 50,257	$ 51,573

Depreciation expense for the years ended December 31, 2007, 2006 and 2005 was approximately $11,172,000, $13,123,000, and $16,790,000 respectively. At December 31, 2007, the Company had approximately $2,047,000 of capital expenditure commitments.

7. INVESTMENTS

In August 2003, the Board of Directors approved the investment by the Company of $1,000,000 in non-voting preferred stock of Great Wall Semiconductor Corporation (GWS). In March and August 2004, the Audit Committee of the Board of Directors approved additional investments by the Company of $1,000,000 each for a total 2004 investment of $2,000,000 in non-voting preferred stock of GWS. In May 2007, the Audit Committee of the Board of Directors approved an additional investment of $1,000,000 in non-voting convertible preferred stock of Great Wall Semiconductor Corporation (GWS) and agreed to an additional investment of $1,000,000 if certain conditions were met by November 2007. Those conditions were not met by November 2007. However, the Company did make the additional $1,000,000 investment in February 2008, which will increase its ownership in GWS to approximately 30%. The additional $1,000,000 investment was approved by the Audit Committee of the Company s Board of Directors. The Company expects that it will take an impairment charge of approximately $700,000 in the first quarter of 2008. The Company s total gross investment in GWS was $4,000,000 as of December 31, 2007 and $3,000,000 as of December 31, 2006. GWS designs, develops and manufactures high performance power semiconductors. A director of Vicor is the founder, President, Chairman of the Board, Chief Executive Officer and the majority voting shareholder of GWS. In addition to the investment, the Company and GWS have entered into a cross-license agreement and the Company purchases certain components from GWS. Purchases from GWS were approximately $1,260,000, $387,000, and $384,000 in 2007, 2006 and 2005, respectively. Revenue under the cross-license agreement was not significant in 2007, 2006 and 2005.

The Company considered the requirements of FASB Interpretation No. 46 (revised December 2003 Consolidation of Variable Interest Entities (FIN 46R), in accounting for the additional investment in GWS, and determined that GWS is a variable interest entity. However, the Company concluded that it is not the primary beneficiary. As a result, the Company is accounting for the investment under the equity method of accounting in accordance with Accounting Principles Board Opinion No. 18, The Equity Method for Accounting for Investments in Common Stock (APB 18). The Company has also considered FIN No. 35, Criteria for Applying the Equity Method of Accounting for Investments in Common Stock (FIN 35) and EITF 02-14, Whether an Investor Should Apply the Equity Method of Accounting to Investments Other Than Common Stock (EITF 02-14). The additional investment made in May 2007 resulted in the Company owning approximately 24% of GWS which management believes, along with other qualitative factors considered, gives

VICOR CORPORATION

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)

7. INVESTMENTS (Continued)

the Company significant influence over GWS. In addition, the Company has an option to purchase an additional 1.5% of GWS for $81,000 in connection with technical consulting services. The Company also believes that its investment in GWS represents in-substance common stock. As a result, the additional investment requires the Company to account for the investment in GWS under the equity method of accounting and to retroactively restate its previously issued consolidated financial statements. Previously, the Company accounted for the investment as a cost method investment as management believed it did not have significant influence over GWS. At December 31, 2006 and 2005, the Company owned approximately 17.5% and 18.6%, respectively, of GWS.

In accordance with APB 18, each investment in GWS has been accounted for as a step acquisition using the purchase method of accounting in accordance with Statement of Financial Accounting Standards No. 141, Business Combinations (FAS 141). The allocation of the purchase price included acquired intangible assets, including core and developed technology as well as in-process research and development (IPR&D). The excess of the purchase price over the fair value allocated to the net assets is goodwill. The core and developed technology is being amortized over three years. The amounts allocated to IPR&D were charged to expense in accordance with FAS 141, which specifies that the amount assigned to the acquired intangible assets to be used in a particular research and development project that have no alternative future use shall be charged to expense at the acquisition date. The amounts included in other assets in the accompanying consolidated balance sheets related to the net GWS investment were $687,000 and $826,000 as of December 31, 2007 and 2006, respectively, as follows (in thousands):

	December 31,	
	2007	2006
Equity method goodwill	$ 634	$ 775
Intangible assets, net of amortization	53	51
	$ 687	$ 826

The negative net equity of GWS was approximately ($1,280,000) at December 31, 2007 and ($1,008,000) at December 31, 2006.

Loss from equity method investment (net of tax) for the years ended December 31 consists of the following (in thousands):

	Year Ended December 31		
	2007	2006 (as restated)	2005 (as restated)
Allocation of losses from equity method investment (net of tax)	$ 306	$ 84	$ 165
Amortization of intangible assets and other (net of tax)	213	237	258

Other than temporary decline in investment	620		
	$ 1,139	$ 321	$ 423

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VICOR CORPORATION

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)

7. INVESTMENTS (Continued)

The following financial statement line items for fiscal years 2004, 2005 and 2006 were affected by the change in accounting principle from cost method to equity method of accounting for the investment in GWS (in thousands except for per share amounts):

	As Restated	As Previously Reported
As of December 31, 2006:		
Other assets	$ 5,691	$ 6,865
Total assets	247,461	248,107
Retained earnings	133,405	134,579
Total stockholder s equity	170,172	171,346
As of December 31, 2005:		
Retained earnings	$ 173,807	$ 175,660
Total stockholder s equity	214,937	216,790
As of December 31, 2004:		
Retained earnings	$ 175,339	$ 176,769
Total stockholder s equity	219,193	220,623
Year ended December 31, 2006:		
Other income (expense), net	$ 5,092	$ 4,092
Loss from equity method investment, net	321	$
Net loss	(29,059)	(29,738)
Net loss per share basic	(0.69)	(0.71)
Net loss per share diluted	(0.69)	(0.71)
Year ended December 31, 2005:		
Loss from equity method investment, net	$ 423	$
Net Income	3,493	3,916
Net income per share basic	0.08	0.09
Net income per share diluted	0.08	0.09

As a result of the accounting change, retained earnings as of January 1, 2006 decreased by $1,853,000 from $175,660,000 to $173,807,000 due to the expensing of IPR&D of $908,000, the allocation of equity method investment losses of $454,000 and amortization expense for the acquired intangible assets and other of $491,000. This represents the retroactive application of the equity method of accounting for the period from August 2003, the date of the Company s initial investment in GWS, through December 31, 2005.

The Company periodically evaluates the investment in GWS to determine if there are any events or circumstances that are likely to have a significant adverse effect on the fair value of the investment, including the net book value of acquired intangible assets and goodwill. Examples of such impairment indicators include, but are not limited to: GWS actual results of operations, actual results of operations compared to forecast, working capital requirements, additional third-party equity investment, if any, and other considerations. If we identify an impairment indicator, we will estimate the fair value of the investment and compare it to its carrying value. If the fair value of the investment is less than its carrying value, the investment is impaired and we make a determination as to whether the impairment is other-than-temporary. For other-than-temporary impairments, we recognize an impairment loss equal to the difference between an investment s carrying value and its fair value. During the year ended December 31, 2007, the investment was adjusted for a decline in value judged to be other than temporary of $620,000. Deterioration or changes in GWS business in

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VICOR CORPORATION

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)

7. INVESTMENTS (Continued)

the future could lead to such impairment adjustments in future periods and the impairment adjustments may be material.

Summary financial information for GWS is as follows (in thousands):

	2007	2006	2005
As of December 31:			
Current assets	$ 2,322	$ 1,157	
Noncurrent assets	3,110	3,074	
Total assets	5,432	4,231	
Current liabilities	1,743	495	
Noncurrent liabilities	1,354	1,096	
Minority interests	3,614	3,648	
Total stockholders deficit	(1,280)	(1,008)	
For the year ended December 31:			
Net revenue	3,368	2,292	$ 2,423
Gross margin	646	818	461
Net loss	1,280	441	882

The financial statements of GWS have not been audited by Ernst & Young LLP.

8. GOODWILL AND OTHER INTANGIBLE ASSETS

The Company accounts for goodwill and other intangible assets under Statement of Financial Accounting Standards No. 142 Goodwill and Other Intangible Assets (FAS 142). Under FAS 142, goodwill and indefinite lived intangible assets are not amortized but are tested for impairment at least annually at the reporting unit level. The Company reassessed the carrying value of its goodwill of approximately $2,000,000 related to the operations of one of its subsidiaries, VJCL, during the fourth quarter of fiscal 2007 as required by the provisions of FAS 142, and determined that there was no impairment to the carrying value. Additionally, the Company has $634,000 and $775,000 of equity method goodwill related to its investment in GWS as of December 31, 2007 and 2006, respectively, as discussed in Note 7 .

Patent costs, which are included in other assets in the accompanying balance sheets, were as follows, (in thousands):

	December 31,	
	2007	2006
Patent costs	$ 3,491	$ 4,042

Less accumulated amortization	1,432	1,630
	$ 2,059	$ 2,412

In 2007 and 2006, the Company wrote off patent costs associated with abandoned patents with net book values of approximately $245,000 and $785,000, respectively, which was charged to amortization expense.

VICOR CORPORATION

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)

Amortization expense was approximately $447,000, $1,036,000 and $292,000 in 2007, 2006 and 2005, respectively. The estimated amortization expense for the next five years is as follows (in thousands):

Year	
2008	$ 217
2009	216
2010	214
2011	207
2012	195

9. PRODUCT WARRANTIES

Product warranty activity for the years ended December 31, 2007, 2006 and 2005 were as follows (in thousands):

	2007	**2006**	**2005**
Balance at the beginning of the period	$ 1,046	$ 755	$ 1,042
Accruals for warranties for products sold in the period	735	714	173
Fulfillment of warranty obligations	(704)	(185)	(180)
Revisions of estimated obligations	(398)	(238)	(280)
Balance at the end of the period	$ 679	$ 1,046	$ 755

10. STOCKHOLDERS EQUITY

In November 2000, the Board of Directors of the Company authorized the repurchase of up to $30,000,000 of the Company s Common Stock (the November 2000 Plan). The plan authorizes the Company to make repurchases from time to time in the open market or through privately negotiated transactions. The timing of this program and the amount of the stock that may be repurchased is at the discretion of management based on its view of economic and financial market conditions. In 2006 and 2005, the Company spent $10,835,000 and $5,544,000, respectively, in the repurchase of 825,700 and 452,200 shares, respectively, of its Common Stock under the November 2000 Plan (none in 2007). At December 31, 2007, the Company had approximately $8,541,000 remaining under the plan.

Common Stock

Each share of Common Stock entitles the holder thereof to one vote on all matters submitted to the stockholders.

Each share of Class B Common Stock entitles the holder thereof to ten votes on all such matters.

Shares of Class B Common Stock are not transferable by a stockholder except to or among the stockholder s spouse, certain of the stockholder s relatives, and certain other defined transferees. Class B Common Stock is not listed or traded on any exchange or in any market. Class B Common Stock is convertible at the option of the holder thereof at any time and without cost to the stockholder into shares of Common Stock on a one-for-one basis.

Dividends are declared at the discretion of the Company s Board of Directors and depend on actual cash from operations, the Company s financial condition and capital requirements and any other factors the Company s Board of Directors may consider relevant.

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VICOR CORPORATION

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)

10. STOCKHOLDERS EQUITY (Continued)

On June 24, 2005, the Company s Board of Directors approved an annual cash dividend for 2005 of $.12 per share of the Company s stock. The total dividend of approximately $5,025,000 was paid on August 31, 2005 to shareholders of record at the close of business on August 11, 2005.

On February 4, 2006, the Company s Board of Directors approved a cash dividend of $.12 per share of the Company s stock. The total dividend of approximately $5,030,000 was paid on March 20, 2006 to shareholders of record at the close of business on February 28, 2006.

On June 23, 2006, the Company s Board of Directors approved a cash dividend of $.15 per share of the Company s stock. The total dividend of approximately $6,313,000 was paid on August 7, 2006 to shareholders of record at the close of business on July 17, 2006.

On February 16, 2007 the Company s Board of Directors approved a cash dividend of $.15 per share of the Company s stock. The dividend of approximately $6,235,000 was paid on March 27, 2007 to shareholders of record at the close of business on March 9, 2007.

On July 25, 2007, the Company s Board of Directors approved a cash dividend of $.15 per share of the Company s stock. The total dividend of approximately $6,242,000 was paid on August 30, 2007 to shareholders of record at the close of business on August 14, 2007.

During the second quarter of 2007, two subsidiaries paid a total of $180,000 in dividends, of which $92,000 was paid to outside shareholders.

On March 14, 2008, the Company s Board of Directors approved a cash dividend of $.15 per share of the Company s stock. The total dividend of approximately $6,245,000 will be paid on April 18, 2008 to shareholders of record at the close of business on April 2, 2008.

During 2007 a total of 73,109 shares of Common Stock were issued upon the exercise of stock options, and 30,000 shares of Class B Common Stock were converted into Common Stock.

At December 31, 2007, there were 17,187,290 shares of Vicor Common Stock reserved for issuance under Vicor stock options and upon conversion of Class B Common Stock.

11. OTHER INCOME (EXPENSE), NET

The major components of the other income (expense), net were as follows (in thousands):

	2007	2006 (as restated)	2005
Interest income	$ 4,484	$ 5,389	$ 3,124

Minority interest in net income of subsidiaries	(539)	(562)	(807)
Foreign currency gains (losses)	186	139	(771)
Gain (loss) on disposal of equipment	129	67	(41)
Other	128	59	(5)
	$ 4,388	$ 5,092	$ 1,500

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VICOR CORPORATION

Gaming monitoring units installed base

276,000

279,000

240,000

(1

)%

16

%

Casino management systems installed base

225

219

194

3

%

13

%

Systems managed cashless games

128,000

83,000

28,000

54

%

196

%

End of period installed base:

Wide-area progressive

1,660

1,726

1,910

(4

)%

(10

)%

Daily-fee games

8,804

7,985

2,485

10

%

221

%

Centrally determined games

18,885

17,995

5

%

Fiscal 2005 vs. Fiscal 2004

Total revenues increased $6.8 million or 2% in fiscal year 2005 compared to the prior fiscal year due to the following:

Gaming Equipment. Gaming Equipment revenue decreased by $20.5 million or 9% primarily due to the decrease in domestic new unit sales to 11,301 units sold in fiscal year 2005 as compared to 14,213 units sold in the prior fiscal year. This decrease in total units sold reflects the general casino industry reduction in new unit purchases which followed the rapid pace of ticket-in ticket-out game replacements which occurred over the prior two years. In addition, the Company s legacy video products did not perform as well as competitor products, which led to the Company s decision to move to the new Alpha Game Engine. During 2005, there were very few new casino openings in the United States. The decrease in domestic new unit sales was partially offset by a 8% increase in international new unit sales from 2,595 in fiscal year 2004 to 2,796 in the current fiscal year as we expanded our marketing efforts outside the United States and a 2% increase in the new unit average selling price. We believe that foreign markets will likely expand in coming years, and will be an important source of revenues for us. We will continue to dedicate research and development to developing products for foreign markets.

Systems. Systems revenue decreased $24.9 million or 20% primarily as a result of:

- A decrease in new property installations in the current year. In the current year, new property installations represented approximately $18.5 million of systems revenue compared to $31.0 million in the prior fiscal year. The decrease in new property installations resulted from the above mentioned slowdown following the TITO system upgrades in the prior two years, and the reduced number of new casino openings during the current year.

- A $1.2 million increase in deferral of revenue for contracts with non-perpetual licenses based on the accounting under SOP No. 97-2.

The decrease in new property installations was partially offset by an increase in recurring hardware and software maintenance revenue of 22% or $4.8 million to $26.9 million due to the larger base of installed units.

Gaming Operations. Gaming Operations revenue increased 66% for fiscal year 2005 compared to fiscal year 2004 due to the following:

- An increase in revenue of $40.1 million or 337% to $52.0 million from centrally determined linked games due to a full year of revenue compared to four months in the prior year due to the acquisition of SDG in March 2004.

- An increase in the installed base of games and the benefits of certain Class II enhancements, such as the One System, for which we are generating additional daily fee revenue.

- An increase in daily fee games placements of 10% and an increase in average revenue per day for both wide-area progressives and Monte Carlo daily fee games.

Gross margin declined to 44% primarily as a result of the write-off of obsolete inventory in the amount of $26.4 million and an increase in sales of Class II games, which traditionally have a lower sale margin when compared to traditional (or Class III) games and which is compensated by the recurring revenue stream they generate through license fee arrangements that have terms of three to five years. The inventory write-off was primarily a result of a substantial retooling of our product lines to the new Alpha platform and the decline in the current market conditions.

Selling, general and administrative expense increased 29% primarily as a result of the following:

- The addition of Class II and central determination operations for a full year in fiscal year 2005.

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- An increase in legal expense of approximately $4.0 million resulting from higher patent and litigation costs.

- An increase in the provision for doubtful accounts receivable of $3.4 million, which includes a charge for a large customer that declared bankruptcy during fiscal year 2005.

- Severance charges of $3.0 million for reductions in the workforce both domestically and in our European operations.

We continued to make progress on reducing selling, general and administrative costs during the last half of the fiscal year 2005.

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

Depreciation and amortization expense increased as a result of the increase in acquisition-related intangible assets and the increased base of wide-area and daily fee games.

Fiscal 2004 vs. Fiscal 2003

Total revenues increased $118.0 million or 39% in fiscal year 2004 compared to the prior fiscal year due to the following:

Gaming Equipment. Gaming Equipment revenue increased by $53.3 million or 31% primarily due to:

- The acquisition of SDG in March 2004, which contributed an incremental $49.6 million.

- Higher domestic new unit sales due to increased sales of TITO games and sales to several new casinos which opened during the year.

Systems. Systems revenue increased by $41.2 million or 51% primarily as a result of:

- Increased sales to multi-property operators resulting from displacements of competitor systems which occurred as certain casinos were acquired by larger multi-property operators.

- Increased sales of software licenses for our TITO solution, as well as its bonusing and promotions software, caused by the casino industry focus on improved marketing and player retention programs and operating cost efficiencies achieved with TITO systems and games which reduces coin handling.

- Recurring hardware and software maintenance revenue increased by 23% to $20.7 million for the fiscal year, resulting from the larger base of installed units, which now stands at approximately 276,000.

Gaming Operations. Gaming Operations revenue increased 42% for fiscal year 2004 compared to the prior fiscal year due to an increase of 221% in the installed base of daily-fee games deployed, which increased to 7,985 units installed. This increase is primarily a result of the launch of the New York Lottery operations and the acquisition of SDG.

Gross Margin improved to 53% as a result of higher margin systems sales and gaming operations revenue, as a proportion of total sales.

Selling, general and administrative expenses increased 38% in fiscal year 2004 over 2003 primarily due to the acquisitions of SDG, MindPlay and Crown Gaming, LTD, as well as the launch of the New York Lottery resulting in increases in all operating expense categories except bad debt expense. In addition, selling, general and administrative expenses also increased as a result of higher legal costs related to the protection of our intellectual property rights and higher payroll and payroll related costs primarily in our customer service departments.

Research and development costs increased primarily as a result of increased headcount and reflect the additional costs incurred to expand our product offerings.

Depreciation and amortization increased as a result of increased capital expenditures and an increase in acquisition related intangible assets.

Casino Operations

Our Rainbow Casino is one of four casinos currently operating in the Vicksburg, Mississippi market. Our casino primarily draws customers from within a 75-mile radius surrounding Vicksburg, which includes Jackson, Mississippi. We believe that fiscal year 2006 will represent a year of modest revenue growth for our casino. While a number of properties located on the gulf coast sustained heavy damage, our casino was not damaged during the 2005 hurricanes season. Although it was temporarily closed, we reopened the property for business within four days of Hurricane Katrina once power was restored to the general area. While the play levels at our casino have generally increased following the reopening, we anticipate that the play level may return to a more typical level once the Gulf coast casinos reopen.

The summary of our financial results and operating statistics for our Casino Operation is as follows:

	Year Ended June 30,						Increase/(Decrease)	
	2005	% Rev	2004	% Rev	2003	% Rev	05 vs. 04	04 vs. 03
	(dollars in millions)							
Revenue	$ 52.0	100 %	$ 52.3	100 %	$ 50.9	100 %	%	3 %
Gross margin	33.3	64 %	32.2	62 %	29.7	58 %	3 %	8 %
Selling, general and administrative	13.2	25 %	12.5	24 %	12.2	24 %	6 %	3 %
Depreciation and amortization	3.3	6 %	2.8	5 %	2.2	4 %	18 %	28 %
Operating income	$ 16.8	32 %	$ 16.9	32 %	$ 15.3	30 %	(1)%	11 %
Operating Statistics:								
Average Number of Gaming Devices	890		930		930		(4)%	
Average Number of Table Games	12		12		15			(20)%

Fiscal 2005 vs. Fiscal 2004

Rainbow Casino revenue was relatively flat in fiscal year 2005 compared to the prior year in a market that grew 3.9% for the year with the majority of the increase in the fourth quarter of fiscal year 2005 due to completion of capital improvement projects in the Vicksburg market.

Gross margin improved to 64% in fiscal year 2005 as a result of continued improvement in operating cost reductions and increases in slot and table wins per day per unit.

The overall selling, general and administrative expenses remained relatively stable year over year as a percentage of revenue. We plan on increasing these expenses marginally in fiscal year 2006 in order to attract players following Hurricane Katrina.

Depreciation and amortization expense increased $0.5 million resulting from additional capital expenditures relating to new game replacements.

Fiscal 2004 vs. Fiscal 2003

Rainbow Casino revenue increased by $1.4 million in fiscal year 2004 resulting primarily from the remodeling project completed in fiscal year 2003. The remodeling adversely effected revenues in 2003, and positively impacted the results in 2004 due to the additional amenities added to the property.

Gross margin improved to 62% in fiscal year 2004 as a result of increases in slot and table wins per day per unit.

The overall selling, general and administrative expenses remained relatively stable year over year as a percentage of revenue.

Depreciation and amortization expense increased 28% for the fiscal year 2004 period resulting from additional capital improvements made to the Rainbow Casino late in fiscal year 2003 relating to the remodeling project.

Parent Company

The summary financial results of Bally Technologies, Inc., our parent entity, are set forth below. These results also include certain other income and expenses that are otherwise not allocated to a specific business segment.

	Year Ended June 30,			Increase/(Decrease)	
	2005	2004	2003	05 vs. 04	04 vs. 03
	(dollars in millions)				
General and administrative	$ 17.1	$ 12.8	$ 10.9	34 %	17 %
Depreciation and amortization	1.3	1.5	2.3	(12)%	(34)%
Total Parent company expense	$ 18.4	$ 14.3	$ 13.2	29 %	8 %
Other income (expense):					
Interest income	3.4	4.3	2.2	(20)%	94 %
Interest expense	(18.3)	(17.9)	(25.6)	2 %	(30)%
Loss on extinguishment of debt	(0.6)	(12.3)		(95)%	
Other, net	0.6	(0.5)	0.4	(223)%	(215)%
Total other expense	$ (14.9)	$ (26.4)	$ (23.0)	(44)%	15 %
Income tax expense (benefit)	$ (5.2)	$ 21.1	$ 15.4	(125)%	37 %
Minority interest	$ (3.7)	$ (2.3)	$ (2.0)	(62)%	16 %

Fiscal 2005 vs. Fiscal 2004

Our general and administrative expenses at the parent company increased $4.3 million, or 34% in the fiscal year 2005 primarily as a result of:

- Increase in payroll and related expense during the fiscal year 2005, primarily due to restricted stock unit amortization totaling $2.1 million and a $0.6 million charge for severance benefits resulting from reorganization, offset by a decrease in salaries and wages of $1.0 million due to reduced corporate headcount and for certain personnel reassigned to the gaming equipment and systems segment.

- Increase in legal fees of $1.3 million during the fiscal year 2005, relative to the ongoing SEC investigation and other related matters. We expect these higher costs to continue in fiscal year 2006.

- Increase in professional fees of $1.4 million related to Sarbanes-Oxley compliance. We expect these additional costs to continue into fiscal year 2006.

- Minority interest increased as a result of the consolidation of certain variable interest entities.

- As a result of a refinancing completed during fiscal year 2004, we recorded a pre-tax charge in the quarter ended September 30, 2003 of $12.3 million. In December 2004, we amended our bank loan agreement, which resulted in a charge of $0.6 million which was classified as a loss on extinguishment of debt.

- Interest expense for the current year totaled $18.3 million compared to $17.9 million in the prior year period due to higher interest rates on lower total debt outstanding. Virtually all of our debt is floating rate, therefore future interest expense will be impacted by future changes in the LIBOR which is the base rate for our interest payments.

Our effective income tax rate for continuing operations for fiscal year 2005 was approximately 27%. This rate reflects a Federal tax benefit computed using a rate of 35% offset by a tax charge for the estimated potential tax liability for the reorganization of our European distribution operations, as well as reserves

applied to certain deferred tax assets. The effective rate for fiscal year 2006 is expected to be between 35% and 38%.

Fiscal 2004 vs. Fiscal 2003

General and administrative expenses increased in fiscal year 2004 compared to the prior fiscal year primarily as a result of:

- Increase in general corporate legal costs resulting from the class action lawsuit and related matters.
- Increase in general liability and director and officer insurance costs resulting from market conditions.

Total other expense increased as a result of the September 2003 refinancing of our credit facilities. The refinancing charge of $12.3 million was partially offset by decreases in our net interest expense as a result of the lower interest rates achieved in the refinancing.

Significant Items Affecting Comparability

Certain significant items affect the comparability of financial statements from the fiscal years ended June 30, 2005, 2004 and 2003. These items are discussed below.

Inventory and asset write-downs: We perform detailed inventory valuation procedures at least quarterly. This process includes examining the carrying values of new and used gaming devices, parts and ancillary equipment in comparison to the current fair market values for such equipment (less costs to sell or dispose). Some of the factors involved in this analysis include the overall levels of our inventories, the current and projected sales levels for such products, the projected markets for such products both domestically and internationally, the costs required to sell the products including refurbishment costs and importation costs for international shipments, and the overall projected demand for products once the next generation of products are scheduled for release.

During fiscal year 2005 we faced declining demand for gaming devices based on our legacy platform, and therefore we continually assessed this particular portion of our inventory. In October 2004, we made the strategic decision to move to our new Alpha video platform, which was made commercially available in April 2005 in most markets.

The decision to move our gaming devices to the new video platform, the targeting of used equipment for non-domestic markets, and the consolidation of certain warehouses all led to accelerated disposals of legacy products. This process has required continual updating of estimates for the net realizable value of inventories due to the subjectivity involved in projecting sales volumes, used game sales values, refurbishment costs, and customer demand in non-domestic jurisdictions. As a result of our ongoing analysis of inventory valuations, we have taken a series of inventory and related asset write-downs totaling $26.4 million during fiscal year 2005, which included a charge of $4.4 million in the fourth quarter. We continue to hold a significant number of used gaming devices, therefore there can be no assurances that further write-downs will not occur in subsequent periods.

Impairment charges: We entered into an agreement during fiscal year 2004 to provide a development loan to a Native American tribe to further their pursuit of developing a gaming facility. The amounts advanced under the terms of the loan totaled $1.5 million, and we are not obligated for any additional advances. In March 2005, the tribe received an adverse court ruling that we believe materially impairs the tribe s ability to pay the loan, and we therefore recorded an impairment charge for the full amount of the loan.

During the March 2005 quarter, we performed a review of our intellectual property rights for various video games used on our then existing video platforms, which we refer to as our legacy platform. This review was triggered by the declining sales of the games using our legacy platform during fiscal year 2005. We

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evaluated the carrying value of certain intellectual property assets and determined that several were no longer recoverable and were therefore deemed to be impaired. The impairment charge totaled $1.3 million.

During the March 2005 quarter, we also evaluated the useful lives and salvage values for our leased gaming equipment. Based on recent historical data indicating a shortening of the average length such games were deployed, we decided to reduce the depreciable life for certain video products to two years. The change in the useful life resulted in an impairment charge of $0.8 million to write-off the undepreciated portion of the game values (down to salvage value) for games at the end of their two-year life.

Refinancing and loan amendment charges: During fiscal year 2005, we amended our bank loan agreement. The fee incurred for the amendment totaled approximately $1.0 million, and resulted in a charge of $0.6 million to write off a portion of the previously capitalized fees.

During fiscal year 2004, we initiated a tender offer for all of our outstanding 10% Senior Subordinated Notes due 2007, which we refer to as our senior subordinated notes, at a price of 103.33% plus a .25% tender premium. The offer was completed on September 16, 2003. As a result, we recorded a pre-tax charge in the September 2003 quarter of $12.3 million, which included a $5.0 million charge of the early extinguishment of the senior subordinated notes, $7.0 million for the write off of deferred financing costs, and $0.3 million in fees and expenses.

Severance charges: During fiscal year 2005, we undertook an extensive review of our operations and reduced our workforce during the September 2004 quarter and the March 2005 quarter. As a result of these reductions in force, we incurred severance charges totaling $3.6 million for the fiscal year 2005.

Discontinued Operations

As previously discussed, we sold our Nevada route operations, the Rail City Casino and Bally Wulff during fiscal year 2004.

On June 30, 2004, we completed the sale of United Coin to Century Gaming, Inc. and received approximately $100 million in cash and the assumption by Century Gaming of approximately $5 million in debt. Additionally, Century Gaming has agreed to acquire a certain number of gaming devices from our Bally Gaming and Systems business unit over a five-year period. United Coin revenue totaled $220.9 million and $202.4 million for the years ended June 30, 2004, and 2003, respectively. For the same periods, operating income totaled $22.5 million and $7.0 million respectively. In fiscal year 2004, we reported a gain on the sale before income taxes of $15.3 million, or $9.1 million after tax. During fiscal year 2005, the gain on sale was adjusted for charges incurred for an adverse outcome in a patent infringement case and the resolution of certain sale related liabilities, the sum of which totaled $6.3 million net of tax, which is included in the discontinued operations section of the statement of operations for the fiscal year ended June 30, 2005.

The sale of the Rail City Casino to the Sands Regent was completed on May 3, 2004. Total consideration was $37.9 million in cash. Rail City revenue totaled $19.2 million and $21.2 million for the years ended June 30, 2004 and 2003, respectively. For the same periods, operating income totaled $5.4 million and $5.0 million respectively. We reported a gain on the sale before income taxes of $23.1 million, or $14.3 million after tax.

On July 18, 2003, we sold Bally Wulff wall machine and amusement game business unit to a third party equity investor for $16.5 million in cash and recorded a loss on sale totaling $25.4 million. Bally Wulff reported an operating loss of $40.6 million on revenues of $60.2 million for fiscal year 2003.

The Louisiana route operations were sold in October 2004 and had revenues totaling $17.0 million and $14.9 million for the years ended June 30, 2004 and 2003, respectively. For the same period, operating income totaled $2.8 million and $2.0 million respectively. We recorded a gain on the sale of $1.3 million or

$0.8 million after taxes in fiscal year 2005, which is included in the discontinued operations section of the statement of operations for the fiscal year ended June 30, 2005.

Recent Developments

In late August 2005, a devastating hurricane hit the gulf coast of Mississippi and Louisiana causing substantial damage to the Gulfport and Biloxi, Mississippi area, as well as New Orleans, Louisiana. In September 2005, Louisiana was again impacted by a severe hurricane that caused additional flooding in New Orleans as well as other locations in Louisiana.

We earn revenue in both Louisiana and Mississippi from machine rentals and participations in various casinos that were damaged by the hurricanes. In some instances, the machines have been damaged or destroyed; in other cases, the machines are undamaged, but the casinos are currently closed.

We carry both property and business interruption insurance which will serve to offset some of the losses indicated above. At this time we are actively working with our insurance providers to assess losses and associated recoveries, but anticipate the full claim cycle will cover an extended period of time. Therefore, we cannot reasonably estimate the net proceeds to be recovered in connection with these losses.

Initial indications are that the casinos in the Biloxi and Gulfport areas will need to be rebuilt and will not open for a protracted period of time. Some casinos may decide not to rebuild. Casinos in New Orleans may need major reconstruction and, given the devastation in the area, may be closed for months. Casinos outside of these areas may also need some restoration, but others have reopened for business, although their business may be at lower than historical levels.

For the September 2005 quarter, the impact on our Gaming Operations division as a result of the hurricane is estimated to be less than $0.02 per diluted share. Revenue was negatively impacted by approximately $1.4 million related to games scheduled to be sold to customers in the affected area, with an associated gross margin of $0.9 million. Our balance sheet exposure for accounts receivable and net book value of games placed in affected casinos is approximately $1.9 million.

Management believes that the impact of the hurricane will continue throughout fiscal year 2006. At this time we estimate the total impact to revenue and gross margin will be $9.8 million and $4.9 million, respectively, for fiscal year 2006 period.

Financial Condition

Liquidity

As of June 30, 2005, we had $33.2 million in cash and cash equivalents. In addition, we had net working capital of approximately $125.2 million, a decrease of approximately $132.1 million from June 30, 2004, which is explained in Working Capital below. Consolidated cash and cash equivalents at June 30, 2005 includes approximately $2.7 million of cash utilized in our Casino Operations that is held in vaults, cages or change banks. Additionally, pursuant to various state gaming regulations, certain cash accounts totaling approximately $13.4 million as of June 30, 2005, are maintained to ensure availability of funds to pay wide-area progressive jackpot awards which are classified as restricted cash on the consolidated balance sheets. 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 included in restricted long-term investments in the accompanying consolidated balance sheets, and totaled $10.1 million and $2.5 million as of June 30, 2005 and 2004, respectively.

