

DOVER DOWNS GAMING & ENTERTAINMENT INC  
Form 10-Q  
August 04, 2006

## **UNITED STATES**

## **SECURITIES AND EXCHANGE COMMISSION**

Washington, D.C. 20549

### **Form 10-Q**

**Quarterly Report Pursuant to Section 13 or 15(d) of the Securities Exchange Act of 1934**

**For the quarterly period ended June 30, 2006**

**Commission file number 1-16791**

### **Dover Downs Gaming & Entertainment, Inc.**

(Exact name of registrant as specified in its charter)

**Delaware**  
(State or Other Jurisdiction of Incorporation)

**51-0414140**  
(I.R.S. Employer Identification No.)

**1131 North DuPont Highway, Dover, Delaware 19901**

(Address of principal executive offices)

**(302) 674-4600**

(Registrant's telephone number, including area code)

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N/A

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

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

Indicate by check mark whether the registrant is a large accelerated filer, accelerated filer or a non-accelerated filer. See definition of accelerated filer and large accelerated filer in Rule 12b-2 of the Exchange Act.

Large accelerated filer ☐ Accelerated filer ☒ Non-accelerated filer ☐

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

As of July 31, 2006, the number of shares of each class of the registrant's common stock outstanding is as follows:

|                        |                   |
|------------------------|-------------------|
| Common Stock -         | 14,913,952 shares |
| Class A Common Stock - | 17,512,030 shares |

**Part I Financial Information****Item 1. Financial Statements**

**DOVER DOWNS GAMING & ENTERTAINMENT, INC.**  
**CONSOLIDATED STATEMENT OF EARNINGS**  
**In Thousands, Except Per Share Amounts**  
**(Unaudited)**

|  | <b>Three Months Ended June 30,</b> |                 | <b>Six Months Ended June 30,</b> |                  |
|--|------------------------------------|-----------------|----------------------------------|------------------|
|  | <b>2006</b>                        | <b>2005</b>     | <b>2006</b>                      | <b>2005</b>      |
| <b>Revenues:</b>                               |                                    |                 |                                  |                  |
| Gaming   | \$ 52,634                          | \$ 50,843       | \$ 108,121                       | \$ 99,888        |
| Other operating                                | 4,197                              | 3,831           | 7,982                            | 6,877            |
|  | 56,831                             | 54,674          | 116,103                          | 106,765          |
| <b>Expenses:</b>                               |                                    |                 |                                  |                  |
| Gaming   | 38,776                             | 38,283          | 80,184                           | 75,584           |
| Other operating                                | 3,746                              | 3,546           | 7,091                            | 6,541            |
| General and administrative                     | 1,548                              | 1,094           | 3,187                            | 2,348            |
| Depreciation                                   | 1,739                              | 1,752           | 3,476                            | 3,469            |
|  | 45,809                             | 44,675          | 93,938                           | 87,942           |
| <b>Operating earnings</b>                      | <b>11,022</b>                      | <b>9,999</b>    | <b>22,165</b>                    | <b>18,823</b>    |
| <b>Interest expense</b>                        | <b>797</b>                         | <b>487</b>      | <b>1,441</b>                     | <b>914</b>       |
| <b>Earnings before income taxes</b>            | <b>10,225</b>                      | <b>9,512</b>    | <b>20,724</b>                    | <b>17,909</b>    |
| <b>Income taxes</b>                            | <b>4,203</b>                       | <b>3,868</b>    | <b>8,517</b>                     | <b>7,286</b>     |
| <b>Net earnings</b>                            | <b>\$ 6,022</b>                    | <b>\$ 5,644</b> | <b>\$ 12,207</b>                 | <b>\$ 10,623</b> |
| <b>Net earnings per common share (Note 3):</b> |                                    |                 |                                  |                  |
| Basic  | \$ 0.19                            | \$ 0.16         | \$ 0.38                          | \$ 0.30          |
| Diluted  | \$ 0.18                            | \$ 0.16         | \$ 0.37                          | \$ 0.30          |

The Notes to the Consolidated Financial Statements are an integral part of these consolidated statements.

**DOVER DOWNS GAMING & ENTERTAINMENT, INC.**  
**CONSOLIDATED BALANCE SHEET**  
**In Thousands, Except Share and Per Share Amounts**  
**(Unaudited)**

|  | <b>June 30,<br/>2006</b> | <b>December 31,<br/>2005</b> |
|--|--------------------------|------------------------------|
| <b>ASSETS</b>  |                          |                              |
| Current assets:  |                          |                              |
| Cash   | \$ 20,123                | \$ 19,986                    |
| Accounts receivable  | 1,165                    | 3,805                        |
| Due from State of Delaware   | 4,703                    | 9,100                        |
| Inventories  | 1,945                    | 1,955                        |
| Prepaid expenses and other   | 2,471                    | 2,000                        |
| Prepaid income taxes   | 214                      |                              |
| Receivable from Dover Motorsports, Inc.  | 1                        | 15                           |
| Deferred income taxes  | 1,960                    | 2,067                        |
| Total current assets   | 32,582                   | 38,928                       |
| Property and equipment, net  | 118,402                  | 114,533                      |
| Total assets   | \$ 150,984               | \$ 153,461                   |
| <b>LIABILITIES AND STOCKHOLDERS' EQUITY</b>  |                          |                              |
| Current liabilities:   |                          |                              |
| Accounts payable   | \$ 6,929                 | \$ 4,814                     |
| Purses due horsemen  | 4,394                    | 8,332                        |
| Accrued liabilities  | 8,544                    | 12,748                       |
| Income taxes payable   |                          | 3,706                        |
| Deferred revenue   | 147                      | 112                          |
| Total current liabilities  | 20,014                   | 29,712                       |
| Notes payable to banks   | 56,100                   | 24,075                       |
| Deferred income taxes  | 6,226                    | 6,404                        |
| Commitments and contingencies (see Notes to the Consolidated Financial Statements)   |                          |                              |
| Stockholders' equity:  |                          |                              |
| Preferred stock, \$0.10 par value; 1,000,000 shares authorized; shares issued and outstanding: none  |                          |                              |
| Common stock, \$0.10 par value; 74,000,000 shares authorized; shares issued and outstanding: 14,903,952 and 10,639,874, respectively         | 1,490                    | 1,064                        |
| Class A common stock, \$0.10 par value; 50,000,000 shares authorized; shares issued and outstanding: 17,512,030 and 13,254,687, respectively | 1,751                    | 1,326                        |
| Additional paid-in capital   | 328                      | 36,461                       |
| Retained earnings  | 65,075                   | 55,459                       |
| Deferred compensation  |                          | (1,040)                      |
| Total stockholders' equity   | 68,644                   | 93,270                       |
| Total liabilities and stockholders' equity   | \$ 150,984               | \$ 153,461                   |

The Notes to the Consolidated Financial Statements are an integral part of these consolidated statements.

**DOVER DOWNS GAMING & ENTERTAINMENT, INC.**  
**CONSOLIDATED STATEMENT OF CASH FLOWS**
**In Thousands**
**(Unaudited)**

|   | <b>Six Months Ended June 30,</b> |             |
|---|----------------------------------|-------------|
|   | <b>2006</b>                      | <b>2005</b> |
| <b>Operating activities:</b>  |                                  |             |
| Net earnings  | \$ 12,207                        | \$ 10,623   |
| Adjustments to reconcile net earnings to net cash provided by operating activities: |                                  |             |
| Depreciation  | 3,476                            | 3,469       |
| Amortization of credit facility origination fees                                    | 22                               | 22          |
| Stock-based compensation  | 401                              | 104         |
| Deferred income taxes   | (71 )                            | (267 )      |
| Changes in assets and liabilities:  |                                  |             |
| Accounts receivable   | 2,640                            | 1,717       |
| Due from State of Delaware  | 4,397                            | 4,561       |
| Inventories   | 10                               | 264         |
| Prepaid expenses and other  | (493 )                           | (491 )      |
| Prepaid income taxes/income taxes payable   | (3,920 )                         | (620 )      |
| Receivable from Dover Motorsports, Inc.   | 14                               | 16          |
| Accounts payable  | 625                              | (2,969 )    |
| Purses due horsemen   | (3,938 )                         | (4,313 )    |
| Accrued liabilities   | (4,204 )                         | (2,762 )    |
| Deferred revenue  | 35                               | (14 )       |
| Net cash provided by operating activities   | 11,201                           | 9,340       |
| <b>Investing activities:</b>  |                                  |             |
| Capital expenditures  | (5,855 )                         | (2,515 )    |
| Net cash used in investing activities   | (5,855 )                         | (2,515 )    |
| <b>Financing activities:</b>  |                                  |             |
| Borrowings from notes payable to banks  | 147,325                          | 97,234      |
| Repayments of notes payable to banks  | (115,300 )                       | (101,534 )  |
| Dividends paid  | (2,591 )                         | (2,869 )    |
| Repurchase of common stock  | (35,042 )                        |             |
| Proceeds from stock options exercised   | 349                              |             |
| Excess tax benefit on stock awards  | 50                               |             |
| Other   |                                  | (21 )       |
| Net cash used in financing activities   | (5,209 )                         | (7,190 )    |
| Net increase (decrease) in cash   | 137                              | (365 )      |
| Cash, beginning of period   | 19,986                           | 17,688      |
| Cash, end of period   | \$ 20,123                        | \$ 17,323   |
| <b>Supplemental information:</b>  |                                  |             |
| Interest paid   | \$ 1,311                         | \$ 794      |
| Income taxes paid   | \$ 12,458                        | \$ 8,173    |

