

INTERNATIONAL GAME TECHNOLOGY

Form 10-Q

August 11, 2005

Table of Contents

**United States
Securities and Exchange Commission
Washington, D.C. 20549
FORM 10-Q**

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

For the Quarterly Period Ended June 30, 2005

OR

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

For the transition period from _____ to _____

Commission File Number 001-10684

International Game Technology

(Exact name of registrant as specified in its charter)

Nevada

(State of Incorporation)

88-0173041

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

9295 Prototype Drive

Reno, Nevada 89521

(Address of principal executive offices)

(775) 448-7777

(Registrant's telephone number, including area code)

www.IGT.com

(Registrant's website)

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 whether the registrant is an accelerated filer (as defined in Exchange Act Rule 12b-2). Yes þ No o

Indicate the number of shares outstanding of each of the issuer's classes of common stock, as of the latest practicable date.

Class	Outstanding at August 11, 2005
Common Stock par value \$.00015625 per share	341,068,550

As of and for the periods ended June 30, 2005 and 2004

	Page
<u>DEFINITIONS</u>	ii
<u>PART I FINANCIAL INFORMATION</u>	1
<u>Item 1. Unaudited Condensed Consolidated Financial Statements</u>	1
<u>CONSOLIDATED INCOME STATEMENTS</u>	1
<u>CONSOLIDATED BALANCE SHEETS</u>	2
<u>CONSOLIDATED CASH FLOWS STATEMENTS</u>	3
<u>NOTES TO UNAUDITED CONDENSED CONSOLIDATED FINANCIAL STATEMENTS</u>	5
<u>Item 2. Management's Discussion and Analysis</u>	18
<u>Item 3. Quantitative and Qualitative Disclosures about Market Risk</u>	33
<u>Item 4. Controls and Procedures</u>	33
<u>PART II OTHER INFORMATION</u>	34
<u>Item 1. Legal Proceedings</u>	34
<u>Item 2. Unregistered Sales of Equity Securities and Use of Proceeds</u>	34
<u>Item 3. Defaults Upon Senior Securities</u>	34
<u>Item 4. Submission of Matters to a Vote of Security Holders</u>	34
<u>Item 5. Other Information</u>	34
<u>Item 6. Exhibits</u>	34
<u>Signature</u>	35
<u>EXHIBIT 31.1</u>	
<u>EXHIBIT 31.2</u>	
<u>EXHIBIT 32.1</u>	
<u>EXHIBIT 32.2</u>	

Table of Contents

DEFINITIONS

Certain abbreviations or acronyms used in this Form 10-Q have the following meanings:

Abbreviation	Definition
Acres	Acres Gaming Incorporated
Act	American Jobs Creation Act of 2004
Anchor	Anchor Gaming
APB	Accounting Principles Board
ARB	Accounting Research Bulletin
ARPU	average product sales revenue per unit
ARS	Auction Rate Securities
ASP	average sales price per machine
AVP®	Advanced Video Platform
CCSC	Colorado Central Station Casino
CDS	central determination system
CIP	construction-in-process
EITF	Emerging Issues Task Force
EPA	Environmental Protection Agency
EPS	earnings per share
ERP	enterprise resource planning
FAS	Financial Accounting Standard
FASB	Financial Accounting Standards Board
FSP	FASB Statement of Position
Friendly Matrix	Friendly Matrix Internet Company LLC
Hi-Tech	Hi-Tech Gaming.com, Ltd.
MDA	management's discussion & analysis
NDT	The Nevada Department of Taxation
OES	IGT OnLine Entertainment Systems, Inc. and the lottery systems business of VLC, Inc. collectively
OSHA	Occupational Safety & Health Administration
PGIC	Progressive Gaming International
pp	percentage points
R&D	research and development
RFID	radio frequency identification
SAB	Staff Accounting Bulletin
SBG	server-based gaming
SEC	Securities and Exchange Commission
SFAS	Statement of Financial Accounting Standards
SMI	Shuffle Master, Inc.
SG&A	selling, general and administrative
TITO	ticket-in/ticket-out
TRO	temporary restraining order
UK	United Kingdom
US	United States
VIE	variable interest entity
VLT	video lottery terminal
WagerWorks	WagerWorks, Inc.
WAP	wide area progressive
*	not meaningful (in tables)

IGT, we, our, management, the Company

International Game Technology and its consolidated subsidiaries
and VIEs unless the context indicates otherwise

ii

Table of Contents**PART I FINANCIAL INFORMATION****Item 1. Unaudited Condensed Consolidated Financial Statements****CONSOLIDATED INCOME STATEMENTS**

	Quarters Ended June 30,		Nine Months Ended June 30,	
	2005	2004	2005	2004
<i>(In thousands, except per share amounts)</i>				
Revenues				
Product sales	\$ 274,452	\$ 315,582	\$ 880,878	\$ 1,008,419
Gaming operations	305,104	303,305	890,888	854,613
Total revenues	579,556	618,887	1,771,766	1,863,032
Costs and operating expenses				
Cost of product sales	130,751	143,787	445,691	478,603
Cost of gaming operations	140,624	136,843	431,162	385,997
Selling, general and administrative	86,339	72,938	236,543	220,157
Depreciation and amortization	17,157	16,633	50,755	47,158
Research and development	35,759	32,843	103,828	95,736
Provision for bad debts	1,516	4,761	488	16,044
Total costs and operating expenses	412,146	407,805	1,268,467	1,243,695
Operating income	167,410	211,082	503,299	619,337
Other income (expense)				
Interest income	28,520	15,656	60,051	43,831
Interest expense	(13,922)	(22,649)	(43,200)	(76,824)
Loss on debt redemption			(5)	(6,891)
Other	(2,013)	(1,030)	(2,688)	(4,423)
Total other income (expense)	12,585	(8,023)	14,158	(44,307)
Income from continuing operations before tax	179,995	203,059	517,457	575,030
Provision for income taxes	65,251	61,957	186,342	199,586
Income from continuing operations	114,744	141,102	331,115	375,444
Discontinued operations, net of \$35,312 tax				58,924
Net income	\$ 114,744	\$ 141,102	\$ 331,115	\$ 434,368
Basic earnings per share				
Continuing operations	\$ 0.33	\$ 0.40	\$ 0.96	\$ 1.08
Discontinued operations				0.17

Edgar Filing: INTERNATIONAL GAME TECHNOLOGY - Form 10-Q

Net income	\$ 0.33	\$ 0.40	\$ 0.96	\$ 1.25
Diluted earnings per share				
Continuing operations	\$ 0.32	\$ 0.38	\$ 0.91	\$ 1.01
Discontinued operations				0.16
Net income	\$ 0.32	\$ 0.38	\$ 0.91	\$ 1.17
Weighted average shares outstanding				
Basic	343,474	348,426	344,828	346,921
Diluted	369,279	378,482	371,907	377,104
Cash dividends declared per share	\$ 0.12	\$ 0.10	\$ 0.36	\$ 0.30

See accompanying notes.

1

Table of Contents**CONSOLIDATED BALANCE SHEETS**

	June 30, 2005	September 30, 2004
<i>(In thousands, except par value)</i>		
Assets		
Current assets		
Cash and equivalents	\$ 302,862	\$ 306,980
Investment securities, at market value	486,689	316,976
Restricted cash and investments	133,348	142,667
Accounts receivable, net of allowances for doubtful accounts of \$22,630 and \$26,064	309,694	359,714
Current maturities of notes and contracts receivable, net	87,270	55,202
Inventories	180,213	165,601
Investments to fund jackpots to winners	52,013	50,191
Deferred income taxes	38,324	35,944
Prepaid expenses and other	75,785	76,429
Total current assets	1,666,198	1,509,704
Notes and contracts receivable, net	49,805	87,284
Property, plant and equipment, net	354,695	329,058
Investments to fund jackpots to winners	473,959	468,238
Deferred income taxes	47,709	49,056
Intangible assets, net	260,158	258,169
Goodwill, net	1,035,026	1,035,589
Other assets	104,835	135,866
	\$ 3,992,385	\$ 3,872,964
Liabilities and Stockholders Equity		
Liabilities		
Current liabilities		
Current maturities of notes payable	\$ 599,616	\$ 103
Accounts payable	86,161	85,692
Jackpot liabilities	210,263	209,205
Accrued employee benefit plan liabilities	43,004	59,071
Dividends payable	41,198	41,531
Accrued interest	4,510	3,838
Accrued income taxes	28,009	7,537
Other accrued liabilities	176,054	153,032
Total current liabilities	1,188,815	560,009
Notes payable, net of current maturities	200,000	791,848
Non-current jackpot liabilities	502,681	510,057
Other liabilities	39,106	34,401

	1,930,602	1,896,315
--	------------------	-----------

Commitments and Contingencies**Stockholders Equity**

Common stock: \$.00015625 par value; 1,280,000 shares authorized;

712,263 and 707,973 shares issued

Additional paid-in capital

Treasury stock at cost: 368,947 and 361,882 shares

Deferred compensation

Retained earnings

Accumulated other comprehensive income

	111	111
	1,687,725	1,607,717
	(2,022,026)	(1,821,770)
	(12,381)	(11,822)
	2,408,263	2,201,436
	91	977
	2,061,783	1,976,649
	\$ 3,992,385	\$ 3,872,964

See accompanying notes.

2

Table of Contents**CONSOLIDATED CASH FLOWS STATEMENTS**

	Nine Months Ended	
	June 30,	
	2005	2004
<i>(In thousands)</i>		
Operations		
Net income	\$ 331,115	\$ 434,368
Adjustments:		
Depreciation, amortization, and asset charges	150,318	115,686
Debt discounts and deferred offering costs	12,413	14,000
Stock-based compensation	2,872	4,063
Provision for bad debts	488	16,044
Provision for inventory obsolescence	13,697	7,530
(Gain) loss on assets sold	(61)	675
Loss on debt redemption	5	6,891
Gain on sale of discontinued operations		(90,820)
Changes in operating assets and liabilities, net of acquisitions and VIE consolidations:		
Receivables	28,323	1,160
Inventories	(28,621)	(20,442)
Accounts payable and accrued liabilities	7,392	(54,168)
Jackpot liabilities	(30,062)	(29,534)
Income taxes, net of employee stock plans	47,241	33,320
Other current assets	(18)	(25,778)
Other non-current assets	27,239	(42,062)
Net cash from operations	562,341	370,933
Investing		
Capital expenditures	(166,197)	(141,308)
Restricted cash	26,485	(234)
Investment securities proceeds (purchases), net	(186,966)	196,351
Jackpot annuity investments proceeds (purchases), net	15,900	11,305
Loans receivable cash advanced	(500)	(20,563)
Loans receivable payments received	26,280	61,604
Proceeds from assets sold	332	5,164
Proceeds from discontinued operations sold		151,548
Business acquisitions	(3,961)	(109,711)
Net cash (to) from investing	(288,627)	154,156
Financing		
Debt proceeds (repayments), net	494	(415,337)
Debt redemption premium	(5)	(6,368)
Employee stock plan proceeds	48,993	46,300

Dividends paid	(124,621)	(104,027)
Share repurchases	(200,020)	(24,054)
Net cash to financing	(275,159)	(503,486)
Foreign exchange rates effect on cash	(2,673)	3,013
Net change in cash and equivalents	(4,118)	24,616
Beginning cash and equivalents	306,980	440,410
Ending cash and equivalents	\$ 302,862	\$ 465,026

See accompanying notes.

3

Table of Contents**Supplemental Cash Flows Information**

Depreciation, amortization and asset charges reflected in the cash flows statements is comprised of amounts presented separately on the income statements, plus depreciation and asset charges included in cost of product sales and cost of gaming operations.