On September 5, 2003, we completed a refinancing transaction whereby we entered into a new $275.0 million term loan and a $125.0 million revolving credit facility. We used the proceeds from the refinancing transaction to (1) repay an aggregate of approximately $188.0 million outstanding under our existing term loan, (2) repurchase the $150 million aggregate amount of our senior subordinated notes, and (3) pay $5.0 million in transaction fees and expenses. The fees and expenses were capitalized and are being amortized on the straight-line basis over the remaining term of the loan. The term loan has a 1% per year mandatory principal amortization after the first year, and a six-year maturity. The revolving credit facility commitment decreases ratably over its five-year term to a 60% balloon.

In December 2003, we increased the term loan by $75.0 million to a total of $350.0 million. We used the proceeds primarily to fund the acquisition of SDG. As a result of the increase, we incurred an additional $1.6 million in debt issuance costs, which amount has been capitalized and is amortized on the straight-line basis over the remaining term of the term loan.

The sale of our Rail City Casino was completed in May 2004, and the sale of United Coin was completed in June 2004. The bank loan agreement governing the term loan and the revolving credit facility required that we use approximately 50% of the net proceeds from the disposition of these assets to reduce the term loan and revolving credit facility principal balances on a pro rata basis. As a result, in August, 2004, we made a payment to permanently reduce the term loan by $31.6 million, and paid down the revolving credit facility from $70.0 million to zero.

In December 2004, we amended our bank loan agreement. The amendment provides for (1) an increase in the maximum allowable leverage ratio under the bank loan agreement to a minimum of 4.75 times at June 30, 2005, which declines thereafter, (2) a reduction in the revolving credit facility commitment to $75.0 million and (3) an increase in the term loan interest rate to LIBOR plus 3.00%, which can be adjusted to be LIBOR plus 3.75% based on certain credit rating and leverage ratio criteria. We incurred a fee of approximately $1.0 million in connection with the amendment. As of June 30, 2005, we had $314.9 million outstanding under our term loan accruing interest at a rate of 6.77%, and zero outstanding under the revolving credit facility.

As a result of the additional time required to complete the year end closing process we failed to deliver to our lenders our 2005 audited financial statements and the unaudited interim financial statements for the fiscal quarter ended September 30, 2005 in a timely manner, and therefore were not in compliance with certain of our debt covenants under the bank loan agreement. Pursuant to an agreement with the lenders, we cured the default in December 2005 by delivering our 2005 audited financial statements contained in our Annual Report on Form 10-K and our unaudited interim financial statements for the fiscal quarter ended September 30, 2005. During the default period through the date of the filing of our Annual Report on Form 10-K, we incurred default interest of approximately $0.7 million.

In October 2006, we executed an amendment to our bank loan agreement, which, among other things, (i) extended the due date for the delivery of the our audited financial statements for the fiscal year ended June 30, 2006, to December 31, 2006, (ii) provided that we will deliver our quarterly reports on Form 10-Q for the Fiscal Quarters ending on September 30, 2005, December 31, 2005 and March 31, 2006 no later than December 31, 2006, (iii) modified the definition of EBITDA to exclude up to $10 million of certain cash charges, and (iv) clarified that the definition of EBITDA includes interest income on trade receivables. We paid an administrative fee of $964,000 in exchange for the concessions granted under the amendment. There can be no assurances we will be able to comply with the amended covenants. See Risk Factors below for a discussion of the risks associated with our non-compliance with certain of our debt covenants under the bank loan agreement.

We are in compliance with our financial covenants under the bank loan agreement, which consist of a leverage ratio, a fixed charges coverage ratio, and a minimum EBITDA (as that term is defined in the bank loan agreement) ratio. The leverage ratio is computed as total average debt outstanding during the quarter divided by the trailing 12 months EBITDA excluding certain cash and non-cash charges, and is further adjusted to remove EBITDA from discontinued operations at the time those operations are sold. The Company s leverage ratio as of June 30, 2005 was 4.6 times versus the covenant maximum of 4.75 times.

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Cash flows from operating activities are derived primarily from the cash receipts from the sale of goods and services, the operation of wide-area progressive systems, lease payments, and monthly cash receipts from maintenance agreements for our casino systems customers. In addition, we generate cash through our casino operations. We utilize our cash to acquire materials for the manufacture of goods for resale or lease, payroll, and all other selling, general and administrative expenses.

Management believes that cash flows from current operating activities and the availability under the revolving credit facility should provide us with sufficient capital resources and liquidity. Although the leverage ratio limited our availability under the revolving credit facility at June 30, 2005, access to the revolving credit facility in the future will depend on our ability to generate adequate levels of EBITDA, as described above. At June 30, 2005, we had no material commitments for capital expenditures.

Working Capital

The following table presents the components of consolidated working capital at June 30, 2005 and 2004:

	2005 (dollars in 000s)	2004	Increase (decrease) Amount	%
Current Assets:				
Cash and cash equivalents	$ 33,170	$ 154,258	$ (121,088)	(78)%
Restricted cash	13,421	15,590	(2,169)	(14)%
Accounts and notes receivable, net	97,679	126,212	(28,533)	(23)%
Inventories	63,523	63,285	238	%
Deferred tax assets, net	30,884	22,571	8,313	37 %
Other current assets	33,034	33,300	(266)	(1)%
Assets of discontinued operations held for sale		4,442	(4,442)	(100)%
Total current assets	$ 271,711	$ 419,658	$ (147,947)	(35)%
Current Liabilities:				
Accounts payable	$ 36,807	$ 37,515	$ (708)	(2)%
Accrued liabilities	43,838	48,900	(5,062)	(10)%
Deferred revenue	40,962	48,030	(7,068)	(15)%
Jackpot liabilities	13,025	12,075	950	8 %
Taxes payable	1,752	5,718	(3,966)	(69)%
Current maturities of long-term debt	10,163	5,866	4,297	73 %
Liabilities of discontinued operations held for sale		4,337	(4,337)	(100)%
Total current liabilities	146,547	162,441	(15,894)	(10)%
Net working capital	$ 125,164	$ 257,217	$ (132,053)	(51)%

For the year ended June 30, 2005, our net working capital declined $132.1 million. The $121.1 million decrease in cash and cash equivalents was most significantly impacted by our use of $101.6 million in proceeds from the sale of United Coin and Rail City to pay down the term loan and revolving credit facility in accordance with the bank loan agreement, as discussed above, as well as cash used to deploy wide-area and daily-fee gaming devices.

The decrease in working capital was also affected by:

- A net decrease in accounts and notes receivable relating to the early payments by certain significant customers, as well as our lower revenue levels in the second half of fiscal year 2005, which were caused by the transition to the new Alpha Game Engine and a reduction in purchases by casinos following the TITO placements over the preceding two years.

- A net decrease in inventory, which resulted from inventory obsolescence (non-cash) charges of $26.4 million. Excluding such charges, inventory increased $12.3 million during fiscal year 2005 due to the build up of inventory related to our new products being introduced.

- A decrease in other assets, primarily as a result of: a decrease in refundable deposits of $1.7 million and a decrease in prepaid insurance and royalties, all of which were offset by a $2.2 million increase in trial games.

- A decrease in accrued liabilities, primarily as a result of: (i) a $7.1 million decrease in deferred revenue related to transactions involving the delivery of games and systems not meeting the revenue recognition requirements of SOP No. 97-2 in fiscal 2004 that were subsequently recognized in fiscal 2005, (ii) a decrease of approximately $4.0 million in divesture related accruals for the sale of United Coin, (iii) a $4.2 million decrease in payroll and payroll related accruals, and

(iv) a $1.9 million decrease in royalty accrual due to lower sales, all of which were partially offset by a $7.4 million increase in patent litigation accruals.

Cash Flow

During the year ended June 30, 2005, cash flows provided by operating activities of continuing operations totaled $52.1 million as a result of:

- A reported net loss of $(22.6) million, which includes certain non-cash inventory and asset impairment charges totaling $30.0 million, primarily resulting from the writedown of certain legacy products to net realizable value due primarily to the introduction of the Alpha Game Engine.

- An increase in inventory of $12.3 million, primarily resulting from the build up of inventory related to our new products being introduced.

- A decrease in accounts and notes receivables of $32.8 million, primarily resulting from a decrease in fourth quarter sales of $35.4 million from fiscal 2004 to 2005, that was primarily related to the strategic shift to our new Alpha Game Engine sales which began late in the June 2005 quarters.

- A decrease in accounts payable, accrued liabilities, and deferred revenue jackpot liabilities of $22.1 million, due primarily to timing of payments to vendors and lower levels of purchases due to the lower fourth quarter sales levels discussed above.

During the year ended June 30, 2005, cash flows used in investing activities of continuing operations totaled $65.1 million as a result of:

- Capital expenditures of $12.4 million.

- Costs incurred to deploy additional leased gaming devices totaling $40.6 million.

- Additions to other long-term assets of $2.2 million.

- SDG earn out buyout of $12.0 million, described in Note 4 to consolidated financial statements, Business Combinations.

During the year ended June 30, 2005, cash used in financing activities of continuing operations totaled $108.1 million as a result of:

- Our pay down of the term loan and revolving credit facility of $101.6 million discussed above.

- Principal payments on other long term debt totaling $6.3 million.

- Cash provided from exercise of stock options of $1.1 million.

- $1.0 million in cash used to pay the fees and expenses related to the amendment of the bank loan agreement amendment discussed above.

Contractual Commitments

We are committed to make future payments pursuant to various contracts and agreements. A summary of those contractual obligations existing as of June 30, 2005, is as follows:

	2006 (in 000s)	2007	2008	2009	2010	Total
Debt:						
Term loan facility(a)	$ 3,500	$ 3,500	$ 3,500	$ 3,500	$ 300,882	$ 314,882
Revolving credit facility(b)						
Subordinated debt(c)	2,800	2,800	2,800	2,800	2,800	14,000
Other debt	3,863	372	2,000			6,235
Estimated interest payments(d)	22,344	21,773	21,267	20,772	20,559	106,715
	32,507	28,445	29,567	27,072	324,241	441,832
Other commitments:						
Net minimum rentals	2,641	2,278	1,512	1,114	407	7,952
MindPlay earn-out(e)						
Purchase commitments(f)						
Employment agreements(g)	980	980	245			2,205
Kirkland consulting agreement(h)	600	600	300			1,500
Total commitments	$ 36,728	$ 32,303	$ 31,624	$ 28,186	$ 324,648	$ 453,489

(a) The term loan facility requires principal payments of $3.5 million per year with the balance due in 2010.

(b) There are currently no amounts outstanding on the $75.0 million revolving credit facility.

(c) In December 2004, we agreed to terminate the SDG earn out for $40.0 million, of which $12.0 million was paid in cash and $28.0 million in the form of an unsecured promissory note. In June 2005, $14.0 million of the principal balance of the unsecured promissory note was extinguished through the issuance of approximately 1.0 million shares of common stock. The remaining $14.0 million outstanding as of June 30, 2005 is payable over the subsequent five years.

(d) Our debt is virtually all variable rate (tied to LIBOR); therefore, we computed the estimated future interest payments for our total debt outstanding based on the average interest rate in effect as of June 30, 2005 of 6.77%.

(e) Pursuant to the MindPlay purchase agreement, we are obligated to make certain contingent earn-out payments to the former principals of MindPlay, amounts that cannot currently be estimated.

(f) Except in certain rare instances, Bally Gaming and Systems is not required by its suppliers to enter into quarterly commitments for products.

(g) We have employment agreements with most of our employees with positions of Vice President or above. These agreements generally provide for an initial rate of pay and the terms of the severance benefits generally range from three to twelve months salary continuation with similar non-compete periods. Almost all such agreements contain language that the employee is still an at will employee, and as such can be terminated at anytime subject to the individual termination provisions. The only multi-year arrangement is with Richard Haddrill, our CEO effective October 1, 2004, which covers a three-year term, with a base salary of $980,000. Only Mr. Haddrill s compensation is reflected in the table above.

(h) Pursuant to an Advisory Agreement with Kirkland Investment Corporation (100% owned by Joel Kirschbaum who is a director of Alliance, and therefore treated as a related-party) dated July 1, 2004, we agreed to pay Kirkland

$600,000 annually for a period of 3.5 years for consulting services.

Our long-term debt is virtually all floating rate and therefore future interest payments will be impacted by future LIBOR rate changes as well as the balance of debt outstanding in those future periods. Interest payments for fiscal year 2005 totaled $17.5 million.

The payment obligations in the above table are based on the contractually scheduled due dates. The only payment acceleration that could be demanded of us would generally be in the event of a default under the bank credit agreement that was not cured within the provisions set forth in that agreement.

Off Balance Sheet Arrangements

We do not have any off balance sheet arrangements.

Risk Factors

Investing in our common stock involves risks. Prospective investors in our common stock should carefully consider, among other things, the following factors and other information contained in this document, including our financial statements and the notes to those statements, prior to making an investment decision. We have identified the following important factors that could cause actual results to differ materially from those projected in any forward-looking statements we may make from time to time.

The gaming industry is intensely competitive. We face competition from a number of companies, some of which have greater resources, and if we are unable to compete effectively, our business could be negatively impacted.

Bally Gaming and Systems

Competition among gaming machine manufacturers is based on, among other things, competitive customer pricing and financing terms, appeal to the player, product quality and having an extensive distribution and sales network. There are a number of established, well-financed and well-known companies producing machines that compete with each Bally Gaming and Systems product line in each of the Bally Gaming and Systems markets. While there are a number of competitors in the field, a single competitor, IGT, dominates the domestic market for gaming machines. In addition, certain technology-oriented companies recently entered or may soon enter the gaming machine market. Certain of these competitors have access to greater capital resources than we do, and as a result, may be better positioned to compete in the marketplace.

The casino enterprise systems market is crowded, with IGT, Aristocrat, Acres Gaming, Inc., MIS and, to a lesser extent, Konami and Mikohn Gaming Corporation, comprising the competition. The competition is intense due to the number of providers, as well as the limited number of casinos and jurisdictions in which they operate. Pricing, product feature and function, accuracy and reliability are all main factors in determining a provider s success in selling its system.

Casino Operations

The principal competitive factors in the casino operations industry include the quality and location of the facility, the nature and quality of the amenities and customer services offered, and the implementation and success of marketing programs. Our Rainbow Casino in Vicksburg, Mississippi faces intense direct competition from other gaming facilities serving the Vicksburg market. As the overall size of the potential customer base is limited, competition from casinos in nearby locations may further dilute the market from which Vicksburg casinos draw most of their patrons. Moreover, additional potential gaming sites remain in and around Vicksburg. Some of these sites may be closer to larger population centers and, if developed, may enjoy a competitive advantage over our casino.

Our success in the gaming industry depends in large part on our ability to develop innovative products and systems; if we fail to keep pace with rapid change in product design, manufacturing and marketing strategies our business could be negatively impacted.

Our revenues depend on the earning power and life span of our games. Newer games tend to have a shorter life than more traditional games, and as a result, we face pressure to design and deploy successful games to maintain our revenue stream and to remain competitive. Our future success depends to a large extent upon our ability to continue to design, manufacture and market technologically sophisticated and entertaining products that achieve high levels of player acceptance. However, our ability to develop new and innovative products could be adversely affected by:

- a decline in the popularity of our gaming products with players,
- a lack of success in developing new products, services or systems,
- an inability to roll out new games, services or systems on schedule as a result of delays in connection with regulatory product approval in the applicable jurisdictions, or otherwise,
- an increase in the popularity of competitors games, and
- a negative change in the trend of consumer acceptance of our newest systems innovations including our Alpha Game Engine and our MindPlay System.

The competitive contract terms required in non-traditional gaming markets may affect our future revenues.

Management believes that customer leasing and financing terms have become increasingly important competitive factors for the company in non-traditional markets such as Class II and other Native American jurisdictions. We sometimes are required to grant extended payment terms on gaming machines, systems and other gaming equipment to gain entry into a developing market that we would not otherwise extend. While the product normally collateralizes these financings, in an event of default, the resale value of the collateral may be considerably less than the amount financed. Accordingly, we have greater exposure to fluctuations in the financial condition of our customers in emerging markets than has historically been the case in the established markets.

The unpredictable growth of non-traditional gaming markets may affect our business and prospects.

The continued growth of non-traditional gaming markets for electronic gaming machines, systems and other gaming equipment depends heavily on the public s acceptance of gaming in these markets, as well as the ongoing development of the regulatory approval process by national and local governmental authorities. A portion of our growth is directly tied to our ability to access these new markets. We cannot predict which new jurisdictions or markets, if any, will approve the operation of electronic gaming machines, the timing of any such approval, the public s acceptance of our gaming machines in these markets or our market share or profitability in these markets.

We may not be able to attract or retain the management or employees necessary to remain competitive in our industry.

The competition for qualified personnel in the gaming industry is intense. Our future success depends on the retention and continued contributions of our key management, finance, marketing, and staff personnel, many of whom would be difficult or impossible to replace. Our success is also tied to our ability to recruit additional key personnel in the future. We cannot assure you that we will be able to retain our current personnel or recruit any additional key personnel required. In addition, we do not have employment agreements with many members of our senior management. The loss of services of any of our personnel could have a material adverse effect on our business, financial condition, results of operations and prospects.

The gaming industry is heavily regulated and changes in regulation by gaming authorities may adversely impact our ability to operate the business.

The manufacture and distribution of gaming machines and the conduct of gaming operations are subject to extensive federal, state, local and foreign regulation by various gaming authorities. Our ability to continue to operate in certain jurisdictions could be adversely affected by:

- unfavorable public referendums,
- unfavorable legislation affecting or directed at manufacturers or gaming operators, such as referendums to increase taxes on gaming revenues,
- adverse changes in or finding of non-compliance with applicable governmental gaming regulations,
- delays in approvals from regulatory agencies,
- a limitation, conditioning, suspension or revocation of any of our gaming licenses, and
- unfavorable determinations or challenges of suitability by gaming regulatory authorities with respect to our officers, directors, major stockholders or key personnel.

Although the laws, rules and regulations of the various jurisdictions in which we operate vary in their technical requirements, virtually each jurisdiction requires licenses, permits, qualification documentation, including evidence of integrity and financial stability, and other forms of approval to engage in gaming operations or the manufacture and distribution of gaming machines. Our officers, directors, major stockholders and key personnel are also subject to significant regulatory scrutiny. In the event that gaming or governmental authorities determine that any person is unsuitable to act in such capacity with respect to the company, we could be required to terminate our relationship with such person. To our knowledge, the Company and our key personnel have obtained, or applied for, all government licenses, registrations, findings of suitability, permits and approvals necessary to conduct their respective activities in the various jurisdictions that we operate. However, there can be no assurance those licenses, registrations, findings of suitability, permits or approvals will be renewed in the future, or that new forms of approval necessary to operate in emerging or existing markets will be given.

Gaming operators are subject to additional taxes and fees that could change at any time.

The gaming industry is typically subject to significant taxation and fee assessment in addition to those corporate and state income taxes generally assessed on business operations. These additional taxes and fees are subject to increase at any time, and may be materially increased either prospectively or retroactively. There can be no assurance as to future changes in taxation and fee assessment on the gaming industry. Any material increase could adversely affect our ability to operate our business.

Our intellectual property protections may be insufficient to properly safeguard our technology; expenses incurred with respect to protecting and defending intellectual property rights could adversely affect our business.

The gaming industry is constantly employing new technologies in both new and existing markets. We rely on a combination of patent and other technical security measures to protect our products, and continue to file for patents protecting such technologies. Notwithstanding these safeguards, our competitors may still be able to obtain our technology or to imitate our products. Furthermore, others may independently develop products similar or superior to ours.

Competitors and other third parties may infringe on our intellectual property rights, or may allege that we have infringed on their intellectual property rights. We may incur significant litigation expenses protecting our intellectual property or defending our use of intellectual property, reducing our ability to fund product initiatives. These expenses could have an adverse effect on our future cash flow and results of operations. We are currently subject to litigation regarding patent infringement which, if resolved adverse to the

Company, could have material impact on our business. Litigation can also divert management focus from running the day-to-day operations of the business. There can be no assurances that certain of our products, including those with currently pending patent applications, will not be determined to have infringed upon an existing third party patent.

We are currently subject to securities and derivative litigation, the unfavorable outcome of which might have a material adverse effect on our business.

A number of federal class action lawsuits and state derivative lawsuits have been filed against us, including certain of our current and former officers, alleging violations of securities laws. We strongly believe that these lawsuits are without merit and are vigorously defending them and have notified our applicable insurers. We cannot, however, determine with certainty the outcome or resolution of these claims or the timing of their ultimate resolution. In addition to the expense and burden incurred in defending these lawsuits and any damages that we may suffer, our management s efforts and attention may be diverted from the ordinary business operations in order to address these claims. If the final resolution of any of these lawsuits is unfavorable to us, our financial condition, results of operations, cash flows and liquidity might be materially adversely affected if our existing insurance coverage is unavailable or inadequate to resolve the matter.

The restatement may subject us to actions or additional litigation which could have an adverse effect on our business, results of operations, financial condition and liquidity.

In the First Restatement we restated our originally issued consolidated financial statements as of June 30, 2004, and for the fiscal years ended June 30, 2004 and 2003. In the Second Restatement, included in this Amendment No. 1, we are restating our previously issued consolidated financial statements as of June 30, 2005 and 2004 and for each of the three years in the period ended June 30, 2005. The Restatements may result in additional scrutiny in our ongoing SEC investigation or to new regulatory actions or civil litigation which could require us to pay fines or other penalties or damages and could have an adverse effect on our business, results of operations, financial condition and liquidity. The Restatements may also result in negative publicity and we may lose or fail to attract and retain key customers, employees and management personnel as a result of these matters.

In some jurisdictions, audited financial statements must be filed with the gaming regulatory authorities. The late filing of our Annual Report on Form 10-K for the fiscal year ended June 30, 2006 could generate inquiries from regulators, including possible disciplinary action. However, the Company has been keeping regulators informed of the situation and has received no indication that any disciplinary action will be filed in any jurisdiction.

Ongoing SEC investigations could adversely affect us.

The SEC had been conducting an informal inquiry into certain matters surrounding the allegations relating to the securities class action litigation and our methods of revenue recognition. On August 18, 2005, the SEC issued a formal order of investigation with respect to these matters. In accordance with its normal practice, the SEC has not advised us when its investigation may be concluded, and we are unable to predict the outcome of this investigation. While we are cooperating fully with the investigation, adverse developments in connection with the investigation, including any expansion of the scope of the investigation, could negatively impact us and could divert the efforts and attention of our management team from our ordinary business operations. In connection with any SEC investigation, it is possible that we will be required to, among other things, pay fines, consent to injunctions on future conduct, further restate our financial statements or suffer other penalties, any of which could have a material adverse effect on our business.

We have material weaknesses in our internal controls over financial reporting, which could adversely affect our ability to report our financial condition, results of operations and cash flows accurately.

As required by Section 404 of the Sarbanes-Oxley Act of 2002, management has conducted an assessment of our internal control over financial reporting. In performing our assessment management identified material weaknesses in our internal control over financial reporting and concluded that our internal control over financial reporting was not effective as of June 30, 2005. For a detailed description of these material weaknesses, see Item 9A, Controls and Procedures.

Material weaknesses in our internal control over financial reporting could adversely impact our ability to provide timely and accurate financial information. We have taken and will continue to take certain measures to strengthen our internal controls, as set forth under Item 9A, Controls and Procedures. However, additional work remains to be done to address the identified material weaknesses. If we are unsuccessful in implementing or following our remediation initiatives plan, or fail to update our internal controls as our business evolves, or to integrate acquired businesses into our controls system, we may not be able to report accurately our financial condition, results of operations or cash flows or maintain effective disclosure controls and procedures. If we are unable to report financial information accurately or maintain effective disclosure controls and procedures, we could be subject to, among other things, an additional SEC enforcement action, additional securities litigation and a general loss of investor confidence, any one of which by itself could adversely affect our business and prospects.

We face increased costs and have extensive work remaining to remediate the material weaknesses in our internal control over financial reporting.

We have extensive work remaining to remediate the identified material weaknesses in our internal control over financial reporting. This work has extended into the 2006 fiscal year and will continue until we are able to remediate the material weaknesses we have identified. These matters have required, and will continue to require, a significant amount of management time and a significant commitment of external resources. The costs of these efforts are substantial and could have a material adverse impact on the Company s financial performance. We expect that they will continue to do so in future periods.

Certain consequences of our reporting situation under the federal securities laws may adversely affect our financial condition and results of operations, including our ability to raise capital.

Our failure to meet the reporting requirements of the federal securities laws affects our ability to access the capital markets. We are restricted in our ability to make any registered offering of securities until we can present our most recent financial statements. We are also ineligible to use short-form registration that allows us to incorporate by reference our Form 10-K, Form 10-Q and other SEC reports into our registration statements, or shelf registration until we have filed all of our periodic reports in a timely manner for a period of twelve months.

We are also ineligible to use Form S-8 until we have prepared and filed all of our delinquent periodic reports. We use Form S-8 to register grants of equity compensation to our employees, including grants in the form of options and restricted stock. The unavailability of Form S-8 reduces our flexibility in granting options and restricted stock to our employees.

In addition, the NYSE has broad power to commence delisting proceedings for violations of its rules and may do so at any time. Because we are late in making our SEC filings, the NYSE could commence delisting proceedings against the Company; however, they have not indicated an intention to do so.

Consumer spending on leisure activities is affected by changes in the economy and consumer tastes, as well as other factors that are difficult to predict and beyond our control.

We cannot assure you that demand for our products or services will remain constant. Consumers willingness to spend money on leisure activities such as gaming is affected by changes in the economy and consumer tastes, both of which are both difficult to predict and beyond our control. Continued adverse developments affecting economies throughout the world, including a general tightening of the availability of credit, increasing interest rates, increasing energy costs, acts of war or terrorism, natural disasters, declining consumer confidence or significant declines in the stock market could lead to a further reduction in discretionary spending on leisure activities adversely affecting our business.

International operations, unfavorable political developments, weak foreign economies and other foreign risks may negatively impact our financial condition and results of operations.

Our business is dependent on international markets as a portion of our revenues. As of June 30, 2005, Bally Gaming and Systems had $16.8 million of receivables, or 17% of our total receivables, from customers in foreign countries. We expect that receivables with respect to foreign sales will continue to account for a portion of our total revenues. As a result, our business in these markets is subject to a variety of risks, including:

- recessions in foreign economies;
- the adoption and expansion of trade restrictions;
- expropriation, nationalization and limitation on repatriation of earnings;
- currency exchange fluctuations;
- reduced protection of intellectual property rights in some countries;
- longer receivables collection periods and greater difficulty in collecting accounts receivable;
- difficulties in managing foreign operations;
- social, political and economic instability;
- unexpected changes in regulatory requirements;
- acts of war and terrorism;
- ability to finance foreign operations;
- changes in consumer tastes and trends;
- tariffs and other trade barriers;
- acts of war or terrorism; and
- U.S. government requirements for export.

There can be no assurances that any of these international developments, or others, would not adversely affect our financial condition and results of operation.

Our bank loan agreement imposes significant restrictions and failure to comply with these restrictions could result in the acceleration of a substantial portion of our debt, which we may not be able to repay or refinance.

Our bank loan agreement contains a number of covenants that, among other things, restrict our ability and certain of our 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 our subsidiaries, and
- engage in mergers or consolidations or certain other transactions with subsidiaries and affiliates.

In addition, the bank loan agreement requires us to maintain compliance with certain financial ratios, including certain leverage ratios. Our ability to comply with such ratios, meet our debt service obligations or reduce our total debt is dependent upon our future performance, which may be affected by events beyond our control. There can be no assurance that we will be able to comply with such restrictions and limitations, or that they will not adversely affect our ability to finance our future operations or capital needs, or engage in other business activities that would otherwise be in the company s interest.

A breach of any of these covenants or our inability to comply with the required financial ratios could result in a default under the bank loan agreement. In the event of any such default, the lenders could elect to declare all borrowings outstanding under the bank loan agreement, together with any accrued interest and other fees, to be due and payable, as well as require us to apply all available cash to repay the amounts. If we were unable to repay the indebtedness upon its acceleration, the lenders could proceed against the underlying collateral. There can be no assurance that our assets would be sufficient to repay the amount in full, or that we would be able to borrow sufficient funds to refinance the indebtedness.

Virtually all of our debt is subject to variable interest rates; rising interest rates could negatively impact our business.

Certain borrowings under our bank loan agreement bear interest at a variable rate. In addition, we may incur other variable rate indebtedness in the future. Carrying indebtedness subject to variable interest rates makes the Company more vulnerable to economic and industry downturns, as well as reduces our flexibility in responding to changing business and economic conditions. Increases in interest rates on this indebtedness would increase our interest expense, which could adversely affect our cash flow, our ability to service our debt and to generally grow the business.

Current borrowings, as well as potential future financings, may substantially increase our current indebtedness.

No assurance can be given that we will be able to generate the cash flow necessary to permit us to meet our fixed charges and payment obligations with respect to our debt. We could be required to incur additional indebtedness to meet these fixed charges and payment obligations. Should we incur additional debt, among other things, such increased indebtedness could:

- adversely affect our ability to expand the business, market our products and make investments and capital expenditures;

- adversely affect the cost and availability of funds from commercial lenders, debt financing transactions and other sources; and

- create competitive disadvantages compared to other companies with lower debt levels.

Any inability of us to service our fixed charges and payment obligations, or incurrence of additional debt, would have an adverse effect on our cash flows, results of operations and business generally.

An inability to maintain sufficient liquidity could negatively affect expected levels of operations and new product development.

Future revenue may not be sufficient to meet operating, product development and other cash flow requirements. Sufficient funds to service our debt and maintain new product development efforts and expected levels of operations may not be available, and additional capital, if and when needed by us, may not be available on terms acceptable to us. If we cannot obtain sufficient capital on acceptable terms when needed, we may not be able to carry out our planned product development efforts and level of operations, which could harm our business.

Our financial results vary from quarter to quarter, which could negatively impact our business.

Various factors affect our quarterly operating results, some of which are not within our control. These factors include, among others:

- the financial strength of the gaming industry;

- consumer s willingness to spend money on leisure activities;

- the timing and introduction of new products and services;

- the mix of products and services sold;

- the timing of significant orders from and shipments to customers;

- product and service pricing and discounts;

- the timing of acquisitions of other companies and businesses or dispositions; and

- general economic conditions.

These and other factors are likely to cause our financial results to fluctuate from quarter to quarter. Based on the foregoing, we believe that quarter-to-quarter comparisons of our results of operations may not be meaningful. In addition, such fluctuations could cause us to be unable to comply with the financial ratios in our bank loan agreement.

Certain market risks may affect our business, results of operations and prospects.

In 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 rate movements, collectibility of receivables and recoverability of residual values on leased assets. Further, some of our payors may experience financial difficulties, or may otherwise not pay accounts receivable when due, resulting in increased write-offs. 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.

Our strategic plan, involving growth through the acquisition of other companies, may not succeed.

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Our strategic plan involves, in part, growth through the acquisition of other companies. Such growth involves a number of risks, including:

- the difficulties related to combining previously separate businesses;
- the substantial diversion of management s attention from day-to-day operations;
- the assumption of liabilities of an acquired business, including unforeseen liabilities;
- the failure to realize anticipated benefits, such as cost savings and revenue enhancements;
- the dilution of existing stockholders due to the issuance of equity securities, utilization of cash reserves, or incurrence of debt in order to fund the acquisitions;
- the potentially substantial transaction costs associated with acquisitions; and
- the difficulties related to assimilating the products, personnel and systems of an acquired business and to integrating distribution and other operational capabilities.

We have adopted a shareholder rights plan, which, together with provisions in our restated articles of incorporation and Nevada law, could discourage or prevent a potential takeover of our company that might otherwise result in you receiving a premium over the market price for your common stock.

We adopted a shareholder rights plan pursuant to which we distributed one right for each outstanding share of common stock held by stockholders of record as of March 12, 1998. Because the rights may substantially dilute the stock ownership of a person or group attempting a take-over of us without the approval of our Board of Directors, even if such a change in control would result in our stockholders receiving a premium for their shares, the plan could make it more difficult for a third party to acquire us, or a significant percentage of our outstanding capital stock, without first negotiating with our Board of Directors. Additionally, our restated articles of incorporation permit our Board of Directors to issue special shares from time to time, with such rights and preferences as they consider appropriate. Our Board of Directors could authorize the issuance of special shares with terms and conditions and under circumstances that could have an effect of discouraging a takeover or other transaction.

As a Nevada corporation, we are also subject to certain provisions of the Nevada General Corporation Law that have anti-takeover effects and may inhibit a non-negotiated merger or other business combination. These provisions are intended to encourage any person interested in acquiring us to negotiate with, and to obtain the approval of, our Board of Directors in connection with such a transaction. However, certain of these provisions may discourage a future acquisition of the Company, including an acquisition in which the stockholders might otherwise receive a premium for their shares. As a result, stockholders who might desire to participate in such a transaction may not have the opportunity to do so.