The Notes to the Consolidated Financial Statements are an integral part of these consolidated statements.

**DOVER DOWNS GAMING & ENTERTAINMENT, INC.**  
**NOTES TO THE CONSOLIDATED FINANCIAL STATEMENTS**  
**(Unaudited)**

**NOTE 1 Basis of Presentation**

References in this document to the Company, we, us and our mean Dover Downs Gaming & Entertainment, Inc. and/or its wholly owned subsidiaries, as appropriate.

The accompanying consolidated financial statements have been prepared in compliance with Rule 10-01 of Regulation S-X and U.S. generally accepted accounting principles, but do not include all of the information and disclosures required for audited financial statements. These consolidated statements should be read in conjunction with the consolidated financial statements and notes thereto included in the Company's latest Annual Report on Form 10-K filed on March 9, 2006. In the opinion of management, these consolidated statements include all adjustments (consisting of normal recurring adjustments) considered necessary for a fair presentation of the results of operations, financial position and cash flows for the interim periods presented. Operating results for the three and six-month periods ended June 30, 2006 are not necessarily indicative of the results that may be expected for the year ending December 31, 2006.

**NOTE 2 Business Operations**

We are a diversified gaming and entertainment company whose operations consist of Dover Downs Slots a 95,000 square foot video lottery (slots) casino complex; the Dover Downs Hotel featuring luxury accommodations with conference, banquet, fine dining, ballroom and concert hall facilities; and Dover Downs Raceway a harness racing track with pari-mutuel wagering on live and simulcast horse races.

Dover Downs Gaming & Entertainment, Inc. is a public holding company that has two wholly owned subsidiaries: Dover Downs, Inc. and Dover Downs Management Corp. Dover Downs, Inc. was incorporated in 1967 and began motorsports and harness racing operations in 1969. In June of 1994, legislation authorizing video lottery operations in the State of Delaware (the State) was adopted. Our video lottery (slots) casino operations began on December 29, 1995. As a result of several restructurings, Dover Downs, Inc. became a wholly owned subsidiary of Dover Motorsports, Inc. (f/k/a Dover Downs Entertainment, Inc.) (DVD), and became the operating entity for all of DVD's gaming operations.

Dover Downs Gaming & Entertainment, Inc. was incorporated in the State in December of 2001 as a wholly owned subsidiary of DVD. Effective March 31, 2002, DVD completed a tax-free spin-off of its gaming operations by contributing 100% of the issued and outstanding common stock of Dover Downs, Inc. to the Company, and subsequently distributing 100% of the issued and outstanding common stock of the Company to DVD stockholders. Immediately following the spin-off, Dover Downs Gaming & Entertainment, Inc. became an independent public company.

Dover Downs, Inc. is authorized to conduct video lottery operations as a Licensed Agent under the Delaware State Lottery Code. Pursuant to Delaware's Horse Racing Redevelopment Act, enacted in 1994, the Delaware State Lottery Office administers and controls the operation of the video lottery.

Our license from the Delaware Harness Racing Commission (the Commission) to hold harness race meetings on our premises and to offer pari-mutuel wagering on live and simulcast horse races must be renewed on an annual basis. In order to maintain its license to conduct video lottery operations, the Company is required to maintain its harness horse racing license. The Company has received an annual license from the Commission for the past 37 consecutive years and management believes that its relationship with the Commission remains good.

Our entertainment complex is located in Dover, the capital of the State of Delaware. Approximately 66% of our customers come from Maryland, Pennsylvania, Virginia and the District of Columbia.

Due to the nature of the Company's business activities, it is subject to various federal, state and local regulations.

**NOTE 3 Summary of Significant Accounting Policies**

*Basis of consolidation* The consolidated financial statements include the accounts of Dover Downs Gaming & Entertainment, Inc. and its wholly owned subsidiaries. Intercompany transactions and balances have been eliminated.

*Property and equipment* Property and equipment is stated at cost. Depreciation is provided for financial reporting purposes using the straight-line method. Accumulated depreciation was \$43,420,000 and \$39,999,000 as of June 30, 2006 and December 31, 2005, respectively.

The Company performs reviews for impairment of long-lived assets whenever events or changes in circumstances indicate that the carrying value of an asset may not be recoverable. No such events or changes in circumstances have occurred to date. An impairment loss would be measured as the amount by which the carrying amount of the asset exceeds its fair value. Generally, fair value will be determined using valuation techniques such as the present value of future cash flows.

*Point loyalty program* The Company currently has a point loyalty program for its video lottery customers which allows them to earn points based on the volume of their video lottery activity. The points may be redeemed for various services and merchandise throughout the gaming facility and for cash under certain circumstances. All reward points earned by customers are expensed in the period they are earned. The estimated amount of points redeemable for cash is recorded as a reduction of revenue and the estimated amount of points redeemable for services and merchandise is recorded as gaming expense. In determining the amount of the liability, which was \$2,091,000 and \$2,289,000, respectively, at June 30, 2006 and December 31, 2005, the Company estimates a redemption rate, a cost of rewards to be offered and the mix of cash, goods and services for which reward points will be redeemed. We use historical data to estimate those amounts.

*Revenue and expense recognition* Gaming revenues represent (i) the net win from video lottery (slot) machine wins and losses and (ii) commissions from pari-mutuel wagering. Other operating revenues consist of hotel rooms revenue, food and beverage sales and other miscellaneous income. Revenues do not include the retail amount of hotel rooms, food and beverage and other miscellaneous goods and services provided without charge to customers as promotional items of \$3,507,000 and \$7,323,000, and \$3,928,000 and \$7,802,000 for the three and six-month periods ended June 30, 2006 and 2005, respectively. The estimated direct cost of providing these items has been charged to the casino through interdepartmental allocations and is included in gaming expenses in the consolidated statement of earnings.

For the video lottery operations, which account for approximately 90% of revenues for all periods presented, the difference between the amount wagered by bettors and the amount paid out to bettors is referred to as the win. The win is included in the amount recorded in the Company's consolidated financial statements as gaming revenue. The Delaware State Lottery Office sweeps the win from the video lottery operations, collects the State's share of the win and the amount due to the vendors under contract with the State who provide the video lottery (slot) machines and associated computer systems, collects the amount allocable to purses for harness horse racing and remits the remainder to the Company as its commission for acting as a Licensed Agent. Gaming expenses include the amounts collected by the State (i) for the State's share of the win, (ii) for remittance to the providers of the video lottery (slot) machines and associated computer systems, and (iii) for harness horse racing purses. The Company recognizes revenues from pari-mutuel commissions earned from live harness horse racing and importing of simulcast signals from other race tracks when the race occurs. Revenues from hotel rooms, food and beverage sales and other miscellaneous income are recognized at the time the service is provided.