	Nine Months Ended June 30,	
	2005	2004
<i>(In thousands)</i>		
Investment securities		
Purchases	\$(572,849)	\$(1,354,668)
Proceeds from sales	385,883	1,551,019
Net (purchases) proceeds	\$(186,966)	\$ 196,351
Jackpot funding		
Collections to fund jackpots	\$ 187,226	\$ 204,884
Payments to winners	(217,288)	(234,418)
Net change in jackpot liabilities	(30,062)	(29,534)
Purchases of jackpot annuity investments	(27,606)	(24,542)
Proceeds from jackpot annuity investments	43,506	35,847
Net jackpot annuity investments	15,900	11,305
Net jackpot funding cash flows	\$ (14,162)	\$ (18,229)
Capital expenditures		
Property, plant and equipment	\$ (34,823)	\$ (24,359)
Gaming operations equipment	(113,226)	(94,207)
Intellectual property	(18,148)	(22,742)
Total capital expenditures	\$(166,197)	\$ (141,308)
Payments		
Interest	\$ 6,820	\$ 73,733
Income taxes	145,908	207,541
Non-cash investing and financing items:		
Tax benefit of employee stock plans	27,760	33,208
Treasury stock acquired for stock awards exercised or forfeited	236	108
Interest accretion for jackpot funding investments	23,472	19,465

Edgar Filing: INTERNATIONAL GAME TECHNOLOGY - Form 10-Q

Interest accretion on zero-coupon convertible debentures	7,768	7,671
Accruals for capital purchases	5,875	
Acquisitions		
Fair value of assets	5,151	149,891
Fair value of liabilities	1,190	40,180
Initial VIE consolidations		
Fair value of assets		185,244
Fair value of liabilities		185,244

See accompanying notes.

4

Table of Contents

NOTES TO UNAUDITED CONDENSED CONSOLIDATED FINANCIAL STATEMENTS

1. Summary of Significant Accounting Policies**Basis of Presentation and Consolidation**

Our consolidated financial statements have been prepared pursuant to the rules and regulations of the SEC and include all adjustments necessary to fairly present our consolidated results of operations, financial position, and cash flows for each period presented. Results for interim periods are not necessarily indicative of results for the full year. This quarterly report should be read in conjunction with our Annual Report on Form 10-K for the year ended September 30, 2004.

Our consolidated financial statements include the accounts of International Game Technology and all majority-owned or controlled subsidiaries and variable interest entities of which we are the primary beneficiary. All appropriate inter-company accounts and transactions have been eliminated. We account for investments in 50% or less owned joint ventures using the equity method.

Our fiscal year is reported on a 52/53-week period that ends on the Saturday nearest to September 30 each year. Similarly, our quarters end on the Saturday nearest to the last day of the quarter end month. For simplicity, all fiscal periods are presented as ending on the calendar month end. Consistent with this practice, the current quarter ended July 2, 2005 is presented as ended June 30, 2005, the prior year quarter ended July 3, 2004 is presented as ended June 30, 2004, and the prior fiscal year ended October 2, 2004 is presented as ended September 30, 2004. The results of operations for fiscal 2005 will contain 52 weeks versus 53 weeks in fiscal 2004. The results of operations for the nine months ended June 30, 2005 contained 39 weeks versus 40 weeks for the nine months ended June 30, 2004. The results of operations for the quarters ended June 30, 2005 and 2004 both contained 13 weeks.

Certain prior period amounts have been reclassified to be consistent with the presentation used in the current period, specifically with respect to the presentation of restricted cash and Auction Rate Securities (ARS) in our balance sheets and cash flows statements.

Restricted cash

In conjunction with the preparation of this quarterly report for the period ended June 30, 2005, we determined it appropriate to classify restricted cash separately from cash and equivalents on our balance sheets. We are required by gaming regulators to maintain sufficient reserves in restricted accounts for the purpose of funding payments to progressive jackpot winners.

Restricted cash totaling \$60.1 million at June 30, 2005 and \$86.5 million at September 30, 2004 has been presented separately on our balance sheets as a component of restricted cash and investments. The net change in restricted cash is reflected as an increase in investing cash flows of \$26.5 million for the nine months ended June 30, 2005 and a decrease of \$234,000 for the nine months ended June 30, 2004, rather than as a component of net change in cash as presented previously. Restricted cash provided from our initial VIE consolidations at March 30, 2004 was also reclassified, reducing investing cash flows and net change in cash by \$47.5 million for the nine months ended June 30, 2004, and included in supplemental disclosures for non-cash fair value of assets. These reclassifications had no impact on operating cash flows.

ARS

In conjunction with the preparation of the quarterly report for the period ended March 31, 2005, we determined it appropriate to classify our ARS as short-term investments. Although ARS have an underlying long-term maturity, they are traded and interest rates reset through a modified Dutch auction at predetermined short-term intervals, usually 7, 28, or 35 days. We previously classified ARS as cash equivalents based on the period from purchase to first auction date.

We reclassified ARS totaling \$371.5 million (including restricted amount of \$56.2 million) at September 30, 2004 from cash equivalents to short-term investments. Additionally, we reclassified ARS purchases of \$1.4 billion and proceeds of \$1.6 billion for the nine months ended June 30, 2004, increasing investing cash flows, as well as net change in cash and equivalents, by \$196.4 million. As of and for the nine months ended June 30, 2005, ARS purchases totaled \$572.8 million, proceeds totaled \$385.9 million, and the ending balance totaled \$558.5 million (including restricted amount of \$73.2 million).

Table of Contents

Recently Issued Accounting Standards

FSP FAS143-1

In June 2005, the FASB issued final FSP FAS143-1, *Accounting for Electronic Equipment Waste Obligations*, to address accounting for obligations associated with the European Union's Directive 2002/96/EC on Waste Electrical and Electronic Equipment. The Directive, enacted in 2003, requires EU-member countries to adopt legislation to regulate the collection, treatment, recovery, and environmentally sound disposal of electrical and electronic waste equipment. The Directive distinguishes between products put on the market after August 13, 2005 as new waste and before that date as historical waste. FSP FAS143-1 only addresses accounting for historical waste and is required to be applied the later of the first reporting period ending after June 8, 2005 or the date of adoption of the law by the applicable European Union member country. We anticipate no material impact on our results of operations, financial position or cash flows as a result of adopting this FSP.

SFAS 154

In May 2005, the FASB issued SFAS 154, *Accounting Changes and Error Corrections*, requiring retrospective application to prior-period financial statements of changes in accounting principle, unless it is impracticable to determine either the period-specific effects or the cumulative effect of the change. SFAS 154 also redefines restatement as the revising of previously issued financial statements to reflect the correction of errors made in fiscal years beginning after December 15, 2005, which will be IGT's fiscal year 2007. Although we have no current application for this statement, the adoption of this statement may impact our future results of operations, financial position or cash flows.

FIN 47

In March 2005, the FASB issued FIN 47, *Accounting for Conditional Asset Retirement Obligations, an Interpretation of FAS 143*. FIN 47 requires recognition of a liability for the fair value of a conditional asset retirement obligation if the fair value of the liability can be reasonably estimated. When sufficient information exists, uncertainty about the amount and/or timing of future settlement should be factored into the liability measurement. The interpretation is effective for the end of fiscal years ending after December 15, 2005, which will be IGT's fiscal year 2006. We continue to evaluate the impact of FIN 47 on our results of operations, financial position or cash flows.

SFAS 109-1

In December 2004, the FASB issued SFAS 109-1, *Applications 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*. SFAS 109-1 states that the qualified production activities deduction should be accounted for as a special deduction in accordance with SFAS 109. This statement is effective immediately. The adoption of this statement had no material impact on our results of operations, financial position or cash flows.

SFAS 109-2

In December 2004, the FASB issued SFAS 109-2, *Accounting and Disclosure Guidance for the Foreign Earnings Repatriation Provision within the American Jobs Creation Act of 2004*. SFAS 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 109. This statement is effective immediately. We anticipate no material impact on our results of operations, financial position or cash flows as a result of adopting this statement.

EITF 04-8

In December 2004, the FASB issued and we adopted EITF 04-8, *The Effect of Contingently Convertible Debt on Diluted Earnings per Share*, requiring the inclusion of convertible shares in diluted EPS regardless of whether the market price trigger has occurred for all periods presented. We restated the first quarter of fiscal 2004 to reduce diluted EPS from continuing operations by \$0.01, related to an additional 20.5 million outstanding debenture shares previously excluded because the conversion event had not occurred. EPS for the nine months ended June 30, 2004 was also recalculated to reflect the additional debentures shares outstanding for the first quarter of fiscal 2004.

Table of Contents

SFAS 123R and SAB 107

In December 2004, the FASB issued SFAS 123R (revised 2004), *Share-Based Payment*, replacing SFAS 123, *Accounting for Stock-Based Compensation*, and superseding APB 25, *Accounting for Stock Issued to Employees*. SFAS 123R requires recognition of share-based compensation in the financial statements. SFAS 123R will be effective for the first annual reporting period that begins after June 15, 2005, which will be IGT's first quarter of fiscal 2006. We continue to evaluate our stock-based compensation policies and currently expect to continue using the Black-Scholes valuation model. We estimate the adoption of FAS123R will reduce earnings consistent with our pro forma disclosures presented in Note 2.

In March 2005, the SEC issued SAB 107, *Share-Based Payment*, providing interpretive guidance on FAS 123R valuation methods, assumptions used in valuation models, and the interaction of SFAS 123R with existing SEC guidance. The additional SAB 107 requirement for the classification of stock compensation expense to the same financial statement line as cash compensation will impact our cost of product sales and gaming operations, related gross profits and margins, R&D, and SG&A expenses.

SFAS 153

In December 2004, the FASB issued SFAS 153, *Exchanges of Nonmonetary Assets*, amending APB 29, which treated nonmonetary exchanges of similar productive assets as an exception from fair value measurement. SFAS 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, which will be IGT's fourth quarter of fiscal 2005. We anticipate no material impact on our results of operations, financial position or cash flows as a result of adopting this statement.

SFAS 151

In November 2004, the FASB issued SFAS 151, *Inventory Costs, amending ARB 43 Chapter 4, Inventory Pricing*. SFAS 151 clarifies the accounting for abnormal amounts of idle facility expense, freight and handling costs, and wasted material (spoilage). SFAS 151 introduces the concept of "normal capacity" requiring allocation of fixed production overheads to inventory based upon normal capacity of production facilities. Unallocated overhead costs must be expensed in the period in which they are incurred. This statement is effective for inventory costs incurred during fiscal years beginning after June 15, 2005, which will be IGT's fiscal year 2006. We anticipate no material impact on our results of operations, financial position or cash flows as a result of adopting this statement.

Table of Contents**2. Stock Based Compensation**

As permitted by SFAS 123, we continue to account for stock based compensation plans in accordance with APB 25 which determines the compensation cost of stock options issued for non-variable plans like ours as the difference between the quoted market value at the measurement date and the amount, if any, required to be paid by employees. Our stock-based compensation plans are predominantly plans where the option price is equal to or greater than the price the stock would be in an offer to all shareholders and therefore, no compensation cost is recorded. We do record stock-based compensation for the intrinsic value of restricted shares issued and when terms of an outstanding option are modified or converted in an acquisition.

The following pro forma financial information reflects the difference between stock compensation costs charged to operations under the APB 25 intrinsic value method and pro forma stock compensation costs that would have been recorded if the SFAS 123 fair value method had been applied to all awards granted, modified, or settled since the beginning of fiscal 1996. The current quarter pro forma stock compensation includes the recapture of previously recognized expense related to unvested options forfeited by certain retiring key executives.

