INTERNATIONAL GAME TECHNOLOGY
Form 10-Q
August 11, 2004

Table of Contents

United States
Securities and Exchange Commission

Washington, D.C. 20549

FORM 10-Q

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

For the Quarterly Period Ended June 30, 2004

OR

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

For the transition period from ______ to ______

Commission File Number 001-10684

International Game Technology

(Exact name of registrant as specified in its charter)

Nevada	**88-0173041**
(State of Incorporation)	(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 x No o

Indicate by check mark whether the registrant is an accelerated filer (as defined in Exchange Act Rule 12b-2). Yes x 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, 2004

Common Stock par value $.00015625 per share	344,634,543

International Game Technology

Table of Contents

Table of Contents

PART I FINANCIAL INFORMATION

Item 1. Unaudited Condensed Consolidated Financial Statements

INCOME STATEMENTS

	Quarters Ended June 30,		Nine Months Ended June 30,	
(In thousands, except per share amounts)	**2004**	2003	**2004**	2003
Revenues				
Product sales	**$315,582**	$300,068	**$1,008,419**	$ 795,847
Gaming operations	**303,305**	261,853	**854,613**	784,795
Total revenues	**618,887**	561,921	**1,863,032**	1,580,642
Costs and operating expenses				
Cost of product sales	**143,787**	156,556	**478,603**	414,506
Cost of gaming operations	**136,843**	126,322	**385,997**	369,818
Selling, general and administrative	**72,938**	67,968	**220,157**	200,007
Depreciation and amortization	**16,633**	11,297	**47,158**	35,483
Research and development	**32,843**	23,678	**95,736**	67,609
Provision for bad debts	**4,761**	2,537	**16,044**	9,550
Total costs and operating expenses	**407,805**	388,358	**1,243,695**	1,096,973
Operating income	**211,082**	173,563	**619,337**	483,669
Other income (expense)				
Interest income	**15,656**	14,143	**43,831**	38,784
Interest expense	**(22,649)**	(31,166)	**(76,824)**	(87,100)
Loss on the sale of assets	**(150)**	(61)	**(675)**	(124)
Other	**(880)**	939	**(10,639)**	1,108
Other expense, net	**(8,023)**	(16,145)	**(44,307)**	(47,332)
Income from continuing operations before tax	**203,059**	157,418	**575,030**	436,337

Provision for income taxes	**61,957**	57,537	**199,586**	162,689
Income from continuing operations	**141,102**	99,881	**375,444**	273,648
Discontinued operations, net of tax of $2,246, $35,312 and $5,299		3,804	**58,924**	8,738
Net income	**$141,102**	$103,685	**$ 434,368**	$ 282,386
Basic earnings per share				
Continuing operations	**$ 0.40**	$ 0.29	**$ 1.08**	$ 0.80
Discontinued operations		0.01	**0.17**	0.02
Net income	**$ 0.40**	$ 0.30	**$ 1.25**	$ 0.82
Diluted earnings per share				
Continuing operations	**$ 0.38**	$ 0.29	**$ 1.03**	$ 0.78
Discontinued operations		0.01	**0.16**	0.02
Net income	**$ 0.38**	$ 0.30	**$ 1.19**	$ 0.80
Weighted average shares outstanding				
Basic	**348,426**	342,367	**346,921**	344,009
Diluted	**378,482**	349,755	**369,919**	350,978

See accompanying notes.

Table of Contents

BALANCE SHEETS

(In thousands, except shares and par value)	June 30, 2004	September 30, 2003
Assets		
Current assets		
Cash and equivalents (restricted $136,296 and $85,479)	**$ 1,187,568**	$ 1,311,558
Investment securities, at market value	**4,006**	4,013
Accounts receivable, net of allowances for doubtful accounts of $25,742 and $20,945	**372,914**	351,062
Current maturities of long-term notes and contracts receivable, net	**54,134**	83,752
Inventories	**165,440**	147,066
Investments to fund liabilities to jackpot winners	**50,156**	41,502
Deferred income taxes	**60,894**	29,743
Prepaid expenses and other	**73,232**	35,044
Assets of discontinued operations held for sale		69,967
Other assets held for sale		4,521
Total current assets	**1,968,344**	2,078,228
Long-term notes and contracts receivable, net	**93,147**	133,039
Property, plant and equipment, net	**291,559**	261,620
Investments to fund liabilities to jackpot winners	**473,478**	333,454
Deferred income taxes	**25,596**	94,918
Intangible assets, net	**261,109**	218,184
Goodwill	**1,059,663**	980,427
Other assets	**131,307**	85,361
	$ 4,304,203	$ 4,185,231
Liabilities and Stockholders Equity		
Current liabilities		
Current maturities of long-term notes payable	**$ 366,259**	$ 406,147
Accounts payable	**71,970**	65,259
Jackpot liabilities	**191,841**	164,089
Accrued employee benefit plan liabilities	**51,105**	57,771
Dividends payable	**34,899**	34,554
Accrued interest	**8,176**	29,988
Accrued income taxes	**8,272**	31,928
Other accrued liabilities	**146,373**	137,769
Liabilities of discontinued operations		17,576
Total current liabilities	**878,895**	945,081
Long-term notes payable, net of current maturities	**780,690**	1,146,759