*Earnings per share* Basic and diluted earnings per share ( EPS ) are calculated in accordance with Financial Accounting Standards Board ( FASB ) Statement No. 128, *Earnings Per Share*. Weighted average shares used in computing basic and diluted EPS are as follows:

|                               | Three Months Ended June 30, |            | Six Months Ended June 30, |            |
|-------------------------------|-----------------------------|------------|---------------------------|------------|
|                               | 2006                        | 2005       | 2006                      | 2005       |
| Basic EPS                     | 32,141,000                  | 35,681,000 | 32,540,000                | 35,681,000 |
| Effect of dilutive securities | 705,000                     | 205,000    | 594,000                   | 223,000    |
| Diluted EPS                   | 32,846,000                  | 35,886,000 | 33,134,000                | 35,904,000 |

Dilutive securities include stock options and nonvested stock awards.

For the three and six-month periods ended June 30, 2005, options to purchase 30,000 shares of common stock were not included in the computation of diluted EPS because the options' exercise prices were greater than the average market price of the common stock during the period. There were no anti-dilutive securities excluded from diluted EPS for the three and six-month periods ended June 30, 2006.

*Accounting for stock-based compensation* Prior to January 1, 2006, the Company accounted for its stock-based compensation expense in accordance with Accounting Principles Board ( APB ) Opinion No. 25, *Accounting for Stock Issued to Employees*, and related interpretations, pursuant to which the Company recognized compensation expense for its nonvested stock awards over the vesting period equal to the fair market value of the stock on the grant date. The Company was not required to recognize compensation expense related to its stock options as all options granted had an exercise price equal to the market value of the underlying common stock on the grant date.

Effective January 1, 2006, the Company adopted FASB Statement No. 123 (Revised 2004), Share-Based Payment. Statement No. 123R revises FASB Statement No. 123, Accounting for Stock Based Compensation, and supercedes APB Opinion No. 25 and related interpretations. Statement No. 123R requires recognition of the cost of employee services received in exchange for an award of equity instruments in the financial statements over the period the employee is required to perform the services. The Company adopted Statement No. 123R using the modified prospective method. Under this method, the Company is required to record compensation expense for all awards granted after the date of adoption and for the unvested portion of previously granted awards that remain outstanding at the date of adoption. The Company calculates compensation expense for its stock options based upon the fair value at the grant date using the Black-Scholes option-pricing model. The modified prospective approach does not allow for the restatement of prior period amounts.

The Company recorded total stock-based compensation expense of \$205,000 and \$401,000, and \$44,000 and \$104,000 as general and administrative expenses for the three and six-month periods ended June 30, 2006 and 2005, respectively. Total stock-based compensation expense of \$165,000 and \$353,000 would have been recorded as general and administrative expenses for the three and six-month periods ended June 30, 2005, had the Company been subject to reporting under Statement No. 123R during that period. The Company's earnings before income taxes and net earnings for the three and six-month periods ended June 30, 2006 were \$106,000 and \$205,000 lower than they would have been pursuant to the Company's previous accounting method for stock-based compensation, respectively. The Company recorded income tax benefits of \$40,000 and \$80,000, and \$18,000 and \$42,000 for the three and six-month periods ended June 30, 2006 and 2005, respectively, related to its stock-based compensation. The adoption of Statement No. 123R reduced diluted earnings per share by \$0.01 for the three months ended June 30, 2006 and had no impact on diluted earnings per share for the six months ended June 30, 2006. The adoption of Statement No. 123R had no impact on basic earnings per share for the three and six-month periods ended June 30, 2006.

Statement No. 123R requires the cash flows resulting from the tax benefits from tax deductions in excess of the compensation cost recognized for nonvested stock awards and options ( Excess Tax Benefits ) to be classified as a financing activity in our consolidated statement of cash flows.



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The following table illustrates the effect on net earnings and net earnings per common share if the Company had applied the fair-value recognition provisions of Statement No. 123R to stock-based employee compensation related to its stock options in 2005:

|   | Three Months<br>Ended<br>June 30, 2005 | Six Months<br>Ended<br>June 30, 2005 |
|---|--|--------------------------------------|
| Net earnings, as reported   | \$ 5,644,000                           | \$ 10,623,000                        |
| Add: Stock-based employee compensation expense included in reported net earnings, net of related tax effects                                | 26,000                                 | 62,000                               |
| Deduct: Total stock-based employee compensation expense determined under fair-value based method for all awards, net of related tax effects | (147,000)                              | (311,000)                            |
| Pro forma net earnings  | \$ 5,523,000                           | \$ 10,374,000                        |
| Net earnings per common share:  |  |                                      |
| Basic as reported   | \$ 0.16                                | \$ 0.30                              |
| Basic pro forma   | \$ 0.15                                | \$ 0.29                              |
| Diluted as reported   | \$ 0.16                                | \$ 0.30                              |
| Diluted pro forma   | \$ 0.15                                | \$ 0.29                              |

The Company has a stock incentive plan which provides for the grant of up to 2,250,000 shares of common stock to our officers and key employees through stock options and/or awards valued in whole or in part by reference to our common stock, such as nonvested stock awards. Under the plan, option grants must have an exercise price of not less than 100% of the fair market value of the underlying shares of common stock at the date of the grant. The stock options have eight-year terms and generally vest equally over a period of six years from the date of grant. The nonvested stock vests an aggregate of twenty percent each year beginning on the second anniversary date of the grant. As of June 30, 2006, there were 945,809 shares available for granting options or stock awards.

### *Stock Options*

Stock option activity for the six months ended June 30, 2006 was as follows:

|                                  | Number of<br>Shares | Weighted<br>Average<br>Exercise Price | Weighted<br>Average<br>Remaining<br>Contractual<br>Term (in yrs) | Aggregate<br>Intrinsic<br>Value |
|----------------------------------|---------------------|---------------------------------------|--|---------------------------------|
| Outstanding at December 31, 2005 | 1,026,384           | \$ 6.88                               |  |                                 |
| Forfeited                        | (7,500)             | \$ 6.34                               |  |                                 |
| Exercised                        | (49,977)            | \$ 6.95                               |  |                                 |
| Outstanding at June 30, 2006     | 968,907             | \$ 6.88                               | 3.38   | \$ 12,365,279                   |
| Exercisable at June 30, 2006     | 615,582             | \$ 6.92                               | 2.97   | \$ 7,831,020                    |

The total intrinsic value of stock options exercised during the three and six-month periods ended June 30, 2006 was \$446,000 and \$459,000, respectively. No stock options were exercised during the three or six-month periods ended June 30, 2005.

Nonvested stock option activity for the six months ended June 30, 2006 was as follows:

|                                | Number of<br>Shares | Weighted<br>Average<br>Grant Date<br>Fair Value |
|--------------------------------|---------------------|---|
| Nonvested at December 31, 2005 | 505,929             | \$ 2.99   |
| Forfeited                      | (3,750)             | \$ 2.68   |
| Vested                         | (148,854)           | \$ 3.02   |
| Nonvested at June 30, 2006     | 353,325             | \$ 2.99   |



The Company recorded compensation expense of \$106,000 and \$205,000 related to stock options for the three and six-month periods ended June 30, 2006, respectively. As of June 30, 2006, there was \$770,000 of total unrecognized compensation cost related to nonvested stock options granted to employees under the Company's stock incentive plan. That cost is expected to be recognized over a weighted-average period of 2.2 years.

#### *Nonvested Stock Awards*

Nonvested stock activity for the six months ended June 30, 2006 was as follows:

|                                | Number of<br>Shares | Weighted<br>Average<br>Grant Date<br>Fair Value |
|--------------------------------|---------------------|---|
| Nonvested at December 31, 2005 | 160,500             | \$ 8.23   |
| Granted                        | 112,500             | \$ 9.58   |
| Vested                         | (14,100 )           | \$ 7.75   |
| Forfeited                      | (1,500 )            | \$ 8.61   |
| Nonvested at June 30, 2006     | 257,400             | \$ 8.84   |

The aggregate market value of the nonvested stock at the date of issuance is being amortized on a straight-line basis over the six-year service period. The Company recorded compensation expense of \$99,000 and \$196,000 related to nonvested stock awards for the three and six-month periods ended June 30, 2006, respectively. As of June 30, 2006, there was \$1,908,000 of total deferred compensation cost related to nonvested stock awards granted to employees under the Company's stock incentive plan. That cost is expected to be recognized over a weighted-average period of 4.9 years.

*Use of estimates* The preparation of financial statements in conformity with U.S. generally accepted accounting principles 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.

*Fair value of financial instruments* The carrying amounts of financial instruments reported in the balance sheet for current assets and current liabilities approximates their fair values because of the short maturity of these instruments. The carrying value of long-term debt at June 30, 2006 and December 31, 2005 approximates its fair value based on the interest rates available on similar borrowings.