	Quarters Ended		Nine Months Ended	
	June 30,		June 30,	
	2005	2004	2005	2004
<i>(In thousands, except per share amounts)</i>				
Reported net income	\$ 114,744	\$ 141,102	\$ 331,115	\$ 434,368
Reported stock compensation, net of tax	565	903	1,838	2,580
Pro forma stock compensation, net of tax	(2,933)	(7,278)	(17,441)	(22,399)
Pro forma net income	112,376	134,727	315,512	414,549
Interest expense on convertible debentures, net of tax	2,394	2,337	7,123	7,007
Pro forma diluted EPS numerator	\$ 114,770	\$ 137,064	\$ 322,635	\$ 421,556
Basic earnings per share				
As reported	\$ 0.33	\$ 0.40	\$ 0.96	\$ 1.25
Pro forma	0.33	0.39	0.91	1.19
Diluted earnings per share				
As reported	\$ 0.32	\$ 0.38	\$ 0.91	\$ 1.17
Pro forma	0.31	0.36	0.87	1.12

3. Inventories

	June 30,	September
	2005	30,
		2004
<i>(In thousands)</i>		
Raw materials	\$ 80,036	\$ 84,486
Work-in-process	6,568	4,535
Finished goods	93,609	76,580
Total inventories	\$ 180,213	\$ 165,601

Table of Contents**4. Property, Plant and Equipment**

	June 30, 2005	September 30, 2004
<i>(In thousands)</i>		
Land	\$ 19,979	\$ 19,979
Buildings	103,469	89,958
Gaming operations equipment	440,265	392,036
Manufacturing machinery and equipment	223,548	206,499
Leasehold improvements	12,138	8,141
Construction-in-process (CIP)	22,273	25,813
Total	821,672	742,426
Less accumulated depreciation and amortization	(466,977)	(413,368)
Property, plant and equipment, net	\$ 354,695	\$ 329,058

CIP included \$19.4 million at June 30, 2005 and \$22.1 million at September 30, 2004 related to our new facilities under construction in Las Vegas and Reno. We reclassified \$18.8 million of CIP for the Reno expansion to buildings and equipment when it was placed in service during fiscal 2005.

5. Acquisitions, Divestitures and Discontinued Operations*WagerWorks*

On July 26, 2005, we entered into a definitive agreement to acquire WagerWorks, Inc. for total cash consideration of approximately \$90.0 million, subject to a working capital adjustment. Consummation of the merger, expected in our fourth quarter, is contingent upon customary closing conditions and regulatory approvals. IGT deposited \$4.5 million with WagerWorks to be credited against the purchase price at closing. In the event the merger agreement is terminated, IGT would forfeit the deposit unless the decision to terminate is mutual or due to breach or failure by WagerWorks to satisfy certain closing conditions.

WagerWorks is a provider of internet gaming technology, content and services, with a content portfolio and a strict policy of not conducting business with operators who knowingly process gambling transactions from the United States. We expect this business combination will enable us to expand the distribution of IGT game content across new channels and mediums, including internet, mobile devices, and interactive television.

Friendly Matrix

On December 16, 2004, IGT acquired substantially all the assets of Friendly Matrix, including several products that will enhance our *IGT Advantage* systems functionality and extend our reach into key markets. The total purchase consideration of \$1.6 million was allocated primarily to developed technology.

Hi-Tech

On December 31, 2004, IGT acquired substantially all of the assets of Hi-Tech, our former distributor of gaming equipment and services in Canada. This asset acquisition is allowing us to further develop our Canadian customer relationships, integrating Hi-Tech's employees with IGT's resources. The total purchase consideration of \$10.3 million was allocated to accounts receivable, inventories, as well as contract and customer relationship intangibles of \$4.6 million.

Acres

On October 27, 2003, we completed the acquisition of Acres, specializing in the development of gaming systems technology designed to assist casino operators in increasing patron loyalty. This business combination enables us to utilize the Acres gaming systems technology to develop more integrated gaming systems products, as well as increases our competitive marketing capacity. The aggregate purchase price of \$134.0 million was allocated to net tangible assets of \$9.7 million, identifiable intangibles and goodwill of \$122.5 million, and in-process R&D of \$1.8 million charged immediately to expense.

We have not provided pro forma financial information for these acquisitions, as they were not material to our consolidated results.

Table of Contents*Divestitures and Discontinued Operations*

Subsequent to the completion of the Anchor acquisition on December 30, 2001, we divested certain acquired operations inconsistent with IGT's core business strategy. In fiscal 2004, we completed the sale of OES for total cash proceeds of \$151.5 million, resulting in a gain of \$56.8 million, net of tax.

Nine months ended June 30, 2004*(In thousands)*

Net revenue	\$13,558
Income before tax	\$ 3,416
Provision for income taxes	1,254
Income after tax	2,162
Gain on sale before tax	90,820
Provision for income taxes	34,058
Gain on sale after tax	56,762
Discontinued operations after tax	\$58,924

6. Allowances for Doubtful Notes and Contracts Receivable

	June 30, 2005	September 30, 2004
<i>(In thousands)</i>		
Current	\$24,233	\$ 23,871
Long-term	18,672	18,507
	\$42,905	\$ 42,378

7. Concentrations of Credit Risk

The financial instruments that potentially subject us to concentrations of credit risk consist principally of cash or equivalents, short-term investments and receivables. We invest our excess cash in both deposits with major banks throughout the world and other high quality money market instruments. Certain cash balances may be in excess of the Federal Deposit Insurance Corporation insurance limits.

We place short-term investments in high credit quality financial institutions or in short duration high quality securities. With the exception of US Government and Agency securities, our investment policy limits the amount of credit exposure in any one financial institution, industry group or type of instrument.

Our revenues and resulting receivables are concentrated in specific legalized gaming regions. Collection of our receivables may be affected by changes in economic trends or other industry conditions. We perform ongoing credit evaluations of our customers and maintain reserves for potential credit losses. The table below shows the composition of our total net receivables at June 30, 2005.

North America

Nevada	24%
--------	-----

California	13
New Mexico	5
Louisiana	5
New Jersey	4
Mississippi	4
Canada	4
Other US regions, 3% or less individually	19
Total North America	78%
International	
Europe	11%
Other international, 3% or less individually	11
Total international	22%

Table of Contents**8. Intangibles and Goodwill**

Intangible additions below are comprised of cash expenditures of \$18.1 million, \$6.0 million of acquisitions in business combinations described in Note 5, and other accruals of \$5.9 million. Current quarter additions include \$15.4 million for a 50% interest in the SMI portfolio of RFID and optical bet recognition patents. Our patents category also includes capitalized legal costs for patent applications.

Nine months ended June 30, 2005 <i>(In thousands, except life)</i>	Additions	Weighted Average Life (years)
Finite lived intangibles:		
Patents	\$24,023	6
Contracts	3,662	2
Developed technology	1,444	10
Customer relationships	888	2
Total	\$30,017	

Intangible Balances

	June 30, 2005			September 30, 2004		
	Carrying Amount	Accumulated Amortization	Net	Carrying Amount	Accumulated Amortization	Net
<i>(In thousands)</i>						
Finite lived intangible assets:						
Patents	\$310,722	\$ 85,112	\$225,610	\$286,733	\$64,825	\$221,908
Contracts	11,712	4,367	7,344	8,094	2,341	5,753
Trademarks	9,822	7,350	2,472	9,828	5,969	3,859
Developed technology	25,662	6,543	19,120	24,218	3,717	20,501
Customer relationships	6,671	1,059	5,612	5,800	160	5,640
Backlog	6,100	6,100		6,100	5,592	508
Net carrying amount	\$370,689	\$110,531	\$260,158	\$340,773	\$82,604	\$258,169

Amortization of Intangibles

Our aggregate amortization expense totaled \$9.5 million in the current quarter versus \$9.2 million in the prior year quarter and \$27.9 million in the nine months just ended versus \$26.9 million in the prior year period.

	2005	2006	2007	2008	2009
<i>(in millions)</i>					
Estimated annual amortization	\$37.4	\$36.0	\$33.0	\$29.8	\$27.9

Goodwill Changes and Balances by Segment

Nine months ended June 30, 2005 <i>(In thousands)</i>	North America Division	International Division	Total

Edgar Filing: INTERNATIONAL GAME TECHNOLOGY - Form 10-Q

Beginning balance	\$ 994,686	\$40,903	\$1,035,589
Tax benefit of Anchor options exercised	(413)		(413)
Foreign currency translation adjustment		(150)	(150)
Ending balance	\$ 994,273	\$40,753	\$1,035,026

Table of Contents**9. Debt**

	June 30, 2005	September 30, 2004
Outstanding Balance		
<i>(In thousands)</i>		
Senior credit facility term loan	\$ 200,000	\$200,000
Senior convertible debentures, net of unamortized discount	599,616	591,848
Senior notes		103
Total debt	799,616	791,951
Less current maturities	(599,616)	(103)
Notes payable, net of current maturities	\$ 200,000	\$791,848

We continue to be in compliance with all applicable debt covenants at June 30, 2005.

Senior Credit Facility

The interest rate on the \$200.0 million term loan reset to 3.26% on January 18, 2005, 3.75% on April 18, 2005, and 4.21% on July 18, 2005. The reserve for letters of credit against the available \$1.3 billion revolver totaled \$4.0 million.

Foreign Credit Facilities

Our available foreign credit facilities totaled \$52.6 million at June 30, 2005. Renewals occur annually in January and July.

Senior Convertible Debentures

Our convertible debentures were reclassified as current in January 2005 because the debenture holders will have the right to require IGT to redeem the debentures for cash on January 29, 2006. The market price condition for convertibility was not met during the measurement period ended July 19, 2005.

10. Earnings Per Share

The calculation of diluted EPS from continuing operations below reflects our outstanding debenture shares for all periods presented, in conjunction with the adoption of EITF 04-8, *The Effect of Contingently Convertible Debt on Diluted Earnings per Share*, in our first quarter of fiscal 2005.

From the end of our third quarter just ended through August 11, 2005, we repurchased 2.5 million additional common shares or approximately 1% of outstanding shares. There were no other transactions during this period that would have materially changed the number of basic or diluted shares outstanding.

	Quarters Ended June 30,		Nine Months Ended June 30,	
	2005	2004	2005	2004
<i>(In thousands, except per share amounts)</i>				
Income from continuing operations	\$114,744	\$141,102	\$331,115	\$375,444
After-tax interest expense on convertible debentures	2,394	2,337	7,123	7,007
Diluted EPS numerator	\$117,138	\$143,439	\$338,238	\$382,451
Weighted average common shares outstanding:				
Basic	343,474	348,426	344,828	346,921
Dilutive effect of stock awards	5,274	9,525	6,548	9,652
Dilutive effect of debentures	20,531	20,531	20,531	20,531

Edgar Filing: INTERNATIONAL GAME TECHNOLOGY - Form 10-Q

Diluted EPS denominator	369,279	378,482	371,907	377,104
Basic earnings per share	\$ 0.33	\$ 0.40	\$ 0.96	\$ 1.08
Diluted earnings per share	\$ 0.32	\$ 0.38	\$ 0.91	\$ 1.01
Weighted average antidilutive stock award shares excluded from diluted EPS	10,176	699	8,342	318

12

Table of Contents**11. Income Taxes**

Our provision for income taxes is based on estimated effective annual income tax rates. The provision differs from income taxes currently payable because certain items of income and expense are recognized in different periods for financial statement purposes than for tax return purposes.

12. Comprehensive Income

	Quarters Ended June 30,		Nine Months Ended June 30,	
	2005	2004	2005	2004
<i>(In thousands)</i>				
Net income	\$ 114,744	\$ 141,102	\$ 331,115	\$ 434,368
Currency translation adjustments	(3,357)	(29)	(831)	5,145
Investment securities unrealized gains (losses)	8	(99)	(55)	(6)
Comprehensive income	\$ 111,395	\$ 140,974	\$ 330,229	\$ 439,507

13. Commitments and Contingencies**Litigation**

IGT has been named in and has brought lawsuits in the normal course of business. We do not expect the outcome of these suits, including the lawsuits described below, to have a material adverse effect on our financial position or results of future operations.

Alliance

On December 7, 2004, IGT filed a complaint in US District Court for the District of Nevada, alleging that defendants Alliance Gaming Corp., Bally Gaming Int'l, Inc., and Bally Gaming, Inc. infringed six US patents held by IGT, US Patent numbers 6,827,646; 5,848,932; 5,788,573; 5,722,891; 6,712,698; and 6,722,985. On January 21, 2005, defendants filed an answer to IGT's complaint raising various affirmative defenses to IGT's asserted claims. Defendants also asserted fourteen counterclaims against IGT, including counterclaims for a declaratory judgment of non-infringement, invalidity, unenforceability of the asserted patents, antitrust violations and for intentional interference with prospective business advantage. IGT denies these allegations. In addition, IGT has filed a motion to strike portions of defendants' answer and affirmative defenses and to dismiss certain of defendants' counterclaims. Discovery is ongoing.