Long-term jackpot liabilities	**515,633**	377,043
Other liabilities	**44,698**	28,870
	2,219,916	2,497,753
Commitments and Contingencies		
Stockholders Equity		
Common stock: $.00015625 par value; 1,280,000,000 shares authorized; 707,469,365 and 703,348,533 shares issued	**111**	110
Additional paid-in capital	**1,623,938**	1,537,111
Treasury stock: 358,478,847 and 357,806,048 shares, at cost	**(1,716,120)**	(1,691,959)
Deferred compensation	**(13,690)**	(12,697)
Retained earnings	**2,188,654**	1,858,658
Accumulated other comprehensive income (loss)	**1,394**	(3,745)
	2,084,287	1,687,478
	$ 4,304,203	$ 4,185,231

See accompanying notes.

2

Table of Contents

CASH FLOWS STATEMENTS

	Nine Months Ended June 30,	
	2004	**2003**
(In thousands)		
Operations		
Net income	**$ 434,368**	$ 282,386
Adjustments to reconcile net income to net cash from operations:		
Depreciation and amortization	**115,686**	102,163
Discounts, premiums and deferred offering costs	**14,000**	8,296
Stock-based compensation	**4,063**	2,817
Provision for bad debts	**16,044**	9,550
Provision for inventory obsolescence	**7,530**	11,593
Loss on sale of assets	**675**	124
Loss on redemption of debt	**6,891**	
(Gain) loss on sale of discontinued operations	**(90,820)**	12,622
Changes in operating assets and liabilities, net of acquisitions and initial VIE consolidations:		
Receivables	**1,160**	(112,709)
Inventories	**(20,442)**	(15,771)
Other current assets	**(25,778)**	13,727
Other non current assets	**(42,062)**	(28,424)
Income taxes payable and deferred	**33,320**	(53,742)
Accounts payable and accrued liabilities	**(54,168)**	2,813
Net cash from operations	**400,467**	235,445
Investing		
Investment in property, plant and equipment	**(24,359)**	(23,253)
Investment in gaming operations equipment	**(94,207)**	(70,668)
Investment in intellectual property	**(22,742)**	(7,182)
Proceeds from sale of property, plant and equipment	**5,164**	463
Proceeds from sale of discontinued operations	**151,548**	142,507
Proceeds from sale of investment securities		10,000
Investments to fund jackpots:		
Purchases	**(24,542)**	(19,029)
Proceeds	**35,847**	28,296
Cash advanced on loans receivable	**(20,563)**	(11,260)
Payments received on loans receivable	**61,604**	19,291
Acquisition of business	**(109,711)**	
Initial consolidation of variable interest entities (VIEs)	**47,511**	
Net cash from investing	**5,550**	69,165

Financing		
Net (repayments on) proceeds from borrowings	**(415,337)**	564,176
Premium paid on redemption of debt	**(6,368)**	
Jackpot liabilities:		
Collections to fund jackpots	**204,884**	196,966
Payments to winners	**(234,418)**	(223,055)
Proceeds from employee stock plans	**46,300**	38,737
Dividends paid	**(104,027)**	
Share repurchases	**(24,054)**	(161,321)
Net cash (used for) from financing	**(533,020)**	415,503
Effect of exchange rates on cash and equivalents	**3,013**	(3,031)
Net (decrease) increase in cash and equivalents	**(123,990)**	717,082
Cash and equivalents at:		
Beginning of year	**1,311,558**	416,707
End of third quarter	**$1,187,568**	$1,133,789

See accompanying notes.

3

Table of Contents

Supplemental Cash Flows Information

Depreciation and amortization reflected in the cash flows statements includes the amounts presented separately on the income statements, plus depreciation that is classified as a component of cost of product sales and cost of gaming operations.