ITEM 7A. QUANTITATIVE AND QUALITATIVE DISCLOSURES ABOUT MARKET RISK

Currency Rate Fluctuations

Revenues and results of operations derived from our non-U.S. subsidiaries are denominated in their local currencies and 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 have strengthened versus the U.S. dollar, which resulted in assets and liabilities denominated in local currencies being translated into more dollars. The Company does 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

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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 of changes in the market interest rates or currency exchange rates on earnings.

The results of the sensitivity analysis at June 30, 2005 are as follows:

Interest Rate Risk

We had total debt of approximately $335.1 million, consisting primarily of the $314.9 million term loan under our senior credit facilities and the $14.0 million subordinated loan and other debt at approximately $6.2 million. The interest rate for the term loan is reset every six months. 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 $3.4 million 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 earnings reported in the consolidated group of approximately $0.6 million.

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 8. FINANCIAL STATEMENTS AND SUPPLEMENTARY DATA

RESTATEMENTS TO THE CONSOLIDATED FINANCIAL STATEMENTS

As described in Note 2 to consolidated financial statements, Restatement of Previously Issued Financial Statements, we have restated our previously issued consolidated financial statements as of June 30, 2005 and 2004, and for each of the three years in the period ended June 30, 2005 and our previously reported unaudited selected quarterly financial data within such periods presented in Note 22 to consolidated financial statements, Selected Quarterly Financial Data (Unaudited).

Our consolidated financial statements, including the notes thereto, and supplementary financial information are listed in Item 15, Exhibits and Financial Statement Schedules, and are included after the signature page beginning at page F-1.

ITEM 9. CHANGES IN AND DISAGREEMENTS WITH ACCOUNTANTS ON ACCOUNTING AND FINANCIAL DISCLOSURE

None.

ITEM 9A. CONTROLS AND PROCEDURES

Disclosure Controls and Procedures

As required by Rule 13a-15(b) promulgated under the Exchange Act, our management, with the participation of our Chief Executive Officer and Chief Financial Officer, evaluated the design and operating effectiveness as of June 30, 2005 of our disclosure controls and procedures, as defined in Rule 13a-15(e) promulgated under the Exchange Act. Based on this evaluation our Chief Executive Officer and Chief Financial Officer concluded that, because of the deficiencies in our internal control over financial reporting described below, as of June 30, 2005 our disclosure controls and procedures were not effective.

Notwithstanding management s assessment that our internal control over financial reporting was ineffective as of June 30, 2005 and the material weaknesses described below, we believe that the consolidated financial statements included in this Annual Report on Form 10-K correctly present our financial condition, results of operations and cash flows for the fiscal years covered thereby in all material respects.

Internal Control Over Financial Reporting

Management s Report on Internal Control Over Financial Reporting

Our management is responsible for establishing and maintaining adequate internal control over financial reporting, as defined in Rule 13a-15(f) promulgated under the Exchange Act. Internal control over financial reporting is a process designed to provide reasonable assurance regarding the reliability of financial reporting and the preparation of an issuer s financial statements for external purposes in accordance with accounting principles generally accepted in the United States of America (GAAP). Internal control over financial reporting includes policies and procedures that:

- pertain to the maintenance of records that, in reasonable detail, accurately and fairly reflect the transactions and dispositions of an issuer s assets;

- provide reasonable assurance that transactions are recorded as necessary to permit preparation of financial statements in accordance with GAAP, and that an issuer s receipts and expenditures are being made only in accordance with authorizations of its management and directors; and

- provide reasonable assurance regarding prevention or timely detection of unauthorized acquisition, use or disposition of an issuer s assets that could have a material effect on the financial statements.

Because of its inherent limitations, internal control over financial reporting may not prevent or detect misstatements. Also, the application of any evaluation of effectiveness to future periods is subject to the risk that controls may become inadequate because of changes in conditions, or that compliance with the policies or procedures may deteriorate.

As required by Rule 13a-15(c) promulgated under the Exchange Act, our management, with the participation of our Chief Executive Officer and Chief Financial Officer, evaluated the effectiveness of our internal control over financial reporting as of June 30, 2005. Management s assessment was based on criteria set forth by the Committee of Sponsoring Organizations of the Treadway Commission in *Internal Control Integrated Framework* (COSO). Our assessment identified deficiencies that were determined to be material weaknesses.

A material weakness is a control deficiency, or combination of control deficiencies, that results in more than a remote likelihood that a material misstatement of the annual or interim financial statements will not be prevented or detected. Because of the material weaknesses described below, management concluded that our internal control over financial reporting was not effective as of June 30, 2005.

The specific material weaknesses identified by management as of June 30, 2005 are described as follows:

- **Inadequate staffing and training in finance and accounting:** Management has identified two broad issues related to our finance and accounting staff. First, accounting personnel did not have an adequate understanding of the complex rules over revenue recognition and how the application of those rules applied to our evolving business in recent years. This issue contributed to the majority of the dollar amount and number of financial statement adjustments required to fiscal year end 2005 as well the need for the restatement of the previously issued financial statements. Second, a high level of turnover of key finance and accounting personnel in fiscal year 2005, a year in which we were integrating the SDG acquisition, resulted in certain controls not operating effectively as of June 30, 2005. As a result of these two issues, our finance and accounting staff was, in some cases, inadequately trained and, in fiscal year 2005, understaffed. These weaknesses resulted in material adjustments to fiscal year end 2005 and contributed to the First Restatement of the consolidated financial statements, described under Note 2 to consolidated financial statements, due to: (i) misinterpretation of certain accounting literature, (ii) lack of understanding and interpretation of customer contracts, (iii) untimely application of accounting principles, (iv) improper classification of certain balance sheet and income statement items and (v) untimely performance of the year end evaluation of obsolete inventory and fixed asset reserves.

Additionally, this material weakness contributed to the Second Restatement of the consolidated financial statements described under Note 2 to consolidated financial statements.

- **Ineffective controls related to the preparation of certain account analyses, account summaries and account reconciliations:** Certain controls designed to ensure timely preparation, review and approval of certain account analyses and reconciliations did not operate effectively. Specifically, certain reconciliations in areas including accounts receivable, accrued liabilities, other current assets, and property, plant and equipment were not performed in a timely manner. In certain circumstances we did not adequately follow up or resolve the reconciliation of certain items. These weaknesses resulted in material adjustments to fiscal year end 2005 and contributed to the First Restatement of the consolidated financial statements.

Additionally, this material weakness contributed to the Second Restatement of the consolidated financial statements.

- **Inadequate controls related to revenue recognition:** We did not have appropriate internal controls related to the recognition of revenue for game and system sales, including the lack of a comprehensive contract administration function to address the operating, legal, financial and accounting ramifications of game and system revenue contracts. Our controls were not adequate to capture and analyze the terms and conditions of all contracts to ensure the proper recording of revenue contracts with standard and non-standard terms, including FOB destination provisions, extended payment terms and other contractual arrangements that can affect the timing and amount of revenue to be recognized. Certain of our revenue transactions are accounted for in accordance with the AICPA s Statement of Position 97-2, *Software Revenue Recognition* (SOP No. 97-2), as amended, which includes complex revenue recognition criteria that were not always adequately assessed. These weaknesses were the result of a material deficiency in the design of internal control over financial reporting and resulted in material adjustments to our 2005 consolidated financial statements discovered during our year-end close process and contributed to the First Restatement of the consolidated financial statements as follows:

(i) decrease in gaming and systems revenues by $6.0 million $8.5 million and $23.2 million in fiscal years 2005, 2004 and 2003, respectively; and

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(ii) decrease in cost of sales by $4.2 million, $2.9 million and $9.9 million in fiscal years 2005, 2004 and 2003, respectively.

Additionally, this material weakness contributed to the Second Restatement of the consolidated financial statements.

- **Inadequate controls related to inventory valuation:** The Company did not design and implement sufficient controls related to the valuation of inventory. As a result inventory, prior to year-end adjustments was not stated at the lower of cost or market value due to the following: (i) certain manufacturing labor and overhead costs were not charged to inventory because we did not accurately assess the purchase price variance associated with the use of standard costs within our accounting systems, (ii) the restocking of excess inventory pulled for work orders was not always properly identified and removed from the bill of materials and (iii) certain packaging materials had not always been properly charged to cost of sales. This weakness resulted in material adjustments to fiscal year end 2005 and contributed to the First Restatement of the consolidated financial statements. The net effect of these adjustments increased cost of goods sold by $1.9 million, $0.7 million and $0.6 million for the fiscal years ended June 30, 2005, 2004 and 2003 respectively.

Additionally, this material weakness contributed to the Second Restatement of the consolidated financial statements.

- **Ineffective controls related to income taxes:** Our policies and procedures did not include adequate review of certain complex income tax issues, resulting in material deficiencies in the operating effectiveness of internal control over financial reporting. These deficiencies resulted in an adjustment of our effective tax rate resulting from the establishment of reserves for certain tax credits, and additional U.S. and foreign deferred tax expense related to our foreign operations. Certain adjustments were also required in the First Restatement for deferred taxes related to a prior acquisition totaling $8.3 million as of June 30, 2004.

- **Ineffective controls at the entity level:** As evidenced by the material weaknesses described above, and management s final assessment of our internal controls, we have determined that our entity-level controls related to the control environment, risk assessment, monitoring function and dissemination of information and communication activities did not operate effectively, resulting in a material weakness in each COSO component. Such entity level controls, and a comprehensive monitoring of internal controls by the internal audit function, are part of the framework to ensure that the designed system of internal control is operating effectively to ensure that significant transactions are adequately identified, recorded and disclosed.

Additionally, this material weakness contributed to the Second Restatement of the consolidated financial statements.

Our independent registered public accounting firm, Deloitte & Touche LLP, has issued an attestation report on management s assessment of our internal control over financial reporting which is set forth below.

Changes in Internal Control

Based on the evaluation required by Rule 13a-15(d) of the Exchange Act, there were no changes to our internal control over financial reporting during the fiscal quarter ended June 30, 2005 that have materially affected, or are reasonably likely to materially affect, our internal control over financial reporting.

Remediation Plan

We are including information in this Annual Report on Form 10-K/A with respect to our internal control over financial reporting for the period subsequent to June 30, 2005, in order to provide readers with a current understanding of the identified material weaknesses, as well as how they are being addressed as part of our remediation plan.

Subsequent to June 30, 2005, we have undertaken, extensive work to remediate the material weaknesses identified in our internal control over financial reporting described above, including developing the specific remediation initiatives described below. The implementation of these initiatives was a priority for us in fiscal 2006 and continues to be a priority in fiscal 2007. We have begun implementing the actions described below with respect to the identified material weaknesses; however, there can be no assurances as to when the implementation of these initiatives will be completed. Furthermore, we are in process of evaluating our internal control over financial reporting as of June 30, 2006. There can be no assurances that the material weaknesses described above were cured as of such date, or that we will not identify additional material weaknesses as a result of such evaluation. Until such initiatives are implemented, we will continue to incur the expenses and management burdens associated with the additional resources required to prepare our consolidated financial statements.

Inadequate Staffing and Training in Finance and Accounting

Inadequate Staffing. We have focused intensive efforts on improving the overall level and quality of our staffing in a number of finance and accounting areas related to the identified material weaknesses, including the tax and revenue departments. These efforts have resulted in the creation of several new positions, as well as the hiring of a number of key employees. To this point, we have filled the following positions: Chief Financial Officer, Vice President/Corporate Controller, Vice President of Corporate Accounting, Director of Financial Reporting and a Tax Manager.

Inadequate Training. We have held a number of internal meetings with our sales staff to review our revenue recognition policies and procedures. Our goal is to provide the sales staff with a better understanding of the applicable accounting rules, the consistency in contractual language that is required, as well as the new contract administration procedures discussed below under Inadequate Controls Related to Revenue Recognition Contract Administration. We are also educating the sales department as to certain standard sales contracts discussed below and with respect to the types of contractual language that has been reviewed and pre-approved by members of the legal and finance departments.

Additionally, the finance and accounting department continues to encourage and pay for all personnel who enroll in Continuing Professional Education, as well as for any college and master s level courses that relate to their respective job functions.

Ineffective Controls related to the Preparation of Certain Account Analyses, Account Summaries and Account Reconciliations

As a result of the adjustments made with respect to certain balance sheet accounts for the fiscal year ended June 30, 2005, we determined a more detailed review for these accounts was necessary in connection with our quarterly account reconciliation process. The Company completed a thorough review of balance sheet accounts to determine whether the supporting schedules were adequately prepared and/or reviewed, and that they included adequate supporting documentation.

The finance and accounting department has also developed a spread sheet management process to ensure that various departments are working from the same schedules thereby reducing the likelihood of errors from using outdated files stored on individual computers.

Inadequate Controls Related to Revenue Recognition

In addition to the additional internal training of our sales staff discussed above, we have also taken the following actions to remediate the issues previously identified with respect to inadequate controls related to revenue recognition.

Internal Review of All Game Sale Transactions. Management has implemented a procedure to review each game and system sale transaction for compliance with AICPA Statement of Position No. 97-2, *Software Revenue Recognition*. The initial revenue recognition determination is made by the revenue department, and is then reviewed by a member of our finance department at a director or higher level. In addition, our Chief Financial Officer reviews both randomly selected contracts, as well as those related to large and/or complex transactions.

Outside Review of Game Sale Transactions. We engaged an outside consultant to assist us in performing additional review procedures for revenue transactions during fiscal 2006. The scope of the consultant s review was designed to ensure a comprehensive review of all large transactions, as well as certain types of transactions that have previously resulted in adjustments to the timing of revenue recognition. The outside consultant s scope also included reviewing a sample of contracts from the general population for proper revenue recognition.

We have also reviewed certain complex transactions and new proposed contracts with our consultants to identify any accounting issues prior to the final contract execution.

Implementation of Standard Sales Contract. As part of the pre-review processes, discussed above under Internal Review of All Game Sale Transactions, we have created a standard contract for domestic game sales. This contract was introduced to the sales force in draft form in January 2006, and was implemented in February 2006. We are also reviewing our system sales contracts and international sales contracts to determine the feasability of developing standardized contracts for all those markets.

Contract Administration. We have designed a multiple step action plan to develop a contract administration process that is well defined, well understood and efficient in its operation. Our previous contract administration process could not be relied upon to produce consistently prepared contracts as documents could be edited by a number of individuals at anytime prior to execution.

Beginning in September 2005, we implemented Phase I of our plan which required each sales contract to follow the contract approval flow chart process. Phase I includes a review of all terms and conditions of each contract, and requires formal sign off as well as execution of the sales agreement by certain levels of management based on a predetermined approval process. We have also established procedures that will now require approval by our Chief Executive Officer for certain contracts. The contract is then returned to the sales person for delivery and sign off by the customer. Any further edits would then be re-reviewed by members of our finance and accounting department to gauge their accounting impact to ensure proper revenue recognition.

In February 2006, we began Phase II of our process and hired a Contract Administrator. Phase II of the contract administration process involves the establishment of a Contract Administrator position, and related enhanced policies and procedures. This individual reports directly to the legal department. Members of our Senior Management team have agreed to certain contractual terms that have been defined as standard and, consequently, we developed standard game sales contracts discussed above under *Implementation of Standard Sales Contract*. If the draft contract uses these standard terms, it will receive only limited review by our finance and accounting department. If the contract goes beyond these standard terms, then the Contract Administrator must follow a newly created decision tree which involves review and approval by various members of the finance and legal departments, depending on the issue identified.

Phase III of the process introduces a new contract management and work flow software to better manage the decision tree and track contract approvals.

Quarterly Certifications. We have expanded our quarterly Sarbanes-Oxley certification procedures and disclosure controls. In addition to the internal certifications we previously required from the Executive Vice President of each business division and the Vice President/Corporate Controller, our process now requires internal sub-certifications from all sales directors and Vice Presidents, including the Executive Vice President of Sales. These additional internal sub-certifications include a number of representations regarding the various signatories respective duties and responsibilities.

Inadequate Controls Related to Inventory Valuation

We have taken the following actions to remediate the issues previously identified with respect to our inadequate controls related to inventory valuation.

Expanded review by Senior Management. Members of our senior management team have met with members of the manufacturing management team, cycle counters, and warehouse supervisors, as well as performed expanded reviews of the supporting schedules prepared by the cost accounting manager in regards to inventory valuation, and have selected various accounts for additional analysis. We have also filled the new role of Accounting Manager Inventory. This individual s entire focus will be on inventory related issues.

Game Inventory Live Data. The Company s intra-net site is in the process of being upgraded to include real time data for game inventory; both for new and used games. This upgrade has allowed for increased accounting for the game inventory, as well as greater awareness by a greater number of individuals of the inventory levels and the availability of certain finished goods.

Negative Bill of Materials. We identified an issue regarding the accounting for excess inventory that was issued with respect to work orders but was subsequently restocked. Ultimately, the manufacturing system will be programmed to perform these entries automatically; however, until the programming is complete, we will continue to make manual adjustments with respect thereto.

Physical Inventories. We utilize a perpetual inventory system with a substantial portion of our inventory being subjected to daily cycle counts. Management performed added physical counts during fiscal year 2006 and the Inventory Accounting Manager and members of the cycle count teams visited certain of our offsite warehouses to perform additional detailed physical counts and tests during fiscal 2006. We will continue to perform additional detailed physical counts at our offsite warehouses during fiscal 2007.

Quarterly Adjustments of Purchase Price Variances. Our Vice President/Corporate Controller and our Inventory Accounting Manager are performing quarterly analyses of any purchase price variances that may occur when there is a deviation from our standard prices and are making the necessary adjustments to properly value our cost of sales, inventory and fixed assets.

Ineffective Controls Related to Income Taxes

We have increased our internal capabilities in the income tax area with the addition of our Vice President/Corporate Controller and Manager of Tax, as well as with the continued assistance of third party consultants. We also perform significant internal reviews of our income tax provision each quarter. We continue to use the services of large local law firms and accounting firms in foreign jurisdictions in order to ensure that we are in compliance with local tax laws. We are also performing an annual R&D tax study and consulting with a nationally recognized accounting firm on certain transfer pricing studies as well.

Ineffective Controls at the Entity Level

We have taken the following actions to remediate the issues previously identified with respect to our ineffective controls at the entity level.

IT Systems. We continue to address areas of our IT system that require additional investment. Consultants from the IT Systems provider (MAPICS) have been engaged to perform a review of our current usage of our system, and the cost benefits of upgrades that are available.

Control Environment. The Nominating and Corporate Governance Committee has begun the search for a fully independent new board member, who will also qualify as an Audit Committee financial expert under the rules of the SEC. A search consultant has been engaged and we have initiated the search.

Internal Audit. In addition to the personnel changes discussed above, we have hired a new Vice President to head our Internal Audit department. This individual led our Sarbanes-Oxley testing for fiscal year 2006 as well coordinated efforts with the outside firm we hired in the 2005 compliance effort. To better utilize the resources of the outside firm during fiscal year 2007 and 2006, several changes have been made to its engagement, including changing the protocols and personnel on the engagement team.

REPORT OF INDEPENDENT REGISTERED PUBLIC ACCOUNTING FIRM

To the Board of Directors and Stockholders of Bally Technologies, Inc.
Las Vegas, Nevada

We have audited management s assessment, included in the accompanying Management s Report on Internal Control Over Financial Reporting, that Bally Technologies, Inc. and Subsidiaries (the Company) did not maintain effective internal control over financial reporting as of June 30, 2005, because of the effect of the material weaknesses identified in management s assessment based on criteria established in *Internal Control Integrated Framework* issued by the Committee of Sponsoring Organizations of the Treadway Commission (COSO). The Company s management is responsible for maintaining effective internal control over financial reporting and for its assessment of the effectiveness of internal control over financial reporting. Our responsibility is to express an opinion on management s assessment and an opinion on the effectiveness of the Company s internal control over financial reporting based on our audit.

We conducted our audit in accordance with the standards of the Public Company Accounting Oversight Board (United States). Those standards require that we plan and perform the audit to obtain reasonable assurance about whether effective internal control over financial reporting was maintained in all material respects. Our audit included obtaining an understanding of internal control over financial reporting, evaluating management s assessment, testing and evaluating the design and operating effectiveness of internal control, and performing such other procedures as we considered necessary in the circumstances. We believe that our audit provides a reasonable basis for our opinions.

A company s internal control over financial reporting is a process designed by, or under the supervision of, the company s principal executive and principal financial officers, or persons performing similar functions, and effected by the company s board of directors, management, and other personnel to provide reasonable assurance regarding the reliability of financial reporting and the preparation of financial statements for external purposes in accordance with generally accepted accounting principles. A company s internal control over financial reporting includes those policies and procedures that (1) pertain to the maintenance of records that, in reasonable detail, accurately and fairly reflect the transactions and dispositions of the assets of the company; (2) provide reasonable assurance that transactions are recorded as necessary to permit preparation of financial statements in accordance with generally accepted accounting principles, and that receipts and expenditures of the company are being made only in accordance with authorizations of management and directors of the company; and (3) provide reasonable assurance regarding prevention or timely detection of unauthorized acquisition, use, or disposition of the company s assets that could have a material effect on the financial statements.

Because of the inherent limitations of internal control over financial reporting, including the possibility of collusion or improper management override of controls, material misstatements due to error or fraud may not be prevented or detected on a timely basis. Also, projections of any evaluation of the effectiveness of the internal control over financial reporting to future periods are subject to the risk that the controls may become inadequate because of changes in conditions, or that the degree of compliance with the policies or procedures may deteriorate.

A material weakness is a significant deficiency, or combination of significant deficiencies, that results in more than a remote likelihood that a material misstatement of the annual or interim financial statements will not be prevented or detected. The following material weaknesses have been identified and included in management s assessment:

- **Inadequate staffing and training in finance and accounting:** Accounting personnel did not have an adequate understanding of certain rules over revenue recognition and how those rules applied to its business. Additionally, the Company experienced a high level of turnover of key finance and accounting personnel in fiscal year 2005 and an inability to recruit and retain qualified finance and accounting staff. As a result, the Company s finance and accounting staff was inadequately trained and understaffed. These weaknesses resulted in material adjustments to the Company s consolidated financial statements for the year ended June 30, 2005 and contributed to the initial restatement of the 2004 and 2003 consolidated financial statements in the Company s Annual Report on Form 10-K for the fiscal year ended June 30, 2005 (the First Restatement) filed in December 2005 (the Original Filing) due to: (i) misinterpretation of certain accounting literature, (ii) lack of understanding and interpretation of customer contracts, (iii) untimely application of accounting principles, (iv) improper classification of certain balance sheet and income statement items and (v) untimely performance of the year end evaluation of obsolete inventory and fixed asset reserves.

Additionally, this material weakness contributed to the subsequent restatement of the previously reported consolidated financial statements filed in this Amendment No.1 to the Company s Annual Report on Form 10-K (the Second Restatement) as discussed in Note 2.

- **Ineffective controls related to the preparation of certain account analyses, account summaries and account reconciliations:** Certain controls designed to ensure timely performance, review and approval of certain account analyses and reconciliations did not operate effectively. Specifically, certain reconciliations in areas including accounts receivable, accrued liabilities, other current assets, and property, plant and equipment were not performed in a timely manner. In certain circumstances the Company did not properly resolve reconciling items. These weaknesses resulted in material adjustments to the Company s consolidated financial statements for the year ended June 30, 2005 and contributed to the First Restatement of the consolidated financial statements.

Additionally, this material weakness contributed to the Second Restatement of the previously reported consolidated financial statements.

- **Inadequate controls related to revenue recognition:** The Company did not have appropriate internal controls related to the recognition of revenue for game and system sales, including the lack of a comprehensive contract administration function to address the operating, legal, financial and accounting ramifications of game and system revenue contracts. The Company s controls were not adequate to capture and analyze the terms and conditions of all contracts to ensure the proper recording of revenue contracts with standard and non-standard terms, including FOB destination provisions, extended payment terms and other contractual arrangements that can affect the timing and amount of revenue to be recognized. Certain revenue transactions are accounted for in accordance with the AICPA s Statement of Position 97-2, *Software Revenue Recognition* (SOP No. 97-2), which includes complex revenue recognition criteria that were not adequately assessed. These weaknesses were the result of a material deficiency in the design of internal control over financial reporting, and resulted in material adjustments to the consolidated financial statements for the fiscal year ended June 30, 2005 and contributed to the First Restatement of the consolidated financial statements.

Additionally, this material weakness contributed to the Second Restatement of the previously reported consolidated financial statements.

- **Inadequate controls related to inventory valuation:** The Company did not design and implement sufficient controls related to the valuation of inventory. As a result inventory, prior to year end adjustments, was not stated at the lower of cost of market value due to the following: (i) certain manufacturing labor and overhead costs were not charged to inventory because the Company did not accurately assess the purchase price variance associated with the use of standard costs within the accounting systems, (ii) the restocking of excess inventory pulled for work orders was not always properly identified and removed from the bill of materials and (iii) certain packaging materials had

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not always been properly charged to cost of sales. This weakness resulted in material adjustments to the Company s consolidated financial statements for the year ended June 30, 2005 and contributed to the First Restatement of the consolidated financial statements.

Additionally, this material weakness contributed to the Second Restatement of the previously reported consolidated financial statements.

- **Ineffective controls related to income taxes:** The Company s policies and procedures did not include adequate review of certain complex income tax issues, resulting in material deficiencies in the operating effectiveness of internal control over financial reporting. These deficiencies resulted in an adjustment of the effective tax rate resulting from the establishment of reserves for certain tax credits, additional U.S. and foreign deferred tax expense related to foreign operations, and adjustments to deferred taxes related to a prior acquisition and contributed to the First Restatement of the consolidated financial statements.

- **Ineffective controls at the entity level:** As evidenced by the material weaknesses described above, the Company determined that entity-level controls related to the control environment, risk assessment, monitoring function and dissemination of information and communication activities did not operate effectively, resulting in material weaknesses in each COSO component. Such entity level controls, and a comprehensive monitoring of internal controls by the internal audit function, are part of the framework to ensure that that the designed system of internal control is operating effectively to ensure that significant transactions are adequately identified, recorded and disclosed.

Additionally, this material weakness contributed to the Second Restatement of the previously reported consolidated financial statements.

These material weaknesses were considered in determining the nature, timing, and extent of audit tests applied in our audit of the consolidated financial statements as of and for the year ended June 30, 2005 of the Company and this report does not affect our report on such consolidated financial statements.

In our opinion, management s assessment that the Company did not maintain effective internal control over financial reporting as of June 30, 2005, is fairly stated, in all material respects, based on the criteria established in *Internal Control Integrated Framework* issued by the Committee of Sponsoring Organizations of the Treadway Commission . Also in our opinion, because of the effect of the material weaknesses described above on the achievement of the objectives of the control criteria, the Company has not maintained effective internal control over financial reporting as of June 30, 2005, based on the criteria established in *Internal Control Integrated Framework* issued by the Committee of Sponsoring Organizations of the Treadway Commission.

We have also audited, in accordance with the standards of the Public Company Accounting Oversight Board (United States), the consolidated financial statements as of and for the year ended June 30, 2005 of the Company and our report dated December 29, 2005 (October 30, 2006 as to the effects of the restatement discussed in Note 2 under the caption Second Restatement and the last paragraph in Note 11) expressed an unqualified opinion on those consolidated financial statements.

DELOITTE & TOUCHE LLP
Las Vegas, Nevada
December 29, 2005 (October 30, 2006 as to the effects of the material weaknesses in connection with the Second Restatement discussed in Management s Report on Internal Control over Financial Reporting)

ITEM 9B. OTHER INFORMATION

None

PART III

ITEM 10. DIRECTORS AND EXECUTIVE OFFICERS OF THE REGISTRANT

Directors, Executive Officers and Other Significant Employees

The name, age, present principal occupation or employment and five-year employment history of each of our directors and executive officers is set forth below. No director or executive officer is related by blood, marriage or adoption to any other director or executive officer.

Name	Age	Position with the Company
Richard Haddrill	52	Director, President, Chief Executive Officer
Jacques André	68	Director
Anthony DiCesare	43	Director
Joel Kirschbaum	54	Director
Stephen Race	56	Director
David Robbins	46	Director, Chairman of the Board of Directors
Kevin Verner	47	Director
Steven Des Champs	40	Senior Vice President, Chief Financial Officer
Mark Lipparelli	40	Executive Vice President of Operations
Mark Lerner	56	Senior Vice President for Law and Government, Secretary and General Counsel
Robert Luciano	47	Chief Technology Officer
Robert Miodunski	54	President and Chief Executive Officer(1)
Robert Saxton	52	Executive Vice President, Gaming, and Treasurer
Ramesh Srinivasan	45	Executive Vice President, Bally Systems Division

(1) Mr. Miodunski resigned as President and Chief Executive Officer of the Company effective as of September 30, 2004, pursuant to the Separation and Consulting Agreement dated as of June 30, 2004, more fully described below under Item 11, Executive Compensation.

Biographies

Richard Haddrill. Mr. Haddrill, age 52, became a director in April 2003 and, effective October 1, 2004, was appointed Chief Executive Officer of the Company. Prior to becoming Chief Executive Officer of the Company, Mr. Haddrill most recently completed five years as CEO of Manhattan Associates, Inc., a leader in software solutions to the supply chain industry throughout the world. During his tenure at Manhattan, the company expanded its product offerings and market share, more than tripled revenues to almost $200 million and increased its share price more than eight fold. Mr. Haddrill previously served as President and CEO for Powerhouse Technologies, Inc., a successful technology and gaming company from September 1996 until June 1999, when Powerhouse was acquired by Anchor Gaming, a publicly traded gaming company that was acquired by IGT in 2001. Mr. Haddrill currently serves as Vice Chairman of Manhattan Associates, Inc., and previously served on the board of directors of Danka Business Products, a digital imaging systems products provider and services producer until October 2004, and Outlooksoft, a provider of corporate performance management solutions until June 2005.

David Robbins. Mr. Robbins, age 46, initially served as a director for the Company from July 1994 to September 1997 and as Chairman of the Board of Directors of the Company from February 1997 to September 1997. Mr. Robbins received a B.S. in Economics from the Wharton School of the University of Pennsylvania and a J.D. from the New York University School of Law. Mr. Robbins was also licensed as a certified public accountant (inactive status) in the state of New York. From 1984 through 2004, he practiced corporate, securities and real estate law at various law firms, as an associate, partner and of counsel. From 1993 through the present, Mr. Robbins invested in various private equity and other

investment opportunities, and since January 1996 has managed funds for private investors, including private investment partnerships that invest in public securities and a private equity investment partnership. In addition to serving on the Company s Board, Mr. Robbins previously served on the board of directors of Medisys, plc, a health care diagnostics company. Mr. Robbins has served as an assistant adjunct professor of law at the Benjamin N. Cardozo Law School, where he taught courses in corporate finance, securities and real estate.

Jacques André. Mr. André, age 68, became a director in August 1996. Mr. André was a Vice President of A.T. Kearney Executive Search, a global management consulting firm from October 2002 until February 2005. Mr. André was a partner with Ray & Berndtson, Inc. an international executive search firm, from 1975 until 2002.

Anthony DiCesare. Mr. DiCesare, age 43, became a director in July 1994. Mr. DiCesare was employed by Kirkland Investment Corporation (KIC), which was the sole general partner of Kirkland-Ft. Worth Investment Partners, L.P., an investment partnership, from April 1991 to July 1994. Mr. DiCesare served as Executive Vice President Development of the Company from July 1994 through June 1997. He has been a personal investor since 1997.

Joel Kirschbaum. Mr. Kirschbaum, age 54, became a director in July 1994 and served as Chairman of the Board of Directors of the Company from July 1994 to March 1995. Mr. Kirschbaum is the sole stockholder, director and officer of KIC. Previously, he worked at Goldman, Sachs & Co. for 13 years, during the last six of which he was a General Partner.

Stephen Race. Mr. Race, age 56, became a director in June 2005. From 1999 to 2004, Mr. Race worked with a variety of private equity groups analyzing leveraged buyout opportunities in consumer branded goods and services, and with venture capital groups on financial restructuring of selected portfolio companies, often serving as acting chief executive officer. Mr. Race also served as interim CEO to restructure and sell a troubled dot com. From 1995 to 1998, Mr. Race served as CEO of Microprose, Inc., a NASDAQ video game company. From 1993 to 1995, Mr. Race served as President of the division of SONY Computer Entertainment responsible for development and launch of the PlayStation video game. Prior to that time, Mr. Race provided a broad range of management counsel primarily in the areas of marketing, strategic planning, mergers and acquisitions, and new business development. In 1990, Mr. Race served as General Manager of Reebok at the time of introduction and launch of the PUMP athletic footwear technology. Mr. Race also previously served as Chairman and CEO of Homestar International, Executive Vice President and one of the founders of Worlds of Wonder, Inc., and as Vice President of Marketing and Communications, International Division, of Atari, Inc. Mr. Race holds degrees in economics and energy management from the University of Pennsylvania and an M.B.A. from the Wharton Graduate School of Finance and Commerce.