Environmental Matters

CCSC, a casino operation sold by IGT in April 2003, is located in an area that has been designated by the EPA as a superfund site as a result of contamination from historic mining activity in the area. The EPA is entitled to proceed against current and prior owners and operators of properties located within the site for remediation and response costs associated with their properties and with the entire site. CCSC is located within the drainage basin of North Clear Creek and is therefore subjected to potentially contaminated surface and ground water from upstream mining related sources. Soil and ground water samples on the site indicate that several contaminants exist in concentrations exceeding drinking water standards. We have applied the guidance in Statement of Position 96-1 Environmental Remediation Liabilities and determined that a liability has not yet been incurred.

Miller

In June 2003, a class action lawsuit was filed in Clark County, Nevada, District Court against Acres and its directors, entitled Paul Miller v. Acres Gaming Incorporated, et al. The complaint alleged that Acres directors breached their fiduciary duties to their stockholders in connection with the approval of the merger transaction between Acres and IGT and sought to enjoin and/or void the merger agreement among other forms of relief. On September 19, 2003, the Court denied plaintiff's motion for a TRO to prevent Acres stockholders from voting on the merger. On September 24, 2003, plaintiff petitioned the Nevada Supreme Court to vacate the denial of the TRO and to enjoin Acres from holding its stockholder vote on the merger. The Nevada Supreme Court denied the petition on September 25, 2003. The

plaintiff's action also seeks damages. On December 23, 2003, defendants filed a motion to dismiss plaintiff's second amended complaint for failure to state a claim on which relief may be granted. On April 29, 2004, the Court issued a ruling denying defendant's motion to dismiss the second amended complaint. On May 12, 2004 the Court issued an order denying defendants motion to dismiss. Pursuant to stipulation of the parties on August 13, 2004, plaintiff filed a third amended complaint. Defendants have filed a motion to dismiss the third amended complaint. The Court has not yet ruled on this motion.

Table of Contents

Nevada Sales/Use Tax Matter

In February 2003, an IGT employee, presently on administrative leave, filed a sealed complaint under Nevada's False Claims Act (State of Nevada ex rel. James McAndrews v. International Game Technology, Anchor Coin and Spin for Cash Wide Area Progressive) alleging that IGT failed to pay requisite Nevada sales/use taxes on certain Wheel of Fortune® games placed in Nevada since 1997 and in connection with royalties received under intellectual property licensing agreements related to the placement of Action Gaming games in Nevada since 1997.

The Attorney General and IGT both filed motions to dismiss the complaint in January 2004, and the Court unsealed the action in February 2004. The Court denied both motions to dismiss the complaint on July 1, 2004. A Petition for Writ of Mandamus was filed with the Nevada Supreme Court in September 2004. The Court granted the petition. A stay of the lower court proceedings pending action by the Nevada Supreme Court was granted by the trial court in September 2004.

In October 2004 and again in July 2005, NDT advised us that we had a good-faith legal basis for our position that no sales tax was payable on royalties received, but that NDT believed that sales tax may be payable on some amount of the royalties. IGT disagrees with NDT's position that sales tax may be payable on any part of the royalties and continues to correspond with NDT on this issue.

OSHA Matter

On July 8, 2004, two former employees filed a complaint with the US Department of Labor, OSHA, alleging retaliatory termination in violation of the Sarbanes-Oxley Act of 2002. The former employees allege that they were terminated in retaliation for questioning whether Anchor and its executives failed to properly disclose information allegedly affecting the value of Anchor's patents in connection with IGT's acquisition of Anchor in 2001. The former employees also allege that the acquired patents are overvalued on the financial statements of IGT. Outside counsel, retained by an independent committee of the Board of Directors, reviewed the allegations and found them to be entirely without merit.

In the purchase price allocation, IGT used the relief of royalty valuation methodology to estimate the fair value of the patents at \$164.4 million, which is being amortized over the useful economic life.

The carrying value of the patents at June 30, 2005 totaled \$113.5 million, with a remaining life of approximately 11 years. On November 10, 2004, the employees withdrew their complaint filed with OSHA and filed a notice of intent to file a complaint in federal court. On December 1, 2004, a complaint was filed under seal in the US District Court for Nevada. IGT filed a motion to dismiss the complaint in December 2004. The court denied the motion on May 2, 2005. IGT has appealed this denial to the US Court of Appeals for the Ninth Circuit. IGT believes that the allegations are without merit and intends to vigorously defend this matter.

Poulos

Along with a number of other public gaming corporations, IGT is a defendant in three class action lawsuits: one filed in the US District Court of Nevada, entitled Larry Schreier v. Caesars World, Inc., et al, and two filed in the US District Court of Florida, entitled Poulos v. Caesars World, Inc., et al. and Ahern v. Caesars World, Inc., et al., which have been consolidated into a single action. The Court granted the defendants' motion to transfer venue of the consolidated action to Las Vegas. The actions allege that the defendants have engaged in fraudulent and misleading conduct by inducing people to play video poker machines and electronic slot machines, based on false beliefs concerning how the machines operate and the extent to which there is an opportunity to win on a given play. The amended complaint alleges that the defendants' acts constitute violations of the Racketeer Influenced and Corrupt Organizations Act, and also give rise to claims for common law fraud and unjust enrichment, and seeks compensatory, special, incidental and punitive damages of several billion dollars.

In December 1997, the Court denied the motions that would have dismissed the Consolidated Amended Complaint or that would have stayed the action pending Nevada gaming regulatory action. The defendants filed their consolidated answer to the Consolidated Amended Complaint in February 1998. In March 2002, the Court directed that certain merits discovery could proceed. In June 2002, the Court denied the plaintiffs' motion for class certification. An appeal of that denial was filed timely with the US Court of Appeals for the Ninth Circuit. All briefings were completed and oral arguments were heard in January 2004. On August 10, 2004, a three-judge panel of the Ninth Circuit Court of Appeals upheld US District Court Judge Roger Hunt in his denial of class certification. The class plaintiffs did not

appeal the decision and are proceeding with only their individual claims. A jury trial has been set for September 12, 2005.

Table of Contents*Siena*

In November 2001, Wild Games NG, LLC, owner and operator of the Siena Hotel Spa Casino, filed suit against Acres in Washoe County Nevada District Court. Siena alleged Acres failed to perform obligations under an Equipment Sale Agreement and sought consequential damages largely comprised of lost profits. Acres believes that Siena's claims are unfounded and not permitted by the Equipment Sales Agreement. Acres filed a counterclaim seeking payments due from Siena.

We have made an accrual to reflect a jury verdict of \$1.7 million returned on March 24, 2005 in favor of Siena, along with related interest and legal costs. Acres subsequently filed several post-trial motions that resulted in the verdict amount being affirmed, but costs and fees were reduced. The time for either party to file notice of appeal is thirty days from July 17, 2005.

Arrangements with Off-Balance Sheet Risks

In the normal course of business, we are party to financial instruments with off-balance sheet risk such as performance bonds, guarantees and product warranties not reflected in our balance sheet. We do not expect any material losses to result from these off-balance sheet arrangements, and we are not dependent on off-balance sheet financing arrangements to fund our operations.

Performance Bonds

Performance bonds outstanding related to our gaming operations totaled \$4.7 million at June 30, 2005. We are liable to reimburse the bond issuer in the event the bonds are exercised as a result of our nonperformance.

Letters of Credit

Outstanding letters of credit issued under our line of credit to ensure payment to certain vendors and governmental agencies totaled \$4.0 million at June 30, 2005.

IGT Licensor Arrangements

Our sales agreements that include software and intellectual property licensing arrangements may provide a clause whereby IGT indemnifies the third party licensee against liability and damages (including legal defense costs) arising from any claims of patent, copyright, trademark or trade secret infringement. Should such a claim occur, we could be required to make payments to the licensee for any liabilities or damages incurred. Historically, we have not incurred any significant costs due to infringement claims. As we consider the likelihood of recurring future costs to be remote, no liability has been recorded.

Product Warranties

We accrue for warranty costs based on historical trends in product failure rates and the expected material and labor costs to provide warranty services. The majority of our products are generally covered by a warranty for periods ranging from 90 days to one year. The following table summarizes the activities related to our product warranty liability.

Nine months ended June 30, <i>(In thousands)</i>	2005	2004
Balance at beginning of year	\$ 6,939	\$ 6,104
Reduction for payments made	(3,611)	(2,587)
Accrual for new warranties issued	4,285	3,050
Adjustments for pre-existing warranties	(2,486)	(361)
Balance at end of period	\$ 5,127	\$ 6,206

Self-Insurance

We are self-insured for various levels of workers' compensation, directors' and officers' liability, electronic errors and omissions liability, as well as employee medical, dental, prescription drug, and disability coverage. We purchase stop loss coverage to protect against unexpected claims. Accrued insurance claims and reserves include estimated settlements for known claims, and actuarial estimates of claims incurred but not reported.

State and Federal Taxes

We are subject to sales, use, income and other tax audits and administrative proceedings in various federal, state, and local jurisdictions. While we believe we have properly reported our tax liabilities in each jurisdiction, we can give no assurance that taxing authorities will not propose adjustments that increase our tax liabilities.

Table of Contents**14. Derivatives**

We recognize all derivatives as either assets or liabilities at the fair value of the instruments. Accounting for changes in the fair value of derivatives depends on the intended use and resulting designation. We use derivative financial instruments to minimize our market risk exposure resulting from fluctuations in foreign exchange rates and interest rates. The primary business objective of our hedging program, as defined in our corporate risk management policy, is to minimize the impact of transaction, remeasurement, and specified economic exposures to our net income and earnings per share. The counterparties to these instruments are major commercial banks and we believe that losses related to credit risk are remote. We are not party to leveraged derivatives and do not hold or issue financial instruments for speculative purposes.

Foreign Currency Hedging

We routinely use derivative financial instruments to hedge our net exposure, by currency, related to our monetary assets and liabilities denominated in nonfunctional foreign currency. Fluctuations in the value of these derivative instruments are generally offset by the value of underlying exposures. Our forward currency contracts are not designated FAS 133 hedging instruments and resulting gains or losses are recognized in current earnings. At June 30, 2005, we hedged \$49.1 million of net foreign currency exposure with \$37.3 million in forward currency contracts compared to \$53.1 million of exposure hedged with \$43.8 million in forward contracts at September 30, 2004.

Interest Rate Management

In the fourth quarter of fiscal 2003, we entered into four interest rate swap agreements with a combined notional amount of \$350.0 million, primarily to diversify a portion of our debt portfolio between fixed and variable rate instruments. These swaps were cancelled on July 9, 2004 in conjunction with the early redemption of our 2009 senior notes on July 16, 2004.

Under the terms of the interest rate swaps, we made payments based on a specific spread over six-month LIBOR and received payments equal to the interest rate on our fixed rate senior notes. These interest rate swaps were fair value hedges, which qualified for the shortcut method of accounting under SFAS 133, allowing for an assumption of no ineffectiveness in the hedging relationship. Accordingly, we recorded the change in the fair value of the swap instruments as non-current assets or liabilities with an offsetting adjustment to the carrying value of the related debt.

Debentures Yield Adjustment

The yield adjustment feature of our debentures requires contingent cash interest payments that are triggered by our stock price and is considered a FAS 133 embedded derivative requiring bifurcation. However, since IGT could exercise its redemption right in anticipation of an upward adjustment, we expect that an investor would attribute no economic value to this feature. Accordingly, we have ascribed no value and recorded no derivative asset or liability for this embedded derivative.

Table of Contents**15. Business Segments**

We currently view our business in two regional operating segments, each incorporating all relevant revenues from product sales and gaming operations:

- ^a The North America Division aggregates our operations in the US and Canada, including the IGT Systems Group
- ^a The International Division aggregates our operations in Asia, Australia, New Zealand, Europe, Japan, Latin America, South Africa, and the UK

Our business segments are designed to allocate resources within a framework of management responsibility. Operating costs from one segment may benefit another segment. We continually evaluate the alignment of our business development and sales organizations for reporting purposes, which may result in changes to segment allocations. Prior year amounts have been reclassified to conform to the current management view and presentation. The Corporate Division manages certain unallocated income and expenses related to company-wide initiatives, including capital deployment, treasury and cash management, as well as administrative and oversight functions such as human resources, information systems, and legal counsel. The Corporate Division includes all income and expenses related to debt, certain investment securities, hedging and other corporate assets.