*Recent Accounting Pronouncements* In June 2006, the FASB issued Interpretation No. 48 (FIN 48), *Accounting for Uncertainty in Income Taxes*. FIN 48 prescribes detailed guidance for the financial statement recognition, measurement and disclosure of uncertain tax positions recognized in an enterprise's financial statements in accordance with FASB Statement No. 109, *Accounting for Income Taxes*. Tax positions must meet a more-likely-than-not recognition threshold at the effective date to be recognized upon the adoption of FIN 48 and in subsequent periods. FIN 48 will be effective for fiscal years beginning after December 15, 2006 and the provisions of FIN 48 will be applied to all tax positions under Statement No. 109 upon initial adoption. The cumulative effect of applying the provisions of this interpretation will be reported as an adjustment to the opening balance of retained earnings for that fiscal year. The Company is currently evaluating the potential impact of FIN 48 on its consolidated financial statements.

In June 2006, the Emerging Issues Task Force (EITF) issued EITF 06-3, *How Taxes Collected from Customers and Remitted to Governmental Authorities Should Be Presented in the Income Statement (That Is, Gross versus Net Presentation)* to clarify diversity in practice on the presentation of different types of taxes in the financial statements. The Task Force concluded that, for taxes within the scope of the issue, a company may adopt a policy of presenting taxes either gross within revenue or net. That is, it may include charges to customers for taxes within revenues and the charge for the taxes from the taxing authority within cost of sales, or, alternatively, it may net the charge to the customer and the charge from the taxing authority. If taxes subject to EITF 06-3 are significant, a company is required to disclose its accounting policy for

presenting taxes and the amounts of such taxes that are recognized on a gross basis. The guidance in this consensus is effective for the first interim reporting period

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beginning after December 15, 2006. The Company will adopt EITF 06-3 as of January 1, 2007. The adoption of EITF 06-3 is not expected to have an impact on our consolidated financial statements.

#### NOTE 4 Indebtedness

The Company has a \$105,000,000 credit facility under an amended and restated credit agreement with Wilmington Trust Company dated March 25, 2002, as amended, that expires on April 17, 2011. Interest is based, at the Company's option, upon LIBOR plus a margin that varies between 75 and 125 basis points depending on the ratio of funded debt to earnings before interest, taxes, depreciation and amortization (the leverage ratio) or the base rate (the greater of the prime rate or the federal funds rate plus 0.5%) less a margin that varies between 50 and 100 basis points depending on the leverage ratio. The terms of the credit facility contain, among others, minimum net worth, interest coverage and maximum leverage covenant requirements. Material adverse changes in the Company's results of operations could impact its ability to maintain financial ratios necessary to satisfy these requirements. The facility is for seasonal funding needs, capital improvements (including the proposed expansion of our hotel that was announced by the Company on March 16, 2006) and other general corporate purposes. At June 30, 2006, the Company was in compliance with all terms of the facility and there was \$56,100,000 outstanding at a weighted average interest rate of 6.1%. At June 30, 2006, \$48,900,000 was available pursuant to the facility.

#### NOTE 5 Pension Plans

The Company maintains a non-contributory, tax qualified defined benefit pension plan. All of the Company's full time employees are eligible to participate in this qualified pension plan. Benefits provided by the Company's qualified pension plan are based on years of service and employees' remuneration over their term of employment. Pension costs are funded in accordance with the provisions of the Internal Revenue Code. The Company also maintains a non-qualified, non-contributory defined benefit pension plan for certain employees. This excess plan provides benefits that would otherwise be provided under the qualified pension plan but for maximum benefit and compensation limits applicable under federal tax law. The cost associated with the excess plan is determined using the same actuarial methods and assumptions as those used for the Company's qualified pension plan.

The components of net periodic pension cost are as follows:

|                                    | Three Months Ended June 30, |            | Six Months Ended June 30, |            |
|------------------------------------|-----------------------------|------------|---------------------------|------------|
|                                    | 2006                        | 2005       | 2006                      | 2005       |
| Service cost                       | \$ 280,000                  | \$ 257,000 | \$ 560,000                | \$ 493,000 |
| Interest cost                      | 99,000                      | 77,000     | 198,000                   | 160,000    |
| Expected return on plan assets     | (80,000 )                   | (64,000 )  | (160,000 )                | (131,000 ) |
| Recognized net actuarial loss      | 9,000                       | 6,000      | 18,000                    | 14,000     |
| Amortization of prior service cost | 2,000                       | 2,000      | 4,000                     | 4,000      |
|                                    | \$ 310,000                  | \$ 278,000 | \$ 620,000                | \$ 540,000 |

The Company expects to contribute approximately \$1,000,000 to its pension plans in 2006, of which \$500,000 and \$775,000 was contributed during the three and six-month periods ended June 30, 2006, respectively.

**NOTE 6 Stockholders Equity**

Changes in the components of stockholders equity are as follows:

|   | <b>Common<br/>Stock</b> | <b>Class A<br/>Common<br/>Stock</b> | <b>Additional<br/>Paid-in<br/>Capital</b> | <b>Retained<br/>Earnings</b> | <b>Deferred<br/>Compensation</b> |
|---|-------------------------|-------------------------------------|---|------------------------------|----------------------------------|
| <b>Balance at December 31, 2005</b>   | \$ 1,064,000            | \$ 1,326,000                        | \$ 36,461,000                             | \$ 55,459,000                | \$ (1,040,000 )                  |
| Reclassification of deferred compensation upon adoption of Statement No. 123R |                         |                                     | (1,040,000 )                              |                              | 1,040,000                        |
| Net earnings  |                         |                                     |   | 12,207,000                   |                                  |
| Dividends paid, \$0.08 per share (1)  |                         |                                     |   | (2,591,000 )                 |                                  |
| Repurchase and retirement of common stock                                     | (106,000 )              | (133,000 )                          | (34,803,000 )                             |                              |                                  |
| Proceeds from stock options exercised   | 3,000                   |                                     | 346,000                                   |                              |                                  |
| Issuance of nonvested stock awards, net of forfeitures                        | 7,000                   |                                     | (7,000 )                                  |                              |                                  |
| Stock-based compensation  |                         |                                     | 401,000                                   |                              |                                  |
| Excess tax benefit on stock awards  |                         |                                     | 50,000                                    |                              |                                  |
| Conversion of Class A common stock to common stock                            | 26,000                  | (26,000 )                           |   |                              |                                  |
| Three-for-two stock split   | 496,000                 | 584,000                             | (1,080,000 )                              |                              |                                  |
| <b>Balance at June 30, 2006</b>   | \$ 1,490,000            | \$ 1,751,000                        | \$ 328,000                                | \$ 65,075,000                | \$                               |

(1) Restated for stock split (see below).

On July 26, 2006, the Company's Board of Directors declared a quarterly cash dividend on both classes of common stock of \$0.045 per share. The dividend represents a 12.5% increase from the previously paid \$0.04 per share. The dividend is payable on September 10, 2006 to shareholders of record at the close of business on August 10, 2006.

On April 26, 2006, the Company's Board of Directors approved a three-for-two split of both classes of its common stock. The split was effected in the form of a stock dividend by issuing one additional share of common stock for every two shares of common stock held. On June 15, 2006, 4,967,650 shares of common stock and 5,837,343 shares of Class A common stock were distributed to shareholders of record at the close of business on May 10, 2006. No fractional shares were issued. Shareholders were paid cash in lieu of any fractional shares. All share and per share amounts have been restated to give effect to the stock split, except for the number of shares shown as outstanding at December 31, 2005 on the Company's consolidated balance sheet. The statement of stockholders equity presented above reflects the stock split by reclassifying from additional paid-in capital to common stock and Class A common stock an amount equal to the par value of the additional shares issued to effect the stock split.

On October 23, 2002, the Company's Board of Directors authorized the repurchase of up to 3,000,000 shares of the Company's outstanding common stock. The purchases may be made in the open market or in privately negotiated transactions as conditions warrant. The repurchase authorization does not obligate the Company to acquire any specific number of shares and may be suspended at any time. No purchases of the Company's equity securities were made pursuant to this authorization during the three and six-month periods ended June 30, 2006 and 2005. At June 30, 2006, the Company had remaining repurchase authority of 2,668,733 shares.