Kevin Verner. Mr. Verner, age 47, became a director in April 2001. From 1997 to 2000, Mr. Verner held various positions with WMS Industries, Inc., and WMS Gaming, the last of which was Chief Operating Officer. Prior to his employment at WMS, Mr. Verner was Vice President of New Business Development at R.J. Reynolds Tobacco Co., where he held various marketing and senior management positions for sixteen years. Mr. Verner is currently a consultant and provides interim management to early-stage companies to include financial planning, securing of seed funding, management recruitment and development of operating budgets and pro forma financial projections. Mr. Verner is also a CEO advisor for Chicago venture fund Alpha Capital Fund III and provides consultation on enterprise valuation and due diligence for consumer products investments.

Steven Des Champs. Mr. Des Champs, age 40, was appointed Chief Financial Officer in March 2005, succeeding Mr. Robert Saxton in this position. Mr. Des Champs re-joined the Company in February 2000 as Vice President Finance, was promoted to Chief Accounting Officer in August 2000 and Senior Vice President in October 2002. The Company previously employed Mr. Des Champs in the capacity of

Director of Finance from October 1995 to November 1998. From December 1998 to January 2000, Mr. Des Champs was the Chief Financial Officer for PDS Financial, a provider of lease financing for the gaming industry.

Mark Lipparelli. Mr. Lipparelli, age 40, joined the Company as Executive Vice President of Bally Systems in 2002. Mr. Lipparelli currently serves as Executive Vice President of Operations, a position he assumed in March 2005. As head of Operations, he oversees Manufacturing, Intellectual Property, Strategic Planning, Product Compliance, Human Resources and Information Technology. Previously, Mr. Lipparelli served as Executive Vice President and then President of Shuffle Master, Inc., a gaming supply company. Prior to joining Shuffle Master, Mr. Lipparelli was Chief Financial Officer of Camco, Inc., a retail chain holding company. From 1998 to 2000, he was Senior Vice President of Entertainment Systems for Bally Gaming and Systems. Mr. Lipparelli also previously served as Vice President of Finance for Casino Data Systems and worked for the Nevada State Gaming Control Board from 1988 to 1993.

Mark Lerner. Mr. Lerner, age 56, joined the Company in December 1996 as Assistant General Counsel. A former deputy attorney general for the Nevada Gaming Commission and State of Nevada Gaming Control Board, Mr. Lerner has been practicing law since 1980. Before joining Alliance he was general counsel to Becker Gaming, Inc., a Las Vegas gaming company. From 1987 to 1994, Mr. Lerner practiced law at Jones, Jones, Close & Brown (now Jones Vargas), a prominent Las Vegas commercial and litigation law firm.

Robert Luciano. Mr. Luciano, age 47, joined the Company in March 2004 as Chief Technology Officer in connection with the Company s acquisition of SDG. Mr. Luciano founded SDG in 1996 as a research, development and consulting company focusing on the gaming industry. Prior to founding SDG, Luciano was employed by IGT in the position of Vice President of Advanced Engineering. Prior to joining IGT, Mr. Luciano held several engineering positions with a variety of companies including Soabar, a division of Avery International, and Mobil Oil Corporation.

Robert Miodunski. Mr. Miodunski, age 54, joined the Company in March 1994 and served as, among other things, a director beginning in February 2000 and Chief Executive Officer beginning in April 2001 until he resigned from both positions effective September 30, 2004. Commencing January 1, 2005, Mr. Miodunski began serving as a consultant to the Company. From January 1991 to March 1994, Mr. Miodunski was President of Mulholland-Harper Company, a sign manufacturing and service company. From 1984 through 1990, Mr. Miodunski held various positions with Federal Signal Company, the last of which was Vice President and General Manager of the Midwest Region of the Sign Group. Mr. Miodunski was elected to Alliance s Board of Directors in February 2000.

Robert Saxton. Mr. Saxton, age 52, joined the Company in July 1982 as Corporate Controller. Mr. Saxton became a Vice President of United Coin in 1987 and was elected Vice President Casino Operations of Alliance Gaming in December 1993, and Senior Vice President Casino Group in June 1996. In March 2000, Mr. Saxton was appointed Chief Financial Officer and Treasurer of the Company, and in December 2003 was promoted to Executive Vice President. In March 2005, Mr. Saxton was appointed Executive Vice President of Bally Gaming. In this capacity, Mr. Saxton is responsible for the daily management of Gaming Operations, Customer Service, and Domestic & International Sales in the Games Division of Bally Gaming, Inc. He continues to serve as Treasurer of the Company and since 1994 has served as President of Rainbow Casino located in Vicksburg, Mississippi.

Ramesh Srinivasan. Mr. Srinivasan, age 45, joined the Company in March 2005 as Executive Vice President of Bally Systems. From 1998-2005, Mr. Srinivasan was an Executive Vice President, Senior Vice President and Vice President for Manhattan Associates, and brings a strong blend of technical and customer experiences to the Company. Mr. Srinivasan is responsible for system sales, services and product development.

Audit Committee of the Board of Directors

The Audit Committee of the Board of Directors is comprised of Messrs. Jacques André, David Robbins and Kevin Verner. The composition of the Audit Committee was changed as of October 27, 2004 to comply with the corporate governance requirements of the NYSE with respect to the independence, financial literacy and financial expertise of Audit Committee members. The Board of Directors has determined that Mr. Robbins is an audit committee financial expert, pursuant to Item 401(h) of Regulation S-K. The Board of Directors made this determination based on Mr. Robbins qualifications and business experience, as briefly described above under Biographies.

Code of Ethics

We amended our Code of Ethics and Business Conduct in October, 2005 for our chief executive, chief financial and principal accounting officers, as well as our directors (the Code of Ethics). In the event we make any amendment to, or grant any waiver from, a provision of the Code of Ethics that applies to the principal executive officer, principal financial officer or principal accounting officer that requires disclosure under applicable SEC rules, we intend to disclose such amendment or waiver and the reasons therefore on our website www.ballytech.com. The full text of the Code of Ethics is available by following links to Investor Relations and Corporate Governance on our website www.ballytech.com, or upon written request to us. Requests should be addressed to: Bally Technologies, Inc., 6601 South Bermuda Road, Las Vegas, Nevada 89119, Attention: Corporate Secretary.

Section 16(a) Beneficial Ownership Reporting Compliance

Section 16(a) of the Exchange Act requires our directors and executive officers and persons who own more than 10 percent of a registered class of our equity securities to file with the SEC and the NYSE initial reports of ownership and reports of changes in ownership of our common stock and other of our equity securities. These individuals are required by the SEC s regulations to furnish us with copies of all Section 16(a) reports filed by such persons. To our knowledge, based solely on our review of the copies of such reports furnished to us, all Section 16(a) filing requirements applicable to the our directors, executive officers and greater than ten percent beneficial owners were complied with on a timely basis during the fiscal year ended June 30, 2005, except that (i) on October 18, 2005, a Form 3 was filed on behalf of Mr. Ramesh Srinivasan, an executive officer of Bally Gaming, reporting Mr. Srinivasan s ownership of 11,000 shares of common stock, 1,000 shares of restricted stock, and options to purchase 300,000 shares of common stock on March 9, 2005, and (ii) on July 27, 2005, a Form 3 and Form 4 were filed on behalf of Stephen M. Race, a director, reporting Mr. Race s appointment to the Board of Directors on June 30, 2005 and the award of stock options to purchase 50,000 shares of common stock in connection therewith, respectively.

ITEM 11. EXECUTIVE COMPENSATION

Report on Executive Compensation

As of the end of the fiscal year ended June 30, 2005, the Compensation Committee consisted of Messrs. Jacques André, David Robbins and Kevin Verner, each of whom is an independent director. The composition of the Compensation Committee was changed as of October 27, 2004, to comply with the corporate governance requirements of the NYSE with respect to the independence of Compensation Committee members. The Compensation Committee s duties and responsibilities are set forth in a formal charter adopted by the Board of Directors and include, among others things:

- Review and approve executive compensation philosophy.
- Approve all executive compensation plans and structures.

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- Approve annual and long-term incentive performance metrics, as well as determine and approve payouts.

- Approve compensation for the Company s management executive committee, consisting of certain members of senior management, as well as senior management of the Company s subsidiaries.

- Approve plan payouts to the members of the management executive committee that are outside of approved parameters.

- Recommend approval for all management incentive plans, including stock options, to the Board of Directors, and approve new change-in-control or special retention plans.

- Approve bonus criteria, incentives, including stock options and payouts for employee-directors.

General Compensation Philosophy. The Compensation Committee s general philosophy has been, and continues to be, providing a compensation package to attract and retain the most highly qualified executive officers while providing incentives to create stockholder value. To accomplish this objective, the Compensation Committee varies total cash compensation based on the Company s performance in achieving the financial and non-financial objectives, and aligns long-term incentive compensation closely with the stockholder s interests. However, the Compensation Committee believes that it will continue to be constrained by competitive factors as there continues to be demand from competing businesses to attract and retain management talent of the type the Company desires to recruit.

The Compensation Committee believes as a general matter, but particularly with respect to senior executive officers, that the most effective method of compensation, and the method that most closely aligns management s interest with those of the Company s stockholders, is long-term compensation tied to the creation of stockholder value. Thus, it has been the Company s policy where feasible and consistent with competitive market conditions, and unless otherwise obligated by contract, to attempt to limit base cash compensation while providing incentives for management to increase stockholder value. The Company hopes to achieve this goal of focusing on long-term compensation through the use of stock options and, where appropriate, restricted stock and restricted stock units. The Compensation Committee believes this compensation philosophy has the greatest probability of achieving significant returns to stockholders.

Pearl Meyer & Partners, a Clark Consulting Practice, has also been retained to advise the Compensation Committee on matters relating to executive compensation. Pearl Meyer & Partners was engaged by and reports directly to the Compensation Committee.

Base Salaries. Base salary levels are the fixed portion of an executive s compensation package. The Compensation Committee annually reviews and determines the base salaries of members of senior management, except as limited by contractual obligation. Where adjustable, salary levels reflect a combination of factors, including competitive pay levels, the executive s experience and tenure, and the Company s overall annual budget for merit increases and the executive s individual performance. In each case, the Compensation Committee takes into account the results achieved by the executive, his or her future potential, scope of responsibilities and experience, and competitive salary practices. However, the Company s compensation formulas for certain executives salaries during the fiscal year ended June 30, 2005, were largely determined based on pre-existing contractual arrangements in place from the previous fiscal periods.

Bonuses. Annual performance bonuses are tied to the Company s overall performance, as well as the performance of each executive and of his or her area of responsibility. The Compensation Committee sets certain financial and operational objectives that are designed to promote key Company initiatives, such as achievement of specific strategic, operational or financial tasks or targets, including Business Unit performance, operating income and EPS, which the Board of Directors believes will result in increases in stockholder value. As a result of the Company s performance on many of these metrics during fiscal year

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2005, the Company did not pay any cash bonuses for the fiscal year ended June 30, 2005, other than as contractually obligated with respect to one executive officer and bonuses paid to two executive officers early in fiscal 2005 in connection with a transaction occurring in fiscal 2004.

Long-Term Compensation. Long-term compensation is provided by stock options and, from time to time when appropriate, restricted stock or restricted stock units. The Compensation Committee believes that long-term compensation tied to stockholder value should constitute a significant portion of an executive s compensation as options are intended to provide long-term compensation specifically tied to increases in the price of the Company s common stock. Options are granted at the market price of the Company s common stock on the date of grant, and provide compensation only to the extent the market price of the common stock increases between the date of grant and the date the option is exercised. Restricted stock and restricted stock units also tie compensation to the long term appreciation of the Company s common stock by restricting the holders ability to receive and/or dispose of the related shares of common stock.

The total number of options granted in each year, which may vary, is tied to a number of factors including, but not limited to, overall Company performance, individual performance of the executive, and competitive and retention considerations.

The Compensation Committee continues to review its overall long-term incentive structure in light of the shifting competitive and regulatory environment. The Compensation Committee, with input from senior management and outside consultants, may decide to make changes to the long-term compensation program in the future.

401(k) Plan. The Company offers a 401(k) plan. Employees are eligible to participate after completion of six months of service. Employees may defer from 1% to 25% of eligible earnings up to the IRS maximum of $14,000 for 2005. Participating employees who have attained age 50 are allowed to contribute an extra $3,000 in the 401(k) plan as catch-up contributions. Employee contributions are 100% vested. Participants hired before November 1, 2001, are 100% vested in both employee and employer contributions. For participants hired on or after November 1, 2001, employer-matching contributions become vested based on a five-year vesting schedule, to vest 20% per year, for each year of service. The Company, on a discretionary basis, may make matching contributions at the end of each quarter. Matching contributions may be made each pay period in lieu of each quarter. The current match is 50% of the participant s contribution up to 6% of employee compensation. Bally Technologies, Inc. may make a discretionary Profit Sharing contribution to the 401(k) plan each year.

Chief Executive Officer Compensation. Effective as of September 30, 2004, Mr. Miodunski resigned as President and Chief Executive Officer of the Company, at which time Mr. Haddrill assumed responsibility for both positions. On June 30, 2004, Mr. Haddrill and the Company entered into an Employment Agreement (the Haddrill Agreement) pursuant to which Mr. Haddrill began serving as the Company s Chief Executive Officer as of October 1, 2004. Mr. Haddrill s annual salary as President and Chief Executive Officer is $980,000, as provided for in the Haddrill Agreement. Mr. Haddrill s contract does not provide for an annual cash bonus; therefore, Mr. Haddrill did not receive a cash bonus for fiscal year 2005. Additionally, during fiscal year 2005 Mr. Haddrill was awarded a stock option grant covering 430,000 shares of common stock which vest as set forth under Option/SAR Grants in Last Fiscal Year. Of the 430,000 shares, vesting of 95,000 was accelerated as described below under Acceleration of Option Vesting. Mr. Haddrill was also granted $1,900,000 in restricted stock during fiscal year 2005 pursuant to the Haddrill Agreement which vest on October 1, 2010; provided, however, that the vesting will be accelerated to 50% of the total award on each of October 1, 2005, and October 1, 2006, if the Company attains certain strategic and/or financial measures, which are to be mutually agreed to by the Board of Directors and Mr. Haddrill. Measures established for the first 50% addressed the near-term and longer-term strategic positioning of the Company s technology platforms, game content and human and financial

assets. The Board of Directors has determined that Mr. Haddrill achieved these objectives, and the first 50% have accordingly accelerated as of October 1, 2005.

Pursuant to his employment agreement and his Separation and Consulting Agreement, Mr. Miodunski received a salary of $250,000 during fiscal year 2005 through December 31, 2004, including the three months of fiscal year 2005 that he served as President and Chief Executive Officer. Mr. Miodunski did not receive a bonus for fiscal year 2005 in respect of his service as President and Chief Executive Officer; however, pursuant to the terms of his Separation and Consulting Agreement, Mr. Miodunski received a bonus of $1,000,000 for the successful sale of United Coin on June 30, 2004, $500,000 of which was paid in July 2004 and $500,000 of which is payable in twenty-four monthly installments beginning January 1, 2005. In addition, pursuant to the Separation and Consulting Agreement, Mr. Miodunski will receive $250,000 annually for services as a consultant to the Board of Directors for four years.

Acceleration of Option Vesting. On June 13, 2005, the Board of Directors approved a resolution accelerating the vesting and exerciseability of all outstanding, unvested stock options granted to employees with an exercise price equal to or greater than $15.00 per share. This accelerated vesting will affect options for approximately 2,400,000 shares of the Company s common stock, including an aggregate of 500,000 options held by Mr. Haddrill. All performance-based vesting criteria were also eliminated with respect to the 500,000 options held by Mr. Haddrill. In order to prevent unintended personal benefits to individuals resulting from the accelerated vesting of options, sales of the shares of the Company s common stock acquired upon exercise of any such options referenced above will be restricted in a manner such that the sales restrictions parallel the vesting requirements previously applicable to such options. The decision to accelerate vesting of these underwater stock options was made primarily to avoid recognizing compensation expense in the Company s future income statements upon the Company s adoption of SFAS No. 123R effective on July 1, 2005. Because the option subject to the acceleration of vesting were underwater , the Company believes that these options may not be offering a sufficient incentive to employees when compared to the potential future compensation expense that the Company would incur under SFAS 123R.

Deductibility of Compensation Under Internal Revenue Code Section 162(m). Section 162(m) of the Internal Revenue Code of 1986, as amended (the Tax Code) places a limit of $1,000,000 on the amount of compensation that Alliance may deduct in any one year with respect to its CEO and each of the next four most highly compensated executive officers. If the Company were to seek and obtain approval from stockholders for certain performance-based compensation, then such compensation would not be subject to the deduction limitation.

Respectfully submitted,
COMPENSATION COMMITTEE
Kevin Verner, Chairman
Jacques André
David Robbins

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Summary Compensation Table*

The following table sets forth the compensation paid or to be paid by the Company to its chief executive officer, former chief executive officer and the four other most highly compensated executive officers receiving over $100,000 per year (collectively, the Named Executive Officers) for services rendered in all capacities to the Company during the fiscal year ended June 30, 2005, 2004 and 2003.

		Annual Compensation		Long-Term Compensation		
Name & Principal Position	**Fiscal Year Ended June 30,**	**Salary**	**Bonus**	**Restricted Stock Awards(1)**	**Securities Underlying Options(2)**	**All Other Compensation(3)**
Richard Haddrill(4)	2005	$ 701,077	$	$ 2,073,718 (5)	430,000	$ 342,970 (6)
President and Chief	2004			6,498,835 (7)	600,000	60,000 (6)
Executive Officer	2003				50,000	10,000 (6)
Steven Des Champs	2005	240,000	20,000		100,000	7,634
Sr. Vice President, Chief	2004	237,308	116,000		25,000	5,996
Accounting and Chief Financial Officer	2003	237,308	192,500		22,500	5,387
Robert Saxton	2005	370,000			50,000	9,108
Executive Vice President	2004	357,307	279,240		50,000	6,328
and Treasurer	2003	333,000	350,000		50,000	5,700
Mark Lerner	2005	235,000	20,000		25,000	9,106
Sr. Vice President and	2004	232,308	94,000		25,000	6,307
General Counsel	2003	223,650	168,750		22,500	5,250
Robert Luciano	2005	250,000	50,000		600,000	
Chief Technology Officer	2004	57,692	49,500 (9)			
Robert Miodunski(8)	2005	250,000	500,000			284,290 (9)
Former Chief Executive	2004	478,846	465,000		100,000	6,375
Officer	2003	450,000	522,000		100,000	5,500

* As used in the tables provided under the caption Executive Compensation, the character is used to represent zero.

(1) Constitutes grants of Restricted Stock Units (RSUs). Per the requirements of Regulation S-K item 402(b)(2)(iv)(A), dollar value calculated by multiplying the closing market price of our common stock on the date of grant by the number of shares awarded. The closing price of our common stock on December 22, 2004 and June 30, 2004, the dates of grant, were $13.25 and $17.16, respectively. See footnotes 5 and 7 below grading the terms of the RSU grants.

(2) All grants made pursuant to the Company s Amended and Restated 2001 Long Term Incentive Plan.

(3) Unless indicated otherwise, All Other Compensation represents contributions made by the Company to the Company s 401(k) Plan.

(4) Mr. Haddrill began serving as the Company s President and Chief Executive Officer on October 1, 2004.

(5) On December 22, 2004, the Company issued to Mr. Haddrill 156,507 RSUs. The number of RSUs granted was determined by dividing $1,900,000 by the average per share closing price of our common stock on the NYSE for the 20 business days prior to the date of grant. The 156,507 RSUs had an aggregate value of $2,194,228.14 on June 30, 2005, based on the per share closing price of our common stock on the NYSE of $14.02. In accordance with the Haddrill Agreement, the vesting of

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50% of the award was accelerated to October 1, 2005, as a result of the Board of Director s determination that the Company achieved certain strategic and/or financial objectives for the nine month period ending on October 1, 2005 (see Chief Executive Officer Compensation above). In addition, the vesting of the remaining 50% is subject to acceleration as of October 1, 2006. Vested RSUs represents Mr. Haddrill s right to receive an equivalent number of shares of our common stock as follows: (i) 75% of the shares of common stock represented by the vested RSUs shall be issued to Mr. Haddrill (1) on the later of (a) October 1, 2007 or (b) the first date on which such payment or any portion thereof is no longer subject to the limits of Section 162(m) of the Internal Revenue Code (the Code) in which case that portion of the payment that is no longer subject to such limits shall be issued to Mr. Haddrill at the time such limits become inapplicable, or (2) in the event that Mr. Haddrill s employment with the Company is terminated prior to October 1, 2007, on the first date in which such payment or any portion thereof is no longer subject to the limits of Section 162(m) of the Code in which case that portion of the payment that is no longer subject to such limits shall be issued to Mr. Haddrill at the time such limits become inapplicable, and (ii) 25% of the shares of common stock represented by the vested RSUs shall be issued to Mr. Haddrill (1) on the later of (a) October 1, 2008 or (b) the first date on which such payment or any portion thereof is no longer subject to the limits of Section 162(m) of the Code in which case that portion of the payment that is no longer subject to such limits shall be issued to Mr. Haddrill at the time such limits become inapplicable, or (2) in the event that Mr. Haddrill s employment with the Company is terminated prior to October 1, 2008, on the first date in which such payment or any portion thereof is no longer subject to the limits of Section 162(m) of the Code in which case that portion of the payment that is no longer subject to such limits shall be issued to Mr. Haddrill at the time such limits become inapplicable. No dividends will be paid on the RSUs unless and until the underlying shares of common stock have been issued in Mr. Haddrill s name as described above. Except as described below under Employment and Severance Arrangements Haddrill Agreement, all unvested RSUs shall be immediately forfeited if Mr. Haddrill ceases to serve as the Company s Chief Executive Officer.

(6) Amount represents $337,136 paid in moving and relocation expenses and $5,654 in contributions made by the Company to the Company s 401(k) Plan. Prior to his appointment as Chief Executive Officer, Mr. Haddrill received compensation as a board member totaling $60,000 and $10,000 for the fiscal years ended June 30, 2004 and 2003, respectively.

(7) On June 30, 2004, the Company issued to Mr. Haddrill 377,030 RSUs. The number of RSUs granted was determined by dividing $6,500,000 by the average per share closing price of our common stock on the NYSE for the 20 business days prior to the date of grant. The 377,030 RSUs had an aggregate value of $5,285,960.60 on June 30, 2005, based on the per share closing price of our common stock on the NYSE of $14.02. The RSUs vest in one-third equal installments on each of October 1, 2005, October 1, 2006 and October 1, 2007 provided that Mr. Haddrill is continuously employed by the Company as Chief Executive Officer until each such vesting date, except as otherwise provided in Mr. Haddrill s employment agreement, as described below under Employment and Severance Arrangements Haddrill Employment Agreement. Vested RSUs represents Mr. Haddrill s right to receive an equivalent number of shares of our common stock as follows: (i) 75% of the shares represented by the vested RSUs shall be issued to Mr. Haddrill (1) on the later of (a) October 1, 2007 or (b) the first date on which such payment or any portion thereof is no longer subject to the limits of section 162(m) of the Code in which case that portion of the payment that is no longer subject to such limits shall be issued to Mr. Haddrill at the time such limits become inapplicable, or (2) in the event that the Haddrill Agreement is terminated, on the first date in which such payment or any portion thereof is no longer subject to the limits of Section 162(m) of the Code in which case that portion of the payment that is no longer subject to such limits shall be issued to Mr. Haddrill at the time such limits become inapplicable, and (ii) 25% of the shares represented by the vested RSUs shall be issued to Mr. Haddrill (1) on the later of (a) October 1, 2008 or (b) the first date on which such payment or

any portion thereof is no longer subject to the limits of section 162(m) of the Code in which case that portion of the payment that is no longer subject to such limits shall be issued to Mr. Haddrill at the time such limits become inapplicable, or (2) in the event that the Haddrill Agreement is terminated, on the first date in which such payment or any portion thereof is no longer subject to the limits of Section 162(m) of the Code in which case that portion of the payment that is no longer subject to such limits shall be issued to Mr. Haddrill at the time such limits become inapplicable. No dividends will be paid on the RSUs unless and until the underlying shares of common stock have been issued in Mr. Haddrill s name. Except as described below under Employment and Severance Arrangements Haddrill Employment Agreement, all unvested RSUs shall be immediately forfeited if Mr. Haddrill ceases to serve as the Company s Chief Executive Officer.

(8) Mr. Miodunski resigned as President and Chief Executive Officer of the Company effective as of September 30, 2004, pursuant to the Separation and Consulting Agreement dated as of June 30, 2004, described below under Employment and Severance Agreements Miodunski Separation and Consulting Agreement.

(9) Amount represents $250,000 paid pursuant to Mr. Miodunski s Separation and Consulting Agreement described below under Employment and Severance Agreements Miodunski Separation and Consulting Agreement, $5,769 in contributions made by the Company to the Company s 401(k) Plan, and $28,521 which was paid for accrued vacation.

Employment and Severance Arrangements

Haddrill Employment Agreement. On June 30, 2004, Mr. Haddrill and the Company entered into the Haddrill Agreement, pursuant to which Mr. Haddrill began serving as the Company s Chief Executive Officer as of October 1, 2004. The term of the Haddrill Agreement continues until October 1, 2007, unless earlier terminated or extended, as provided for in the Haddrill Agreement. Mr. Haddrill receives a base annual salary of $980,000, participation in the Company s benefit programs for corporate officers and other perquisites. If Mr. Haddrill s employment is terminated by the Company without cause or by Mr. Haddrill for good cause (as defined in the Haddrill Agreement), Mr. Haddrill will receive severance pay in an amount equal to his base salary for one year from the date of termination or until the expiration of the term of the Haddrill Agreement, whichever occurs first. Further, Mr. Haddrill shall be entitled to retain the rights granted under the RSUs, provided that the vesting of the RSUs shall be pro rated through the twelve-month period following the month in which the termination occurs, and the sales restrictions on the stock options granted pursuant to the Haddrill Agreement shall lapse as to a pro rata portion of such options through the date of termination. Upon a Change in Control of the Company, as defined in the Haddrill Agreement, Mr. Haddrill will receive a payment of $980,000 and will be entitled to retain all of the RSUs and stock options granted pursuant to the Haddrill Agreement, all of which will vest immediately upon the Change in Control, and the sale restrictions on the stock options will immediately lapse. The Haddrill Agreement also contains certain non-compete provisions.

The Haddrill Agreement was amended as of December 22, 2004. The December 22, 2004 amendment provided for, among other things, a grant of an additional 300,000 stock options and $1,900,000 in RSUs.

The Haddrill Agreement, as amended, was amended for a second time, effective as of June 13, 2005 (the Second Amendment). The Second Amendment documented the terms and conditions of the acceleration of Mr. Haddrill s stock options approved by the Board of Directors on June 13, 2005, as described below under Acceleration of Option Vesting, and clarified the terms of Mr. Haddrill s RSUs to comply with Section 409A of the Internal Revenue Code.

Miodunski Separation and Consulting Agreement. On June 30, 2004, Mr. Miodunski and the Company entered into a Separation and Consulting Agreement pursuant to which Mr. Miodunski resigned as President and Chief Executive Officer effective September 30, 2004. Pursuant to the agreement,

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Mr. Miodunski received a $1,000,000 bonus for the successful sale of United Coin, $500,000 of which was paid in July 2004 and $500,000 which is payable in twenty-four monthly installments beginning January 1, 2005. In addition, pursuant to the agreement, Mr. Miodunski will receive $250,000 annually for services as a consultant to the Board of Directors for a period of four years.

Des Champs Employment Agreement. On January 28, 2000, Mr. Des Champs and the Company entered into a letter agreement which generally provides for a base salary, which is currently set at $290,000 per year, participation in the Company s compensation programs for corporate officers, participation in the Company s cash bonus program at amounts determined by the Board of Directors and severance benefits of six months base salary if Mr. Des Champs is terminated without cause, including as a result of or subsequent to a change in control.

Lerner Employment Agreement. On August 15, 2000, Mr. Lerner and the Company entered into a letter agreement which generally provides for a base salary, which is currently set at $235,000 per year, participation in the Company s compensation programs for corporate officers, participation in the Company s cash bonus program at amounts determined by the Board of Directors and severance benefits of six months base salary if Mr. Lerner is terminated without cause, including as a result of or subsequent to a change in control.

Luciano Employment Agreement. On March 2, 2004, Mr. Luciano and the Company entered into a letter agreement which generally provides for a base salary, which is currently set at $250,000 per year, an annual bonus of $50,000, participation in Bally s Management Incentive Program (MIP) at the business unit head level in an amount determined by the Board of Directors, and if Mr. Luciano is terminated without cause, severance benefits under the MIP in an amount determined by annualizing the amount Mr. Luciano would have received in respect of the number of full months served in the fiscal year in which Mr. Luciano is terminated.

On April 13, 2005, Mr. Luciano and the Company entered into an amendment to the letter agreement providing for, among other things, the grant of 600,000 stock options on July 1, 2005. The amendment also provides that if Mr. Luciano is terminated without cause, any stock options granted to Mr. Luciano that have vested at the time of termination shall remain outstanding and exercisable until the first anniversary of the date of termination, but in no event beyond the original term of such options.

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Option/SAR Grants in Last Fiscal Year

The following table relates to options granted to the Named Executive Officers during the fiscal year ended June 30, 2005.

Name	Individual Grants Number of Securities Underlying Options /SARS Granted	% of Total Options/SARS Granted to Employees in Fiscal Year	Exercise Price	Expiration Date	Potential Realizable Value at Assumed Annual Rates of Stock Price Appreciation for Option Term(a) 5%	10%
Richard Haddrill	35,000 (b)	0.92 %	$ 14.77	6/13/15	325,108	823,886
	95,000 (c)	2.50 %	17.16	10/27/14		653,979
	300,000 (d)	7.88 %	13.35	12/22/14	2,518,723	6,382,939
Steven Des Champs	25,000 (e)	0.66 %	13.86	8/17/14	217,912	552,232
	75,000 (e)	1.97 %	11.16	1/18/15	526,385	1,333,963
Robert Saxton	50,000 (e)	1.31 %	13.86	8/17/14	435,825	1,104,464
	40,000 (f)	1.05 %	11.29	3/04/15	284,009	719,734
Mark Lerner	25,000 (e)	0.66 %	13.86	8/17/14	217,912	552,232
Robert Luciano	600,000 (g)	15.75 %	11.16	1/18/15	4,211,079	10,671,700
Robert Miodunski						

(a) Amounts shown in these columns are derived by multiplying the exercise price by the annual appreciation rates shown (compounded for the term of the options), multiplying this product by the number of shares of common stock covered by the options, and subtracting the aggregate exercise price of the options. The dollar amounts set forth under this heading are the result of calculations at the 5 percent and 10 percent rates set by the SEC, and are not intended to forecast possible future appreciation, if any, of the price of a share of common stock.

(b) On June 13, 2005 each director of the Company received a grant of 35,000 fully vested options at an exercise price of $14.77 per share of common stock.

(c) On June 13, 2005 the Company accelerated the vesting of these options such that they were fully vested as of June 13, 2005. See Employment and Severance Arrangements Haddrill Employment Agreement above and Acceleration of Option Vesting below.

(d) Options vest as follows: (i) 200,000 in one-third equal installments on each of October 1, 2005, October 1, 2006 and October 1, 2007 provided that Mr. Haddrill is continuously employed by the Company as Chief Executive Officer until each such vesting date, (ii) 100,000 on October 1, 2007 provided that Mr. Haddrill is continuously employed by the Company as Chief Executive Officer through such date, each except as otherwise provided in Mr. Haddrill s employment agreement, as described above under Employment and Severance Arrangements Haddrill Employment Agreement.

(e) Options vest in three equal installments on the first, second and third anniversaries of the date of grant.

(f) Options vest in two equal installments on the first and second anniversaries of the date of grant.

(g) Options vest in five equal installments on the first, second, third, fourth and fifth anniversaries of the date of grant.

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Aggregated Option Exercises in Last Fiscal Year and Fiscal Year-End Option Values

The following table reflects the options exercised during the fiscal year ended as of, and outstanding options held by the Named Executive Officers at, June 30, 2005:

Name	Shares Acquired on Exercise	Value Realized	Number of Unexercised Options at June 30, 2005		Value of Unexercised In-the-Money Options at June 30, 2005 (a)	
			Exercisable	Unexercisable	Exercisable	Unexercisable
Richard Haddrill			780,000	300,000	$	$ 201,000
Steven Des Champs			47,503	100,000	2,026	218,500
Robert Saxton	20,004	$ 115,073	133,335	90,000	9,000	117,200
Mark Lerner			47,503	25,000	2,026	4,000
Robert Luciano				600,000		1,716,000
Robert Miodunski			200,008		9,002	

(a) Represents the amount by which the market value of the underlying stock at June 30, 2005 ($14.02 per share) exceeds the aggregate exercise price of the options.

Acceleration of Option Vesting

On June 13, 2005, the Board of Directors approved a resolution accelerating the vesting and exerciseability of all outstanding, unvested stock options granted to employees with an exercise price equal to or greater than $15.00 per share. This accelerated vesting affected options for approximately 2,400,000 shares of the Company s common stock, including an aggregate of 500,000 options granted to Mr. Haddrill pursuant to the Haddrill Agreement. All performance-based vesting criteria were also eliminated with respect to such 500,000 options of Mr. Haddrill. Sales of the shares of common stock acquired upon exercise of any such options referenced above are restricted in a manner such that the sales restrictions parallel the vesting requirements previously applicable to such options. The decision to accelerate vesting of these underwater stock options was made primarily to avoid recognizing compensation expense in the Company s future statements of operations upon the Company s adoption of SFAS No. 123R effective on July 1, 2005. Because the options subject to the acceleration vesting were underwater , the Company believes that these options may not be offering a sufficient incentive to employees when compared to the potential future compensation expense that the Company would incur under SFAS 123R.