On a consolidated basis we do not recognize inter-company revenues or expenses upon the transfer of gaming products between divisions. IGT's segment profit reflects income from continuing operations before tax.

	Quarters Ended		Nine Months Ended	
	June 30,		June 30,	
	2005	2004	2005	2004
<i>(In thousands)</i>				
North America Division				
Revenues	\$ 480,740	\$ 541,862	\$ 1,420,083	\$ 1,597,781
Product sales	182,590	243,093	548,577	755,665
Gaming operations	298,150	298,769	871,506	842,116
Inter-company revenues	47,960	21,775	110,477	83,765
Segment profit	187,873	230,402	517,580	653,925
International Division				
Revenues	\$ 98,816	\$ 77,025	\$ 351,683	\$ 265,251

Edgar Filing: INTERNATIONAL GAME TECHNOLOGY - Form 10-Q

Product sales	91,862	72,489	332,301	252,754
Gaming operations	6,954	4,536	19,382	12,497
Inter-company revenues	92	772	436	1,277
Segment profit	23,543	17,759	82,522	67,243
Corporate Division				
Segment loss	\$ (31,421)	\$ (45,102)	\$ (82,645)	\$ (146,138)
Consolidated				
Revenues	\$579,556	\$618,887	\$1,771,766	\$1,863,032
Product sales	274,452	315,582	880,878	1,008,419
Gaming operations	305,104	303,305	890,888	854,613
Inter-company revenues	48,052	22,547	110,913	85,042
Segment profit	179,995	203,059	517,457	575,030

17

Table of Contents

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

The following MDA is intended to enhance the reader's understanding of changes in the financial condition and results of operations of International Game Technology. It should be read in conjunction with our Annual Report on Form 10-K for the year ended September 30, 2004. Throughout this section, table amounts are presented in millions, except units, ASP, ARPU and EPS, and may not foot due to rounding.

Italicized text with an attached superscript trademark or copyright notation in this document indicates trademarks of IGT or its licensors. For a complete list of trademark and copyright ownership information, please visit our website at www.IGT.com.

Our MDA is organized into the following sections:

- ^a OUR BUSINESS a general description of our business and operating segments
- ^a OUR FOCUS a summary of our strategies and opportunities
- ^a CONSOLIDATED OPERATING RESULTS a year-over-year comparative analysis of income from continuing operations for the third quarter and nine months of fiscal 2005
- ^a BUSINESS SEGMENT RESULTS a year-over-year comparative analysis of business segment results for the third quarter and nine months of fiscal 2005
- ^a LIQUIDITY AND CAPITAL RESOURCES a year-over-year comparative

analysis of cash
flows and
capital resources

for the first
nine months of
fiscal 2005

^a FINANCIAL
CONDITION -

analysis of
significant
changes in our
financial
position

^a CRITICAL
ACCOUNTING
ESTIMATES ^a

discussion of
accounting
policies that
require critical
judgments and
estimates

^a RECENTLY
ISSUED
ACCOUNTING
STANDARDS ^a

discussion of
recently issued
accounting
standards with
significance
to our business

^a FORWARD
LOOKING
STATEMENTS
AND RISK
FACTORS

cautionary
information
about forward
looking
statements
and a
description of
certain risks and
uncertainties
associated with
our business

OUR BUSINESS

International Game Technology is a global company specializing in the design, development, manufacturing, distribution and sales of computerized gaming machines and systems products. We strive to maintain a diverse

portfolio of gaming products that span a wide range of categories and target customer markets with a variety of games, platforms and systems offered across gaming jurisdictions worldwide.

We had annual revenues of \$2.5 billion in fiscal 2004. We derive our revenues in two ways, either from sales of our products (product sales) or from recurring revenues from the use of our products, services and/or intellectual property (gaming operations). We currently view our business in two regional operating segments:

^a North America,
encompassing
the US and
Canada

^a International,
with offices in
Asia, Australia,
New Zealand,
Europe, Russia,
Latin America,
South Africa,
the UK and
Japan

Additionally, our Corporate Division administers certain unallocated income and expenses related to company-wide initiatives. See the BUSINESS SEGMENT RESULTS below and Note 15 of our Unaudited Condensed Consolidated Financial Statements for additional segment information and financial results.

Table of Contents

OUR FOCUS

Product Demand

Demand for our products is driven principally by:

- ^a technological innovations that create new, more sophisticated games and/or customer cost savings
- ^a new or expanding gaming properties
- ^a establishment or expansion of legalized gaming jurisdictions
- ^a entertainment value to the player

Following several consecutive years of record growth, largely related to the TITO replacement cycle, fiscal 2005 has been, and we expect will continue to be, a transitional year. At the end of the current quarter, we estimate that there are approximately 195,000 total machines that remain unconverted in the market place. Offsetting the decline in North America machine demand, we anticipate growing contributions from international operations, as well as increased non-machine sales, in part, enabled by our significant share of total gaming devices currently installed on casino floors. Non-machine sales include systems, parts, conversions, and royalties or licensing fees.

Notwithstanding these factors, we remain dependent upon gaming market expansion for growth. Expansion of new markets has been slower to materialize than we previously expected due to delays in legislative actions and/or regulatory approvals. Our business strategies remain focused on:

- ^a the development and expansion of our product offerings
- ^a capitalizing on new and expanding market opportunities
- ^a gaining access to important intellectual property
- ^a strategic acquisitions and alliances to enable

development of
leading gaming
technology
^a ensuring access
to new
distribution
channels.

Product Development

Our business can be explained as the creation of game content and the delivery of these games to the consumer via platforms and systems. We are a prominent designer of games, platforms and systems for the gaming industry. We accomplish this by anticipating consumer needs, responding to feedback and marketing trends, and pioneering innovative gaming machines and reliable systems solutions. Our product development efforts are supported by a considerable emphasis and investment in research and development, which we expect will enable us to maintain a leadership position in the industry.

We anticipate continued installations into our casino market gaming operations installed base through new video game introductions. During fiscal 2005, we introduced and placed new units of:

^a *Fort Knox*, a
multi-level
mystery
progressive
penny game

^a *Video
Megabucks*, a
penny game on
our AVP
platform with a
\$10 million
starting jackpot

^a *Star Wars*,
offered with a
\$1 million fixed
top award in a
linked penny
progressive
configuration

Demand for these new game themes remains strong and we continue to observe high levels of customer acceptance. We also maintain our strategy to improve gaming operations revenues by managing the types of games and jurisdictions where games are placed.

During the second quarter of the current fiscal year, we initiated a reorganization of our North America sales and service groups into regional areas, moving IGT closer to and further enhancing responsiveness to our regional customer base.

To date, we have introduced a number of casino-wide integrated products that enhance the players' gaming experience and provide operational efficiencies for our customers. We are now leveraging on this experience and our CDS technology to move forward in developing gaming products of the future that incorporate innovative features, including server based gaming. Developments under way will bring new applications for more active casino floor management, games-on-demand, player-shared interactive games, as well as provide us with tools to better manage customer pricing. As the market shifts toward a more system-centric gaming environment, we expect a greater portion of our business will come from non-machine revenues.

Table of Contents

During the current quarter, we entered into a worldwide product integration agreement with PGIC and SMI to create a comprehensive, automated table management system that we will market as the *Intelligent Table Solution or ITS*, combining complementary capabilities, technologies, and resources of the three companies. A well-implemented casino management and patron loyalty system offers strategic and competitive value to a casino's slot operations. We view the extension of this technology into the table games area as the next logical phase in the expansion of these products.

On July 26, 2005, we entered into a definitive agreement to acquire WagerWorks, a provider of internet gaming technology, content and services, with a content portfolio and a strict policy of not conducting business with operators who knowingly process gambling transactions from the United States. We expect this business combination will enable us to expand the distribution of IGT game content across new channels and mediums, including the internet, mobile devices, and interactive television.

Market Opportunities

We market our gaming products to legalized gaming jurisdictions around the world. While our most significant markets are in North America, we continue to pursue additional opportunities in international markets. The opportunities and challenges, and the extent of our successes, vary across these jurisdictions.

We previously estimated that new North America and international markets would materialize during fiscal 2006, but current market dynamics suggest that significant expansion could be delayed until fiscal 2007. Although the timing has been delayed and remains uncertain, we do expect that opportunities will eventually come from new jurisdictions and expansion of existing markets.

We continue to monitor expanding and emerging markets in North America, including California, Pennsylvania, Florida, Washington, Oklahoma, Maine, New York and Texas. We also track gaming legislation in potential new markets, such as Ohio, Maryland, Massachusetts, Wyoming and Rhode Island, all facing fiscal budget needs with previous legislative activity surrounding the legalization of machine gaming. We anticipate future racino openings in Yonkers and Aqueduct in New York.

Gaming expansion is ongoing in numerous CDS markets nationwide, including Florida and Washington. During the current quarter, we placed CDS units into the Washington market under new IGT agreements. This represents a new direct sales market for IGT as previous units were sold through a third party distributor.

Over the next few years, we expect to benefit from international market expansion opportunities in Russia, Asia, Latin America and the UK. We are concentrating our management and development resources toward product localization, so we export a US manufactured product customized for local cultures.

Competition

Our competition in the gaming machines marketplace has further intensified. The principal method of competition lies in new product development. We maintain a global competitive advantage through our ability to:

- ^a offer a dynamic and diverse library of innovative, strong performing games
- ^a develop and protect our extensive collection of intellectual properties
- ^a provide the highest levels of customer

service and
support

We also hold the added benefits of our:

- ^a financial strength to aggressively research and develop new products
- ^a extensive and well established infrastructure of sales and manufacturing
- ^a worldwide recognition and geographic diversity

We currently hold a significant share of the total gaming devices on North America casino floors. Within that population, our share in spinning reel and video poker machines remains stable, but we are experiencing increased competitive pressures in the video spinning reel gaming machines business. We expect to maintain a leading share of the total population of gaming devices installed over the long-term horizon, despite quarterly fluctuations that will occur from time to time.

The marketplace for recurring revenue units is competitive. We expect our ability to develop exciting new themes to enable us to maintain a leading market share. We also continue to proactively manage our proprietary installed base in order to offer the strongest performing games placed on casino floors.

Sales of our *IGT Advantage^{ai}* systems are successfully capturing additional market share with its value added technology offerings. With a number of significant new *IGT Advantage^{ai}* systems contracts, we now have systems relationships with most major gaming operators. At June 30, 2005, 481 IGT slot systems were installed worldwide connecting approximately 273,000 machines versus 390 slot systems connecting 243,000 machines at June 30, 2004.

Table of Contents

Capital Deployment

We continued to generate substantial operating cash flows in the current nine months of fiscal 2005, affording us the flexibility to reinvest in our business through capital expenditures and business acquisitions, as well as generate returns to our shareholders through dividends and share repurchases. We use cash available from operations after capital expenditures for our share repurchase plan, dividends to our shareholders, and strategic business acquisitions. See the LIQUIDITY AND CAPITAL RESOURCES section that follows for current share repurchase and dividend activity.

We enter into strategic business acquisitions and alliances as part of our ongoing efforts to create shareholder value designed to complement our internal resources. In keeping with efforts to diversify and expand, we entered into agreements for the following strategic business relationships and acquisitions during fiscal 2005:

- ^a WagerWorks, a provider of internet gaming technology, content and services
- ^a PGIC and SMI, gaming suppliers that will collaborate with IGT to sell, market, distribute and integrate our individual technologies to develop the next generation table management system
- ^a Friendly Matrix, with several products that will enhance functionality in our *IGT Advantage* systems and extend our reach into key markets
- ^a Hi-Tech, our former distributor and supplier of gaming equipment and services in Canada

We expect these business relationships and acquisitions will facilitate incremental future growth and eventual economies of scale, although they were not material and are not expected to produce near-term earnings accretion. Pending final purchase accounting adjustments, including amortization of intangibles and in-process R&D, we estimate the WagerWorks acquisition will be approximately \$0.02 dilutive to earnings in both fiscal 2005 and 2006. See Note 5 of our Unaudited Condensed Consolidated Financial Statements for additional financial details of the acquisitions.