During the second quarter of 2006, the Company purchased and retired 3,431 shares of its outstanding common stock for \$56,000. These purchases were made from employees and were not pursuant to the above repurchase plan.

On December 19, 2005, the Company's Board of Directors authorized the Company to commence a tender offer to purchase up to 1,595,906 shares of its common stock and up to 1,988,202 shares of its Class A common stock at a fixed price of \$9.67 per share. The offer expired on January 19, 2006. The Company purchased 1,595,906 shares of

its common stock and 1,987,500 shares of its Class A common stock for \$34,986,000, including expenses, in connection with the tender offer.

#### **NOTE 7 - Related Party Transactions**

During the three and six-month periods ended June 30, 2006 and 2005, the Company allocated costs of \$411,000 and \$830,000, and \$374,000 and \$851,000, respectively, to DVD for certain administrative and operating services. Additionally, DVD allocated costs of \$32,000 and \$58,000, and \$20,000 and \$44,000 to the Company for the three and six-month periods ended June 30, 2006 and 2005, respectively. The allocations were based on an analysis of each company's share of the costs. In connection with DVD's June 2006 and 2005 NASCAR event weekends at Dover International Speedway, the Company provided certain services for which DVD was invoiced \$461,000 and \$400,000, respectively. DVD invoiced the Company \$92,000 during the three and six-month periods ended June 30, 2006, and \$31,000 and \$91,000, respectively, during the three and six-month periods ended June 30, 2005 for tickets and other services related to the events. As of June 30, 2006, the Company's consolidated balance sheet includes a \$1,000 receivable from DVD for the aforementioned items. The Company received payment for the \$1,000 receivable in the third quarter of 2006. The net costs incurred by each company for these services are not necessarily indicative of the costs that would have been incurred if the companies had been unrelated entities and/or had otherwise independently managed these functions; however, management believes that these costs are reasonable.

The Company's use of DVD's 5/8-mile harness racing track is pursuant to an easement granted to the Company by DVD which does not require the payment of any rent. Under the terms of the easement, the Company has exclusive use of the harness track during the period beginning November 1 of each year and ending April 30 of the following year, together with set up and tear down rights for the two weeks before and after such period. The harness track is located on property owned by DVD and is on the inside of DVD's motorsports superspeedway. The Company's indoor grandstands are used by DVD at no charge in connection with its motorsports events. DVD also leases its principal office space from the Company. Various easements and agreements relative to access, utilities and parking have also been entered into between DVD and the Company relative to their respective Dover, Delaware facilities.

Henry B. Tippie, the Chairman of the Company's Board of Directors, controls in excess of fifty percent of the voting power of the Company. This means that Mr. Tippie has the ability to determine the outcome of the election of directors at the Company and to determine the outcome of many significant corporate transactions, many of which only require the approval of a majority of the Company's voting power.

Mr. Tippie's voting control with respect to the Company emanates from his direct and indirect holdings of Common Stock and Class A Common Stock, from his status as executor of the estate of John W. Rollins, the Company's largest stockholder, and from certain shares as to which he has voting rights pursuant to a voting agreement with R. Randall Rollins, one of our directors. As of June 30, 2006, Mr. Tippie has control over approximately 51.2% of the voting power of the Company.

Patrick J. Bagley, Kenneth K. Chalmers, Denis McGlynn, Jeffrey W. Rollins, John W. Rollins, Jr., R. Randall Rollins and Henry B. Tippie are all Directors of the Company and DVD. Denis McGlynn is the President and Chief Executive Officer of both companies, Klaus M. Belohoubek is the Senior Vice President - General Counsel and Secretary of both companies and Patrick J. Bagley is the Senior Vice President - Finance and Chief Financial Officer of DVD. Mr. Tippie controls in excess of fifty percent of the voting power of DVD.

#### **NOTE 8 - Commitments and Contingencies**

The Company is a party to ordinary routine litigation incidental to its business. Management does not believe that the resolution of any of these matters is likely to have a serious adverse effect on our results of operations, financial condition or cash flows.

The Company has employment, severance and noncompete agreements with certain of its officers and directors under which certain change of control, severance and noncompete payments and benefits might become payable in the event of a change in control of the Company, defined to include a tender offer or the closing of a merger or

similar corporate transactions. In the event of such a change in control of the Company and the subsequent termination of employment of all employees covered under these agreements, the maximum contingent liability would be approximately \$6,029,000.

**Item 2.**                    **Management's Discussion and Analysis of Financial Condition and Results of Operations**

The following discussion is based upon and should be read in conjunction with the consolidated financial statements and notes thereto included elsewhere in this Quarterly Report on Form 10-Q.

Dover Downs Gaming & Entertainment, Inc. is a diversified gaming and entertainment company whose operations consist of Dover Downs Slots – a 95,000 square foot video lottery (slots) casino complex; the Dover Downs Hotel – featuring luxury accommodations with conference, banquet, fine dining, ballroom and concert hall facilities; and Dover Downs Raceway – a harness racing track with pari-mutuel wagering on live and simulcast horse races.

Approximately 90% of the Company's revenue is derived from video lottery (slot) machine win (as defined below). Several factors contribute to the video lottery (slot) machine win for any gaming company, including, but not limited to:

- Proximity to major population bases,
- Competition in the Company's market,
- The quantity and types of slot machines available,
- The quality of the physical property,
- Other amenities offered on site,
- Customer service levels, and
- Marketing programs.

The Company believes that it holds a strong position in each of these areas. Our entertainment complex is located in Dover, the capital of the State of Delaware. We draw patrons from several major metropolitan areas. Philadelphia, Baltimore and Washington, D.C. are all within a 2 hour drive. According to the 2000 United States Census, approximately 32.8 million people live within 150 miles of the complex. There are significant barriers to entry related to the gaming business in Delaware, such as the statutory limitation of gaming licenses to the three existing horse racing facilities. The Company's property, designed and developed with the assistance of Caesars World Gaming Development Corporation, is similar to properties found in the country's largest gaming markets. The Company offers the only luxury hotel in the Delaware gaming market, providing a strong marketing tool, especially to higher-end players. The Company also utilizes its recently improved slot marketing system to allow for the most efficient marketing programs and the highest levels of customer service.

Because all of our operations are located at one facility, we face the risk of increased competition from the legalization of new or additional gaming venues. The Company has therefore focused on creating the region's premier gaming destination and building and rewarding customer loyalty through innovative marketing efforts and unparalleled customer service.

**Results of Operations**

Gaming revenues represent (i) the net win from video lottery (slot) machine wins and losses and (ii) commissions from pari-mutuel wagering. Other operating revenues consist of hotel rooms revenue, food and beverage sales and other miscellaneous income. Revenues do not include the retail amount of hotel rooms, food and beverage and other miscellaneous goods and services provided without charge to customers as promotional items. The estimated direct cost of providing these items has been charged to the casino through interdepartmental allocations and is included in gaming expenses in the consolidated statement of earnings.

For the video lottery operations, the difference between the amount wagered by bettors and the amount paid out to bettors is referred to as the win. The win is included in the amount recorded in the Company's consolidated





financial statements as gaming revenue. The Delaware State Lottery Office sweeps the win from the video lottery operations, collects the State's share of the win and the amount due to the vendors under contract with the State who provide the video lottery (slot) machines and associated computer systems, collects the amount allocable to purses for harness horse racing and remits the remainder to the Company as its commission for acting as a Licensed Agent. Gaming expenses include the amounts collected by the State (i) for the State's share of the win, (ii) for remittance to the providers of the video lottery (slot) machines and associated computer systems, and (iii) for harness horse racing purses. The Company recognizes revenues from pari-mutuel commissions earned from live harness horse racing and importing of simulcast signals from other race tracks when the race occurs. Revenues from hotel rooms, food and beverage sales and other miscellaneous income are recognized at the time the service is provided.

*Three Months Ended June 30, 2006 vs. Three Months Ended June 30, 2005*

Gaming revenues increased by \$1,791,000, or 3.5%, to \$52,634,000 in the second quarter of 2006, primarily the result of increased play in our casino. We believe that the increase in casino play can be attributed to our marketing efforts using our player database which allows us to target specific customer segments and our efforts to provide our customers with enhanced video lottery (slot) products and other amenities.