Directors Compensation

Arrangements with Directors. Directors of the Company who are also employees are generally not separately compensated for their services as directors. Except as set forth below under Other Arrangements with respect to Messrs. Robbins and Kirschbaum, and excluding Mr. DiCesare, each non-management director receives $50,000 per year plus $5,000 per year for each committee on which each non-management director serves, except that the chairman of each committee receives $10,000 for such committee service. Each new non-employee director receives a grant of options to purchase 50,000 shares of common stock upon appointment to the Board of Directors as well. Additionally, on June 13, 2005 each director received a fully vested option to purchase 35,000 shares of common stock at an exercise price of $14.77 per share. All options granted to directors of the Company remain outstanding for the full term, whether or not the director continues to be a director of the Company, unless the director resigns or is removed as a director before the expiration of the term the director is serving at the time of the grant, in which event the options expire 60 days after resignation or removal. Directors are also reimbursed for their reasonable out-of-pocket expenses incurred on Company business. The Company may grant both employee and non-employee directors additional cash compensation and options as time commitments, responsibilities and other circumstances may warrant.

Director s Share Ownership Guidelines. The Board adopted a formal share ownership policy and guidelines for non-management directors on October 26, 2004. The guidelines specify that each non-management director shall acquire and hold common stock valued at twice the annual base compensation paid to the director at the time of the director s appointment or election to the board. The policy further provides that purchases under the policy be made within three years of the director s appointment, election or adoption date of the policy with the director holding at least that amount of stock during the director s tenure.

On January 8, 2004, each director was granted options to purchase 195,000 shares of common stock at an exercise price of $24.65 per share. Effective June 13, 2005, the Board of Directors approved a resolution accelerating the vesting and exerciseability of all outstanding, unvested options granted to directors on January 8, 2004. All performance-based vesting criteria were also eliminated with respect to such options. Directors may not sell any of the shares of stock acquired upon exercise of these options before January 8, 2008.

Other Arrangements. Effective July 1, 2004, the Company entered into an agreement with Mr. Robbins in which he agreed to serve as the Chairman of the Board of Directors and as a member of the Office of the Chairman for a period of three and one-half years. Pursuant to this agreement Mr. Robbins receives total fees of $325,000 per year for such services.

Effective July 1, 2004, the Company entered into an agreement with Mr. Kirschbaum in which he agreed to serve as a member of the Office of the Chairman for a period of three and one-half years. Pursuant to this agreement Mr. Kirschbaum receives fees of $100,000 per year for such services.

Compensation Committee Interlocks and Insider Participation

During the fiscal year ended June 30, 2005, Messrs. André, Haddrill, Kirschbaum, Robbins and Verner served on the Compensation Committee of the Board of Directors. Effective October 27, 2005, in response to the new requirements for the Compensation Committee to consist of only independent board members, the composition of the committee was changed to be comprised of Messrs. André, Robbins and Verner. Mr. Haddrill began serving as the Company s President and Chief Executive Officer on September 30, 2004. Mr. Kirschbaum is the sole stockholder, director and officer of KIC, which, effective July 1, 2004, was party to an Advisory Services Agreement with the Company which calls for the Company to pay KIC $600,000 annually for advisory and related services for a period of three and one-half years.

Stock Performance Graph

The following graph compares the Company s cumulative total stockholder return on its common stock for the five years ending June 30, 2005, with cumulative total return, assuming reinvestment of dividends, of (i) the S&P 500, (ii) the Russell 2000 and (iii) an index of peer companies the Company believes are comparable in terms of their lines of business. The company peer group consists of IGT, Progressive Gaming International Corporation, Shuffle Master and WMS Gaming. The presentation assumes a $100 investment on June 30, 2000, the last trading day prior to the end of the Company s 2000 fiscal year. The Company has not paid any dividends during the applicable period.

Comparison of 60 Month Cumulative Return

	6/00	6/01	6/02	6/03	6/04	6/05
BYI	$ 100	$ 1,610.70	$ 2,047.58	$ 3,102.54	$ 2,815.42	$ 2,300.45
S&P 500	100	85.10	69.85	70.03	83.41	88.68
Russell 200	100	100.60	91.93	90.42	120.59	131.98
Peer group	100	230.40	186.35	329.34	513.72	410.87

ITEM 12. SECURITY OWNERSHIP OF CERTAIN BENEFICIAL OWNERS AND MANAGEMENT AND RELATED STOCKHOLDER MATTERS

Beneficial Ownership

The following table sets forth certain information as of December 6, 2005, with respect to the beneficial ownership of common stock, which constitutes our only outstanding class of voting securities, by (i) each person who, to our knowledge, beneficially owned more than 5% of the outstanding common stock, (ii) each director, (iii) the Named Executive Officers and (iv) all of our executive officers and directors as a group. Except as indicated, beneficial ownership includes the sole power to vote and to dispose of the securities in question. The mailing address for each of the beneficial owners listed below is c/o Bally Technologies, Inc., 6601 South Bermuda Road, Las Vegas, Nevada 89119, unless noted otherwise.

Beneficial Owner	Amount of Beneficial Ownership		Percent of Class	
Alfred Wilms(1)	3,832,892		7.35	%
Jacques André	363,572	(2)		*
Steve Des Champs	74,180	(3)		*
Anthony DiCesare	272,728	(4)		*
Richard Haddrill	1,152,927	(5)	2.18	%
Joel Kirschbaum	2,455,602	(6)	4.63	%
Mark Lerner	55,836	(7)		*
Robert Luciano	1,448,313	(8)	2.77	%
Robert Miodunski	200,008	(9)		*
Stephen Race	50,000	(10)		*
David Robbins	642,148	(11)	1.22	%
Robert L. Saxton	200,004	(12)		*
Kevin Verner	310,000	(13)		*
All executive officers and directors as a group	7,540,066	(14)	13.37	%

* Less than 1%

(1) Mr. Wilms mailing address is 2, St. Jansvliet, bus 6-2000 Antwerp, Belgium. Information with respect to Mr. Wilms beneficial ownership of common stock was taken from Schedule 13D dated January 6, 2004.

(2) Includes 36,428 shares of common stock owned and 327,144 shares of common stock subject to options that are currently exercisable or will become exercisable within 60 days.

(3) Includes 2,000 shares of common stock owned and 72,180 shares of common stock subject to options that are currently exercisable or will become exercisable within 60 days.

(4) Represents shares of common stock subject to options that are currently exercisable or will become exercisable within 60 days.

(5) Includes 69,000 shares of common stock owned, 203,930 restricted stock units that are currently vested or will have been vested within 60 days and 879,997 shares of common stock subject to options that are currently exercisable or will become exercisable within 60 days.

(6) Includes 1,530,390 shares of common stock owned and 925,212 shares of common stock subject to options that are currently exercisable or will become exercisable within 60 days.

(7) Represents shares of common stock subject to options that are currently exercisable or will become exercisable within 60 days.

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(8) Includes 1,328,313 shares of common stock owned and 120,000 shares of common stock subject to options that are currently exercisable or will become exercisable within 60 days.

(9) Represents shares of common stock subject to options that are currently exercisable or will become exercisable within 60 days.

(10) Represents shares of common stock subject to options that are currently exercisable or will become exercisable within 60 days.

(11) Includes 87,144 shares of common stock owned and 555,004 shares of common stock subject to options that are currently exercisable or will become exercisable within 60 days.

(12) Includes 50,004 shares of common stock owned and 150,000 shares of common stock subject to options that are currently exercisable or will become exercisable within 60 days.

(13) Includes 10,000 shares of common stock owned and 300,000 shares of common stock subject to options that are currently exercisable or will become exercisable within 60 days.

(14) Includes 4,182,357 shares of common stock subject to options that are currently exercisable or will become exercisable within 60 days.

Equity Compensation Plans

The information required by this Item 12 with respect to our equity compensation plans is set forth above under Item 5, Market for Registrant s Common Equity, Related Shareholder Matters and Issuer Purchases of Equity Securities Equity Compensation Plans.

ITEM 13. CERTAIN RELATIONSHIPS AND RELATED TRANSACTIONS

Mr. Kirschbaum, a director of the Company, is the sole stockholder, director and officer of KIC, which, effective July 1, 2004, was party to an Advisory Services Agreement with the Company which calls for the Company to pay KIC $600,000 annually for advisory and related services for a period of three and one-half years.

In December 2004, we settled the earn out related to the acquisition of SDG with the former shareholders of SDG for an aggregate amount of $40 million consisting of a one-time cash payment of $12.0 million and the issuance of $28.0 million in subordinated debt. Mr. Luciano, the Company s Chief Technology Officer, was the primary shareholder of SDG. Mr. Luciano received approximately $7.4 million in cash and $17.2 million in subordinated debt in connection with the settlement. On June 28, 2005, the Company converted an aggregate of $14.0 million in subordinated debt and accrued interest thereon into approximately 1.0 million shares of common stock. Mr. Luciano received 881,841 of the approximately 1.0 million shares of common stock The remaining $14.0 million in subordinated debt payable in connection with the settlement to the former SDG shareholders, including Mr. Luciano, is payable in annual installments through 2009. At the Company s discretion, the note principal and accrued interest thereon can be paid in cash, or can be converted into shares of the Company s common stock using the average stock price for the 20 business days prior to the delivery of such shares.

We also lease a warehouse and office facility from an entity owned by Mr. Luciano. Rental payments for the fiscal years ended June 30, 2005 and 2004 totaled $412,000 and $103,000, respectively.

ITEM 14. PRINCIPAL ACCOUNTANT FEES AND SERVICES

Fees paid to Registered Public Accounting Firm

The following table presents the aggregate fees billed by Deloitte & Touche LLP, our principal Independent Registered Public Accounting Firm, for services provided during fiscal years 2005 and 2004:

	2005	2004
Audit fees	$ 3,077,160	$ 332,400
Audit-related fees(1)	158,115	154,218
Tax fees(2)	673,523	680,147
All other fees(3)		20,600
Total Fees	$ 3,908,798	$ 1,187,365

(1) Consists primarily of fees paid for accounting and auditing consultation services, audits of the Company s employee benefits plans and services related to Sarbanes-Oxley readiness.

(2) Consists primarily of fees paid for tax compliance and preparation services and tax consultation relating to the acquisition or disposition of certain subsidiaries.

(3) Consists primarily of fees paid for consultation regarding stock compensation and other matters.

The Audit Committee reviews and approves all services to be provided by Deloitte & Touche LLP. The Audit Committee has considered the effect of non-audit services provided by Deloitte & Touche LLP on Deloitte & Touche LLP s independence, and does not believe that such independence has been impaired or otherwise compromised.

Pre-Approval Policy

Pursuant to the Audit Committee s pre-approval policies and procedures for certain audit and non-audit services, the Company s external auditor cannot be engaged to provide any audit and non-audit services to the Company unless the engagement is pre-approved by the Audit Committee in compliance with the Sarbanes-Oxley Act of 2002. The audit, audit related, tax and other fees and services described above were pre-approved by the Audit Committee for 2005 and 2004.

PART IV

ITEM 15. EXHIBITS AND FINANCIAL STATEMENT SCHEDULES

Documents filed as part of this Annual Report on Form 10-K/A:

1. Financial Statements:

- Report of Independent Registered Public Accounting Firm
- Consolidated Balance Sheets as of June 30, 2005 (restated) and 2004 (restated)
- Consolidated Statements of Operations for the Years Ended June 30, 2005 (restated), 2004 (restated) and 2003 (restated)
- Consolidated Statements of Stockholders Equity for the Years Ended June 30, 2005 (restated), 2004 (restated) and 2003 (restated)
- Consolidated Statements of Cash Flows for the Years Ended June 30, 2005 (restated), 2004 (restated) and 2003 (restated)
- Notes to consolidated financial statements

2. Financial Statement Schedules: Not applicable.

3. Exhibits:

Exhibit Number	**Description**
2.1	Amended and Restated Stock Purchase Agreement by and among Alliance Gaming Corporation, Sierra Design Group, and Robert Luciano, as Trustee for the Robert Luciano Family Trust, dated March 2, 2004, filed on March 12, 2004 as Exhibit 2.1 to the Current Report on Form 8-K of Alliance Gaming Corporation, and incorporated herein by reference.
2.2*	Amendment No. 1, dated December 30, 2004, to the Amended and Restated Stock Purchase Agreement, dated March 2, 2004, by and among Alliance Gaming Corporation, Sierra Design Group, and Robert Luciano, as Trustee for the Robert Luciano Family Trust.
2.3	Agreement and Plan of Merger by and among Alliance Gaming Corporation, APT Games, Inc., United Coin Machine Co., and Century Gaming, Inc. dated May 4, 2004, filed on July 6, 2004 as Exhibit 2.1 to the Current Report on Form 8-K of Alliance Gaming Corporation, and incorporated herein by reference.
3.1	Restated Articles of Incorporation of Alliance Gaming Corporation, as amended, filed on May 7, 2004 as Exhibit 4.6 to the Registration Statement on Form S-8 (File No. 333-115271) of Alliance Gaming Corporation, and incorporated herein by reference.
3.2*	Bylaws of Alliance Gaming Corporation.
4.1	Rights Agreement dated as of March 9, 1998 between Alliance Gaming Corporation and American Stock Transfer & Trust Company, filed on March 10, 1998 as Exhibit 1 to the Registration Statement on Form 8-A of Alliance Gaming Corporation, and incorporated herein by reference.
4.2*	First Amendment to Rights Agreement dated as of September 15, 1998 between Alliance Gaming Corporation and American Stock Transfer & Trust Company.

10.1	Loan Agreement, dated as of September 5, 2003 among Alliance Gaming Corporation, the various lenders named therein, Bank of America, N.A. as Administrative Agent, CIBC World Markets Corp., as Syndication Agent and Wells Fargo Bank, N.A., as Documentation Agent, filed On September 12, 2003 as Exhibit 99.2 to the Current Report on Form 8-K of Alliance Gaming Corporation, and incorporated herein by reference.
10.2*	Amendment No. 1 dated February 18, 2004 to Loan Agreement, dated as of September 5, 2003 among Alliance Gaming Corporation, the various lenders named therein, Bank of America, N.A. as Administrative Agent, CIBC World Markets Corp., as Syndication Agent and Wells Fargo Bank, N.A., as Documentation Agent.
10.3	Amendment No. 2 dated December 10, 2004 Loan Agreement, dated as of September 5, 2003 among Alliance Gaming Corporation, the various lenders named therein, Bank of America, N.A. as Administrative Agent, CIBC World Markets Corp., as Syndication Agent and Wells Fargo Bank, N.A., as Documentation Agent, filed on December 15, 2004 as Exhibit 10.1 to the Current Report on Form 8-K of Alliance Gaming Corporation, and incorporated by reference.
10.4	Alliance Gaming Corporation 1996 Long Term Incentive Plan, filed on August 21, 1997 with the Registration Statement on Form S-8 (File No. 333-34077) of Alliance Gaming Corporation, and incorporated herein by reference.
10.5*	Restricted Stock Agreement by and between Alliance Gaming Corporation and Richard Haddrill, dated as of June 30, 2004.
10.6*	Stock Option Agreement by and between Alliance Gaming Corporation and Richard Haddrill, dated as of June 30, 2004.
10.7*	Stock Option Agreement by and between Alliance Gaming Corporation and Richard Haddrill, dated as of October 27, 2004.
10.8	Alliance Gaming Corporation Amended and Restated 2001 Long Term Incentive Plan, filed on November 2, 2004 as Exhibit 4.1 to Post Effective Amendment No. 1 to Registration Statement on Form S-8 (File No. 333-115271) of Alliance Gaming Corporation, and incorporated herein by reference.
10.9*	Restricted Stock Agreement by and between Alliance Gaming Corporation and Richard Haddrill, dated as of December 22, 2004.
10.10	Amendment No. 1 to the Alliance Gaming Corporation Amended and Restated 2001 Long Term Incentive Plan, filed on January 15, 2005 as Exhibit 4.2 to the Registration Statement on Form S-8 (File No. 333-122064) of Alliance Gaming Corporation, and incorporated herein by reference.
10.11*	Form of Stock Option Agreement.
10.12*	Form of Director Stock Option Agreement.
10.13*	Form of Director Stock Option Agreement dated June 13, 2005.
10.14*	Casino Management Agreement, dated as of October 28, 1993, among Rainbow Casino Partnership -Vicksburg, L.P., Mississippi Ventures, Inc. and The Rainbow Casino Corporation.
10.15*	Second Amended and Restated Agreement of Limited Partnership, dated as of March 29,1995, by and between United Gaming Rainbow and The Rainbow Casino Corporation.

10.16	Amended and Restated Trademark License Agreement dated July 8, 1992, by and between Bally Gaming International, Inc. and Bally Manufacturing Corporation, filed on July 9, 1992 as Exhibit 10(i)(d) to the Registration Statement on Form S-1 (File No. 33-48347) of Bally Gaming International, Inc., and incorporated herein by reference.
10.17*	Second Amendment to Trademark License Agreement and Settlement Agreement, dated March 31, 1995, by and between Bally Entertainment Corporation and Bally Gaming International, Inc. and Bally Gaming, Inc.
10.18	Third Amendment to Trademark License Agreement and Settlement Agreement dated May 10, 1996, by and between Bally Entertainment Corporation, Alliance Gaming Corporation and BGII Acquisition Corp., filed on May 29, 1996 as Exhibit 10.77 to Amendment No. 2 to the Registration Statement on Form S-2 (File No. 333-02145) of Alliance Gaming Corporation, and incorporated herein by reference.
10.19	Agreement between Alliance Gaming Corporation and David Robbins dated July 1, 2004, filed on July 6, 2004 as Exhibit 10.3 to the Current Report on Form 8-K of Alliance Gaming Corporation, and incorporated herein by reference.
10.20	Advisory Services agreement between Alliance Gaming Corporation and Kirkland Investment Corporation dated July 1, 2004, filed on July 6, 2004 as Exhibit 10.5 to the Current Report on Form 8-K of Alliance Gaming Corporation, and incorporated herein by reference.
10.21*	Prepayment Agreement, dated as of June 28, 2005 by and among Alliance Gaming Corporation, Robert Luciano, Jr. and Robert Luciano, Jr. as trustee of the Robert Luciano Family Trust dated February 27, 1995.
10.22	Employment Agreement between Alliance Gaming Corporation and Richard Haddrill, dated as of June 30, 2004, filed on July 6, 2004 as Exhibit 10.1 to the Current Report on Form 8-K of Alliance Gaming Corporation, and incorporated herein by reference.
10.23	Amendment dated December 22, 2004, to the Employment Agreement by and between Alliance Gaming Corporation and Richard Haddrill, filed on February 9, 2005 as Exhibit 10.40 to the Quarterly Report on Form 10-Q for the quarter ended December 31, 2004, and incorporated herein by reference.
10.24*	Second Amendment to Employment Agreement by and between Alliance Gaming Corporation and Richard Haddrill, effective as of June 13, 2005.
10.25	Amended and Restated Employment Agreement, effective April 24, 2001, between Alliance Gaming Corporation and Robert L. Miodunski, filed on September 27, 2001 as Exhibit 10.30 to the Annual Report on Form 10-K for the fiscal year ended June 30, 2001, and incorporated herein by reference.
10.26	Separation and Consulting Agreement dated as of June 30, 2004 by and between Alliance Gaming Corporation and Robert L. Miodunski, filed on July 6, 2004 as Exhibit 10.2 to the Current Report on Form 8-K of Alliance Gaming Corporation, and incorporated herein by reference.
10.27*	Employment Agreement dated January 28, 2000 between Alliance Gaming Corporation and Steve Des Champs.
10.28	Employment Agreement dated August 15, 2000 between Alliance Gaming Corporation and Mark Lerner, filed on September 26, 2002 as Exhibit 10.35 to the Annual Report on Form 10-K for the fiscal year ended June 30, 2002 of Alliance Gaming Corporation, and incorporated herein by reference.

10.29*	Employment Agreement dated March 2, 2004 between Alliance Gaming Corporation and Robert Luciano.
10.30*	Amendment dated April 13, 2005 to Employment Agreement between Alliance Gaming Corporation and Robert Luciano.
10.31*	Executive Employment Agreement dated March 9, 2005 by and between Alliance Gaming Corporation and Ramesh Srinivasan.
21#	Subsidiaries of the Registrant
23.1#	Consent of Deloitte & Touche LLP, Independent Registered Public Accounting Firm
31.1#	Certification of Chief Executive Officer pursuant to Securities Exchange Act Rule 13a-14(a).
31.2#	Certification of Chief Financial Officer pursuant to Securities Exchange Act Rule 13a-14(a).
32.1#	Certification of the Chief Executive Officer pursuant to 18 U.S.C. Section 1350.
32.2#	Certification of the Chief Financial Officer pursuant to 18 U.S.C. Section 1350.

* Filed as an Exhibit of like number to the Annual Report on Form 10-K for the fiscal year ended June 30, 2005 of the Company, and incorporated herein by reference.

\# Filed herewith.

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SIGNATURES

Pursuant to the requirements of Section 13 or 15(d) of the Securities Exchange Act of 1934, the Registrant has duly caused this report to be signed on its behalf by the undersigned, thereunto duly authorized.

BALLY TECHNOLOGIES, INC. DATED: October 31, 2006

By /s/ RICHARD M. HADDRILL
Richard M. Haddrill
Chief Executive Officer
(Principal Executive Officer)

By /s/ ROBERT C. CALLER
Robert C. Caller
Executive Vice President, Chief Financial Officer and Treasurer
(Principal Financial and Accounting Officer)

Pursuant to the requirements of the Securities Exchange Act of 1934, this report has been signed below by the following persons on behalf of the Registrant and in the capacities and on the dates indicated.

Name	**Title**	**Date**
/s/ RICHARD M. HADDRILL Richard M. Haddrill	Chief Executive Officer (Principal Executive Officer), and Director	October 31, 2005
/s/ ROBERT C. CALLER Robert C. Caller	Executive Vice President, Chief Financial Officer and Treasurer (Principal Financial and Accounting Officer)	October 31, 2006
/s/ JACQUES ANDRÉ Jacques André	Director	October 31, 2006
/s/ STEPHEN RACE Stephen Race	Director	October 31, 2006
/s/ DAVID ROBBINS David Robbins	Director and Chairman of the Board	October 31, 2006
/s/ KEVIN VERNER Kevin Verner	Director	October 31, 2006

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REPORT OF INDEPENDENT REGISTERED PUBLIC ACCOUNTING FIRM

To the Board of Directors and Stockholders of Bally Technologies, Inc.:
Las Vegas, Nevada

We have audited the accompanying consolidated balance sheets of Bally Technologies, Inc. and Subsidiaries (the Company) (formerly known as Alliance Gaming Corporation) as of June 30, 2005 and 2004, and the related consolidated statements of operations, stockholders equity, and cash flows for each of the three years in the period ended June 30, 2005. These financial statements are the responsibility of the Company s management. Our responsibility is to express an opinion on these financial statements based on our audits.

We conducted our audits in accordance with the standards of the Public Company Accounting Oversight Board (United States). Those standards require that we plan and perform the audit to obtain reasonable assurance about whether the financial statements are free of material misstatement. An audit includes examining, on a test basis, evidence supporting the amounts and disclosures in the financial statements. An audit also includes assessing the accounting principles used and significant estimates made by management, as well as evaluating the overall financial statement presentation. We believe that our audits provide a reasonable basis for our opinion.

In our opinion, such consolidated financial statements present fairly, in all material respects, the financial position of Bally Technologies, Inc. and Subsidiaries as of June 30, 2005 and 2004, and the results of their operations and their cash flows for each of the three years in the period ended June 30, 2005 in conformity with accounting principles generally accepted in the United States of America.

As discussed in Note 2 to consolidated financial statements the accompanying consolidated financial statements have been restated.

We have also audited, in accordance with the standards of the Public Company Accounting Oversight Board (United States), the effectiveness of the Company s internal control over financial reporting as of June 30, 2005, based on the criteria established in Internal Control Integrated Framework issued by the Committee of Sponsoring Organizations of the Treadway Commission, and our report dated December 29, 2005 (October 30, 2006 as to the effects of the material weaknesses in connection with the Second Restatement discussed in Management s Report on Internal Control over Financial Reporting) expressed an unqualified opinion on management s assessment of the effectiveness of the Company s internal control over financial reporting and an adverse opinion on the effectiveness of the Company s internal control over financial reporting because of material weaknesses.

DELOITTE & TOUCHE LLP
Las Vegas, Nevada
December 29, 2005 (October 30, 2006 as to the effects of the restatement discussed in Note 2 under the caption Second Restatement and the last paragraph in Note 11)

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BALLY TECHNOLOGIES, INC. AND SUBSIDIARIES
CONSOLIDATED BALANCE SHEETS

	June 30, 2005 (As restated, see Note 2)	June 30, 2004 (As restated, see Note 2)
	(in 000s, except share amounts)	
ASSETS		
Current assets:		
Cash and cash equivalents	$ 33,170	$ 154,258
Restricted cash	13,421	15,590
Accounts and notes receivable, net of allowances for doubtful accounts of $10,340 and $9,035	97,679	126,212
Inventories	63,523	63,285
Deferred tax assets, net	30,884	22,571
Other current assets	33,034	33,300
Assets of discontinued operations held for sale		4,442
Total current assets	271,711	419,658
Long-term investments (restricted)	10,060	2,528
Long-term receivables , net of allowance for doubtful accounts of $11 and $12	7,450	18,132
Leased gaming equipment, net of accumulated depreciation of $42,495 and $24,903	51,850	52,813
Property, plant and equipment, net of accumulated depreciation of $40,548 and $29,123	66,811	69,160
Goodwill	161,444	127,672
Intangible assets, net of accumulated amortization of $17,356 and $11,472	49,451	57,729
Deferred tax assets, net	16,548	13,987
Other assets, net	19,609	12,248
Total assets	$ 654,934	$ 773,927
LIABILITIES AND STOCKHOLDERS EQUITY		
Current liabilities:		
Accounts payable	$ 36,807	$ 37,515
Accrued liabilities	43,838	48,900
Deferred revenue	40,962	48,030
Jackpot liabilities	13,025	12,075
Income taxes payable	1,752	5,718
Current maturities of long-term debt, including $6,006 and $1,218 owed to related parties	10,163	5,866
Liabilities of discontinued operations held for sale		4,337
Total current liabilities	146,547	162,441
Long-term debt, net of current maturities, including $13,200 and $5,218 owed to related parties	324,954	423,089
Other liabilities	6,931	6,092
Total liabilities	478,432	591,622
Minority interest	479	1,326
Stockholders equity:		
Special stock, 10,000,000 shares authorized: Series E, $100 liquidation value; 115 shares issued and outstanding	12	12
Common stock, $.10 par value; 100,000,000 shares authorized; 52,649,000 and 51,426,000 shares issued and outstanding	5,268	5,145
Treasury stock at cost, 526,000 and 513,000 shares	(665)	(501)
Deferred compensation (restricted stock units)	(6,689)	(6,500)
Additional paid-in capital	212,182	194,040
Accumulated other comprehensive income	1,219	1,524
Accumulated deficit	(35,304)	(12,741)
Total stockholders equity	176,023	180,979
Total liabilities and stockholders equity	$ 654,934	$ 773,927

See accompanying notes to consolidated financial statements.

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BALLY TECHNOLOGIES, INC. AND SUBSIDIARIES
CONSOLIDATED STATEMENTS OF OPERATIONS

	Year Ended June 30, 2005 (As restated, see Note 2)	2004 (As restated, see Note 2)	2003 (As restated, see Note 2)
	(in 000s, except per share amounts)		
Revenues:			
Gaming equipment and systems	$ 431,070	$ 424,327	$ 306,319
Casino operations	52,037	52,280	50,945
	483,107	476,607	357,264
Costs and expenses:			
Cost of gaming equipment and systems	241,486	192,751	143,933
Cost of casino operations	18,727	20,043	21,208
Selling, general and administrative	156,275	124,041	94,867
Research and development costs	43,366	36,615	19,955
Restructuring charges	3,654		
Impairment charges	3,599		
Depreciation and amortization	20,451	14,321	10,934
	487,558	387,771	290,897
Operating income (loss)	(4,451)	88,836	66,367
Other income (expense):			
Interest income	3,401	4,263	2,204
Interest expense	(18,321)	(17,934)	(25,645)
Loss on extinguishment of debt	(564)	(12,293)	
Other, net	565	(460)	413
Income (loss) from continuing operations before income taxes and minority interest	(19,370)	62,412	43,339
Income tax expense (benefit)	(5,192)	21,104	15,354
Minority interest	(3,731)	(2,309)	(2,009)
Income (loss) from continuing operations	(17,909)	38,999	25,976
Income (loss) from discontinued operations, net of income taxes	(4,654)	40,889	(17,638)
Net income (loss)	$ (22,563)	$ 79,888	$ 8,338
Basic earnings (loss) per share:			
Continuing operations	$ (0.35)	$ 0.78	$ 0.53
Discontinued operations	(0.09)	0.82	(0.36)
Total	$ (0.44)	$ 1.60	$ 0.17
Diluted earnings (loss) per share:			
Continuing operations	$ (0.35)	$ 0.76	$ 0.52
Discontinued operations	(0.09)	0.80	(0.36)
Total	$ (0.44)	$ 1.56	$ 0.16
Weighted average shares outstanding:			
Basic	51,114	50,113	49,153
Diluted	51,114	51,248	50,139

See accompanying notes to consolidated financial statements.

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BALLY TECHNOLOGIES, INC. AND SUBSIDIARIES
CONSOLIDATED STATEMENTS
OF STOCKHOLDERS EQUITY
FOR THE YEARS ENDED JUNE 30, 2005, 2004, AND 2003

	Common Stock Shares (in 000s)	Common Stock Dollars	Series E Special Stock	Treasury Stock	Deferred Compensation	Additional Paid-In Capital	Accumulated Other Comprehensive Income (loss)	Accumulated Deficit	Total Stockholders Equity
Balances at June 30, 2002, as previously reported	49,227	$ 4,927	$ 12	$ (501)	$	$ 157,866	$ (19,364)	$ (96,954)	$ 45,986
Prior period adjustment (see Note 2)								(4,013)	(4,013)
Balances at June 30, 2002 (As restated, see Note 2)	49,227	4,927	12	(501)		157,866	(19,364)	(100,967)	41,973
Net income (As restated, see Note 2)								8,338	8,338
Foreign currency translation adjustment							8,760		8,760
Reversal of foreign currency translation adjustments for Bally Wulff (see Note 4)							11,891		11,891
Total comprehensive income (As restated, see Note 2)									28,989
Shares issued upon exercise of stock options	706	69				2,487			2,556
Tax benefit of employee stock option exercises						2,914			2,914
Balances at June 30, 2003 (As restated, see Note 2)	49,933	4,996	12	(501)		163,267	1,287	(92,629)	76,432
Net income (As restated, see Note 2)								79,888	79,888
Foreign currency translation adjustment							237		237
Total comprehensive income (As restated, see Note 2)									80,125
Restricted stock units issued					(6,500)	6,500			
Restricted shares issued upon acquisition of Sierra Design Group (SDG)	662	66				11,883			11,949
Additional paid-in capital upon issuance of warrants						886			886
Shares issued upon exercise of options	831	83				7,205			7,288
Tax benefit of employee stock option Exercises						4,299			4,299
Balances at June 30, 2004 (As restated, see Note 2)	51,426	5,145	12	(501)	(6,500)	194,040	1,524	(12,741)	180,979
Net loss (As restated, see Note 2)								(22,563)	(22,563)
Foreign currency translation adjustment							(305)		(305)
Total comprehensive loss									(22,868)
Restricted stock units issued (As restated, see Note 2)					(2,314)	2,314			
Restricted stock amortization (As restated, see Note 2)					2,125				2,125
Repurchase of shares for treasury				(164)					(164)
Shares issued upon exercise of stock Options	199	21				1,097			1,118
	1,024	102				14,209			14,311

Shares issued upon the partial retirement of subordinated note									
Tax benefit of employee stock option Exercises						522			522
Balances at June 30, 2005 (As restated, see Note 2)	52,649	$ 5,268	$ 12	$ (665)	$ (6,689)	$ 212,182	$ 1,219	$ (35,304)	$ 176,023

See accompanying notes to consolidated financial statements.