	Nine Months Ended June 30,	
(In thousands)	**2004**	**2003**
Payments of interest	**$ 73,733**	$ 80,375
Payments of income taxes	**207,541**	217,208
Non-cash items:		
Tax benefit of employee stock plans	**33,208**	17,912
Treasury stock acquired for stock awards exercised or forfeited	**108**	
Dividends declared, but not yet paid	**34,899**	25,796
Interest accretion for investments to fund jackpots	**19,465**	17,376
Interest accretion on zero-coupon convertible debentures	**7,671**	4,170
Acquisitions and purchase price adjustments within 12 months subsequent to acquisition:		
Fair value of assets acquired	**149,891**	(1,892)
Fair value of liabilities assumed	**40,180**	1,892
Initial consolidation of VIEs:		
Fair value of assets	**137,733**	
Fair value of liabilities	**185,244**	

See accompanying notes.

4

Table of Contents

NOTES TO UNAUDITED CONDENSED CONSOLIDATED FINANCIAL STATEMENTS

1. Summary of Accounting Policies

Basis of Presentation and Consolidation

Our consolidated financial statements have been prepared pursuant to the rules and regulations of the Securities and Exchange Commission (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, 2003. Certain prior period amounts have been reclassified to be consistent with the presentation used in the current period.

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 in each year. Similarly, our quarters end on the Saturday nearest to the last day of the quarter end month. For simplicity of presentation, all financial statement periods in this report are presented as ending on the calendar month end. The results of operations for fiscal 2004 will contain 53 weeks versus 52 weeks in fiscal 2003. Accordingly, the results of operations for the nine months ended June 30, 2004 contained 40 weeks versus 39 weeks for the nine months ended June 30, 2003. The results of operations for the third quarters ended June 30, 2004 and 2003 both contained 13 weeks.

Recently Issued Accounting Standards

FIN 46

In January 2003, the Financial Accounting Standards Board (FASB) issued FASB Interpretation (FIN) 46 (revised December 2003), *Consolidation of Variable Interest Entities* (VIEs). FIN 46 clarifies the application of Accounting Research Bulletin 51, *Consolidated Financial Statements*, establishes standards for determining under what circumstances VIEs should be consolidated with their primary beneficiary, and requires disclosures about significant unconsolidated VIEs. The consolidation requirements of FIN 46 apply immediately to VIEs created after December 31, 2003 and to older entities as of the end of the first period that ends after March 15, 2004. Certain disclosure requirements apply to all financial statements issued after December 31, 2003.

In both Iowa and New Jersey, IGT licenses wide-area progressive (WAP) systems to the trusts and casino members (trustees) that are responsible for the funding of the progressive jackpots. In Iowa, all linked WAP systems are operated under a single trust, administered by IGT, and IGT receives a fee equal to the net profit of the trust. In New Jersey, each WAP system is operated under an individual trust, administered by representatives of the casino members, and IGT receives a flat fee per machine per day.

Prior to the consolidation of the progressive systems trusts   statements of income beginning with our quarter ending June 30, 2004 under the requirements of FIN 46, we recognized revenues from the trusts per the contractual arrangements between IGT and the trusts. In accordance with SEC guidance SAB 101, we recognized revenues when earned and collectibility from the trusts was reasonably assured.

The trusts collect contribution fees from participating casinos members based on a percentage of coin-in generated by the gaming machines. The contribution fees collected by the trusts fund all jackpots liabilities (both won and not yet won) first. When the trusts historical activities in volume of coin-in and frequency of jackpots indicate that the remaining contribution fees are not sufficient to fund IGT s fees, the trusts may defer payment of IGT s fees. Accordingly, we would refrain from recognizing revenue until such time as the trusts cash flows indicated that collectibility was reasonably assured.

IGT, as the primary beneficiary, is required to consolidate these trust VIEs. The initial consolidation of the trusts balance sheets at March 31, 2004 added $185.2 million in total assets and liabilities, primarily consisting of jackpot liabilities and related assets. Beginning with our third quarter ended June 30, 2004, we additionally consolidated $11.2 million in quarterly revenues and $11.3 million in related expenses of the trusts, as well as $187.8 million in total assets and liabilities. The consolidation of the trust VIEs had no material impact to our financial condition or results of operations.

Table of Contents

2. Stock-Based Compensation

On October 1, 1996, we adopted Statement of Financial Accounting Standards (SFAS) 123, *Accounting for Stock-Based Compensation*, which established a fair value based method of accounting for stock compensation plans with employees and others. As permitted by SFAS 123, we continue to account for stock- based compensation plans in accordance with Accounting Principles Board (APB) 25, *Accounting for Stock Issued to Employees*, 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. Compensation cost is incurred, however, when the terms of an outstanding option are modified or converted in an acquisition.