Table of Contents**CONSOLIDATED OPERATING RESULTS A Year Over Year Comparative Analysis**

	Quarters Ended		Increase (Decrease)		Nine Months Ended		Increase (Decrease)	
	June 30, 2005	2004	Amount	%	June 30, 2005	2004	Amount	%
<i>(In millions, except units, ASP, ARPU & EPS)</i>								
Total								
Revenues	\$ 579.6	\$ 618.9	\$ (39.3)	(6%)	\$ 1,771.8	\$ 1,863.0	\$ (91.3)	(5%)
Gross profit	308.2	338.3	(30.1)	(9%)	894.9	998.4	(103.5)	(10%)
Gross margin	53%	55%	(2)pp	(4%)	51%	54%	(3)pp	(6%)
Operating income	\$ 167.4	\$ 211.1	\$ (43.7)	(21%)	\$ 503.3	\$ 619.3	\$ (116.0)	(19%)
Operating margin	29%	34%	(5)pp	(15%)	28%	33%	(5)pp	(15%)
Income from continuing operations								
	\$ 114.7	\$ 141.1	\$ (26.4)	(19%)	\$ 331.1	\$ 375.4	\$ (44.3)	(12%)
Discontinued operations								
				*		58.9	(58.9)	*
Net income	114.7	141.1	(26.4)	(19%)	331.1	434.4	(103.3)	(24%)
Diluted earnings per share:								
Continuing operations								
	\$ 0.32	\$ 0.38	\$ (0.06)	(16%)	\$ 0.91	\$ 1.01	\$ (0.10)	(10%)
Discontinued operations								
						0.16	(0.16)	*
Net income	0.32	0.38	(0.06)	(16%)	0.91	1.17	(0.26)	(22%)
Product sales								
Machines	\$ 185.8	\$ 254.8	\$ (69.1)	(27%)	\$ 652.2	\$ 823.2	\$ (171.0)	(21%)
Systems, parts and conversions	88.7	60.8	28.0	46%	228.7	185.2	43.5	23%
Total product sales	274.5	315.6	(41.1)	(13%)	880.9	1,008.4	(127.5)	(13%)
Gross profit	\$ 143.7	\$ 171.8	\$ (28.1)	(16%)	\$ 435.2	\$ 529.8	\$ (94.6)	(18%)
Gross margin	52%	54%	(2)pp	(4%)	49%	53%	(4)pp	(8%)
Units sold	24,100	35,100	(11,000)	(31%)	102,000	126,600	(24,600)	(19%)
ASP	\$ 7,700	\$ 7,300	\$ 400	5%	\$ 6,400	\$ 6,500	\$ (100)	(2%)
ARPU	11,400	9,000	2,400	27%	8,600	8,000	600	8%
Gaming operations								
Revenues	\$ 305.1	\$ 303.3	\$ 1.8	1%	\$ 890.9	\$ 854.6	\$ 36.3	4%
Gross profit	164.5	166.5	(2.0)	(1%)	459.7	468.6	(8.9)	(2%)
Gross margin	54%	55%	(1)pp	(2%)	52%	55%	(3)pp	(5%)
Installed base units	38,500	36,400	2,100	6%	38,500	36,400	2,100	6%

Decreased income and EPS from continuing operations in the current quarter and nine months of fiscal 2005 were driven by declining product sales volumes in the North America Division. Diluted EPS for the nine months ended June 30, 2004 was recalculated to reflect the additional convertible debenture shares outstanding for the first quarter of fiscal 2004, in keeping with the adoption of EITF 04-8. See the Recently Issued Accounting Standards section of Note 1 of our Unaudited Condensed Consolidated Financial Statements.

Improved operating cash flows enabled us to continue our capital deployment strategy of returning value to our shareholders through dividends and share repurchases. We declared cash dividends of \$0.12 per share and repurchased 3.8 million shares of our common stock in the current quarter.

Significant items affecting comparability of income from continuing operations for the nine month periods included:

- ^a additional interest income of \$6.9 million after-tax in the current year, related to financing fees realized on early loan repayments
- ^a a reduction of \$3.9 million after-tax for severance costs incurred in the current year associated with several operational reorganization initiatives
- ^a the prior year income tax provisions reduction of \$10.3 million, primarily due to utilization of foreign income tax credits
- ^a the prior year loss on early debt redemption of \$4.3 million after-tax
- ^a the additional week in the prior year related to our 52/53-week fiscal year, primarily affecting

gaming
operations and
operating
expenses

See Note 5 of our Unaudited Condensed Consolidated Financial Statements for additional information concerning the prior year discontinued operations related to certain Anchor operations divested subsequent to acquisition.

Table of Contents

Consolidated product sales for the current quarter and nine months of fiscal 2005 were and continue to be adversely affected by the slowdown in demand for TITO related replacement machines, as well as fewer new marketplace opportunities. ASPs declined in the current nine months due to a higher mix of lower priced international machine sales. Current ARPUs improved over the prior year, primarily due to better pricing realization and increasing non-machine revenues. Decreased consolidated gross margins in the current quarter were primarily due to a larger mix of international sales and the allocation of fixed costs across lower domestic sales volumes. We anticipate an increased mix of lower margin sales from Japan in the fourth quarter that while contributing to gross profits will reduce our consolidated product sales gross margin.

Consolidated gaming operations revenues grew in the third quarter and nine months of fiscal 2005, primarily due to increases in our installed base. Gross profit for the current nine months was negatively impacted by charges recorded for technical obsolescence of certain gaming operations assets in response to shifting market demand toward newer IGT products that incorporate more innovative features. Additionally, we began the VIE consolidations in April 2004, causing the current year nine months to include an additional six months of VIE revenues and expenses, but no material impact to gross profit. Partially dependent on the direction of interest rates, we expect our quarterly gaming operations gross margin to fluctuate between 54% and 57% for the remainder of fiscal 2005.

Table of Contents**Operating Expenses**

	Quarters Ended				Nine Months Ended			
	June 30,		Increase		June 30,		Increase	
	2005	2004	Amount	%	2005	2004	Amount	%
<i>(In millions)</i>								
Selling, general and administrative	\$ 86.3	\$ 72.9	\$ 13.4	18%	\$ 236.5	\$ 220.2	\$ 16.4	7%
Depreciation and amortization	17.2	16.6	0.5	3%	50.8	47.2	3.6	8%
Research and development	35.8	32.8	3.0	9%	103.8	95.7	8.1	8%
Provision for bad debts	1.5	4.8	(3.2)	(68%)	0.5	16.0	(15.6)	(97%)
Total	\$ 140.8	\$ 127.2	\$ 13.6	11%	\$ 391.6	\$ 379.1	\$ 12.5	3%
Percent of revenue	24%	21%			22%	20%		

Operating expenses increased in the current quarter and nine months primarily due to additional costs in several SG&A categories, including legal and compliance fees and additional severance costs. R&D also increased as we continued to make additional investments to support our industry-leading R&D efforts. These increases were partially offset by reduced bad debt provisions required to maintain reserves, based on our assessment of an improved customer collections risk profile and lower receivable balances. The prior nine month period included approximately \$8.0 million in additional operating expenses as a result of the extra week related to the timing of our 52/53-week accounting year.

During the second quarter of fiscal 2005, we initiated several operational efficiency initiatives involving international operations and a regional reorganization of our North America sales and service groups. As a result, we recognized operational charges principally consisting of severance totaling \$4.1 million in the current quarter and \$6.0 million for the nine months of fiscal 2005. We also expect to incur an additional \$3-4 million of similar costs related to these initiatives in the fourth quarter of fiscal 2005.

Other Income (Expense) and Taxes

	Quarters Ended				Nine Months Ended			
	June 30,		Increase		June 30,		Increase	
	2005	2004	Amount	%	2005	2004	Amount	%
<i>(In millions)</i>								
Interest income	\$ 28.5	\$ 15.7	\$ 12.9	82%	\$ 60.1	\$ 43.8	\$ 16.2	37%
Interest expense	(13.9)	(22.6)	(8.7)	(39%)	(43.2)	(76.8)	(33.6)	(44%)
Loss on redemption of debt						(6.9)	(6.9)	*
Other	(2.0)	(1.0)	1.0	100%	(2.7)	(4.4)	(1.7)	(39%)
Other income (expense), net	\$ 12.6	\$ (8.0)			\$ 14.2	\$ (44.3)		

Total other income (expense), net, improved in the current quarter and nine months as a result of reduced interest expense related to the prior year early redemption of our senior notes. Additionally, interest income in the current quarter included \$10.2 million in financing fees realized on early loan repayments. The prior nine month period also included \$6.9 million of loss on early debt redemption.

Interest income related to our WAP systems operations for the current quarter and nine months totaled \$9.1 million and \$26.9 million versus \$8.5 million and \$21.0 million in the same prior year periods. Interest expense related to our WAP systems operations for the current quarter and nine months totaled \$7.8 million and \$23.5 million versus \$7.9 million and \$19.5 million in the same prior year periods. WAP interest increased during the current nine month period primarily due to the VIE consolidations.

The operation of our WAP systems games results in interest income on investments to fund installment jackpot payments and interest expense for related jackpot liabilities that accretes at approximately the same rate. The amount of this interest will vary depending on the amount of jackpots won and the number of winners electing installment payments. Our WAP operations also hold a significant amount of cash and short-term investments on which we earn interest income.

Our effective tax rate decreased to 36.0% in the current nine months compared to 36.5% in the prior year based on changes to the geographic mix of estimated annual taxable income and higher R&D tax credits.

Table of Contents**BUSINESS SEGMENT RESULTS A Year Over Year Comparative Analysis**

IGT's operating segments' profit reflects income from continuing operations before tax, including applicable operating expenses, and other income and expense. Prior year amounts have been reclassified to conform to the current management view and presentation. See Note 15 of our Unaudited Condensed Consolidated Financial Statements for additional information about our business segments.

North America Division

	Quarters Ended				Nine Months Ended			
	June 30,		Increase		June 30,		Increase	
	2005	2004	Amount	%	2005	2004	Amount	%
<i>(In millions, except units & ARPU)</i>								
Total segment								
Revenues	\$ 480.7	\$ 541.9	\$ (61.1)	(11%)	\$ 1,420.1	\$ 1,597.8	\$ (177.7)	(11%)
Gross profit	258.8	299.5	(40.7)	(14%)	740.8	872.1	(131.3)	(15%)
Gross margin	54%	55%	(1)pp	(2%)	52%	55%	(3)pp	(5%)
Operating income	\$ 173.7	\$ 223.2	\$ (49.5)	(22%)	\$ 495.7	\$ 641.4	\$ (145.7)	(23%)
Operating margin	36%	41%	(5)pp	(12%)	35%	40%	(5)pp	(13%)
Segment profit	\$ 187.9	\$ 230.4	\$ (42.5)	(18%)	\$ 517.6	\$ 653.9	\$ (136.3)	(21%)
Segment profit margin	39%	43%	(4)pp	(9%)	36%	41%	(5)pp	(12%)
Product sales								
Revenues	\$ 182.6	\$ 243.1	\$ (60.5)	(25%)	\$ 548.6	\$ 755.7	\$ (207.1)	(27%)
Gross profit	99.7	136.6	(36.9)	(27%)	296.5	413.4	(116.9)	(28%)
Gross margin	55%	56%	(1)pp	(2%)	54%	55%	(1)pp	(2%)
Units sold	12,300	22,500	(10,200)	(45%)	40,300	72,300	(32,000)	(44%)
ARPU	\$ 14,800	\$ 10,800	\$ 4,000	37%	\$ 13,600	\$ 10,500	\$ 3,100	30%
Gaming operations								
Revenues	\$ 298.2	\$ 298.8	\$ (0.6)		\$ 871.5	\$ 842.1	\$ 29.4	3%
Gross profit	159.1	162.9	(3.8)	(2%)	444.3	458.7	(14.4)	(3%)
Gross margin	53%	55%	(2)pp	(4%)	51%	54%	(3)pp	(6%)
Installed base units	37,400	35,600	1,800	5%	37,400	35,600	1,800	5%

North America machine sales were down in the current quarter and nine months as a result of decelerated TITO replacement demand and fewer new market opportunities. The most recent replacement cycle that arose from the demand for cashless enabled gaming machines continues to slow and as a result we expect this demand to remain below fiscal 2004 levels.