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BALLY TECHNOLOGIES, INC. AND SUBSIDIARIES
CONSOLIDATED STATEMENTS OF CASH FLOWS

	Fiscal Years Ended June 30, 2005 (As restated, see Note 2) (in 000s)	2004 (As restated, see Note 2)	2003 (As restated, see Note 2)
Cash flows from operating activities:			
Net income (loss)	$ (22,563)	$ 79,888	$ 8,338
Income (loss) from discontinued operations	4,654	(40,889)	17,638
Adjustments to reconcile net income (loss) to net cash provided by operating activities:			
Depreciation and amortization	47,750	31,401	20,420
Stock-based compensation	2,125		
Tax benefit of employee stock option exercise	522	4,299	2,914
Loss on extinguishment of debt	564	12,293	
Deferred income taxes	(6,075)	19,310	13,146
Provision for losses on receivables	5,134	1,753	825
Operating activities of discontinued operations	(4,172)	2,587	6,758
Inventory and other assets write-downs	30,015		38,728
Other	3,323	1,239	884
Change in operating asset and liabilities, net of effects of business acquired:			
Purchase of appeal bond	(7,361)		
Accounts and notes receivable	32,754	(19,044)	(49,174)
Inventories	(12,278)	(8,943)	1,486
Other current assets	(179)	(4,800)	(10,359)
Accounts payable	(876)	7,382	7,278
Accrued liabilities, deferred revenue and jackpot liabilities	(21,199)	25,528	11,351
Net cash provided by operating activities	52,138	112,004	70,233
Cash flows from investing activities:			
Additions to property, plant, and equipment	(12,430)	(11,840)	(9,759)
Additions to leased gaming equipment	(40,589)	(38,109)	(21,357)
Settlement of acquisition related contingency	(12,000)		
Acquisitions, net of cash acquired		(123,495)	(11,528)
Additions to other long-term assets	(2,157)	(14,956)	(3,671)
Restricted cash and investments	116	(2,776)	(8,193)
Investing activities of discontinued operations		(16,001)	(11,975)
Proceeds from sale of net assets discontinued operations	1,911	155,212	
Net cash used in investing activities	(65,149)	(51,965)	(66,483)
Cash flows from financing activities:			
Capitalized debt issuance costs	(1,053)	(6,954)	
Premium paid on early redemption of debt		(5,399)	
Proceeds from issuance of long-term debt		350,000	
Debt extinguished in refinancing		(337,625)	
Net change in revolving credit facility	(70,000)	70,000	
Pay down of term loan due to sale of net assets of discontinued operations	(31,618)		
Reduction of long-term debt	(6,336)	(3,485)	(4,735)
Purchase of treasury shares	(164)		
Financing activities of discontinued operations		(4,186)	(2,998)
Proceeds from exercise of stock options and warrants	1,118	7,288	2,556
Net cash (used in) provided by financing activities	(108,053)	69,639	(5,177)
Effect of exchange rate changes on cash	(24)	174	286
Cash and cash equivalents:			
Increase (decrease) for year	(121,088)	129,852	(1,141)
Balance, beginning of year	154,258	24,406	25,547
Balance, end of year	$ 33,170	$ 154,258	$ 24,406

See accompanying notes to consolidated financial statements

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1. DESCRIPTION OF BUSINESS AND SUMMARY OF SIGNIFICANT ACCOUNTING PRINCIPLES

Bally Technologies, Inc. (Bally or the Company) (formerly known as Alliance Gaming Corporation), a Nevada corporation, is a diversified, worldwide gaming company that (i) designs, manufactures and distributes gaming machines and computerized monitoring systems for gaming machines and (ii) owns and operates one casino.

During fiscal years 2004 and 2005, the Company disposed of several businesses including its Nevada and Louisiana route operations, its Bally Wulff business in Germany and its Rail City Casino operation. Accordingly, these businesses have been classified as discontinued operations for all periods presented (see Note 5).

In fiscal year 2004, the Company completed the acquisitions of Crown Gaming, LTD (Crown), MindPlay LLC (MindPlay) and Sierra Design Group (SDG) (see Note 4).

Principles of presentation and consolidation

The accompanying consolidated financial statements include the accounts of Bally Technologies, Inc., and its wholly owned and partially owned, controlled subsidiaries. All significant intercompany accounts and transactions have been eliminated in consolidation.

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.

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 also consolidates certain Atlantic City progressive trusts in accordance with Financial Accounting Standards Board (FASB) Interpretation No. 46R (FIN), *Consolidation of Variable Interest Entities* (VIE s) which addresses consolidation by a business enterprise of variable interest entities that either: (1) do not have sufficient equity investment at risk to permit the entity to finance its activities without additional subordinated financial support or (2) will hold a significant variable interest in, or have significant involvement with, an existing VIE. For the fiscal year 2005, the Company consolidated $5.5 million in revenues and $6.1 million in related expenses, as well as $5.8 million total assets and liabilities, primarily consisting of restricted cash accounts and restricted investments (included in other assets in the consolidated balance sheet) and related jackpot liabilities.

Reclassifications

Certain reclassifications have been made to prior year financial statements to conform to the current year presentation. The most significant reclassification was depreciation on leased gaming equipment which has been reclassified from depreciation and amortization to cost of gaming equipment, and systems, totaling $17.1 million and $9.5 million for the fiscal years ended June 30, 2004 and 2003, respectively.

Cash and cash equivalents

Cash equivalents consist of highly liquid debt instruments purchased with an original maturity of three months or less at the date of purchase and are carried at cost, which approximates market value. Cash and cash equivalents also includes cash utilized in Casino Operations which is held in vaults, cages or change banks which totaled $2.7 million and $2.1 million at June 30, 2005 and 2004, respectively.

Restricted cash

The Company maintains jackpot reserve accounts totaling approximately $13.4 million and $15.6 million at June 30, 2005 and 2004, respectively, to ensure availability of funds to pay wide-area progressive jackpot awards, which are classified as restricted cash.

Accounts Receivable, Notes Receivable and Allowance for Doubtful Accounts

Accounts and notes receivable are stated at face amounts less an allowance for doubtful accounts. The Company evaluates its receivables and establishes the allowance for doubtful accounts based on a combination of factors including but not limited to customer circumstances, credit conditions and a history of write-offs and collections. The Company s receivables are considered past due if payments have not been received within agreed upon invoice terms. With regard to notes receivable, interest income is recognized ratably over the life of the note receivable.

Inventories

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

	As of June 30, 2005	**2004**
	(in 000s)	
Raw materials	$ 15,975	$ 26,963
Work-in-process	5,690	3,324
Finished goods	41,858	32,998
Total	$ 63,523	$ 63,285

The Company recorded inventory write-downs totaling approximately $26.4 million during the year ended June 30, 2005. These charges are classified in cost of gaming equipment and systems in the consolidated statements of operations.

Restricted long-term investments

The Company purchases U.S. Treasury Strip Securities for the benefit of jackpot winners who elect to receive annual or weekly installment payments. These securities are held to maturity and recorded at cost plus interest accretion to date in accordance with FASB Statement of Financial Accounting Standards (SFAS) No. 115, *Accounting for Certain Investments in Debt and Equity Securities.* Such securities are included in restricted long-term investments in the consolidated balance sheets, and totaled $10.1 million and $2.5 million as of June 30, 2005 and 2004, respectively.

Other current assets

Deferred costs are charged to cost of gaming equipment and systems when the related deferred revenue is recognized. Prepaid and deferred royalties consist mainly of royalty and license fees paid for the use of third party trade names, celebrity likenesses, content, and other intellectual property rights. Royalties are expensed to cost of gaming equipment and systems over the estimated period of expected consumption based on forecasted sales and placement schedules ranging from one to five years. If a pattern cannot be reliably determined, such costs are expensed using the straight-line method over the contract life. The

Company also evaluates the realization of capitalized amounts and any portions deemed unrealizable are charged to cost of gaming equipment and systems (see Note 8).

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 to 40 years; gaming equipment, 4 to 7 years; furniture, fixtures and equipment, 3 to 7 years; and leasehold improvements, 5 to 10 years. Leased gaming equipment is stated at cost and depreciated over its estimated useful life ranging from 2 to 4 years. In the June 30, 2005 fiscal year, the Company evaluated the useful life of its leased games and reduced the lives on all games to two years and recorded the change in estimate prospectively.

Property, plant and equipment and leased gaming equipment consist of the following:

	2005 (in 000s)	2004
Land and land improvements	$ 19,335	$ 19,086
Buildings and leasehold improvements	34,710	29,937
Gaming equipment	29,421	28,439
Furniture, fixtures and equipment	23,893	20,821
Less accumulated depreciation	(40,548)	(29,123)
Property, plant and equipment, net	$ 66,811	$ 69,160
Leased gaming equipment	$ 94,345	$ 77,716
Less accumulated depreciation	(42,495)	(24,903)
Leased gaming equipment, net	$ 51,850	$ 52,813

Depreciation and Amortization Expense

For the fiscal years ended June 30, 2005, 2004 and 2003, depreciation and amortization expense totaled $47.8 million, $31.4 million and $20.4 million, respectively. Of these amounts, $27.3 million, $17.1 million and $9.5 million of depreciation and amortization expense were classified as cost of gaming equipment and systems in the consolidated statements of operations.

Impairment of Long-Lived Assets

The Company reviews long-lived assets for impairment whenever events or changes in circumstances indicate that the carrying amount of an asset may not be recoverable. Recoverability of long-lived assets are measured by a comparison of the carrying amount of an asset to future net cash flows expected to be generated by the asset, undiscounted and without interest. If such assets are considered to be impaired, the impairment to be recognized is measured by the amount by which the carrying amount of the assets exceeds the fair value of the assets. For assets held for sale, the Company carries such assets at fair value less estimated costs to sell.

In July 2001, the Company adopted SFAS 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 based on the difference between the carrying amount and the fair value of the assets.

The Company evaluates the carrying value of goodwill for impairment annually during the fourth quarter of each fiscal year 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 goodwill and is recognized as a component of income from operations.

Other Intangible Assets

Intangible assets consist primarily of acquisition-related software and trademarks, which are amortized over 3 to 13 years (see Note 7).

Jackpot Liabilities and Expenses

The Company recognizes a liability for jackpots not yet won and jackpot expense for the cost to fund jackpots in the future. Jackpots are payable either in equal installments over 20 years, or immediately in the case of instant win progressive jackpots. Winners may elect to receive a single payment for the present value of a jackpot discounted at applicable interest rates in lieu of annual installments. Interest rates eligible for use in the single payment calculation vary by jurisdiction and are impacted by market forces and other economic conditions.

Use of Estimates

The preparation of the consolidated financial statements in conformity with generally accepted accounting principles in the United States of America requires management to make estimates and assumptions that affect the reported amounts of assets and liabilities and disclosure of contingent assets and liabilities at the date of the consolidated financial statements and the reported amounts of revenues and expenses during the reporting period. Actual results could differ from those estimates.

Revenue recognition

The Company derives revenues from the following sources: 1) sale of gaming machines (Gaming Equipment), 2) sales of computerized monitoring systems and related recurring hardware and software maintenance revenue (Systems), 3) operation of wide-area progressive systems, and lease of gaming machines (Gaming Operations revenue) and 4) Casino Operations.

Gaming and systems revenue is recognized in accordance with the provisions of SOP No. 97-2, as amended, and is recognized when all of the following have been satisfied:

- Persuasive evidence of an arrangement exists;
- Delivery has occurred;
- The vendors fee is fixed or determinable; and
- Collectibility is probable.

The Company sells gaming machines and computerized monitoring systems either through credit terms of 120 days or less or with credit terms that may extend up to five years under contracts of sale secured by the related equipment, with interest recognized at market rates. The Company performed a review of contracts, with extended payment terms in excess of 6 months, to determine whether there was sufficient history to conclude that the Company has a history of collecting under the original payment terms. The Company concluded that sufficient history existed for extended payment term contracts of 24 months or less. Accordingly, revenue is recorded in accordance with the terms of sale for contracts with terms of 24 months or less, or as cash is received for contracts with payment terms in excess of 24 months.

The Company also sells gaming devices under arrangements in which there are multiple elements, as that term is defined in SOP No. 97-2. Contracts may contain multiple elements such as a combination of gaming devices, central site monitoring equipment, systems software, license fees and training. The

Company allocates revenue to each element based upon its fair value as determined by vendor specific objective evidence. Vendor specific objective evidence of fair value for all elements of an arrangement is based upon the normal pricing and discounting practices for those products and services when sold separately. In addition, software license updates and product support services are measured by the renewal rate offered to the customer.

The Company recognizes revenue when the product is delivered or over the period in which the service is performed and defers revenue for any undelivered elements. Revenue in respect of product that has been held at Company controlled locations is deferred until the product is physically delivered to a customer controlled location. If the Company cannot objectively determine the fair value of any undelivered elements included in the arrangement, all revenues are deferred until all of the elements are delivered and services have been performed, or until fair value can objectively be determined for any remaining undelivered element.

The majority of the Company s software license arrangements are non-perpetual and include software license updates and product support which are recognized ratably over the term of the arrangement, typically one year. Software license updates provide customers with rights to unspecified software product upgrades, maintenance and patches released during the term of the support period. The majority of the Company s customers purchase both software and hardware maintenance and product support when they purchase the systems. In addition, substantially all customers renew these maintenance agreements annually. Revenue from multi-year licensing arrangements are accounted for as subscriptions, with billings recorded as unearned revenue and recognized as revenue ratably over the billing coverage period, generally one year.

The gaming operation division earns recurring revenue that consists of the operation of wide-area progressive jackpot systems and revenues from gaming machines placed in casinos on a daily lease or rental basis. Revenue from these sources is recognized based on the contractual terms of the participation or rental agreements and is generally based on a share of money wagered, a share of the net winnings, or on a fixed daily rental rate basis.

In accordance with industry practice, gaming revenues in our casino operations are recognized as the net win from gaming machine operations, which is the difference between coins and currency deposited into the machines and payments to customers.

Capitalized Regulatory Approval Costs

In accordance with SFAS No. 86, *Accounting for the Costs of Computer Software to be Sold, Leased, or Otherwise Marketed,* internally generated software development costs associated with new products and significant enhancements to existing software products are expensed as incurred until technological feasibility has been established.

Bally Gaming and Systems incurs significant regulatory approval costs for its products. Such costs are capitalized once technological feasibility has been established and are amortized generally over three years reflective of the estimated product life cycle. Product testing costs related to projects that are discontinued are expensed when such determination is made. Fees incurred for such regulatory approvals totaled approximately $8.9 million and $8.5 million for the fiscal years ended June 30, 2005 and 2004, respectively. Of these amounts incurred, during the fiscal years ended June 30, 2005 and 2004, the Company capitalized a total of $2.0 million and $4.8 million respectively that was directly attributable to products and amortization expense for previously capitalized amounts that totaled $0.9 million and $0.8 million respectively.

The Company has a review process which includes a full review of the costs incurred and the nature and prospects of the related product. After costs are capitalized, they are monitored to ensure that they are

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earning revenues through product sales. Future write-offs are possible if such products do not produce adequate cash flows.

Promotional allowances

The Company accounts for promotional allowances and other cash based incentives in accordance with Emerging Issues Task Force (EITF) Issue 00-22, Accounting for Points and certain other Time-Based or Volume-Based Sales Incentive Offers, and Offers For Free Products or Service to be Delivered in the Future. EITF 00-22 requires that sales incentives such as cash rewards provided to player club members be recorded as a reduction of revenue rather than as an operating expense. These incentives totaled $3.2 million, $3.8 million and $3.7 million for the years ended June 30, 2005, 2004 and 2003, respectively.

Allowances For Doubtful Accounts

Allowances for doubtful accounts are maintained at levels determined by the Company s management to adequately provide for collection losses. In determining estimated losses, the Company s management considers economic conditions, the activity in gaming markets, the financial condition of customers, changes in technology and other factors which management believes are relevant.

Advertising costs

The Company expenses advertising costs as incurred, which totaled $12.2 million, $11.3 million and $10.0 million for the fiscal years ended June 30, 2005, 2004 and 2003, respectively.

Warranty expense

Gaming devices are typically sold with a 90-day parts and labor warranty. For system sales, the Company provides several after-sales, value-added services to customers including customer education programs, a 24-hour customer service telephone hot-line, an Internet web site for technical support, field service support programs, and spare parts programs. Historical warranty expense as a percentage of Gaming and Systems segment revenues has been less than 1%, and is charged to cost of sales. Warranty expense is calculated using historical statistical data, and totaled $1.0 million, $1.7 million and $0.9 million for the fiscal years ended June 30, 2005, 2004 and 2003, respectively.

The activity in the accrued warranty account, which is included in accrued liabilities on the balance sheet, is as follows:

	2005 (in 000s)	2004
Balance at beginning of year	$ 508	$ 344
Warranty costs incurred	(813)	(2,319)
Accrual for new warranties issued	794	2,483
Balance at end of year	$ 489	$ 508

Research and development

Research and development costs are charged to expense as incurred.

Deferred Revenue

Deferred revenue consists of amounts collected or billed in excess of recognizable revenue (see Note 9).

Foreign currency translation

The functional currency of the Company s foreign subsidiaries is their local currency. Assets and liabilities of foreign operations are translated into U.S. dollars at the rate of exchange at the end of the period, and the income and expense accounts are translated at the average rate of exchange for the period. Translation adjustments are reflected as a separate component of stockholders equity. Gains and losses on foreign currency transactions are included in the accompanying consolidated statements of operations.

Fair value of financial instruments

The fair value of a financial instrument is the amount at which the instrument could be exchanged in a current transaction between willing parties, other than in a forced sale or liquidation. The carrying amounts reflected in the accompanying consolidated balance sheets for cash equivalents, receivables, investment to fund jackpot liabilities, accounts payable, jackpot liabilities, accrued liabilities and variable rate long-term debt approximate their respective fair values.

Income taxes

Income taxes are accounted for under the asset and liability method. Deferred tax assets and liabilities are recognized for the future tax consequences attributable to differences between the financial statement carrying amounts of assets and liabilities and their respective tax bases. Deferred tax assets and liabilities are measured using enacted tax rates expected to apply to taxable income in the years in which those temporary differences are expected to be recovered or settled. The effect on deferred tax assets and liabilities of a change in tax rates is recognized in the period that includes the enactment date. Taxes on income of the Company s foreign subsidiaries are provided at the tax rates applicable to the tax jurisdictions in which they are located.

Stock-based compensation

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 No. 25). Under APB No. 25, since 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. The Company recognizes compensation expense for the amortization of certain restricted stock units.

In accordance with SFAS No. 123, *Accounting for Stock-Based Compensation* (SFAS No. 123), the Company has continued to account for employee stock-based compensation under APB No. 25, and discloses historical pro-forma net income (loss) and earnings (loss) per share that would have resulted from the use of the fair value method.

Under the fair value method, compensation costs are measured using an options pricing model and are amortized over the estimated life of the option, which is generally three to five years, with option forfeitures accounted for at the time of the forfeiture, and all amounts are reflected net of tax. The following table presents the Company s reported historical net income (loss) which includes the amortization of restricted stock units (see Note 13), adjusted for the pro forma effect assuming an after-tax charge for stock-based compensation:

	Year Ended June 30,		
	2005	**2004**	**2003**
	(in 000s, except per share data)		
Reported net income (loss)	$ (22,563)	$ 79,888	$ 8,338
Reported stock-based compensation, net of tax	1,615		
Pro forma stock-based compensation, net of tax	(25,147)	(5,377)	(3,384)
Pro forma net income (loss)	$ (46,095)	$ 74,511	$ 4,954
Earnings (loss) per share:			
Basic as reported	$ (0.44)	$ 1.60	$ 0.17
Basic pro forma	$ (0.90)	$ 1.49	$ 0.10
Diluted as reported	$ (0.44)	$ 1.56	$ 0.16
Diluted pro forma	$ (0.90)	$ 1.45	$ 0.10

On June 13, 2005, the Company accelerated the vesting of unvested stock options held by the Company s employees, officers and directors with an exercise price of $15.00 or higher. This accelerated vesting affected options for approximately 2.4 million shares of the Company s common stock and resulted in a pro forma after tax effect of $13.4 million, which is reflected in the table above for fiscal year 2005. The Company imposed sales restrictions on shares acquired upon exercise of these options that parallel the vesting requirements of the original options.

SFAS No. 123R was effective beginning with the Company s quarter ended September 30, 2005, which will require all share-based payments to Company employees, including grants of employee stock options, to be recognized in the Company s financial statements based on their fair values.

Recently issued accounting pronouncements

In March 2005, the SEC issued SAB No. 107, to provide interpretive guidance on SFAS No. 123R valuation methods, assumptions used in valuation models, and the interaction of SFAS No. 123 with existing SEC guidance. SAB No. 107 also requires the classification of stock compensation expense in the same financial statement line as cash compensation, and will therefore impact cost of gaming equipment and systems, casino operations (and related gross profits and margins), research and development costs, and selling, general and administrative expenses. The Company estimates that the expensing of stock options will reduce the net income for the fiscal year 2006 by approximately $4.1 million (or $0.08 per share) for the unvested options outstanding as of June 30, 2005. This amount excludes the accelerated vesting of approximately 2.4 million options in June 2005 (see Note 1 to consolidated financial statements).

In December 2004, the FASB issued FASB Staff Position (FSP) No. 109-1, *Application of SFAS No. 109, Accounting for Income Taxes, to the Tax Deduction on Qualified Production Activities provided by the American Jobs Creation Act of 2004* (FSP No. 109-1). FSP No. 109-1 states that the qualified production activities deduction should be accounted for as a special deduction in accordance with SFAS No. 109. This statement was effective upon issuance. The adoption of this statement had no material impact on the Company s results of operations, financial position or cash flows.

In December 2004, the FASB issued FSP No. 109-2, *Accounting and Disclosure Guidance for the Foreign Earnings Repatriation Provision within the American Jobs Creation Act of 2004* (FSP No. 109-2). FSP No. 109-2 allows enterprises time beyond the financial reporting period of enactment to evaluate the effect of the Act on its plan for reinvestment or repatriation of foreign earnings for purposes of applying SFAS No. 109. This statement was effective upon issuance. The adoption of this statement had no material impact on the results of operations, financial position or cash flows.

In December 2004, the FASB issued SFAS No. 123R that focuses primarily on accounting for transactions in which an entity obtains employee services in share-based payment transactions. Beginning with the quarterly period that begins July 1, 2005, the Company will be required to expense the fair value of employee stock options and similar awards. Because the recording of non-cash stock option expense involves equity-based compensation transactions, the adoption of this statement will have no effect on the Company s cash position.

In November 2004, the FASB issued SFAS No. 151 revising Accounting Research Bulletin (ARB) No. 43, Chapter 4, which clarifies the accounting for abnormal amounts of idle facility expense, freight, handling costs, wasted material (spoilage). This statement is effective for inventory costs incurred during fiscal years beginning after June 15, 2005. The Company does not believe this accounting pronouncement will have a material impact on its financial condition or results of operations.

In December 2004, the FASB issued SFAS No. 153, *Exchanges of Nonmonetary Assets* (SFAS No. 153), amending APB Opinion No. 29. APB Opinion No. 29 treated nonmonetary exchanges of similar productive assets as an exception from fair value measurement. SFAS No. 153 replaces this exception with a general exception from fair value measurement for exchanges of nonmonetary assets that do not have commercial substance. Nonmonetary exchanges have commercial substance if the future cash flows of an entity are expected to change significantly as a result of the exchange. This statement is effective for nonmonetary asset exchanges occurring in fiscal periods beginning after June 15, 2005. The Company anticipates no material impact on the Company s results of operations, financial position or cash flows as a result of adopting this statement.

2. RESTATEMENT OF PREVIOUSLY ISSUED FINANCIAL STATEMENTS

First Restatement

In connection with the year-end closing process for the year ended June 30, 2005, the Company identified accounting errors that required adjustment to the Company s originally issued consolidated financial statements as of June 30, 2004 and for the fiscal years ended June 30, 2004 and 2003 (the First Restatement).

These errors related primarily to revenue recognition, accounting for inventory costs and other miscellaneous items as discussed below.

Revenue Recognition

The Company identified instances where the timing or amount of revenue recognized was not in accordance with SOP No. 97-2. The Company determined that certain requirements of SOP No. 97-2 were not met in a number of instances and therefore, revenue with respect to certain transactions was recognized prematurely. In accounting for these transactions, the Company has determined that it (1) should have deferred the revenue and related cost of sales, (2) should have reflected certain goods shipped as consigned inventory until later periods and (3) should not have recognized certain accounts receivable until later periods.

The specific circumstances which resulted in adjustments are as follows:

Persuasive evidence of an arrangement exists

The Company identified one transaction for which $5.7 million in revenue was recognized in the fiscal quarter ended December 31, 2004 at the time the games were shipped to a customer based on a signed sales-type lease agreement. Subsequently, the customer negotiated a fixed price payment with a cash discount and other concessions. These facts and circumstances called into question whether the original agreement provided adequate evidence of an arrangement that was sufficiently definitive to support recognition of revenue in December 2004. The Company has concluded that there was not persuasive evidence of an arrangement at that time, and therefore the revenue should have been deferred until the cash was received in July 2005.

Delivery has occurred

The Company identified instances in which revenue was recognized for sales at the time the product was shipped to customers when the shipping terms stated or implied that risk of loss and/or title did not transfer until the goods were delivered to the customer s location. In such circumstances, recognition of revenue should have been deferred until the time the products reached the customer s location and therefore the revenue that had previously been recorded in connection with these transactions was adjusted to be recorded in subsequent accounting periods when the delivery criteria was met. The net effect of these adjustments reduced revenue by $(12.1) million and $(0.4) million for the fiscal years ended June 30, 2004 and 2003, respectively

The Company also identified instances in the Systems division where certain standard sales agreements contained contractual terms creating a non-perpetual software license rather than a perpetual license. The Company determined that in such circumstances, revenue for non-perpetual software licenses should not have been recognized as of the acceptance date, but rather should have been deferred and recognized ratably over the twelve-month period from the date of acceptance, rather than in full as of the acceptance date and therefore the revenue that had previously been recorded in connection with these transactions was adjusted to be recorded in the appropriate periods. The net effect of these adjustments was to defer revenue and record it over a twelve-month period for such contracts reduced revenues by $(6.0) million and $(4.1) million for the fiscal year ended June 30, 2004 and 2003, respectively.

The vendors fee is fixed or determinable and collectibility is probable

The use of extended payment terms in a software licensing arrangement may indicate that the fee is not fixed or determinable and collectibility is not probable. The Company identified instances where revenue was recorded upon delivery of both systems and gaming products to customers under contracts that contained payment terms in excess of 24 months. At the time the sales were recorded the Company did not have sufficient historical evidence of collections made under extended contracts with terms beyond 24 months, as required under SOP No. 97-2, and therefore should not have concluded that collectibility was probable. The Company has concluded it should have deferred revenue on all contracts with extended payment terms in excess of 24 months, and recorded revenue upon receipt of payment from the customer and therefore the revenue that had previously been recorded in connection with these transactions was adjusted to be recorded in subsequent accounting periods when payment was received. The net effect of these adjustments increased (decreased) revenues by $15.0 million and $(19.8) million for the fiscal years ended June 30, 2004 and 2003, respectively.

In addition, the Company identified instances in which revenue was recognized at the time product was shipped to customers who either were thinly capitalized or were new customers to the Company for which creditworthiness was not sufficiently established. Pursuant to SOP No. 97-2 collectibility must be determined to be probable at the time of delivery in order for revenue to be recognized, and therefore, in such circumstances recognition of revenue should have been deferred until payment from the customer was received. Therefore revenue that had previously been recorded for these transactions was adjusted to be recorded in subsequent periods when payment was received. The net effect of these adjustments reduced revenue by $(6.6) million for the year ended June 30, 2004.

Inventory

In certain circumstances, standard versus actual raw material variances were recorded in cost of sales rather than as adjustments to inventory and fixed assets. As a result, adjustments have been made to adjust the standard costs to actual costs, resulting in corrections to the carrying value of certain finished goods and fixed assets and related cost of sales and depreciation expense. The net effect of these adjustments increased cost of goods sold by $0.7 million and $0.6 million for the fiscal years ended June 30, 2004 and 2003, respectively.

Other Miscellaneous Adjustments

The Company identified additional net deferred tax assets totaling $9.3 million that were not recorded in the original purchase accounting for an acquisition completed in fiscal year 2004. In addition, the Company determined that it should have established valuation allowances against certain deferred tax assets that were recorded in connection with acquisitions in fiscal year 2004. The adjustments increased the Company s net deferred tax assets as of June 30, 2004 by approximately $8.3 million, with a corresponding decrease in goodwill. The Company also recorded other purchase accounting adjustments, resulting in a net reduction in goodwill as of June 30, 2004 of approximately $1.0 million.

The Company recorded an adjustment to change the classification of certificates of deposit with maturities beyond 90 days when purchased from cash and cash equivalents to other current assets, totaling $3.1 million as of June 30, 2004, and an adjustment to change the classification of certain jackpot reserve cash accounts from cash and cash equivalents to restricted cash totaling $15.6 million as of June 30, 2004.

The Company also determined that it should have presented the cash flows from discontinued operations within the respective categories of operating, investing and financing activities in its statements of cash flows, rather than as one separate line item. The statements of the cash flows were also adjusted for the change in the classification of the jackpot reserve cash accounts to restricted cash.

The Company also determined that certain balance sheet account reconciliations were not performed timely and therefore necessary adjustments were not identified or recorded timely. The Company has completed the account reconciliations and made the corresponding corrections to the financial statements. The net pre-tax effect of such adjustments was less than $0.1 million in each of the fiscal years ended June 30, 2004 and 2003, respectively.

Second Restatement

Subsequent to the issuance of the consolidated financial statements for the year ended June 30, 2005 management identified additional errors in the Company s previously issued consolidated financial statements as of June 30, 2005 and 2004 and for each of the three years in the period ended June 30, 2005 (the Second Restatement).

Revenue Recognition

The Company identified additional instances in which revenue was recognized on the sale of goods prior to their physical delivery to customer locations and therefore, had not met the criteria of revenue recognition. Furthermore, the Company determined that certain requirements of SOP No. 97-2 were not met in a number of instances and revenue with respect to certain transactions was not recognized in the appropriate period. In accounting for these transactions the Company has determined that it should have deferred the revenue and related cost of sales until the revenue recognition requirements of SOP 97-2 were met.

The specific circumstances which resulted in adjustments are as follows:

Persuasive evidence of an arrangement exits

The Company identified a number of transactions for which certain conditions under the terms of the original agreement were not met or for which an agreement could not be found, calling into question whether the original agreement or lack thereof, provided adequate evidence of an arrangement that was sufficiently definitive to support revenue recognition. The Company concluded there was not persuasive evidence of an arrangement and, consequently, has adjusted these transactions to be recorded on a cash basis. The net effects of these adjustments increased (decreased) revenues by $1.0 million, $(4.3) million and $0.4 million for the fiscal years ended June 30, 2005, 2004 and 2003, respectively.

Delivery has occurred

Upon review of additional documentation, it was determined that certain transactions that had previously been accounted for on a bill and hold basis, resulting in revenue recognition prior to the physical delivery of goods to the customer, did not satisfy all of the applicable bill and hold criteria under SAB No. 104. As a result, the revenue on these transactions was adjusted to coincide with the physical delivery of goods to the customer.

The Company also identified additional instances where revenue was recognized on the sale of goods prior to their physical delivery to customer locations and, therefore, the risk of loss and/or title had not passed to the customer. The Company has determined recognition of revenue should have been deferred until the time the devices reached the customer s location and has adjusted the revenue that had been recorded in connection with these transactions to be recorded in subsequent accounting periods when the devices were physically delivered to customer locations.

The net effects of these adjustments increased (decreased) revenues by $2.6 million, $3.8 million and $(4.4) million for the fiscal years ended June 30, 2005, 2004 and 2003, respectively.

Additionally, the Company identified other adjustments that impacted gaming and system revenue which decreased revenue by $(2.4) million, $(1.3) million and $(0.1) million for the fiscal years ended June 30, 2005, 2004 and 2003, respectively. The nature of these adjustments primarily related to proper recording of product returns and adjustments to deferred revenue computations.

Inventory

The Company identified additional circumstances where the calculation used to determine the standard versus actual raw material variances was in error. As a result, adjustments have been made to adjust the standard costs to actual costs, resulting in corrections to the carrying value of certain finished goods and fixed assets and related cost of sales and depreciation expense. The net effect of these adjustments increased (decreased) cost of goods sold by $(1.4) million, $(1.1) million and $0.9 million for the fiscal years ended June 30, 2005, 2004 and 2003, respectively.

Other Miscellaneous Adjustments

The Company determined that is should have recorded the value of restricted stock units based on the closing price of its common stock on the date of grant and not the average closing price for the 20 business days prior to the date of grant. An adjustment was recorded to reflect the fair market value and related stock compensation expense during the fiscal year ended June 30, 2005 based on the closing price of the Company s common stock on the respective dates of grant of the restricted stock units.

Additionally, the Company determined that interest earned on trade accounts receivable should have been recorded as interest income rather than revenue and recorded an adjustment to change the classification of these amounts to interest income totaling $2.1 million $2.0 million and $2.0 million in fiscal years 2005, 2004 and 2003, respectively.

The following is a reconciliation of income from continuing operations as previously reported, to the restated amounts, by category discussed above, net of tax:

	Year ended June 30,		
	2005	**2004**	**2003**
	(in 000s)		
Income (loss) from continuing operations, as originally reported	$ (20,317)	$ 43,625	$ 37,162
First Restatement			
Revenue recognition adjustments, net		(3,405)	(8,624)
Inventory adjustments, net		(441)	(420)
Other miscellaneous adjustments, net		(32)	(6)
Income (loss) from continuing operations, as previously restated	(20,317)	39,747	28,112
Second Restatement			
Revenue recognition adjustments, net	1,298	(1,846)	(1,408)
Inventory adjustments, net	902	706	(557)
Other miscellaneous adjustments, net	208	392	(171)
Income (loss) from continuing operations, as currently restated	$ (17,909)	$ 38,999	$ 25,976

The Restatements also resulted in a reduction of retained earnings as of June 30, 2002 of $4.0 million.