Other operating revenues were \$4,197,000 in the second quarter of 2006 as compared to \$3,831,000 in the second quarter of 2005. Net rooms revenue increased \$179,000 in the second quarter of 2006 as compared to the second quarter of 2005 primarily due to an increase in cash sales and fewer rooms being provided to customers on a complimentary basis. Net food and beverage revenues increased \$185,000 to \$2,899,000 from \$2,714,000 in the second quarter of 2005 primarily due to an increase in sales at our premium buffet restaurant and the opening of a new coffee shop in our hotel lobby during the second quarter. Partially offsetting these increases was a loss of rental income from a property sold by the Company in December 2005. Other operating revenues do not include the retail amount of promotional allowances which are provided to customers on a complimentary basis of \$3,507,000 and \$3,928,000 in the second quarter of 2006 and 2005, respectively. Promotional allowances represented 45.5% and 50.6% of gross other operating revenues in the second quarter of 2006 and 2005, respectively.

Gaming expenses increased by \$493,000, or 1.3%, reflecting the higher gaming revenues. Amounts retained by the State of Delaware and the amount collected by the State for payment to the vendors under contract with the State who provide the video lottery (slot) machines and associated computer systems increased by \$608,000 and \$237,000, respectively. Additionally, amounts allocated from the video lottery operation for harness horse racing purses increased from \$5,906,000 in the second quarter of 2005 to \$6,089,000 in the second quarter of 2006. These increases in gaming expenses were partially offset by decreases in wages and benefit costs as a result of efficiencies created by converting most of our video lottery (slot) machines to ticket-in, ticket-out (cashless) technology and lower promotional expenses.

Other operating expenses increased by \$200,000, or 5.6%. Expenses related to our food and beverage operations were \$3,192,000 in the second quarter of 2006 as compared to \$2,984,000 in the second quarter of 2005. The increase resulted primarily from the increase in food and beverage sales and higher wages and benefits costs.

General and administrative expenses increased by \$454,000 to \$1,548,000 from \$1,094,000 in the second quarter of 2005 primarily the result of stock-based compensation expense from the adoption of FASB Statement No. 123R effective January 1, 2006, higher wages and benefits costs, and increased legal expenses.

Depreciation expense remained consistent at \$1,739,000 in the second quarter of 2006 as compared to \$1,752,000 in the second quarter of 2005.

Interest expense increased by \$310,000 due to an increase in the Company's average interest rate from 4.0% during the second quarter of 2005 to 5.9% during the second quarter of 2006 and from higher average outstanding borrowings on the Company's credit facility during the second quarter of 2006 as compared to the second quarter of 2005 due to the self-tender in January 2006.

The Company's effective income tax rates were 41.1% and 40.7% for the quarters ended June 30, 2006 and 2005, respectively. The increase in the effective rate for the second quarter of 2006 was due to the non-deductibility of stock-based compensation expense recorded as a result of adopting FASB Statement No. 123R.

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Net earnings were \$6,022,000 in the second quarter of 2006 as compared to \$5,644,000 in the second quarter of 2005. The increase of \$378,000, or 6.7%, was primarily due to the improved results for our gaming operations that resulted from an increase in slot win during the quarter, as well as improvements in other operations, partially offset by increased general and administrative expenses and interest expense.

### *Six Months Ended June 30, 2006 vs. Six Months Ended June 30, 2005*

Gaming revenues increased by \$8,233,000, or 8.2%, to \$108,121,000 in the first six months of 2006, primarily the result of increased play in our casino. We believe that the increase in casino play can be attributed to our marketing efforts using our player database which allows us to target specific customer segments and our efforts to provide our customers with enhanced video lottery (slot) products and other amenities.

Other operating revenues were \$7,982,000 in the first six months of 2006 as compared to \$6,877,000 in the first six months of 2005. Net rooms revenue increased \$314,000 in the first six months of 2006 as compared to the first six months of 2005 primarily due to an increase in cash sales and fewer rooms being provided to customers on a complimentary basis. Net food and beverage revenues increased \$702,000 to \$5,491,000 from \$4,789,000 in the first six months of 2005 primarily due to an increase in our banquet business. Additionally, higher sales at our premium buffet restaurant and the opening of a new coffee shop in our hotel lobby during the second quarter contributed to the increase in net food and beverage revenues. Other operating revenues do not include the retail amount of promotional allowances which are provided to customers on a complimentary basis of \$7,323,000 and \$7,802,000 in the first six months of 2006 and 2005, respectively. Promotional allowances represented 47.8% and 53.2% of gross other operating revenues in the first six months of 2006 and 2005, respectively.

Gaming expenses increased by \$4,600,000, or 6.1%, reflecting the higher gaming revenues. Amounts retained by the State of Delaware and the amount collected by the State for payment to the vendors under contract with the State who provide the video lottery (slot) machines and associated computer systems increased by \$2,849,000 and \$779,000, respectively. Additionally, amounts allocated from the video lottery operation for harness horse racing purses increased from \$11,446,000 in the first six months of 2005 to \$12,324,000 in the first six months of 2006.

Other operating expenses increased by \$550,000, or 8.4%. Expenses related to our food and beverage operations were \$5,981,000 in the first six months of 2006 as compared to \$5,513,000 in the first six months of 2005. The increase resulted primarily from the increase in food and beverage sales and higher wages and benefits costs.

General and administrative expenses increased by \$839,000 to \$3,187,000 from \$2,348,000 in the first six months of 2005 primarily the result of stock-based compensation expense from the adoption of FASB Statement No. 123R effective January 1, 2006, higher wages and benefits costs, increased legal fees and the write-off of office expansion costs.

Depreciation expense remained consistent at \$3,476,000 in the first six months of 2006 as compared to \$3,469,000 in the first six months of 2005.

Interest expense increased by \$527,000 due to an increase in the Company's average interest rate from 3.7% during the first six months of 2005 to 5.7% during the first six months of 2006 and from higher average outstanding borrowings on the Company's credit facility during the first six months of 2006 as compared to the first six months of 2005 due to the self-tender in January 2006.

The Company's effective income tax rates were 41.1% and 40.7% for the six months ended June 30, 2006 and 2005, respectively. The increase in the effective rate for the first six months of 2006 was due to the non-deductibility of stock-based compensation expense recorded as a result of adopting FASB Statement No. 123R.

Net earnings were \$12,207,000 in the first six months of 2006 as compared to \$10,623,000 in the first six months of 2005. The increase of \$1,584,000, or 14.9%, was primarily due to the improved results for our gaming operations that resulted from an increase in slot win, as well as improvements in other operations, partially offset by increased general and administrative expenses and interest expense.

## Liquidity and Capital Resources

Net cash provided by operating activities was \$11,201,000 for the six months ended June 30, 2006 compared to \$9,340,000 for the six months ended June 30, 2005. The increase was primarily due to the increase in net earnings from \$10,623,000 for the six months ended June 30, 2005 to \$12,207,000 for the six months ended June 30, 2006, the timing of receipts from the State of Delaware related to our lottery commission and the timing of payments to vendors. These increases were partially offset by increased income tax payments.

Net cash used in investing activities was \$5,855,000 for the six months ended June 30, 2006 compared to \$2,515,000 for the six months ended June 30, 2005. Capital expenditures for the first six months of 2006 related primarily to engineering and architectural work for the Dover Downs Hotel expansion and the renovation of the heating and cooling systems for the entire facility. Capital expenditures for the first six months of 2005 related primarily to the conversion of video lottery (slot) machines to ticket-in, ticket-out (cashless) technology.

Net cash used in financing activities was \$5,209,000 for the six months ended June 30, 2006 compared to \$7,190,000 for the six months ended June 30, 2005. The Company had net borrowings of \$32,025,000 during the first six months of 2006 primarily to fund stock repurchases of \$35,042,000. The Company had net repayments of \$4,300,000 during the first six months of 2005. The Company paid \$2,591,000 and \$2,869,000 in regular quarterly cash dividends during the six months ended June 30, 2006 and 2005, respectively.

On July 26, 2006, the Company's Board of Directors declared a quarterly cash dividend on both classes of common stock of \$0.045 per share. The dividend represents a 12.5% increase from the previously paid \$0.04 per share. The dividend is payable on September 10, 2006 to shareholders of record at the close of business on August 10, 2006.