Despite lower machine volumes in the current quarter and nine month period, ARPUs improved as a result of:

- ^a increased pricing realization for machines and parts

^a

- a higher mix of systems, parts and conversion revenues
- ^a additional intellectual property revenues

North America product sales gross margin declined slightly in the current quarter and nine months related primarily to the allocation of fixed costs across lower sales volumes, as well as increased component costs.

Gaming operations revenues were comparable in the current quarter, as increases in our installed base came primarily from lower yielding racino and CDS units. The current quarter decline in gross margin was primarily due to interest rate fluctuations.

Gaming operations revenues increased in the current nine months as a result of:

- ^a growth in our installed base
- ^a increased play levels ensuing from new game introductions and removal of lower performing units
- ^a VIE consolidations included for nine months in the current period versus three months in the prior year

The additional six months of VIE revenues of \$23.2 million in the current nine month period was offset by the extra week which contributed revenues of approximately \$19.9 million in the prior year period.

Table of Contents

The decrease in gaming operations gross profit and margin in the current nine months was primarily due to:

- ^a technological obsolescence charges related to certain gaming operations assets resulting from the transition in demand toward our newer, more innovative products
- ^a increases in the installed base of lower yielding racino and CDS units
- ^a the extra week which added gross profit of approximately \$11.1 million in the first nine months of the prior year
- ^a VIE consolidations reducing gross margin
- ^a partially offset by increased play levels ensuing from new game introductions and removal of lower performing units

The growth in our installed base of proprietary games was primarily related to additional placements in:

- ^a Native America markets in Florida, Oklahoma and Washington
- ^a the charitable video bingo market in

Alabama
a video lottery
markets in New
York, Delaware,
and Rhode
Island

While growth in our installed base is dependent on gaming industry expansion, we continue to focus on strategies to improve revenue yields centered on managing the types of games and jurisdictions where they are placed. This includes placing our higher yielding games on casino floors and managing removals of lower performing games.

Table of Contents**International Division**

	Quarters Ended				Nine Months Ended			
	June 30,		Increase		June 30,		Increase	
	2005	2004	Amount	%	2005	2004	Amount	%
<i>(In millions, except units & ARPU)</i>								
Total segment								
Revenues	\$ 98.8	\$ 77.0	\$ 21.8	28%	\$ 351.7	\$ 265.3	\$ 86.4	33%
Gross profit	49.4	38.8	10.6	27%	154.1	126.3	27.8	22%
Gross margin	50%	50%			44%	48%	(4)pp	(8%)
Operating income	\$ 23.7	\$ 17.7	\$ 6.0	34%	\$ 81.6	\$ 65.2	\$ 16.4	25%
Operating margin	24%	23%	1pp	4%	23%	25%	(2)pp	(8%)
Segment profit	\$ 23.5	\$ 17.8	\$ 5.8	33%	\$ 82.5	\$ 67.2	\$ 15.3	23%
Segment profit margin	24%	23%	1pp	4%	23%	25%	(2)pp	(8%)

Product sales

Revenues	\$ 91.9	\$ 72.5	\$ 19.4	27%	\$ 332.3	\$ 252.8	\$ 79.5	31%
Units sold	11,800	12,600	(800)	(6%)	61,700	54,300	7,400	14%
ARPU	\$ 7,800	\$ 5,700	\$ 2,100	37%	\$ 5,400	\$ 4,700	\$ 700	16%

Gaming operations

Revenues	\$ 7.0	\$ 4.5	\$ 2.5	56%	\$ 19.4	\$ 12.5	\$ 6.9	55%
Installed base units	1,100	800	300	38%	1,100	800	300	38%

International revenues, gross profit and ARPU improved in the current quarter despite lower volumes as a result of a more favorable product sales mix that included machine replacement sales and systems sales in Latin America, as well as improved premium priced product sales in Australia.

Revenues and gross profit grew in the current nine months primarily due to:

- ^a the current year success of *The Terminator* pachisuro game in Japan, selling 29,600 units versus 18,000 *Nobunaga* units in the prior year
- ^a strong mix of premium products and parts sales in Australia
- ^a increased casino market sales in South Africa
- ^a

increased
machine and
systems sales in
Latin America

^a favorable
foreign
exchange

^a increase in
gaming
operations
installed base

The decline in gross margin for the current nine months was primarily due to a larger mix of lower margin pachisuro games. The increase in international ARPU for the current nine months was predominantly due to:

^a increased price
realization

^a a more
favorable mix of
systems and
other
non-machine
revenues

^a favorable
foreign
exchange

The Terminator, released in the first quarter of fiscal 2005, was our most successful Japan game model to date. Our next game in Japan is scheduled for release in the fourth quarter of fiscal 2005. Although our recent level of success with *The Terminator* may or may not be repeated, this unique and cyclical market is comprised of approximately 1.9 million machines, of which about half are replaced annually.

Successes in Japan can contribute significantly to our gross profit and operating income, but these lower priced pachisuro games reduce gross margin. We anticipate international margins will continue to fluctuate depending upon the geographic mix of product sales.

Table of Contents**LIQUIDITY AND CAPITAL RESOURCES****Capital Resources**

Our principal source of liquidity is cash generated from our operating activities, allowing us to reinvest in our business. Our sources of capital also include, but are not limited to, the issuance of public or private placement debt, bank borrowings under our credit facility and the issuance of equity securities. We expect that our available capital resources are sufficient to fund our capital expenditures and operating requirements, payments for scheduled debt, dividends, interest and income tax obligations.

On July 26, 2005, we entered into a definitive agreement to acquire WagerWorks, Inc. for total cash consideration of approximately \$90.0 million, subject to a working capital adjustment. We expect the transaction to be completed in our fourth quarter. See Note 5 of our Unaudited Condensed Consolidated Financial Statements.

Our working capital decreased to \$477.4 million at June 30, 2005 from \$949.7 million at September 30, 2004, primarily as the result of the reclassification of our Debentures to current liabilities. See Note 9 of our Unaudited Condensed Consolidated Financial Statements. Our working capital statistics for the trailing twelve months ended June 30, 2005 compared to the prior year period included:

- ^a average days sales outstanding, which improved to 68 days from 79 days, largely related to significant note and contract payoffs in the current period
- ^a inventory turns, which decreased to 3.3 from 3.7, primarily related to Japan's build up for fourth quarter sales

Cash Flows Summary

	Nine Months Ended		Increase (Decrease)	
	2005	June 30, 2004	Amount	%
<i>(In millions)</i>				
Operations	\$ 562.3	\$ 370.9	\$ 191.4	\$ 52%
Investing	(288.6)	154.2	(442.8)	(287%)
Financing	(275.2)	(503.5)	228.3	45%

Cash Flows From Operations

Fluctuations in net cash flows from operations for the current nine month period were primarily related to:

- ^a additional cash used in the prior year period to extend exclusive rights to

- licensed properties
- ^a higher interest payments in the nine months of the prior year on our senior notes subsequently redeemed
- ^a timing of receivable collections
- ^a timing of income tax payments

Cash flows related to jackpot liabilities consist of collections to fund jackpots and payments to winners for all WAP systems. Payments to winners include both installment based and single payments. Net cash flows related to jackpots represent timing differences between the growth in liabilities for progressive jackpots and the actual payments to the winners during the period. Fluctuations in net cash flows to fund jackpots reflect variations in the timing of the jackpot life cycles, the pattern of winners payment elections, and the volume of slot play across all of our progressive systems games.

Cash Flows From Investing

The fluctuation in net investing cash flows in the current nine months was primarily attributed to:

- ^a available cash utilized for investment securities in the current period
- ^a prior year proceeds of \$151.5 million from the sale of discontinued OES operations
- ^a \$105.8 million additional cash used in the prior year for business acquisitions

See Note 1 of our Unaudited Condensed Consolidated Financial Statements for additional information related to certain prior period amounts that have been reclassified to be consistent with the presentation used in the current period, specifically with respect to Auction Rate Securities (ARS) and restricted cash. See Note 5 of our Unaudited Condensed Consolidated Financial Statements for additional details related to current and prior year acquisitions. Jackpot annuity investments relate only to installment based payments to winners. Purchases of these investments occur for the present value of a jackpot when the player wins and elects installment based payments. Proceeds occur as the investments mature, in equal annual installments over the life of the annuity.

Table of Contents*Capital Expenditures*

	Nine Months Ended		Increase (Decrease)	
	2005	June 30, 2004	Amount	%
<i>(In millions)</i>				
Property, plant and equipment	\$ 34.8	\$ 24.4	\$10.5	43%
Gaming operations equipment	113.2	94.2	19.0	20%
Intellectual property	18.1	22.7	(4.6)	(20%)
Total capital expenditures	\$166.2	\$141.3	\$24.9	18%
North America	96%	97%		
International	4%	3%		

Capital expenditures increased in the current nine months primarily related to gaming operations equipment spending associated with the deployment of new products incorporating more innovative features and our new penny progressive format. Additionally, construction costs related to our new Las Vegas campus and Reno facility expansion totaled \$16.1 million during the current nine months.

Cash Flows From Financing

Net financing cash flows improved in the current nine months primarily as a result of the prior year redemption of senior notes, partially offset by additional current period share repurchases and dividends paid.

Stock Repurchase Plan

The stock repurchase plan authorized by our Board of Directors in 1990 is used to return value to our stockholders and reduce the number of shares outstanding. Our remaining share repurchase authorization, as amended, totaled 28.8 million shares as of June 30, 2005.

During the first nine months of fiscal 2005, we repurchased 7.1 million shares for an aggregate price of \$200.0 million. We repurchased an additional 2.5 million shares from June 30, 2005 through August 11, 2005 for an aggregate price of \$67.5 million. The expected timing and amount of our future share repurchases will vary depending on market conditions, securities law limitations and other factors. See Part II, Item 2 for additional share repurchase information.

Credit Facilities and Indebtedness

See Note 9 of our Unaudited Condensed Consolidated Financial Statements for additional information.

Table of Contents**FINANCIAL CONDITION**

	June 30, 2005	September 30, 2004	Increase (Decrease)	
			Amount	%
<i>(In millions)</i>				
Total assets	\$3,992.4	\$ 3,873.0	\$119.4	3%
Total liabilities	1,930.6	1,896.3	34.4	2%
Total stockholders' equity	2,061.8	1,976.6	85.1	4%

Total assets grew during the current nine month period mainly due to increased investment securities, partially offset by decreases in receivables and prepaid royalties. Total liabilities increased during the nine months just ended primarily related to payment timing of accrued liabilities.

Total stockholders' equity increased during the current year period predominantly as the result of:

- ^a net income generated during the current period
- ^a proceeds from employee stock plans
- ^a partially offset by dividends declared and share repurchases

Arrangements With Off-Balance Sheet Risks

In the normal course of business, we are a party to financial instruments with off-balance sheet risk such as performance bonds and other guarantees, which are not reflected in our balance sheet. We do not expect any material losses to result from these off-balance sheet arrangements and we are not dependent on off-balance sheet financing arrangements to fund our operations. See Note 13 of our Unaudited Condensed Consolidated Financial Statements.

CRITICAL ACCOUNTING ESTIMATES

Our consolidated financial statements were prepared in conformity with accounting principles generally accepted in the US. Accordingly, we are required to make estimates, judgments and assumptions that we believe are reasonable based on our historical experience, contract terms, observance of known trends in our company and the industry as a whole, and information available from other outside sources. Our estimates affect reported amounts and related disclosures. Actual results may differ from initial estimates.

