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## Crunching Numbers

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A new accounting standard issued by the Financial Accounting Standards Board will affect financial reporting of casino operators. It won't be easy, but here's what savvy operators should be considering.



A historic, highly publicized and complex new revenue recognition standard issued by the Financial Accounting Standards Board (FASB) will become effective very soon. It will affect future financial statements of almost all entities, including casino gaming operators. Preparation for the implementation of this new standard, entitled "Revenue from Contracts with Customers" (*Accounting Standards Codification* Topic 606), will involve significant judgments, estimates and thoughtful decision-making by management regarding the effects on accounting policies and presentation matters.

The core principle of Topic 606 is that revenue should be recognized consistently with the transfer of goods or services to customers in amounts that reflect the value of the consideration the entity expects to be entitled in exchange. Instinctively, one might conclude initially that the new standard will not apply to typical gaming transactions (customer wagers, that is) because it is not readily apparent that they entail customer contracts or even providing customers with good or services. But think again. As explained below, the financial accounting world says they do entail customer contracts, and under some circumstances, accounting for gaming transactions will be somewhat affected. Accordingly, this article contains briefly summarized information intended to assist managements of casino gaming enterprises in evaluating and implementing the expected effects of Topic 606.

Fortunately for casino operators, in most (but not all) areas unique to casino gaming industry accounting, Topic 606 will allow or require continuing the current revenue recognition practices without significant change. With only one minor exception, we currently believe none of these will have an effect on the timing of revenue

recognition and reported net income (or loss). But it also tells us that casino operators will be challenged with several new presentation and more detailed disclosure requirements, only a few of which are discussed here.

Principal effects on casino operators (other than disclosures) will be as follows:

- Reporting entities will need to make appropriate pre-adoption transition disclosures of whether they plan to adopt early and which of two transition options, the full or modified retrospective method (discussed below), management intends to use,
- Topic 606 will prohibit the common practice of presenting a list of departmental revenues gross in the operating statement followed by a single deduction for promotional allowances; rather, its definition of revenue will require that each category of departmental revenue be presented only net of such allowances, and
- Liabilities for loyalty programs will generally be recorded at the point of the related qualifying gaming transactions at retail value, rather than cost, thus reducing reported net gaming revenue and net income (or increasing net loss) as compared to current practice.

### Effective Dates

Topic 606 will be effective for publicly-held companies for annual reporting periods beginning after December 15, 2017, and for interim reporting periods during the initial year of adoption. All other entities will be required to apply the standard initially for annual reporting periods beginning on or after December 15, 2018, and for interim reporting periods after the initial year of adoption. Earlier application is permitted for all entities but no sooner than for periods beginning after December 15, 2016.

### Transition Options

Two transition options are available:

- The **full retrospective** option requires restating prior year financial statements presented (for SEC issuers, one year for smaller reporting companies and two years for accelerated and large accelerated filers) as if the new standard had been applied in all prior years, with a cumulative effect adjustment as of the first day of the earliest year.
- The **modified retrospective** option requires a cumulative effect adjustment as of the first day of the year of adoption and disclosure of the effect of adoption on each financial statement line item in the year of adoption (as if the previous accounting had been continued) and an explanation of the reason for each change. Certain practical expedients (not discussed here) are available with this option.

The modified retrospective application is recommended for most casino operators because it is the simplest and because the retrospective effects, if any, on net income (or loss) on prior years are not likely to be particularly significant but may be disclosed optionally in the notes. Under this option, some operators may also wish to supplement the minimum requirements by making selective optional retroactive pro forma note disclosures.

### Pre-adoption Transition Disclosures

When the effect of a mandated retroactive restatement or cumulative adjustment to be made in the immediately succeeding period is deemed likely to be significant for any company, public or private, it might well be viewed as a non-recognizable subsequent event, in which case, a brief note disclosure should be considered.

More detailed pre-adoption transition disclosures by publicly-held companies are required as early as is practical by SEC Staff Accounting Bulletin (SAB) No. 74, (Disclosure of the Impact that Recently Issued Accounting Standards Will Have on the Financial Statements of the Registrant When Adopted in a Future Period). SAB 74

effectively requires discussion of the probable effects on future financial statements of adopting an issued but not yet effective accounting standard. SAB 74 disclosures need not be made in the financial statement notes but may, instead, be made in SEC filings in the “Management’s Discussion and Analysis.”

In a recent speech, SEC Assistant Deputy Chief Accountant, Jenifer Minke-Girard, indicated that when an issuer is unable to estimate reasonably the impact of adopting Topic 606 quantitatively, instead, the staff would ordinarily expect qualitative SAB 74 disclosures describing its expected future impact. This would include any significant accounting policies to be selected or changed upon adoption and how they differ from current policies, the status of the implementation process, and the nature of any significant implementation matters as yet unaddressed. Once it has been decided, the transition option to be selected also should be disclosed.

Although SAB 74 does not require any disclosure when the future effect of adopting a new standard is not expected to be material, the pervasive significance of the new revenue recognition standards for most other industries should encourage management of a publicly-held gaming entity to consider a defensive disclosure of that expectation.

### **Other Disclosure Requirements**

Topic 606 includes extensive and detailed, qualitative and quantitative new disclosure requirements for the year of transition and thereafter, which are beyond the scope of this discussion. In drafting the required disclosures that are intended to “enable users of financial statements to understand the nature, amount, timing, and uncertainty of revenue and cash flows,” managements will need to apply judgment in determining the level of detail to provide (which the standard does not prescribe), keeping in mind the foregoing overall objective of the standard.

### **Steps for Applying Topic 606**

The five necessary action steps set forth by the FASB for preparing to apply Topic 606 follow:

1. Identify the contract with a customer,
2. Identify the performance obligations in the contract,
3. Determine the transaction price,
4. Allocate the transaction price, and
5. Recognize revenue when or as the entity satisfies a performance obligation.