Based on current business conditions, the Company expects to make additional capital expenditures of approximately \$5,000,000 through December 31, 2006, not including any amounts related to the hotel expansion. These expenditures primarily relate to casino renovations and improvements in our food & beverage departments. Estimated remaining capital expenditures increased subsequent to the end of the first quarter ended March 31, 2006 as a result of the Company's decision to undertake a project to completely modernize its heating, cooling and lighting systems in order to make them more energy efficient. On March 16, 2006, the Company announced an expansion plan that will more than double the number of hotel rooms and add a luxurious 8,000-square-foot spa to the Dover Downs Hotel & Casino. The estimated cost of the expansion is \$53,600,000, of which approximately one-half is expected to be paid in 2006. As of June 30, 2006, the Company had paid out approximately \$3,300,000 related to the hotel expansion. Construction began in the second quarter of 2006 and is expected to be completed in the fall of 2007. Additionally, the Company expects to contribute approximately \$1,000,000 to its pension plans in 2006, of which \$775,000 was contributed during the six months ended June 30, 2006.

On December 19, 2005, the Company's Board of Directors authorized the Company to commence a tender offer to purchase up to 1,595,906 shares of its common stock and up to 1,988,202 shares of its Class A common stock at a fixed price of \$9.67 per share. The offer expired on January 19, 2006. The Company purchased 1,595,906 shares of its common stock and 1,987,500 shares of its Class A common stock for \$34,986,000, including expenses, in connection with the tender offer. The tender offer was funded with borrowings on the Company's unsecured revolving line of credit.

The Company has a \$105,000,000 credit facility under an amended and restated credit agreement with Wilmington Trust Company dated March 25, 2002, as amended, that expires on April 17, 2011. Interest is based, at the Company's option, upon LIBOR plus a margin that varies between 75 and 125 basis points depending on the ratio of funded debt to earnings before interest, taxes, depreciation and amortization (the leverage ratio) or the base rate (the greater of the prime rate or the federal funds rate plus 0.5%) less a margin that varies between 50 and 100 basis points depending on the leverage ratio. The terms of the credit facility contain, among others, minimum net worth, interest coverage and maximum leverage covenant requirements. Material adverse changes in the Company's results of operations could impact its ability to maintain financial ratios necessary to satisfy these requirements. The facility is for seasonal funding needs, capital improvements (including the proposed expansion of our hotel that was announced by the Company on March 16, 2006) and other general corporate purposes. At

June 30, 2006, the Company was in compliance with all terms of the facility and there was \$56,100,000 outstanding at a weighted average interest rate of 6.1%. At June 30, 2006, \$48,900,000 was available pursuant to the facility.

The Company expects that its net cash flows from operating activities and funds available from its credit facility will be sufficient to provide for its working capital needs and capital spending requirements at least through the next twelve months, as well as any cash dividends the Company's Board of Directors may declare. We expect cash flows from operating activities and funds available from our credit facility to also provide for long-term liquidity.

#### **Related Party Transactions**

See NOTE 7 Related Party Transactions of the consolidated financial statements included elsewhere in this Quarterly Report on Form 10-Q for a full description of related party transactions.

#### **Critical Accounting Policies**

The accounting policies described below are those considered critical by the Company in preparing its consolidated financial statements and/or include significant estimates made by management using information available at the time the estimates are made. However, as described below, these estimates could change materially if different information or assumptions were used.

##### *Points Program*

The Company currently has a point loyalty program for its video lottery customers which allows them to earn points based on the volume of their video lottery activity. The points may be redeemed for various services and merchandise throughout the gaming facility and for cash under certain circumstances. All reward points earned by customers are expensed in the period they are earned. The estimated amount of points redeemable for cash is recorded as a reduction of revenue and the estimated amount of points redeemable for services and merchandise is recorded as gaming expense. In determining the amount of the liability, which was \$2,091,000 and \$2,289,000, respectively, at June 30, 2006 and December 31, 2005, the Company estimates a redemption rate, a cost of rewards to be offered and the mix of cash, goods and services for which reward points will be redeemed. We use historical data to estimate those amounts.

##### *Property and Equipment*

Property and equipment are recorded at cost. Depreciation is provided for financial reporting purposes using the straight-line method over estimated useful lives ranging from 5 to 10 years for furniture, fixtures and equipment and up to 40 years for facilities. These estimates require assumptions that are believed to be reasonable. The Company performs reviews for impairment of long-lived assets whenever events or changes in circumstances indicate that the carrying value of an asset may not be recoverable. No such events or changes in circumstances have occurred to date. An impairment loss would be measured as the amount by which the carrying amount of the asset exceeds its fair value. Generally, fair value will be determined using valuation techniques such as the present value of future cash flows.

#### **Recent Accounting Pronouncements**

See NOTE 3 Summary of Significant Accounting Policies of the consolidated financial statements included elsewhere in this Quarterly Report on Form 10-Q for a description of recent accounting pronouncements including the respective expected dates of adoption and effects on results of operations and financial condition.

#### **Factors That May Affect Operating Results; Forward-Looking Statements**

In addition to historical information, this Quarterly Report on Form 10-Q includes forward-looking statements within the meaning of Section 21E of the Securities Exchange Act of 1934, as amended, relating to our financial condition, profitability, liquidity, resources, business outlook, proposed acquisitions, market forces, corporate strategies, consumer preferences, contractual commitments, legal matters, capital requirements and other matters. The Private Securities Litigation Reform Act of 1995 provides a safe harbor for forward-looking statements. To

comply with the terms of the safe harbor, we note that a variety of factors could cause our actual results and experience to differ substantially from the anticipated results or other expectations expressed in our forward-looking statements. When words and expressions such as: believes, expects, anticipates, estimates, plans, intends, objectives, goals, aims, projects, forecasts, possible, seeks, may, could, enable or similar words or expressions are used in this document, as well as statements containing phrases such as in our view, there can be no assurance, although no assurance can be given or there is no way to anticipate with certainty, forward-looking statements are being made.

Various risks and uncertainties may affect the operation, performance, development and results of our business and could cause future outcomes to differ materially from those set forth in our forward-looking statements, including the following factors:

- success of any expansion to or renovation of our existing facilities or changes in our growth strategies;
- our development and potential acquisition of new facilities;
- anticipated trends in the gaming industry;
- patron demographics;
- general market and economic conditions, including consumer and corporate spending sentiment;
- our ability to finance future business requirements;
- our ability to effectively compete in the marketplace;
- the availability of adequate levels of insurance;
- our ability to successfully integrate acquired companies and businesses;
- management retention and development;
- changes in Federal, state, and local laws and regulations, including environmental, gaming license and tax legislation;
- the effect of weather conditions or travel on attendance at our facilities;
- military or other government actions; and
- national or local catastrophic events.

We undertake no obligation to publicly update or revise any forward-looking statements as a result of future developments, events or conditions. New risk factors emerge from time to time and it is not possible for us to predict all such risk factors, nor can we assess the impact of all such risk factors on our business or the extent to which any factor, or combination of factors, may cause actual results to differ significantly from those forecast in any forward-looking statements. Given these risks and uncertainties, stockholders should not overly rely or attach undue weight to our forward-looking statements as an indication of our actual future results.

#### *Our Gaming Activities Compete Directly With Other Gaming Facilities And Other Entertainment Businesses*

We compete in local and regional markets with horse tracks, off-track betting parlors, state run lotteries, casinos and other gaming facilities. We cannot be certain that we will maintain our market share or compete more effectively with our competitors. The introduction or expansion of gaming in neighboring jurisdictions, particularly Maryland, Virginia, Washington, D.C., Pennsylvania or New Jersey, or the legalization of additional gaming venues in Delaware, could have a material adverse effect on our cash flows and results of operations. From time to time



legislation is proposed for adoption in these jurisdictions which if enacted, would further expand state gambling and wagering opportunities, including video lottery (slot) machines at racetracks. Enactment of such legislation could increase our competition and could adversely affect our business, financial condition and overall profitability. For example, in 2005, the Maryland Senate passed a bill providing for various gaming venues for the third straight year and for the third straight year could not reach any consensus with the Maryland House. Accordingly, no legislation was passed. Approximately 66% of our customers come from Maryland, Pennsylvania, Virginia and the District of Columbia. In July 2004, Pennsylvania adopted legislation which authorizes up to 61,000 slot machines at various existing and proposed venues throughout the state. It is difficult for us to predict the effect that such legislation will have on us, but we estimate that one or more facilities in Pennsylvania may begin operations by the end of 2006. Pennsylvania will have one of the highest effective tax rates on slot machine gaming in the country and will charge an up front \$50,000,000 license fee to the horse racing and casino venues that are granted a gaming license. Management has estimated that slot win from Pennsylvania patrons represents approximately 5% of our total slot win.