Critical accounting estimates require IGT's management to make material subjective or complex judgments about matters that are highly uncertain or variable related to estimates and assumptions used for our jackpot liabilities and expenses, intangible assets, goodwill and prepaid royalties, income taxes, bad debt expense and inventory. These areas of our accounting estimates are the most sensitive to change from external factors.

For a discussion of our critical accounting estimates, please refer to Management's Discussion and Analysis of Financial Condition and Results of Operations presented in our Annual Report on Form 10-K for the year ended September 30, 2004. We have made no significant changes to our accounting estimates since September 30, 2004.

RECENTLY ISSUED ACCOUNTING STANDARDS

IGT keeps abreast of new generally accepted accounting principles and disclosure reporting requirements issued by the SEC and other standard setting agencies. Recently issued accounting standards affecting our financial results are described in Note 1 of our Unaudited Condensed Consolidated Financial Statements.

Table of Contents

FORWARD LOOKING STATEMENTS AND RISK FACTORS

Risk Factors and Cautionary Statement for Purposes of the Safe Harbor Provisions of the Private Securities Litigation Reform Act of 1995

Throughout this Quarterly Report on Form 10-Q we make some forward looking statements, which do not relate to historical or current facts, but are forward looking statements within the meaning of the Private Securities Litigation Reform Act of 1995. These statements relate to analyses and other information based on forecasts of future results and estimates of amounts not yet determinable. These statements also relate to our future prospects and proposed new products, services, developments or business strategies. These statements are identified by their use of terms and phrases such as anticipate, believe, could, would, estimate, expect, intend, may, plan, predict, project, pursue, will, continue, feel, or the negative or other variations thereof, and other similar terms and phrases, including references to assumptions, and include but are not limited to the following:

- ^a expectations about our ability to introduce new products and stimulate replacement demand
- ^a estimates of our market share and competitive advantage
- ^a estimates about the total market installed base
- ^a expectations about gaming expansion and new markets
- ^a judgments and assumptions related to our critical accounting estimates
- ^a estimates about our interest expense savings
- ^a estimates about our tax exposure and tax rates
- ^a estimates of expected gross profit margins
- ^a estimates that the replacement market will continue at certain paces

- ^a expectations that our available capital resources will be sufficient to fund our capital expenditures and operating requirements
- ^a expectations about losses from off-balance sheet arrangements
- ^a expectations about foreign exchange rate gain and losses
- ^a expectations about incremental future growth through acquisitions
- ^a expectations about opportunities to increase profit contribution
- ^a expectations about future gaming product developments
- ^a expectations about capitalizing on new and expanding market opportunities
- ^a expectations about ensuring access to new distribution channels
- ^a expectations about gaining access to important intellectual

property

Although we believe that the expectations reflected in any of our forward looking statements are reasonable, actual results could differ materially from those expressed or implied. Our future financial condition and results of operations, as well as any forward looking statements, are subject to change and to inherent known and unknown risks and uncertainties. We do not intend, and undertake no obligation, to update our forward looking statements to reflect future events or circumstances.

We urge you to carefully review the following discussion of the specific risks and uncertainties that affect our business. These include, but are not limited to, the following:

Our success in the gaming industry depends in large part on our ability to develop innovative products and systems and would be adversely affected by:

- ^a a decline in the popularity of our gaming products with players
- ^a a lack of success in developing new products
- ^a an inability to roll out new games on schedule
- ^a an increase in the popularity of competitors games
- ^a a negative change in the trend of consumer acceptance of our newest systems innovations

Demand for our products would be adversely affected by:

- ^a reduced growth or continued delays of new market openings and/or existing market expansions
- ^a delays of scheduled openings of newly constructed or planned casinos
- ^a reduced levels of play or weakened

customer
demand for our
gaming
machines as a
result of
declines in
travel activity,
jackpot fatigue,
or customer
capital
expenditures
^a a decrease in the
desire of
established
gaming
properties to
upgrade
machines,
resulting in a
decline in the
demand for
replacement
machines
^a uncertain timing
for technology
upgrades
^a loss of casino
floor space to
table games
^a casino operators
designing and
developing slot
machine content
^a casino operators
developing
strategic
alliances with
competitors
^a a decline in
public
acceptance of
gaming

Table of Contents

We operate in a highly regulated industry and our ability to operate in certain jurisdictions could be adversely affected by:

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

customers
inability to
repay IGT
development
financing loans
due to
unfavorable
legislation,
regulation, or
regulatory
interpretation
that impairs
their ability to
conduct planned
gaming
operations

Our intellectual property rights are subject to risks, including:

- ^a potential
inability to
obtain, maintain
and protect our
patents,
trademarks,
copyrights or
trade licensing
rights used
competitively in
development of
our games and
technology
- ^a competitors
infringement
upon our
existing
trademarks,
patents and
copyrights
- ^a approval of
competitors
patent
applications that
may restrict our
ability to
compete
effectively

Our business is vulnerable to changing economic conditions, including:

- ^a unfavorable
changes in
economic
conditions
including those

- that affect the relative health of the gaming industry
- ^a unfavorable changes in tax laws or application of such laws that could reduce our profitability
- ^a political or economic instability in international markets
- ^a changes in interest rates causing a reduction of investment income or in the value of market rate sensitive instruments
- ^a fluctuations in foreign exchange rates, tariffs and other trade barriers
- ^a an inability to effectively hedge our foreign currency exposures

Our outstanding debt obligations subject us to certain additional risks, including:

- ^a increasing our vulnerability to general adverse economic and industry conditions
- ^a limiting our ability to obtain additional financing to fund future working capital, capital expenditures, acquisitions and

- other general corporate requirements
- ^a requiring a substantial portion of our cash flows from operations for the payment of interest on our indebtedness and reducing our ability to use our cash flows to fund working capital, capital expenditures, acquisitions, and general corporate requirements
- ^a limiting our flexibility in planning for, or reacting to, changes in our business and the industry
- ^a disadvantaging us compared to competitors with less indebtedness

Our business operations are subject to other risks, including:

- ^a loss or retirement of our key executives or other key employees
- ^a adverse changes in the creditworthiness of parties with whom we have receivables or forward currency exchange contracts
- ^a

the discovery of
facts or
determinations
by judges, juries
or other finders
of facts not
presently known
to us or not in
accordance with
our evaluation
of possible
liability or the
outcome of
existing
litigation related
to legal actions
pending against
IGT

^a the timely and
cost effective
integration of
acquired
companies into
our operations

^a increased costs
due to reliance
on third party
suppliers and
contract
manufacturers

^a agreements with
casinos in
Native America
jurisdictions
which may
subject us to
sovereign
immunity risk

^a acts of war or
terrorist
incidents

^a continued work
through several
implementation
phases of our
company-wide
ERP solution
for computer
system
procedures and
controls; any

failures,
difficulties or
significant
delays in
implementing or
maintaining
computer
information
systems could
result in
material adverse
consequences to
our business,
including
disruption of
operations, loss
of information
and
unanticipated
increases in
costs

Table of Contents

Item 3. Quantitative and Qualitative Disclosures about Market Risk

There have been no material changes in our assessment of sensitivity to market risk since those presented in our Annual Report on Form 10-K, Item 7A, for the fiscal year ended September 30, 2004.

Item 4. Controls and Procedures

Evaluation of Disclosure Controls and Procedures

We maintain disclosure controls and procedures that are designed to provide reasonable assurance that information required to be disclosed in our Exchange Act reports is recorded, processed, summarized and reported within the time periods specified in the SEC's rules and forms, and that such information is accumulated and communicated to our management, including our Chief Executive Officer and Chief Financial Officer, as appropriate, to allow timely decisions regarding required disclosure. In designing and evaluating the disclosure controls and procedures, management recognizes that any controls and procedures, no matter how well designed and operated, can provide only reasonable assurance of achieving the desired control objectives, and management necessarily is required to apply its judgment in evaluating the cost-benefit relationship of possible controls and procedures.

As of the end of the period covered by this report, we carried out an evaluation, under the supervision and with the participation of our management, including our Chief Executive Officer and Chief Financial Officer, of the effectiveness of the design and operation of our disclosure controls and procedures. Based on the foregoing, our Chief Executive Officer and the Chief Financial Officer concluded that IGT's disclosure controls and procedures are effective at the reasonable assurance level.

No change in our internal control over financial reporting occurred during the quarter just ended that has materially affected, or is reasonably likely to materially affect, our internal control over financial reporting.

Changes in Internal Controls

As a part of our normal operations, we update our internal controls as necessary to accommodate any modifications to our business processes or accounting procedures. There have not been any other changes in our internal controls or in other factors that materially affected, or are reasonably likely to materially affect these controls as of the end of the period covered by this report.

Table of Contents**PART II OTHER INFORMATION****Item 1. Legal Proceedings**

For a description of our legal proceedings, see Note 13 of Notes to Unaudited Condensed Consolidated Financial Statements, which is incorporated by reference in response to this item.

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

There were no unregistered sales of equity securities.

Issuer Purchases of Equity Securities

Under the 1990 IGT common stock repurchase plan, as amended and adjusted for stock splits, our remaining share repurchase authorization totaled 28.8 million at June 30, 2005. The stock repurchase authorization is used to return value to our shareholders and reduce the number of shares outstanding. The shares may be repurchased in the open market or in privately negotiated transactions, depending on market conditions and other factors.

Shares purchased in the table below exclude treasury shares acquired in non-cash transactions related to forfeited stock awards or shares exchanged for options exercised. We repurchased an additional 2.5 million shares from the end of our third quarter just ended through August 11, 2005 at an average price of \$27.48 per share.

Periods	Total Number of Shares Purchased	Average Price Paid per Share	Total Number of Shares Purchased as Part of a Publicly Announced Plan	Maximum Number of Shares Still Available for Purchase Under the Plan
April 3 - April 30, 2005	1,158,500	\$26.30	1,158,500	31,411,525
May 1 - May 28, 2005	2,157,700	\$27.51	2,157,700	29,253,825
May 29 - July 2, 2005	462,700	\$28.32	462,700	28,791,125
Total	3,778,900	\$27.24	3,778,900	

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

(a) Exhibits

- 31.1 Certification of Chief Executive Officer pursuant to Rule 13a 14(a) of the Exchange Act, as adopted pursuant to section 302 of the Sarbanes-Oxley Act of 2002
- 31.2 Certification of Chief Financial Officer pursuant to Rule 13a 14(a) of the Exchange Act, as adopted pursuant to section 302 of the Sarbanes-Oxley Act of 2002
- 32.1 Certification of Chief Executive Officer pursuant to Rule 13a 14(b) of the Exchange Act and section 18 U.S.C. Section 1350, as adopted pursuant to section 906 of the Sarbanes-Oxley Act of 2002

32.2 Certification of Chief Financial Officer pursuant to Rule 13a-14(b) of the Exchange Act and section 18 U.S.C. Section 1350, as adopted pursuant to section 906 of the Sarbanes-Oxley Act of 2002

34

Table of Contents

Signature

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.

Date: August 11, 2005

INTERNATIONAL GAME TECHNOLOGY

By: /s/ Maureen Mullarkey

Maureen T. Mullarkey
Executive Vice President,
Chief Financial Officer and
Treasurer

35

Table of Contents

Exhibit Index

- 31.1 Certification of Chief Executive Officer pursuant to Rule 13a 14(a) of the Exchange Act, as adopted pursuant to section 302 of the Sarbanes-Oxley Act of 2002
- 31.2 Certification of Chief Financial Officer pursuant to Rule 13a 14(a) of the Exchange Act, as adopted pursuant to section 302 of the Sarbanes-Oxley Act of 2002
- 32.1 Certification of Chief Executive Officer pursuant to Rule 13a 14(b) of the Exchange Act and section 18 U.S.C. Section 1350, as adopted pursuant to section 906 of the Sarbanes-Oxley Act of 2002
- 32.2 Certification of Chief Financial Officer pursuant to Rule 13a 14(b) of the Exchange Act and section 18 U.S.C. Section 1350, as adopted pursuant to section 906 of the Sarbanes-Oxley Act of 2002