Topic 606 was intended to be, in substance, a one-size-fits-all revenue recognition framework to be applied universally across industry lines. But the AICPA’s Financial Reporting Executive Committee (FinREC) soon recognized a need, and appointed a group of Revenue Recognition Task Forces (RRTFs) for 16 special industries (including gaming), to examine typical transactions in each industry. The RRTFs were to identify revenue recognition implementation issues under Topic 606 and recommend industry-specific helpful hints and illustrative examples to guide management on how to apply the five action steps listed above.

The discussion below is based largely on the work of the Gaming RTTF and should be useful to help management document the preparation process effectively for routine gaming transactions.

### **Typical Gaming Revenue Transactions as Contracts with Customers**

Among the many forms of entertainment services offered by casinos to customers, some may be provided free with no further obligation by the customer as part of a package or loyalty program, or in exchange for

consideration on the part of the customer. The overall main focus of the entertainment package offered customers by the gaming entity is, of course, the opportunity to participate and win in various games of chance. This appears to be the primary reason why gaming transactions are viewed as representing a contract between the customer and the gaming entity. Based on the outcome of a wager, the contract is fully executed, and either (1) the gaming entity retains the amount wagered by the customer or (2) the wager is returned to the customer along with an additional amount (the customer's win) as per the agreement.

The price in a wagering transaction is the amount of consideration to which a gaming entity expects to be entitled in exchange for transferring promised goods or services to a customer. However, net win is determined, not by transaction or by customer but may be measured on a daily or shift basis at each individual gaming table or device. As provided by Topic 606, "as a practical expedient, an entity may apply this guidance to a portfolio of contracts (or performance obligations) with similar characteristics if the entity reasonably expects that the effects of applying this guidance to the portfolio on its future financial statements would not differ materially from applying it to the individual contracts (or performance obligations) within the portfolio."

For "plain vanilla" gaming transactions (wagers placed on games of chance), the customer and the gaming entity are wagering against each other, and there are typically no lingering performance obligations of the casino entity that should delay revenue recognition. However, sports betting transactions generally are made in advance of the event that will determine the outcome of the wager; therefore, recognition of a net win (or loss) is deferred until the event is completed, and the performance obligation is satisfied.

The granting of credit in the transaction (markers, that is) would not change the revenue recognition accounting prescribed by Topic 606; however, because in evaluating collectibility, an entity must consider the customer's ability and intention to pay the consideration when it is due, the amount of consideration to which the entity will be entitled may be less than the "price stated in the contract."

Other than as discussed below, no change from current revenue recognition practice is indicated for typical types of gaming transactions.

### **Promotional Allowances, Cash Sales Incentives and Progressive Jackpot Liabilities**

The standard instructs entities to allocate transaction prices earned from contracts with its customers to the performance obligations in the contracts. Adjustments for cash sales incentives and changes in progressive jackpot liabilities deducted from gross gaming revenue are seen to represent consideration payable to customers and, therefore, should be accounted for as contra-revenues reducing each category of transaction prices. Accordingly, financial statement presentations that historically have presented revenues for goods and services gross in departmental categories, followed by a single offsetting reduction for promotional allowances or complimentaries given as gambling inducements to customers, and yielding net revenues, are not permitted by the new standard. Although not affecting the timing of recognition of revenues, this requires a significant change in financial statement presentation from current practice for many gaming enterprises, particularly those that are SEC registrants.

Since under an older standard, a base jackpot liability may be accrued only to the extent the casino entity has an enforceable obligation to pay, an accrual for an incremental progressive jackpot liability is estimated based on the historical level of customer play and recorded over the period during which the incremental liability is generated. This is consistent with current practice except that offsetting debits would have to be treated as reductions of gross revenue.

### **Loyalty and Other Incentive Programs**

Many casinos have customer loyalty (often called "affinity") programs that provide credits or other incentives to gaming customers in conjunction with the level of their gaming play. It is currently expected that FinREC will conclude that liabilities for loyalty programs generally will be recorded at the point of the related qualifying

gaming transaction(s) at retail value rather than cost thus reducing reported net gaming revenue and net income (or increasing net loss). But those that feature “tier status” (which create separate performance obligations) may require additional evaluation by management. Loyalty programs are the only type of transaction or arrangement common in casino gaming operations likely to effect the timing of revenue recognition.

### **Other Common Casino Revenue Categories**

The Gaming RRTF considered the effects of Topic 606 on the timing of recognition and financial statement presentation of several other types of transactions common in the casino gaming industry. It also considered jackpot insurance recoveries, which are not revenue from contracts with customers. Although discussion of some of these topics are only in the preliminary stages as of this writing, none are currently expected to be affected significantly by adopting Topic 606.

The RRTF’s recommendations will cover fixed-odds wagering contracts, pari-mutuel racetrack wagers and hosting fees, wide area progressive (WAP) operators’ liability for progressive jackpots and presentation of WAP operators’ fees, management of gaming properties for others, and breakage (for example, of outstanding gaming chips and tokens), the amount of revenue from which must be disclosed, if material.

One more note about gaming chips and tokens (“chip float” liability) breakage — operators of casinos in jurisdictions outside Nevada are cautioned to determine if an unclaimed or abandoned property (or escheat) law that requires surrendering unclaimed funds to the state or other authority prevents retention and recognition of revenue from chip float breakage.

Readers are advised to refer to the text of the actual standard and to the latest available versions of the more detailed AICPA FinREC interpretive output based on RTTF recommendations cited herein, several of which are still subject to change. As the project continues to evolve, links to many of the issues papers cited may be found at [www.aicpa.org](http://www.aicpa.org).

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