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The following is a summary of the effects of the restatements on the accompanying consolidated financial statements.

Year Ended June 30,	**2005**			**2004**				**2003**			
(in 000s, except per share data)	**As Previously Reported**	**Second Restatement**	**As Restated**	**As Originally Reported**	**First Restatement**	**Second Restatement**	**As Restated**	**As Originally Reported**	**First Restatement**	**Second Restatement**	**As Restated**
Statement of Operations											
Revenue:											
Gaming equipment & systems	$ 431,993	$ (923)	$ 431,070	$ 436,596	$ (8,468)	$ (3,801)	$ 424,327	$ 335,436	$ (23,169)	$ (5,948)	$ 306,319
Casino operations	52,037		52,037	52,280			52,280	50,945			50,945
Total revenue	484,030	(923)	483,107	488,876	(8,468)	(3,801)	476,607	386,381	(23,169)	(5,948)	357,264
Cost of gaming equipment & systems	243,730	(2,244)	241,486	177,586	15,204	(39)	192,751	144,352	373	(792)	143,933
Depreciation and amortization(1)	20,570	(119)	20,451	31,565	(17,161)	(83)	14,321	20,462	(9,512)	(16)	10,934
Selling, general & administrative expense	156,106	169	156,275	124,345	74	(378)	124,041	95,432	(722)	157	94,867
Operating income (loss)	(5,722)	1,271	(4,451)	98,722	(6,585)	(3,301)	88,836	84,972	(13,308)	(5,297)	66,367
Interest income	1,340	2,061	3,401	2,253		2,010	4,263	220		1,984	2,204
Interest expense	18,201	120	18,321	17,934			17,934	25,645			25,645
Other income (expense), net	565		565	(521)	(73)	134	(460)	180	218	15	413
Income (loss) from continuing operations before income taxes and minority interest	(22,582)	3,212	(19,370)	70,227	(6,658)	(1,157)	62,412	59,727	(13,090)	(3,298)	43,339
Income tax expense (benefit)	(6,510)	1,318	(5,192)	24,293	(2,780)	(409)	21,104	20,556	(4,040)	(1,162)	15,354
Minority interest	(4,245)	514	(3,731)	(2,309)			(2,309)	(2,009)			(2,009)
Income (loss) from continuing operations	(20,317)	2,408	(17,909)	43,625	(3,878)	(748)	38,999	37,162	(9,050)	(2,136)	25,976
Net income (loss)	(24,971)	2,408	(22,563)	84,514	(3,878)	(748)	79,888	19,523	(9,049)	(2,136)	8,338
Basic earnings (loss) per share:											
Continuing operations	$ (0.40)	$ 0.05	$ (0.35)	$ 0.87	$ (0.08)	$ (0.01)	$ 0.78	$ 0.76	$ (0.19)	$ (0.04)	$ 0.53
Discontinued operations	(0.09)		(0.09)	0.82			0.82	(0.36)			(0.36)
Total	$ (0.49)	$ 0.05	$ (0.44)	$ 1.69	$ (0.08)	$ (0.01)	$ 1.60	$ 0.40	$ (0.19)	$ (0.04)	$ 0.17
Diluted earnings (loss) per share:											
Continuing operations	$ (0.40)	$ 0.05	$ (0.35)	$ 0.85	$ (0.08)	$ (0.01)	$ 0.76	$ 0.74	$ (0.18)	$ (0.04)	$ 0.52
Discontinued operations	(0.09)		(0.09)	0.80			0.80	(0.36)			(0.36)
Total	$ (0.49)	$ 0.05	$ (0.44)	$ 1.65	$ (0.08)	$ (0.01)	$ 1.56	$ 0.38	$ (0.18)	$ (0.04)	$ 0.16

(1) Depreciation for leased gaming equipment has been reclassified to cost of gaming equipment and systems (see Note 1).

	As of June 30, 2005 As Previously Reported (in 000s)	Second Restatement	As Restated	2004 As Originally Reported	First Restatement	Second Restatement	As Restated
Balance Sheet							
Cash and cash equivalents	$ 33,170	$	$ 33,170	$ 172,726	$ (18,468)	$	$ 154,258
Restricted cash	13,421		13,421		15,590		15,590
Accounts and notes receivable, net	99,430	(1,751)	97,679	129,779	(1,462)	(2,105)	126,212
Inventories	62,920	603	63,523	61,135	2,145	5	63,285
Current deferred tax assets, net	29,192	1,692	30,884	20,054	(452)	2,969	22,571
Other current assets	27,439	5,595	33,034	12,420	16,535	4,345	33,300
Total current assets	265,572	6,139	271,711	396,114	18,330	5,214	419,658
Property, plant and equipment, net	66,036	775	66,811	68,845		315	69,160
Goodwill	161,444		161,444	136,989	(9,317)		127,672
Long-term deferred tax assets, net	16,622	(74)	16,548		14,020	(33)	13,987
Total assets	648,094	6,840	654,934	750,654	17,777	5,496	773,927
Accrued liabilities	43,239	599	43,838	49,145	(730)	485	48,900
Deferred revenue	31,293	9,669	40,962	2,324	35,311	10,395	48,030
Income taxes payable	1,752		1,752	7,233	(1,515)		5,718
Total current liabilities	136,279	10,268	146,547	118,495	33,066	10,880	162,441
Total liabilities	468,164	10,268	478,432	548,525	32,217	10,880	591,622
Minority interest	993	(514)	479	1,326			1,326
Deferred compensation (restricted stock units)	(6,563)	(126)	(6,689)	(6,500)			(6,500)
Additional paid-in capital	211,994	188	212,182	194,040			194,040
Retained earnings (accumulated deficit)	(32,328)	(2,976)	(35,304)	7,083	(14,440)	(5,384)	(12,741)
Total stockholders equity	178,937	(2,914)	176,023	200,803	(14,440)	(5,384)	180,979

	Year Ended June 30, 2005 As Previously Reported	Second Restatement	As Restated	2004 As Originally Reported	First Restatement	Second Restatement (in 000s)	As Restated	2003 As Originally Reported	First Restatement	Second Restatement	As Restated
Statement of Cash Flows											
Cash flowsfrom operating activities	52,138	-	52,138	110,261	1,743	-	112,004	38,148	32,085	-	70,233
Cash flows from investing activities	(65,149)	-	(65,149)	(32,819)	(19,146)	-	(51,965)	(46,315)	(20,168)	-	(66,483)
Cash flows from financing activities	(108,053)	-	(108,053)	73,826	(4,187)	-	69,639	(2,179)	(2,998)	-	(5,177)
Cash flows from discontinued operations	-	-	-	(17,600)	17,600	-	-	17,144	(17,144)	-	-

3. EARNINGS PER SHARE

The Company calculates earnings per share in accordance with SFAS No. 128, *Earnings Per Share*. Basic earnings per share are computed by dividing reported earnings by the weighted average number of common shares outstanding during the period. Diluted earnings per share reflect the additional dilution from all potentially dilutive securities such as stock options. For fiscal years 2004 and 2003, all outstanding options with an exercise price lower than the market price at the time of grant have been included in the calculation of diluted earnings per share. For fiscal year 2005, no outstanding options were included in the calculation of earnings per share as the effect would have been anti-dilutive due to the net loss reported.

Certain securities do not have a 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:

	Year ended June 30, 2005 (in 000s)	2004	2003
Stock options	4,738	1,498	862
Warrants	100	100	
	4,838	1,598	862

As of June 30, 2005, the Company has certain restrictive stock units and debt outstanding which is potentially convertible into common stock, the potential dilution from which have not been included in the diluted earnings per share computation due to the reported loss for fiscal year 2005.

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The following computation of basic and diluted earnings (loss) per share from continuing operations and discontinued operations and income (loss) applicable to common shares for all periods presented is as follows:

	Year ended June 30, 2005	2004	2003
	(in 000s, except per share amounts)		
Income (loss) from continuing operations	$ (17,909)	$ 38,999	$ 25,976
Income (loss) from discontinued operations	(4,654)	40,889	(17,638)
Net income (loss)	$ (22,563)	$ 79,888	$ 8,338
Weighted average common shares outstanding	51,114	50,113	49,153
Effect of dilutive securities		1,135	986
Weighted average common and dilutive shares outstanding	51,114	51,248	50,139
Earnings (loss) per basic share:			
Income (loss) from continued operations	$ (0.35)	$ 0.78	$ 0.53
Income (loss) from discontinued operations	(0.09)	0.82	(0.36)
Net income (loss)	$ (0.44)	$ 1.60	$ 0.17
Earnings (loss) per diluted share:			
Income (loss) from continued operations	$ (0.35)	$ 0.76	$ 0.52
Income (loss) from discontinued operations	(0.09)	0.80	(0.36)
Net income (loss)	$ (0.44)	$ 1.56	$ 0.16

4. BUSINESS COMBINATIONS

Under the purchase method of accounting, the total purchase price is allocated to the net tangible and intangible assets based upon their estimated fair market values as of the date of the acquisitions. The allocation of the purchase price to goodwill and intangibles is based on final valuation of net assets (including inventory and property, plant and equipment) and is based upon management s estimates, including independent third-party valuations when necessary.

SIERRA DESIGN GROUP (SDG)

On March 2, 2004, the Company purchased SDG, a supplier of Class II and Class III gaming devices, systems and technology, for aggregate initial consideration of approximately $126.4 million. The initial purchase price consisted of $108.6 million cash, 662,000 shares of common stock valued at $11.9 million, the assumption of approximately $8 million of debt and certain transaction fees and expenses. In addition, an earn out provision provided for the payment of up to $95.6 million in additional consideration upon certain financial targets being achieved in the subsequent three-year period. In December 2004, the Company and the selling shareholders renegotiated the earn out for a fixed amount of $40 million, consisting of a one-time cash payment of $12 million and the issuance of a subordinated note of $28 million. In June 2005, the Company extinguished $14 million of the note and accrued interest thereon, by issuing approximately 1.0 million shares of common stock to the note holders. The Company believes that the acquisition of SDG in March 2004 will position the Company to take advantage of significant opportunities in both the domestic and international markets, from the technology advances in traditional casino style gaming to the Class II environments with central determination features. (see Note 12).

The following intangible assets of SDG are being amortized on a straight-line basis using the following estimated lives:

	Years
Contracts	10
Core technology	8
Trademark	5

The fair values assigned to the SDG assets and liabilities acquired in fiscal year 2004 (prior to the settlement of the earn out) were as follows:

	(in 000s)
Assets:	
Cash	$ 1,189
Accounts receivable	6,949
Inventories	12,834
Deposits	1,576
Other current assets	2,233
Property, plant and equipment	22,071
Other assets	678
Deferred tax assets	16,717
Notes receivable	103
Investment in sales-type leases	8,241
Contracts	12,320
Core technology	5,445
Trademark	5,708
Goodwill(a)	55,674
Total assets acquired	151,738
Liabilities:	
Customer deposits	4,973
Accounts payable	6,110
Accrued liabilities	10,558
Notes payable	3,704
	25,345
Total Purchase Price	$ 126,393

(a) Substantially all of goodwill is non-deductible for tax purposes.

The purchase price paid for SDG consists of the following:

	(in 000s)
Cash paid to SDG stockholders	$ 29,846
Fair value of restricted common stock issued	11,949
Other consideration payable	1,350
Transaction fees and expenses	4,740
Subtotal	47,885
SDG debt owed to third parties	5,688
Pre-acquisition loans from Bally to SDG forgiven by Bally	72,820
Acquisition cost	$ 126,393

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The following unaudited pro forma financial information is presented as if the SDG acquisition had been completed at the beginning of the periods presented below:

	June 30, 2004 (in 000s, except per share amounts)	June 30, 2003
Total revenue	$ 538,226	$ 463,396
Income from continuing operations before income taxes	35,903	34,577
Income from continuing operations	23,269	19,721
Earnings per share from continuing operations		
Basic	$ 0.46	$ 0.40
Diluted	$ 0.45	$ 0.39

MINDPLAY

On February 19, 2004, the Company acquired substantially all of the assets and liabilities of MindPlay LLC (MindPlay), a leading developer of advanced table game technologies, for aggregate initial consideration of approximately $16.8 million. The initial purchase price included $9 million cash, a $4 million note payable, the assumption of approximately $2 million of debt and the issuance of warrants to purchase 100,000 shares of the Company s common stock which were valued at approximately $0.9 million. In addition, an earn out provision provided for the payment of 10% of gross margin from the sale of MindPlay products in the first seven years subsequent to the acquisition, and 4.25% of gross margin for the next six years, subject to adjustments pursuant to the conditions contained in the sale agreement. The MindPlay technologies are designed to provide data and information to casino operators to improve customer service, to provide enhanced security and to increase profitability by lowering the cost of operation and enhancing the casino patron experience. As part of the acquisition, the Company acquired a number of patents acquired, which it believes will enable it to introduce a series of new table game products that can potentially redefine the market with the advances of automation and new gaming features to attract and retain table game players.

The fair values assigned to the MindPlay assets and liabilities acquired are as follows:

	(in 000s)
Assets:	
Cash	$ 22
Accounts receivable	41
Inventories	110
Property, plant and equipment	143
Other Assets	43
Patents	9,470
Other intangible assets	1,015
Goodwill	6,414
Total assets acquired	17,258
Liabilities:	
Customer deposits	467
Total Purchase Price	$ 16,791

Intangible assets are being amortized over their estimated remaining life ranging from 3 to 15 years.

CROWN GAMING

On December 31, 2003, Bally acquired 100% of the assets of U.K.-based Crown Gaming from Crown Leisure Limited. The acquisition, which includes Crown s distributorship agreements for a wide variety of automated table games and video bingo machines, strategically builds on the Company s focus towards future growth projected in England. The total cash consideration was $3.9 million, including approximately $2.0 million that was used to repay assumed notes payable.

The fair values assigned to the Crown assets and liabilities are as follows:

	(in 000s)
Tangible Assets:	
Inventories	$ 2,064
Other assets	661
Intangible assets	659
Goodwill	335
Total assets acquired	3,719
Liabilities:	
Accounts payable	1,295
Accrued liabilities	21
Taxes payable	527
	1,843
Total Purchase Price	$ 1,876

Intangible assets are being amortized over their estimated remaining life ranging from 3 - 15 years.

5. DISCONTINUED OPERATIONS

On October 15, 2004, the Company completed the sale of its interest in Video Services, Inc. (VSI) to Churchill Downs Incorporated. The net proceeds received totaled approximately $2.0 million, resulting in a gain of $0.8 million, net of tax, and is included in discontinued operations in the statement of operations in fiscal year 2005.

On June 30, 2004, the Company completed the sale of United Coin Machine Co. (United Coin) to Century Gaming, Inc. and received approximately $100 million in cash and the assumption by Century Gaming of approximately $5 million in debt. The Company reported a gain on the sale before income taxes of $15.3 million, or $9.1 million after tax. During fiscal year 2005, the gain on sale was adjusted for charges incurred for an adverse outcome in a patent infringement case (see Note 19) and the resolution of certain sale related liabilities, the sum of which totaled $6.3 million net of tax.

On May 3, 2004, the Company completed the sale of Rail City Casino to The Sands Regent and subsequently received a total of $37.9 million in cash. The Company reported a gain on the sale before income taxes of $23.1 million, or $14.3 million after tax.

On June 30, 2003, the Company entered into a definitive agreement for the sale of Bally Wulff to a third party equity investor for $16.5 million in cash. The sale was consummated on July 18, 2003. The Company recorded a charge in June 2003 totaling $25.4 million, net of tax, representing the write down of the net carrying value of the Bally Wulff assets to the sales price, including the recognition of previously recorded currency translation adjustments totaling $11.9 million. In June 2004, the Company was notified by the buyer of a claim made against the Company pursuant to an indemnity provision contained in the sale agreement. Subsequent to June 30, 2005, the Company has paid a claim totaling $1.7 million. Additionally, the Company has a remaining accrual of $1.2 million for potential tax assessments related to the pre-sale period, which the Company expects to be resolved by June 2006. Pursuant to the sale agreement, the

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Company is required to maintain a certificate of deposit as collateral for the tax claim discussed above which is included in other long-term assets, net. As of June 30, 2005 and 2004 the amount of the deposit was approximately $1.2 million and $3.4 million, respectively. For the year ended June 30, 2005, the Company reduced the deposit by approximately $0.5 million and recognized a reduction in tax expense related to discontinued operations.

All four business results are presented net of applicable income taxes within income from discontinued operations in the accompanying consolidated statements of operations. The net assets of the businesses are classified as assets held for sale in the accompanying consolidated balance sheet as of June 30, 2004.

Summary operating results for the discontinued operations for United Coin, VSI, Rail City and Bally Wulff are as follows:

	Year ended June 30, 2005 (in 000s)	2004	2003
Net revenues	$ 4,514	$ 257,142	$ 298,739
Asset impairment charges			38,728
Operating income (loss)	358	30,668	(26,576)
Income tax expense (benefit)	(3,350)	26,319	(8,665)(a)
Income (loss) from discontinued operations	$ (4,654)(b)	$ 40,889 (c)	$ (17,638)

(a) Includes a net deferred tax benefit totaling $13.4 million, which was recorded for the sale of Bally Wulff.

(b) Includes the $6.3 million after tax charge referred to above related to the sale of United Coin, offset by the gain on sale of VSI.

(c) Includes a gain on sale of Rail City of $23.1 million and a gain on the sale of United Coin of $15.3 million.

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

	(in 000s)
Cash and cash equivalents	$ 3,543
Accounts and contracts receivable	89
Other current assets	66
Property, plant and equipment	696
Other	48
Total assets	4,442
Current liabilities	4,321
Long-term liabilities	16
Total liabilities	4,337
Net assets of discontinued operation	$ 105

6. RECEIVABLES

The Gaming Equipment and Systems business unit grants customers payment terms under contracts of sale. These contracts are generally for terms of six months to five years, with interest at prevailing rates, and are generally collateralized by the related equipment sold, although the value of such equipment, if repossessed, may be less than the receivable balance outstanding. Contracts with terms beyond 24 months are deferred and revenue is recognized as the payments are received. The total receivables outstanding as of June 30, 2005, net of bad debt allowance totaled approximately $105.1 million, substantially all of which is scheduled to be received within one year.

The following table represents the activity for each of the fiscal years ended June 30, 2005, 2004 and 2003 for each of the valuation reserve and allowance accounts:

	Balance at Beginning of Year (in 000s)	Additions	Net Write-offs/ (Recoveries)	Balance at End of Year
Allowance for doubtful accounts:				
Year ended June 30, 2005	$ 9,035	$ 5,134	$ 3,829	$ 10,340
Year ended June 30, 2004	$ 6,417	$ 1,753	$ (865)	$ 9,035
Year ended June 30, 2003	$ 8,436	$ 825	$ 2,844	$ 6,417

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7. GOODWILL AND OTHER INTANGIBLE ASSETS

In accordance with its accounting policy, during the fourth quarter of fiscal 2005, the Company evaluated the carrying value of goodwill and other intangible assets and determined that no impairment existed as of that measurement date.

Intangible assets excluding discontinued operations consist of the following:

	Wt. Avg. Useful Life (Years) (dollars in 000s)	June 30, 2005 Gross Carrying Amount	Accumulated Amortization	Net Carrying Amount	June 30, 2004 Gross Carrying Amount	Accumulated Amortization	Net Carrying Amount
Computer software	3	$ 9,021	$ (3,463)	$ 5,558	$ 8,963	$ (1,498)	$ 7,465
Computer software from acquisitions	9	11,700	(4,680)	7,020	11,700	(3,380)	8,320
License rights	3-5	1,338	(506)	832	2,745	(1,979)	766
Capitalized regulatory approval costs	3	4,068	(1,703)	2,365	4,767	(833)	3,934
CRM software systems	5	3,300	(1,785)	1,515	3,039	(1,046)	1,993
PLM software systems	5	1,843	(410)	1,433	1,585		1,585
Trademarks	5	1,404	(574)	830	1,404	(288)	1,116
Trademarks (indefinite life)		5,284		5,284	5,284		5,284
Patents	13	9,470	(971)	8,499	9,470	(243)	9,227
Non-compete agreements	6	275	(61)	214	275	(15)	260
Customer relationships	5	740	(197)	543	740	(49)	691
Core technology	8	5,445	(907)	4,538	5,445	(227)	5,218
Contracts	10	12,100	(1,621)	10,479	12,100	(411)	11,689
Other intangibles	7	819	(478)	341	1,684	(1,503)	181
Total		$ 66,807	$ (17,356)	$ 49,451	$ 69,201	$ (11,472)	$ 57,729

Amortization expense totaled $8.6 million, $5.8 million and $3.2 million for the fiscal years ended June 30, 2005, 2004 and 2003, respectively. Computer software amortization expense totaled $3.7 million, $2.9 million and $1.8 million for the fiscal years ended June 30, 2005, 2004 and 2003, respectively.

Future amortization of intangible assets is scheduled as follows:

Years ending June 30,	(in 000s)
2006	$ 9,056
2007	7,639
2008	5,401
2009	4,886
2010	4,673
Thereafter	12,512
Total	$ 44,167

Goodwill

The changes in the carrying amount of goodwill for the years ended June 30, 2004 and 2005 are as follows:

	Total (in 000s)
Balance as of June 30, 2003	$ 63,040
Goodwill acquired during year	62,424
Adjustments to goodwill from prior year acquisitions	1,040
Foreign currency translation adjustment	1,168
Balance as of June 30, 2004	127,672
Buyout of the SDG earn out (see Note 4)	40,000
Tax effect of the buyout of the earn out	(4,070)
Adjustments to goodwill from prior year acquisition	(2,108)
Foreign currency translation adjustment	(50)
Balance as of June 30, 2005	$ 161,444

Adjustments to goodwill during fiscal year 2004 primarily represent management s final allocation and assessment based upon independent third-party valuations of the net assets of acquired companies. Adjustments to goodwill in fiscal year 2005 relate primarily to adjustments to certain acquisition-related deferred tax assets.

8. OTHER CURRENT AND LONG-TERM ASSETS

Other current assets as of June 30, 2005 and 2004 consist of the following:

	2005 (in 000s)	2004
Deferred costs of revenues	$ 18,277	$ 18,200
Prepaid expenses	4,721	5,614
Games placed on trial at customer locations	4,822	2,609
Certificates of deposit	2,775	3,091
Refundable deposits	1,358	3,021
Other	1,081	765
Total other current assets	$ 33,034	$ 33,300

Other long-term assets consist of the following as of June 30, 2005 and 2004:

	2005 (in 000s)	2004
Long-term deposits	$ 8,289	$ 615
Restricted cash	6,253	5,740
Deferred debt issuance costs (net of accumulated amortization of $2,332 and $1,017)	5,067	5,893
Total other assets	$ 19,609	$ 12,248

Deferred costs of revenue relate primarily to the cost of game and system sales which revenue is required to be deferred in accordance with SOP No. 97-2. Long-term deposits as of June 30, 2005 include a cash bond of $7.7 million related to a legal judgment (see Note 19). Included in other assets as of June 30, 2005 and 2004 is a 5.0 million Euro certificate of deposit required pursuant to the sale of Bally Wulff (see Note 5).

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9. DEFERRED REVENUE

Deferred revenue relates primarily to revenue from games and system sales that is required to be deferred in accordance with SOP No. 97-2. Deferred revenue totaled $41.0 million and $48.0 million, as of June 30, 2005 and 2004, respectively. The related deferred cost of such revenue is included in other current assets (see Note 8).

10. ACCRUED AND JACKPOT LIABILITIES

Accrued liabilities and jackpot liabilities as of June 30, 2005 and 2004 consist of the following:

	2005 (in 000s)	2004
Payroll and related costs	$ 7,635	$ 11,874
Interest	1,755	1,265
Professional and consulting fees	1,824	2,834
Regulatory approval cost accruals	944	652
Royalties, rebates, direct mail coupons	4,929	6,867
Customer deposits	8,706	10,094
Acquisition related accruals	1,686	3,807
Divestiture related accruals	386	4,377
Litigation accruals (see Note 19)	7,360	
Severance accruals (see Note 16)	1,290	
Other	7,323	7,130
Subtotal	43,838	48,900
Jackpots accrued not yet awarded	13,025	12,075
Total accrued liabilities	$ 56,863	$ 60,975

The Company recognizes a 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 Company currently estimates that approximately 70% 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.

11. LONG-TERM DEBT

Long-term debt at June 30, 2005 and 2004 consisted of the following:

	2005 (in 000s)	2004
Term loan facility	$ 314,882	$ 350,000
Revolving credit facility		70,000
Related party debt (see Note 12)	19,206	6,436
Other, generally unsecured	1,029	2,519
	335,117	428,955
Less current maturities	10,163	5,866
Long-term debt, less current maturities	$ 324,954	$ 423,089

On September 5, 2003, the Company completed a senior bank debt refinancing transaction (the Refinancing) whereby the Company entered into a new $275 million term loan facility and a $125 million

revolving credit facility. Proceeds from the financing were used to repay the existing bank term loans totaling approximately $188 million, repay the Company s 10% Senior Subordinated Notes (Subordinated Notes), and to pay transaction fees and expenses totaling $5.0 million which have been capitalized and are being amortized over the remaining term of the loan. The term loan has a 1% per year mandatory principal amortization after the first year, and a six-year maturity. The revolving credit facility commitment decreases ratably over its five-year term to a 60% balloon.

In December 2003, the Company increased the term loan by $75 million, to a total of $350 million outstanding. The proceeds were used primarily to fund the acquisition of SDG. As a result, the Company incurred an additional $1.6 million in debt issuance costs, which have been capitalized and are amortized over the remaining term of the loan.

As a result of the Refinancing described above, the Company recorded a pre-tax charge in fiscal year 2004 of $12.3 million, which included a $5.0 million charge for the early extinguishment of the Subordinated Notes, $7.0 million for the write off of deferred financing costs, and $0.3 million in fees and expenses, which is classified as a loss on extinguishment of debt in the accompanying statement of operations.

As a result of the sale of United Coin and Rail City approximately 50% of the net proceeds (as defined in the loan agreement) were used to reduce the term loan and revolver principal balances on a pro rata basis. Accordingly, during fiscal year 2005, the Company used the sale proceeds to reduce the term loan by $31.6 million and used additional excess cash to reduce the balance of the revolver from $70 million to zero.

In December 2004, the Company sought and received consents from a majority of the holders of its bank debt which allowed it to complete the buyout of the SDG earn out (including the issuance of a $28.0 million note payable to former SDG shareowners), and to increase the maximum allowed leverage ratio to a maximum of 4.75 as of June 30, 2005, declining to 4.50 as of September 30, 2005, 4.25 as of March 31, 2006, 4.00 as of September 30, 2006, 3.75 as of December 31, 2006 and 3.50 as of September 30, 2004 through the term of the loan agreement. The Company agreed to increase the term loan interest rate to LIBOR plus 3.00%, which can be adjusted to LIBOR plus 3.00% based on certain criteria and to reduce the revolver commitment to $75 million. The fees incurred for the bank amendment totaled $1.0 million, and the Company recorded a charge of $0.6 million to write off a portion of the previously capitalized fees, which is classified as a loss on extinguishment of debt. As of June 30, 2005, the Company had $314.9 million outstanding under its term loan facility with an interest rate of 6.77%, and zero outstanding under the revolving credit facility.

The bank facility is collateralized by substantially all domestic property and is guaranteed by each domestic subsidiary of the Company, other than the entity that holds the Company s interest in its Louisiana and Mississippi operations, and is secured by a Pledge Agreement. The bank facility contains a number of maintenance covenants and other significant covenants that, among other things, restrict the ability of the Company and the ability of 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. The Company was in compliance with these covenants as of June 30, 2005.

The Company was also in compliance with its financial covenants consisting of leverage ratio, fixed charges coverage ratio, and minimum EBITDA (as that term is defined in the Loan Agreement). The leverage ratio is computed as total average debt outstanding during the quarter divided by the trailing 12 months EBITDA excluding certain cash and non-cash charges. The Company s leverage ratio as of June 30, 2005 was 4.6 times versus an amended covenant maximum of 4.75 times.

As a result of the additional time required to complete the fiscal 2005 year end closing process, the Company failed to deliver the 2005 audited financial statements and the September 30, 2005 interim unaudited internal financial statements to the lenders in a timely manner, and therefore was not in compliance with certain of its debt covenants. Pursuant to an agreement with the lenders, the default was cured in December 2005 by delivering the Company s 2005 audited financial statements contained in the Company s Annual Report on Form 10-K and the unaudited interim financial statements for the September 2005 quarter. During the default period from November 8, 2005 to the delivery of the financial statements in December 2005, the Company incurred default interest of approximately $0.7 million.

Maturities of long-term debt, for each of the five fiscal years ending subsequent to June 30, 2005, are as follows:

Years ending June 30,	**(in 000s)**
2006	$ 4,157
2007	3,872
2008	3,500
2009	3,500
2010	300,882
Total	$ 315,911

In October 2006, the Company executed an amendment to its bank facility, which, among other things, (i) extended the due date for the delivery of the Company s audited financial statements for the fiscal year ended June 30, 2006, to December 31, 2006, (ii) provided that the Company shall deliver its quarterly reports on Form 10-Q for the Fiscal Quarters ending on September 30, 2005, December 31, 2005 and March 31, 2006 no later than December 31, 2006, (iii) modified the definition of EBITDA to exclude up to $10 million of certain cash charges, and (iv) clarified that the definition of EBITDA includes interest income on trade receivables. The Company paid an administrative fee of $964,000 in exchange for the concessions granted under the amendment. There can be no assurances the Company will be able to comply with these amended covenants.

12. RELATED PARTY TRANSACTIONS

As discussed in Note 4, the Company completed three acquisitions (MCC, MindPlay and SDG) in the fiscal year 2004. In each acquisition, a portion of the consideration included subordinated debt owed to the former principals of each business. The former principals are now employees of the Company, and therefore such debt is considered owed to related parties. The interest rates on the outstanding debt range from a variable rate of LIBOR plus 2% to a fixed rate of 6%. See the tables below for outstanding debt and interest rates as of June 30 2005 and 2004, respectively and total interest expense for the years ended June 30, 2005, 2004 and 2003, respectively.

	As of June 30, 2005		**As of June 30, 2004**	
	Interest Rate (in 000s)	**Outstanding Debt**	**Interest Rate**	**Outstanding Debt**
SDG	4 %	$ 14,000		$
MindPlay	6 %	4,000	6 %	4,000
MCC	6 %	1,206	4 %	2,436
		19,206		6,436
Less current maturities		6,006		1,218
Related party debt, less current maturities		$ 13,200		$ 5,218

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On June 28, 2005, the Company issued approximately 1.0 million shares of its common stock in connection with the conversion of $14.0 million of the subordinated debt and accrued interest thereon owed to the former principals of SDG.

The remaining note payable to the former SDG shareholders of $14.0 million is payable in annual installments through 2009. At the Company s discretion, the note principal and accrued interest thereon can be paid in cash, or can be converted into shares of the Company s common stock using the average stock price for the 20 business days prior to the delivery of such shares.

	Total Interest Expense for the Year Ended June 30, 2005 (in 000s)	2004	2003
SDG	$ 624	$	$
MindPlay	241	87	
MCC	95	35	

Accrued interest totaled $0.3 million and $0.1 million as of June 30, 2005 and 2004, respectively.

Maturities of related party debt, for each of the five fiscal years ending subsequent to June 30, 2005, are as follows:

Years ending June 30,	**(in 000s)**
2006	$ 6,006
2007	2,800
2008	4,800
2009	2,800
2010	2,800
Total	$ 19,206

Pursuant to an Advisory Agreement with Kirkland Investment Corporation (100% owned by Joel Kirschbaum who is a director of Bally, and therefore treated as a related-party) dated July 1, 2004, the Company agreed to pay Kirkland $600,000 annually for a period of 3.5 years for advisory and related services.

The Company also leases a warehouse and office facility from an entity owned by Mr. Luciano. Rental payments for the fiscal years ended June 30, 2005 and 2004 totaled $412,000 and $103,000, respectively.

13. STOCKHOLDERS EQUITY, OPTIONS, WARRANTS AND RIGHTS

Stock Option Plans

In December 2001, the Company s shareholders approved the 2001 Long-Term Incentive Plan, which has been amended several times (the 2001 Plan). The 2001 Plan provides for the issuance of up to 10,000,000 shares (as amended in fiscal year 2005) of common stock to Company employees, directors and designated paid consultants and up to 600,000 shares of restricted stock or restricted stock units (RSUs). Generally, options are granted at the fair value of the Company s common stock at the date of grant and are exercisable over five to ten years. The 2001 Plan also allows for the issuance of RSUs. A total of 377,030 RSUs were granted on June 30, 2004, and an additional 176,507 were issued during fiscal year 2005, as part of the employment agreement of the Company s Chief Executive Officer and 20,000 to another Company officer. The RSUs granted were treated as deferred compensation, and accordingly deferred compensation of $2.3 million and $6.5 million was recorded in the statement of stockholders equity as of the grant dates for the years ended June 30, 2005 and 2004, respectively. Amortization expense for the RSUs totaled $2.1 million and zero for the fiscal years end June 30, 2005 and 2004, respectively and is included in selling, general and administration expense in the accompanying statements of operations.