*All Of Our Facilities Are In One Location*

Our facilities are located adjacent to one another at a single location in Dover, Delaware. Any prolonged disruption of operations at these facilities due to destruction of or material damage to the facilities or other reasons could adversely affect our financial condition and results of operations. We maintain property and business interruption insurance to protect against such types of disruption, but there can be no assurance that the proceeds of such insurance would be adequate to repair or rebuild our facilities in such event or to compensate us for lost profit during the period of any such disruption.

*The Revocation, Suspension Or Modification Of Our Gaming Licenses Would Adversely Affect Our Gaming Business*

The Delaware State Lottery Office and the Delaware Harness Racing Commission regulate our gaming operations. Our license from the Commission must be renewed on an annual basis. To keep our license for video lottery (slot) machine gaming, we must remain licensed for harness horse racing by the Commission and conduct at least 80 live race days each racing season, subject to the availability of harness race horses. The Commission has broad discretion to reject any application for a license or suspend or revoke a license once it is issued. The Director of the Delaware State Lottery Office (the "Lottery Director") has broad discretion to revoke, suspend or modify the terms of a video lottery license. Any modification or termination of existing licensing regulations or any revocation, suspension or modification of our licenses could adversely affect our business, financial condition and overall profitability.

*Our Gaming Activities Are Subject To Extensive Government Regulation And Any Additional Government Regulation Or Taxation Of Gaming Activities Could Substantially Reduce Our Revenue Or Profit*

Video lottery (slot) machine gaming, harness horse racing and pari-mutuel wagering are subject to extensive government regulation. Delaware law regulates the win we are entitled to retain and the percentage of commission we are entitled to receive from our gaming revenues, which comprises a significant portion of our overall revenues. The State granted us a license to conduct video lottery (slot) machine operations and a license to conduct harness horse races and pari-mutuel wagering. The laws under which these licenses are granted could be modified or repealed at any time and we could be required to terminate our gaming operations. If we are required to terminate our gaming operations or if the amount of the commission we receive from the State for conducting our gaming operations is decreased, our business operations and overall profitability would be significantly impaired.

We believe that the prospect of significant additional tax revenue is one of the primary reasons why jurisdictions have legalized gaming. As a result, gaming operators are typically subject to significant taxes and fees in addition to normal federal and state corporate income taxes. These taxes and fees are subject to increase at any time. We pay substantial taxes and fees with respect to our operations and will likely incur similar burdens in any other jurisdiction in which we may conduct gaming operations in the future. Any material increase in taxes or fees, or the adoption of additional taxes or fees, may have a material adverse effect on our future financial results.



We are subject to various federal, state and local laws and regulations in addition to gaming regulations. These laws and regulations include, but are not limited to, restrictions and conditions concerning alcoholic beverages, environmental matters, employees, currency transactions, taxation, zoning and building codes, and marketing and advertising. Such laws and regulations are always subject to change, can be interpreted differently in the future, and new laws and regulations may be enacted which could adversely affect the tax, regulatory, operational or other aspects of the gaming industry and our Company. Furthermore, noncompliance with one or more of these laws and regulations could result in the imposition of substantial penalties against us.

*We Do Not Own Or Lease Our Video Lottery (Slot) Machines And Related Technology*

We do not own or lease the video lottery (slot) machines or computer systems used by the State in connection with our video lottery gaming operations. The Lottery Director enters into contracts directly with the providers of the video lottery (slot) machines and computer systems. The State purchases or leases all equipment and the Lottery Director licenses all technology providers. Our operations could be disrupted if a licensed technology provider violates its agreement with the State or ceases to be licensed for any reason. Such an event would be outside of our control and could adversely affect our gaming revenues.

**Item 3. Quantitative and Qualitative Disclosures About Market Risk**

The Company does not utilize financial instruments for trading purposes and holds no derivative financial instruments which could expose it to market risk. Our exposure to market risks related to fluctuations in interest rates is limited to our variable rate borrowings of \$56,100,000 at June 30, 2006 under our revolving credit facility. A change in interest rates of one percent on the balance outstanding at June 30, 2006 would cause a change in total annual interest costs of \$561,000. The carrying values of these borrowings approximate their fair values at June 30, 2006.

**Item 4. Controls and Procedures**

*Evaluation of Disclosure Controls and Procedures*

We have established disclosure controls and procedures to ensure that material information relating to the Company, including its consolidated subsidiaries, is made known to the officers who certify the Company's financial reports and to other members of senior management and the Board of Directors.

Based on their evaluation as of June 30, 2006, the Chief Executive Officer and Chief Financial Officer of the Company have concluded that the Company's disclosure controls and procedures (as defined in Rules 13a-15(e) and 15d-15(e) under the Securities Exchange Act of 1934) are effective to ensure that the information required to be disclosed by the Company in the reports that it files or submits under the Securities Exchange Act of 1934 is recorded, processed, summarized and reported within the time periods specified in SEC rules and forms.

*Changes in Internal Control Over Financial Reporting*

There have been no changes in our internal control over financial reporting during the fiscal quarter ended June 30, 2006 that have materially affected, or that are reasonably likely to materially affect, our internal control over financial reporting.

**Part II Other Information**

**Item 1. Legal Proceedings**

We are a party to ordinary routine litigation incidental to our business. Management does not believe that the resolution of any of these matters is likely to have a serious negative effect on our financial condition, cash flows or profitability.

**Item 1A. Risk Factors**

Disclosure regarding the most significant factors that may adversely affect our business, operations, industry or financial position or our future financial performance is set forth under the section entitled, Factors That May Affect Operating Results; Forward-Looking Statements, beginning on page 17.

**Item 2. Unregistered Sales of Equity Securities and Use of Proceeds**

On October 23, 2002, the Company's Board of Directors authorized the repurchase of up to 3,000,000 shares of the Company's outstanding common stock. The purchases may be made in the open market or in privately negotiated transactions as conditions warrant. The repurchase authorization does not obligate the Company to acquire any specific number of shares and may be suspended at any time. At June 30, 2006, the Company had remaining repurchase authority of 2,668,733 shares.

The following table details the Company's purchases of equity securities for the three months ended June 30, 2006 (the average price paid per share does not include associated expenses):

| Period        |                | Total Number of Shares Purchased | Average Price Paid Per Share | Total Number of Shares Purchased as Part of Publicly Announced Plans or Programs | Maximum Number of Shares that May Yet Be Purchased Under the Plans or Programs |
|---------------|----------------|----------------------------------|------------------------------|--|--|
| April 1, 2006 | April 30, 2006 | 3,431                            | \$ 16.40                     |  | 2,668,733  |
| May 1, 2006   | May 31, 2006   |                                  |                              |  | 2,668,733  |
| June 1, 2006  | June 30, 2006  |                                  |                              |  | 2,668,733  |

During the second quarter of 2006, the Company purchased and retired 3,431 shares of its outstanding common stock for \$56,000. These purchases were made from employees and were not pursuant to the aforementioned repurchase plan.

**Item 3. Defaults Upon Senior Securities**

None.

**Item 4. Submission of Matters to a Vote of Security Holders**

None.

**Item 5. Other Information**

None.

**Item 6. Exhibits**

- 31.1 Certification of Chief Executive Officer pursuant to Rule 13a-14(a)
- 31.2 Certification of Chief Financial Officer pursuant to Rule 13a-14(a)
- 32.1 Certification of Chief Executive Officer Pursuant to 18 U.S.C. Sec. 1350, as Adopted Pursuant to Section 906 of the Sarbanes-Oxley Act of 2002
- 32.2 Certification of Chief Financial Officer Pursuant to 18 U.S.C. Sec. 1350, as Adopted Pursuant to Section 906 of the Sarbanes-Oxley Act of 2002



**Signatures**

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

DATED: August 4, 2006

Dover Downs Gaming & Entertainment, Inc.  
Registrant

/s/ Denis McGlynn  
Denis McGlynn  
President, Chief Executive Officer and Director

/s/ Timothy R. Horne  
Timothy R. Horne  
Senior Vice President-Finance,  
Treasurer and Chief Financial Officer