The following pro forma net income and earnings per share (EPS) 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 Black-Scholes option pricing model used in this valuation was developed for use in estimating the fair value of traded options, which have no vesting restrictions and are fully transferable. Option valuation models require the input of highly subjective assumptions. IGT s employee stock-based compensation has characteristics significantly different from those of traded options, and changes in the assumptions used can materially affect the fair value estimate.

	Quarters Ended June 30,		**Nine Months Ended June 30,**	
(In thousands, except per share amounts)	**2004**	**2003**	**2004**	**2003**
Reported net income	**$141,102**	$103,685	**$434,368**	$282,386
Reported stock compensation, net of tax	**903**	618	**2,580**	1,766
Pro forma stock compensation, net of tax	**(7,278)**	(5,771)	**(22,399)**	(15,789)
Pro forma net income	**134,727**	98,532	**414,549**	268,363
After-tax interest expense on convertible debentures	**2,338**		**4,642**	
Pro forma diluted EPS numerator	**$137,065**	$ 98,532	**$419,191**	$268,363
Basic EPS				
As reported	**$ 0.40**	$ 0.30	**$ 1.25**	$ 0.82
Pro forma	**0.39**	0.29	**1.19**	0.78
Diluted EPS				
As reported	**$ 0.38**	$ 0.30	**$ 1.19**	$ 0.80
Pro forma	**0.36**	0.28	**1.13**	0.76

3. Inventories

Inventories consisted of the following:

(In thousands)	June 30, 2004	September 30, 2003
Raw materials	**$ 79,752**	$ 71,263
Work-in-process	**5,932**	7,622
Finished goods	**79,756**	68,181
Total inventories	**$165,440**	$147,066

Table of Contents

4. Property, Plant and Equipment

Property, plant and equipment consisted of the following:

(In thousands)	June 30, 2004	September 30, 2003
Land	**$ 19,993**	$ 20,112
Buildings	**89,229**	83,870
Gaming operations equipment	**363,954**	296,288
Manufacturing machinery and equipment	**204,771**	168,317
Leasehold improvements	**8,045**	7,973
Construction in process	**6,898**	24,030
Total	**692,890**	600,590
Less accumulated depreciation	**(401,331)**	(338,970)
Property, plant and equipment, net	**$ 291,559**	$ 261,620

5. Acquisitions, Divestitures and Discontinued Operations

Acquisitions

Acres

On October 27, 2003, IGT completed the acquisition of Acres Gaming (Acres), which specializes in the development of gaming systems technology designed to assist casino operators in increasing patron loyalty. This business combination will provide us the ability to work more closely with the Acres gaming systems technology to develop more integrated gaming systems products, as well as increase our competitive marketing capacity.

Under the terms of the agreement, IGT paid $11.50 in cash for each outstanding share of Acres common stock for an aggregate purchase price of approximately $134.0 million. Under the guidance of SFAS 141, *Business Combinations*, we have substantially completed our evaluation of the purchase price allocation to total assets and liabilities. See Note 8 for the purchase price allocation to identifiable intangibles and goodwill. We have not provided pro forma financial information including Acres prior to the acquisition, as it was not material to our consolidated results. The following table summarizes the values assigned to the assets acquired and liabilities assumed.

(In millions)	
Current assets	$ 44.7
Identifiable intangibles	49.0
Goodwill	75.3

Non-current assets	5.2
Total assets acquired	174.2
Current liabilities	22.5
Non-current liabilities	17.7
Total liabilities assumed	40.2
Purchase price	$134.0

Divestitures and Discontinued Operations

During fiscal 2003, we divested certain non-core businesses acquired with Anchor Gaming (Anchor) on December 30, 2001, including our slot route operations in Nevada, two casinos in Colorado and our pari-mutuel systems operations, United Tote. The sale of our online lottery system operations, IGT OnLine Entertainment Systems, Inc., and the lottery systems business of VLC, Inc., collectively referred to as OnLine Entertainment Systems (OES), was completed in November 2003. Cash proceeds, including the final working capital adjustment, totaled $151.5 million, resulting in a gain of $56.8 million, net of tax. These operations were reflected in discontinued operations for all periods presented.

Table of Contents

The results of our discontinued operations were comprised of:

	Quarters Ended June 30,		Nine Months Ended June 30,	
(In thousands)	**2004**	**2003**	**2004**	**2003**
Net revenue	**$**	$46,026	**$13,558**	$184,353
Income before tax	**$**	$ 7,911	**$ 3,416**	$ 26,659
Provision for income taxes		(2,940)	**(1,254)**	(10,009)
Income, net of tax		4,971	**2,162**	16,650
Gain (loss) on sale before tax				