Transactions involving stock options and RSUs are summarized as follows:

	Options and RSUs Outstanding Shares (in millions)	Weighted Average Exercise Price
Balance, June 30, 2002	3.1	$ 5.93
Granted	1.1	16.32
Exercised	(0.7)	3.70
Canceled	(0.1)	11.40
Balance, June 30, 2003	3.4	$ 9.51
Granted	2.8	22.16
RSUs granted	0.4	
Exercised	(0.8)	8.74
Canceled	(0.2)	18.00
Balance, June 30, 2004	5.6	$ 15.50
Granted	3.8	11.58
RSUs granted	0.2	
Exercised	(0.2)	5.53
Canceled	(0.7)	17.34
Balance, June 30, 2005	8.7	$ 13.79

	Shares (in millions)	Weighted Average Exercise Price
Options and RSUs exercisable at:		
June 30, 2003	2.0	$ 6.31
June 30, 2004	1.9	$ 8.31
June 30, 2005	5.2	$ 16.12

At June 30, 2005, the range of exercise prices for options outstanding was $0.53 to $33.17. The weighted average remaining contractual life, by range of exercise price, for options and RSUs outstanding and exercisable at June 30, 2005 is as follows:

	Options Outstanding			**Options Exercisable**	
Range of Exercise Prices	**Weighted-Avg. Remaining Contractual Life**	**Weighted-Avg. Exercise Price**	**Shares**	**Weighted-Avg. Exercise Price**	**Shares**
$0.00 - $6.00	4.8	$ 1.61	0.8	$ 2.25	1.1
$6.01 - $12.00	9.4	11.05	2.4	10.59	0.1
$12.01 - $17.00	8.3	14.04	1.7	14.36	0.9
$17.01 - $22.00	8.2	18.82	1.6	18.81	1.6
$22.01 - $33.17	6.5	24.65	1.5	24.65	1.5
All Options	7.7	$ 13.79	8.1	$ 16.12	5.2
RSUs			0.6		
			8.7		5.2

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:

	Year ended June 30,					
	2005		**2004**		**2003**	
Risk-fee interest rate (weighted average)	3.5	%	2.5	%	3.5	%
Expected volatility	0.62		0.26		0.28	
Expected dividend yield	0	%	0	%	0	%
Expected life	6-7.5 years		3-10 years		3-10 years	

The resulting fair values applied to the options granted were $7.49, $8.86, and $6.19 per share for the years ended June 30, 2005, 2004 and 2003, respectively.

Warrants

In February 2004, the Company completed the acquisition of substantially all of the assets of MindPlay. A portion of the consideration consisted of 100,000 stock purchase warrants with a strike price of $24.69, and a term of 7 years. The warrants were valued at $886,000, and were included as part of the purchase price.

Share Repurchase Plan

In January 1999, the Company s Board of Directors approved a share repurchase plan for up to 4.6 million shares of its common stock. Under the plan, subject to price and market conditions, purchases of shares can be made from time to time in the open market or in privately negotiated transactions using available cash. During the fiscal years ended June 30, 2005 and 2004, the Company repurchased 13,000 shares and zero shares of common stock, respectively.

Shares Reserved

The following shares are reserved for options issued and available for issue under the Company s stock plans (in millions):

Stock options and restricted stock units issued and currently outstanding	8.7
Stock options available for future issuance	2.0
Warrants	0.1
Total	10.8

Stockholder Rights Plan

In February 1998, the Company s Board of Directors adopted a Stockholder Rights Plan (Plan). The Plan is designed to preserve the long-term value of the shareholders investment in the Company. Pursuant to the Plan, each shareholder received a distribution of one Right for each share of the Company s outstanding common stock of record on March 12, 1998. Each Right expires on March 12, 2008, and entitles the holder to purchase one one-hundredth (1/100) of a share of a Series F Special Stock for $87.50. Initially the Rights are represented by the Company s common stock certificates and are not exercisable. The Rights become exercisable only after a person or group acquires beneficial ownership of 10% or more of the Company s common stock (or 15% if the acquirer is an institutional investor) or publicly announces its intention to commence a tender offer that would result in that beneficial ownership level. Under certain circumstances involving a buyer s acquisition of 10% of the Company s common stock (or 15% in the case of an institutional investor), all Rights holders except the buyer will be entitled to purchase common stock at half price. If the Company is acquired through a merger, after such an acquisition, all Rights holders except the buyer will be entitled to purchase stock in the buyer at half price. The Company may redeem the rights at $0.0035 at any time before a buyer acquires 10% (or 15% in the case of an institutional investor) of the Company s common stock.

Special Stock

The Company s Articles of Incorporation authorize the issuance of up to 10,000,000 shares of special stock (Special Stock). To date, there have been four series of Special Stock authorized for issuance: the Initial Series, the Series B, the Series E and the Series F. Special Stock consists of non-voting stock where no holder of the Special Stock shall be entitled to vote at any meeting of stockholders or otherwise, except as may be specifically provided by law or as approved by the Board of Directors in certain limited circumstances at the time of the stock issuance. The Special Stock may be issued from time to time in one or more series, each series having such designations, preferences and relative, participating, optional or other special rights, qualifications, limitations or restrictions as shall be stated and expressed in the resolution providing for the issuance of Special Stock or any series thereof adopted by the Board of Directors.

In June 1996, the Company issued shares of Series E Special Stock to certain holders of the Company s 7½% Convertible Subordinated Debentures (which were retired in 1996) who elected to receive such stock in lieu of receiving common stock. The holders of shares of Series E Special Stock have no voting rights except as required by law. A total of 115 shares of Series E Special Stock remain outstanding.

14. INCOME TAXES

The components of the Company s income tax expense (benefit) from continuing operations for the years ended June 30, 2005, 2004 and 2003 are as follows:

	2005 (in 000s)	2004	2003
Current tax expense (benefit):			
Federal	$ 611	$ (192)	$ (418)
Foreign	999	683	1,644
State	(727)	1,303	982
	883	1,794	2,208
Deferred tax expense (benefit):			
Federal	(5,965)	15,913	12,773
Foreign	229		17
State	(339)	3,397	356
	(6,075)	19,310	13,146
Total provision for (benefit) income taxes	$ (5,192)	$ 21,104	$ 15,354

A reconciliation of the Company s income tax provision as compared to the tax provision for continuing operations calculated by applying the statutory federal tax rate (35%) to the income (loss) from continuing operations before income taxes for the years ended June 30, 2005, 2004 and 2003 are as follows:

	2005 (in 000s)	2004	2003
Computed expected income tax (benefit) expense at 35%	$ (6,779)	$ 21,844	$ 15,169
Partnership income attributable to minority interest	(1,306)	(808)	(703)
Foreign earnings subject to US tax	572	463	258
Change in valuation allowance	2,149	(1,809)	(943)
Net increase in accrual for potential tax contingencies	3,049	564	540
State income taxes, net of federal benefit	(149)	2,987	996
Tax credits	(3,018)	(3,120)	
Other, net	290	983	37
	$ (5,192)	$ 21,104	$ 15,354

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The major components of the deferred tax assets and liabilities as of June 30, 2005 and 2004 are as follows:

	2005 (in 000s)	2004
Deferred tax assets:		
Net operating loss carryforwards	$ 23,789	$ 19,476
Capital loss carryforwards	9,025	8,155
Foreign tax credit carryforwards	231	
Other tax credits	11,811	8,457
Deferred revenue, net of cost of goods sold	8,509	10,527
Inventory obsolescence reserves	4,050	2,023
Deferred compensation for tax purposes	4,780	1,268
Financing lease assets	1,827	708
Bad debt reserves	4,227	2,621
Accruals not currently deductible for tax purposes	13,471	12,913
Other	2,511	3,008
Total gross deferred tax assets	84,231	69,156
Less: Valuation allowance	(11,174)	(8,343)
Deferred tax assets	$ 73,057	$ 60,813
Deferred tax liabilities:		
Property and equipment	$ 6,677	$ 12,760
Intangible assets	10,811	6,638
Deferred lease revenue	5,130	3,237
Other	3,007	1,620
Total gross deferred tax liabilities	25,625	24,255
Net deferred tax assets	$ 47,432	$ 36,558

The Company has not provided income taxes on approximately $3.0 million of undistributed earnings from certain foreign subsidiaries. The Company plans to invest the earnings in the foreign subsidiaries and therefore has not recorded a deferred tax liability associated with the undistributed earnings.

In connection with the acquisition of SDG in fiscal year 2004, the Company recorded net deferred tax assets of $16.7 million and a corresponding decrease to goodwill (see Note 4).

At June 30, 2005, the Company had net operating loss carryforwards for U.S. federal income tax purposes of approximately $61.2 million subject to limitations under Section 382 of the Internal Revenue Code (Section 382). Section 382 limits the amount of losses available per year for use against future taxable income. Based on the Company s projections of taxable income, the Company expects to utilize 100% of its net operating loss carryforwards. The Company s net operating loss carryforwards will begin to expire in 2022. At June 30, 2005, the Company had $0.2 million in foreign tax credit carryforwards, alternative minimum tax (AMT) credit carryforwards of approximately $3.9 million, and a research and development tax credit carry forward of approximately $7.7 million. Foreign tax credits have a 100% valuation allowance as the Company does not expect to be able to utilize these credits before their expiration. AMT credits are available to be carried forward indefinitely and may be utilized against regular U.S. corporate tax to the extent it does not exceed computed AMT calculations. Research and developmental credits have a carry forward period of 20 years. The Company expects to utilize all of its AMT and research and development tax credits.

15. SUPPLEMENTAL CASH FLOW INFORMATION

The following supplemental information is related to the consolidated statements of cash flows:

	Year ended June 30,		
	2005	2004	2003
	(in 000s)		
Cash paid for interest	$ 17,509	$ 23,967	$ 25,449
Cash paid for income taxes	1,901	4,954	2,751
Non-cash investing and financing transactions:			
Reclassify property, plant and equipment to inventory	9,923	7,732	3,765
Notes payable issued in acquisitions	28,000	4,000	8,073
Value of restricted stock issued in partial satisfaction of subordinated debt and accrued interest	14,312		
Value of restricted stock issued in SDG acquisition		11,949	
Value of restricted stock issued to employees	2,314	6,500	
Value of warrants issued in MindPlay acquisition		886	
Consolidation of variable interest entities	6,044		
Deferred taxes/goodwill adjustments related to SDG acquisition	6,124		

16. SEVERANCE CHARGES

During fiscal year 2005, the Company undertook a review of its operations and reduced its workforce during the September 2004 quarter and the March 2005 quarter. As a result of these reductions in workforce, the Company incurred charges totaling $3.7 million for the year ended June 30, 2005, respectively, which is primarily related to the Gaming and Systems segment. The balance of the accrued liability for unpaid severance costs is as follows:

	(in 000s)
Beginning balance at June 30, 2004	$
Additions to the accrual	3,654
Amounts paid	2,364
Ending balance at June 30, 2005	$ 1,290

The workforce reduction completed in the March 2005 quarter included a change in the Company s European distribution operations. The Company has accrued a tax liability of $1.4 million (included in tax expense in the accompanying consolidated statement of operations) for the estimated tax obligation resulting from this restructuring.

17. IMPAIRMENT CHARGES

The Company entered into an agreement during fiscal year 2004 to provide a development loan to a Native American tribe to further their pursuit of developing a gaming facility. The amounts advanced under the terms of the loan totaled $1.5 million, and the Company was not obligated for any additional advances. During the quarter ended March 31, 2005, the tribe received an adverse court ruling which the Company believes materially impairs the tribe s ability to repay the loan. Therefore the Company recorded an impairment charge for the full amount of the loan.

During the quarter ended March 31, 2005, the Company performed a review of its intellectual property rights for various video games used on certain legacy platforms. This review was triggered by the declining sales of these legacy games during fiscal 2005. The Company evaluated the carrying value of certain intellectual property assets and determined that several were no longer recoverable and were therefore deemed to be impaired. The impairment charge totaled $1.3 million.

During the quarter ended March 31, 2005, the Company evaluated the useful lives and salvage values for its leased gaming equipment. Based on recent historical data indicating a shortening of the average length such games were deployed, the Company reduced the depreciable life for certain video products to 2 years. The change in the useful life resulted in an impairment charge of $0.8 million to write-off the undepreciated portion of the game values (down to salvage value) for games at the end of their 2-year life.

18. INVENTORY IMPAIRMENT CHARGES

The decision to move to the new video platform, the targeting of used equipment for non-domestic markets, and the consolidation of certain warehouses all led to accelerated disposals of legacy products. This process required updating of estimates for the net realizable value of inventories due to the subjectivity involved in projecting sales volumes, used game sales values, refurbishment costs, and customer demand in non-domestic jurisdictions. As a result of its ongoing analysis of inventory valuations, the Company recognized inventory write downs totaling $26.4 million during the year ended June 30, 2005, which are included in cost of gaming equipment and systems in the accompanying consolidated statements of operations.

19. COMMITMENTS AND CONTINGENCIES

Commitments

The Company is obligated under several agreements to pay certain royalties ranging from approximately $100 to $2,300 per applicable game depending on the components in the gaming machines. Total royalty expense for the Company for the years ended June 30, 2005, 2004 and 2003 was $16.7 million, $9.4 million and $4.2 million, respectively, and is included in the cost of Gaming Equipment and Systems in the accompanying consolidated statements of operations. In addition, the Company has obtained the rights to certain game themes and intellectual property that call for payment of royalties based on either fixed amounts or variable amounts based on game performance. The Company also pays $0.5 million annually for the use of the Bally trademark.

The Company leases certain office space, equipment, warehouse and repair facilities and other property locations under non-cancelable operating leases which are generally included in the selling, general and administrative expense. Operating rental expense for years ended June 30, 2005, 2004 and 2003 was as follows:

	2005 (in 000s)	2004	2003
Continuing Operations:			
Equipment and office space leases	$ 6,257	$ 4,953	$ 4,047
Sublease rental income			(332)
	$ 6,257	$ 4,953	$ 3,715

	2004	2003
Discontinued Operations:		
Contingent route location leases	$ 147,062	$ 132,062
Fixed route location leases	17,326	18,786
Equipment and office space leases	1,170	2,852
	165,558	153,700
Sublease rental income		(1,812)
	$ 165,558	$ 151,888

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During fiscal years 2004 and 2003, the Company had locations where the Company operated gaming devices (Route Location Leases), which were included in the cost of route operations. Such leases provided for sharing of the net gaming win between the Company and the location owner and were cancelable at any time by either party. Such leases were part of the net assets sold as part of the disposition of the Company s Nevada and Louisiana route operations.

The contractual lease commitments for each of the five fiscal years subsequent to June 30, 2005 are as flows:

Fiscal year ending June 30,	**(in 000s)**
2006	$ 2,641
2007	2,278
2008	1,512
2009	1,114
2010	407
Total	$ 7,952

Liabilities for loss contingencies arising from claims, assessments, litigation, fines and penalties, or other sources are recorded when it is probable that a liability has been incurred and the amount of the liability can be reasonably estimated.

Litigation

On September 25, 1995, Bally Gaming International, Inc., a wholly-owned subsidiary of the Company, was named as a defendant in a class action lawsuit filed in the United States District Court for the District of Nevada. The plaintiffs filed suit against BGII and approximately 45 other defendants. Each defendant is involved in the gaming business as a gaming machine manufacturer, distributor or casino operator. The class action lawsuit arises out of alleged fraudulent marketing and operation of casino video poker machines and electronic slot machines. The plaintiffs allege that the defendants have engaged in a course of fraudulent and misleading conduct intended to induce people into playing their gaming machines based on a false belief concerning how those machines actually operate as well as the extent to which there is actually an opportunity to win on any given play. The plaintiffs allege that the defendants actions constitute violations of the Racketeer Influenced and Corrupt Organizations Act (RICO) and give rise to claims of common law fraud and unjust enrichment. The plaintiffs are seeking monetary damages in excess of $1.0 billion. In July 2002 the federal district court denied the plaintiffs request for class action certification. In August 2004, the United States Court of Appeals for the Ninth Circuit affirmed the district court s denial of class action certification, and the plaintiffs did not appeal. Subsequently, two of the four named plaintiffs elected to continue their cases as individual, non-class actions. However, in September 2005, the court granted defendants motions for summary judgment, resolving all claims in defendants favor without a trial. In October 2005, the plaintiffs appealed the District Court s granting of summary judgment in favor of the defendants to the Ninth Circuit. Management believes the plaintiffs lawsuit to be without merit. The Company will continue to pursue all available legal defenses.

In June 2004, putative class actions were filed against Bally Technologies, Inc. and its officers, Robert Miodunski, Robert Saxton, Mark Lerner, and Steven Des Champs, in the United States District Court for the District of Nevada. The nearly identical complaints alleged violations of the Exchange Act stemming from revised earnings guidance, declines in the stock price, and sales of stock by insiders, and sought damages in unspecified amounts. The federal district court granted the plaintiffs unopposed motions to consolidate the cases and to appoint a lead counsel and a lead plaintiff, and the plaintiffs filed a consolidated complaint. Bally and the other defendants have moved for summary judgment, and the motion is being briefed. Bally believes the lawsuits are without merit and intends to vigorously defend itself and its officers. 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 Bally. 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 and seek injunctive relief and damages in unspecified amounts. These two cases were consolidated, and Bally and the other defendants moved to dismiss the case. In February 2005, the state district court granted the defendants motion and dismissed the case, and the plaintiffs have appealed the case the Nevada Supreme Court, where the matter is pending. Management believes the plaintiffs lawsuit to be without merit. The Company will continue to pursue all available legal defenses.

In August 2004, Shuffle Master, Inc. sued the Company in the United States District Court for the District of Nevada, alleging infringement of various patents in connection with the Company s MindPlay product line and seeking injunctive relief and damages in unspecified amounts. In June 2005, it was announced that IGT had acquired an interest in the patents at issue in the case, and thereafter IGT joined the case as a plaintiff. The Company is vigorously defending against the lawsuit, which is in the discovery phase. Management believes the plaintiffs lawsuit to be without merit. The Company will continue to pursue all available legal defenses.

In September 2004, a federal district court jury in the District of Nevada 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, infringed the plaintiffs patents. The district court 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 cash bond totaling $7.6 million to stay payment of the judgment and accrued interest pending appeal. The cash bond is included in other non-current assets and the accrued liability is included in accrued liabilities in the accompanying balance sheet. This amount has been accrued and the expense for this charge is included in discontinued operations in the accompanying statement of operations in fiscal year 2005.

On December 7, 2004, IGT filed a patent infringement lawsuit against Bally Technologies, Inc. in the United States District Court for the District of Nevada. The complaint asserts that Bally s wheel-based games, such as Monte Carlo and Cash For Life, and its iView products infringe patents held by IGT, and seeks injunctive relief and damages in unspecified amounts. Bally believes IGT s claims are without merit and is vigorously defending itself against the lawsuit. As part of its defense, Bally has asserted counterclaims against IGT, including claims that IGT s patents are invalid as well as several claims that IGT has engaged in anti-competitive conduct in violation of state and federal antitrust laws. By its counterclaims, Bally is seeking damages and other relief from IGT. The litigation is in the discovery phase and no trial date has been set.

In February 2005, the SEC initiated an informal inquiry and requested documents and information regarding matters related to the allegations in the class actions and similar matters. In August 2005, the SEC notified the Company that its investigation had entered a formal phase, and has requested additional information from the Company covering the same general areas that were addressed in the informal inquiry. Management is cooperating fully with the SEC in this matter.

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, including the matters above, in the aggregate, will have a material adverse effect on its financial position, results of operations or cash flows.

At June 30, 2005, the Company had no significant material purchase commitments for capital expenditures.

Federal, State and Local Taxes

The Company is subject to sales, use, income and other tax audits and administrative proceedings in various federal, state, and local jurisdictions. While the Company believes it has properly recorded its tax liabilities and expenses in each jurisdiction, there is no assurance that taxing authorities will not propose adjustments that will increase the Company s tax liabilities and expense.

In addition, a degree of judgment is required in determining the Company s effective tax rate and in the evaluation of certain tax positions taken by the Company. The Company establishes reserves when, despite support for the Company s filing position, a belief exists that these positions may be challenged by the respective tax jurisdiction. The reserves are adjusted upon the occurrence of external, identifiable events. A change in the Company s tax reserves could have a significant impact on its effective tax rate and operating results.

20. SEGMENT AND GEOGRAPHICAL INFORMATION

The Company currently operates in two business segments: (i) Bally Gaming and Systems which designs, manufactures and distributes gaming machines and computerized monitoring systems for gaming machines, and (ii) Casino Operations which owns and operates one regional casino. 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, operating income (loss), identifiable assets, capital expenditures and depreciation and amortization by segment:

	Year Ended June 30, 2005 (in 000s)	2004	2003
Revenues:			
Gaming Equipment and Systems	$ 431,070	$ 424,327	$ 306,319
Casino Operations	52,037	52,280	50,945
Total revenues	$ 483,107	$ 476,607	$ 357,264
Inter-segment revenues:			
Gaming Equipment and Systems	$ 518	$ 578	$ 1,164
Casino Operations			
Total inter-segment revenues	$ 518	$ 578	$ 1,164
Gross Profit:			
Gaming Equipment and Systems	$ 189,584	$ 231,576	$ 162,386
Casino Operations	33,310	32,237	29,737
Total gross profit	$ 222,894	$ 263,813	$ 192,123
Operating income (loss):			
Gaming Equipment and Systems	$ (2,724)	$ 86,148	$ 64,274
Casino Operations	16,775	16,942	15,306
Corporate/other	(18,502)	(14,254)	(13,213)
Total operating (loss) income	$ (4,451)	$ 88,836	$ 66,367
Identifiable assets:			
Gaming Equipment and Systems	$ 550,611	$ 542,958	$ 324,318
Casino Operations	43,094	41,790	43,399
Corporate/other	61,229	184,737	62,831
Total identifiable assets	$ 654,934	$ 769,485	$ 430,548
Goodwill:			
Gaming Equipment and Systems	$ 161,444	$ 127,672	$ 63,040
Casino Operations			
Corporate/other			
Total goodwill	$ 161,444	$ 127,672	$ 63,040
Capital expenditures:			
Gaming Equipment and Systems	$ 6,942	$ 8,396	$ 3,589
Casino Operations	4,325	2,716	6,068
Corporate/other	1,163	728	102
Total capital expenditures	$ 12,430	$ 11,840	$ 9,759
Depreciation and amortization:			
Gaming Equipment and Systems	$ 15,813	$ 10,016	$ 6,474
Casino Operations	3,296	2,780	2,174
Corporate/other	1,342	1,525	2,286
Total depreciation and amortization	$ 20,451	$ 14,321	$ 10,934

The Company has operations based primarily in the United States with a significant sales and distribution office based in Europe.

The table below presents information as to the Company s revenues, operating income (loss), identifiable assets capital expenditures and depreciation and amortization by geographic region determined based upon the location of the customer:

	Year Ended June 30, 2005 (in 000s)	2004	2003
Revenues:			
United States	$ 456,078	$ 445,318	$ 314,417
Europe	13,314	24,817	32,617
Other foreign	13,715	6,472	10,230
Total revenues	$ 483,107	$ 476,607	$ 357,264
Gross Margin:			
United States	$ 214,333	$ 251,194	$ 179,224
Europe	4,249	10,975	10,492
Other foreign	4,312	1,644	2,407
Total gross margin	$ 222,894	$ 263,813	$ 192,123
Operating income (loss):			
United States	$ 155	$ 87,769	$ 60,701
Europe	(6,863)	1,686	4,883
Other foreign	2,257	(619)	783
Total operating income (loss)	$ (4,451)	$ 88,836	$ 66,367
Identifiable assets:			
United States	$ 604,453	$ 714,219	$ 377,584
Europe	33,336	43,661	41,798
Other foreign	17,145	11,605	11,166
Total identifiable assets	$ 654,934	$ 769,485	$ 430,548
Goodwill:			
United States	$ 143,491	$ 109,498	$ 47,393
Europe	17,953	18,174	15,647
Other Foreign			
Total goodwill	$ 161,444	$ 127,672	$ 63,040
Capital expenditures:			
United States	$ 11,283	$ 11,145	9,664
Europe	1,140	684	90
Other foreign	7	11	5
Total capital expenditures	$ 12,430	$ 11,840	$ 9,759
Depreciation and amortization:			
United States	$ 19,098	$ 13,491	$ 10,588
Europe	737	636	339
Other Foreign	616	194	7
Total depreciation and amortization	$ 20,451	$ 14,321	$ 10,934

21. 401(k) PLAN

The Company is the sponsor of the Bally Technologies, Inc. 401(k) Savings Plan (the 401(k) Plan). The 401(k) Plan was adopted for domestic employees of Bally Technologies, Inc. and all its domestic subsidiaries. Employees may enroll in the plan after meeting certain age and length of employment

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criteria, and plan participants may defer up to 25% of their compensation, up to certain IRS imposed limitations, currently $14,000.

The Company matches 50% of any participants contributions, up to the first 6% of their compensation (as the term compensation is defined in the 401(k) plan document). Company matching contributions totaled approximately $1.5 million, $0.8 million and $1.0 million for the fiscal years ended June 30, 2005, 2004 and 2003, respectively.

For participants hired through December 31, 2000, employee and employer matching contributions were 100% vested immediately. For employees hired on or after January 1, 2001, vesting of the employer match is on a 20%, 5-year vesting schedule. Employer profit sharing contributions are 100% after the completion of 3 years of service.

22. SELECTED QUARTERLY FINANCIAL DATA (UNAUDITED)

The following tables set forth unaudited quarterly financial information for the years ended June 30, 2005 and 2004.

As discussed in Note 2, the unaudited quarterly information for the fiscal quarters ended June 30, 2005 and 2004, March 31, 2005 and 2004, December 31, 2004 and 2003, and September 30, 2004 and 2003 have been restated. A comparison of originally reported and restated unaudited quarterly financial information is presented within the tables below:

	Fiscal Year 2005 Quarterly Results September 30, As Originally Reported	First Restatement	Second Restatement	As Restated	December 31, As Originally Reported	First Restatement	Second Restatement	As Restated
	(in 000s, except per share data)							
Statement of Operations Data:								
Revenues	$116,913	$(6,112)	$8,840	$119,641	$113,702	$11,848	$(1,115)	$124,435
Cost of gaming equipment, systems and casino operations	55,638	1,496	2,532	59,666	57,926	13,386	(750)	70,562
Selling, general and administrative	45,090	15	(31)	45,074	41,051	(100)	(186)	40,765
Income (loss) from continuing operations before income taxes and minority interest	(9,757)	(1,042)	6,725	(4,074)	(11,274)	5,572	537	(5,165)
Income tax (benefit) expense	(3,851)	(203)	2,375	(1,679)	(4,879)	1,789	189	(2,901)
Loss from continuing operations	(6,405)	(839)	4,350	(2,894)	(7,540)	3,783	348	(3,409)
Income (loss) from discontinued operations	(4,391)			(4,391)	15			15
Net loss	(10,796)	(839)	4,350	(7,285)	(7,525)	3,783	348	(3,394)
Diluted loss per share from continuing operations	$ (0.13)	$(0.01)	$0.08	$ (0.06)	$ (0.15)	$ 0.08	$ 0.00	$ (0.07)
Diluted loss per share from continuing operations	(0.08)			(0.08)				
Diluted loss per share	$ (0.21)	$(0.01)	$0.08	$ (0.14)	$ (0.15)	$ 0.08	$ 0.00	$ (0.07)

	Fiscal Year 2005 Quarterly Results March 31, As Originally Reported	First Restatement	Second Restatement	As Restated	June 30, As Originally Reported	First Restatement	Second Restatement	As Restated
	(in 000s, except per share data)							
Statement of Operations Data:								
Revenues	$125,412	$1,589	(5,312)	$121,689	$120,678	$	$(3,336)	$117,342
Cost of gaming equipment, systems and casino operations	62,310	8,222	(3,102)	67,430	63,479		(924)	62,555
Selling, general and administrative	38,729	9	131	38,869	34,966		255	35,221
Income (loss) from continuing operations before income taxes and minority interest	(7,022)	612	(1,240)	(7,650)	329		(2,810)	(2,481)
Income tax (benefit) expense	(1,480)	2,438	(437)	521	(324)		(809)	(1,133)
Loss from continuing operations	(6,449)	(1,826)	(803)	(9,078)	(1,042)		(1,486)	(2,528)
Income (loss) from discontinued operations	(395)			(395)	117			117
Net loss	(6,844)	(1,826)	(803)	(9,473)	(925)		(1,486)	(2,411)
Diluted loss per share from continuing operations	$ (0.13)	$(0.03)	$(0.02)	$ (0.18)	$ (0.02)	$	$(0.03)	$ (0.05)
Diluted loss per share from continuing operations	(0.01)			(0.01)				
Diluted loss per share	$ (0.14)	$(0.03)	$(0.02)	$ (0.19)	$ (0.02)	$	$(0.03)	$ (0.05)

	Fiscal Year 2004 Quarterly Results September 30, As Originally Reported	First Restatement	Second Restatement	As Restated	December 31, As Originally Reported	First Restatement	Second Restatement	As Restated
	(in 000s, except per share data)							
Statement of Operations Data:								
Revenues	$101,223	$(4,884)	$(1,024)	$95,315	$108,631	$11,768	$(5,045)	$115,354
Cost of gaming equipment, systems and casino operations	38,240	1,067	(768)	38,539	43,664	9,239	(2,772)	50,131
Selling, general and administrative	29,065		(429)	28,636	21,548	209	11	21,768
Income (loss) from continuing operations before income taxes and minority interest	3,600	(2,802)	669	1,467	23,203	5,797	(1,662)	27,338
Income tax (benefit) expense	1,266	(981)	236	521	8,444	2,029	(585)	9,888
Loss from continuing operations	1,848	(1,821)	434	461	14,218	3,768	(1,077)	16,909
Income (loss) from discontinued operations	4,180			4,180	4,526			4,526
Net income (loss)	6,028	(1,821)	434	4,641	18,744	3,768	(1,077)	21,435
Diluted income (loss) per share from continuing operations	$ 0.04	$(0.04)	$ 0.01	$ 0.01	$ 0.28	$ 0.07	$(0.02)	$ 0.33
Diluted income (loss) per share from continuing operations	0.08			0.08	0.09			0.09
Diluted income (loss) per share	$ 0.12	$(0.04)	$ 0.01	$ 0.09	$ 0.37	$ 0.07	$(0.02)	$ 0.42

	Fiscal Year 2004 Quarterly Results March 31, As Originally Reported	First Restatement	Second Restatement	As Restated	June 30, As Originally Reported	First Restatement	Second Restatement	As Restated
	(in 000s, except per share data)							
Statement of Operations Data:								
Revenues	$116,239	$(4,477)	$1,426	$113,188	$162,783	$(10,875)	$ 842	$152,750
Cost of gaming equipment, systems and casino operations	46,702	3,005	1,800	51,507	69,023	1,893	1,701	72,617
Selling, general and administrative	30,198	36	21	30,255	43,534	(171)	19	43,382
Income (loss) from continuing operations before income taxes and minority interest	19,197	(3,367)	130	15,960	24,227	(6,286)	(294)	17,647
Income tax (benefit) expense	6,234	(1,180)	49	5,103	8,349	(2,648)	(109)	5,592
Loss from continuing operations	12,241	(2,187)	81	10,135	15,319	(3,639)	(186)	11,494
Income (loss) from discontinued operations	1,593			1,593	30,590			30,590
Net income (loss)	13,834	(2,187)	81	11,728	45,908	(3,639)	(185)	42,084
Diluted income (loss) per share from continuing operations	$ 0.24	$(0.04)	$0.00	$ 0.20	$ 0.30	$ (0.07)	$(0.01)	$ 0.22
Diluted income (loss) per share from continuing operations	0.03			0.03	0.60			0.60
Diluted income (loss) per share	$ 0.27	$(0.04)	$0.00	$ 0.23	$ 0.90	$ (0.07)	$(0.01)	$ 0.82

23. SUBSEQUENT EVENTS

In August 2005, a hurricane hit the gulf coast of Mississippi and Louisiana causing substantial damage to the Gulfport and Biloxi, Mississippi area, as well as New Orleans, Louisiana. In September 2005, Louisiana was again impacted by a hurricane that caused additional flooding in New Orleans as well as other locations in Louisiana.

The Company earns revenue in both Louisiana and Mississippi from machine rentals and participations in various casinos that were damaged by the hurricanes. In some instances, the machines have been damaged or destroyed; in other cases, the machines are undamaged, but the casino is currently closed.

The Company carries both property and business interruption insurance which will serve to offset some of the losses indicated above. At this time the Company is actively working with its insurance providers to assess losses and associated recoveries, but anticipate the full claim cycle will cover an extended period of time. Therefore, the Company cannot reasonably estimate the net proceeds to be recovered in connection with these losses.

The effect of the hurricanes, net of eventual insurance recoveries, is not expected to have a material impact on the financial position of the Company; however it may affect the Company s quarterly results of operations depending on the timing of the insurance recoveries and the pace at which properties are rebuilt**.**