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The Spanish Springs Casino Slot Revenue Recognition Case

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THE SPANISH SPRINGS CASINO SLOT REVENUE RECOGNITION CASE

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ABSTRACT

The primary objective of this case is the development of an understanding of the revenue recognition criteria and the complications that develop given alternative variations in the same product. This case uses the casino environment to define the initial critical event for revenue recognition (slot revenues). The case expands on the basic revenue recognition criteria with the application of the matching concept. That is, what costs (slot jackpots, unpaid winning tickets, etc.) must be recognized given the recognition of revenue. Additional complexities to revenue recognition are added that cover the issues of defining gross versus net revenues (participation agreements with vendors, players' loyalty clubs, and special promotions).

INTRODUCTION

The Ma&Mi Corporation is in the process of completing the construction of a small neighborhood casino in Sparks, Nevada. This casino will be called the Spanish Springs Casino. The plans call for the casino to have a bar room, a restaurant, and a gaming area that will have 250 slot machines. The casino is located on a commercial strip in an area with high growth and many new housing developments. The Ma&Mi Corporation's strategic plan is to market to the local community. The corporation is currently in the process of hiring a management team and staff before the opening.

The Ma&Mi Corporation has just hired Cathy Buck as its joint CFO/Controller for the Spanish Springs Casino. This will be a new adventure for her as she is making a complete career change. Cathy spent the last ten years working initially as a CPA and then as controller for the Ridgeview Golf and Country Club in California. She realizes that taking over as the controller will require her to develop an understanding of slot machine revenue recognition, which will be very different from booking golf revenues.

Cathy decides to talk to the new GM, Gonzalo Hernandez (who had previously been a controller) about where she might obtain reading materials on casino accounting. Gonzalo tells her that, while very outdated, the Greenlees (1988) book is still one of the best sources to learn the basics of casino accounting. In addition, he tells her that there is an AICPA Audit and Accounting Guide, *Audit of Casinos* (AICPA, 2002). Finally, he directs her to go to the website of the Nevada Gaming Commission and State Gaming Control Board, <http://gaming.nv.gov>. This site provides a wide variety of materials on gaming regulations, current internal accounting controls requirements, and checklists for testing controls for internal and external auditors. In addition, Gonzalo tells Cathy that another good source of information on slot machines is the website of International Gaming Technology Inc. (IGT), which is www.igt.com. The company sells over 75% of the total slot machines in the United States. Its website provides information on all of the different types of slot machines. Its annual report also provides a good source of information on revenue recognition in its footnotes.

BACKGROUND

Cathy knows the basics of how a slot machine works. She knows that each machine has a computer chip which defines the amount of money that will be paid out. The machine's computer program is carefully designed and tested to achieve a certain **payback percentage**. The payback percentage is the percentage of the money paid out to a player divided by the amount of money put into the machine. With a payback percentage of 90%, for example, the casino would take 10% of all money put into the slot machine and 90% would be winning payouts to the customer. Normally, players continue to play the money that is paid out to them. For obvious reasons, casino managers normally talk in terms of **hold or win percentage**, that is the 10% proportion that is retained by the casino.

The odds for a particular slot machine are built into the computer program in the machine's computer chip. The casino cannot change the odds on a machine without replacing this chip. Despite popular opinion, there is no way for the casino to instantly "tighten up" or "loosen" the payback percentage on a particular machine. Naturally, the casino management installs chips with lower payouts in the machines with the types of games that are "popular." For the machines that have very large potential jackpot payouts, there are much smaller payouts for other winning combinations to

ensure that the overall payout percentage is about the same as other machines which have smaller jackpots and more frequent small payouts.

The Spanish Springs Casino will have a range of machines with payback percentages ranging from 84% to 98%. With the 250 machines up and running, the average payback percentage is expected to be 95%. So the casino will expect to win about 5% of every bet that is played on its machines.

Gonzalo tells Cathy that all the slot machines are connected electronically to the casino's central computer using a computerized slot accounting system. This system tracks the play of each individual slot machine. Each machine has several meters that automatically accumulate all bills and coins put into the machine, all coins paid out from the machine in winnings, and all hand paid jackpots that have to be paid when the winnings are too big for the machine to pay out from the coins held in the machine. A report is generated on a daily basis that provides, for each machine and for the total for all machines, the total dollar amounts played on the machine (currency in) and total dollar amounts paid out on the machine (currency out and all hand paid jackpots). The report also provides a variance analysis report that compares actual win figures to the theoretical win that would have resulted if the pre-programmed win percentage had occurred exactly as predicted during that period.

Slot Machine Cash Flow

When a customer wants to play a machine they could insert either paper currency into a bill acceptor or they could insert coins into the coin slot. The player can place their bet and then pull a handle or push a button to set the play in motion. A random number generator goes into action and provides a set of possible outcomes. If the outcomes represent a winning combination, the machine will either drop the winning combination in coins or it could accumulate credits that the player can then play again. When the player wants to leave, the player can collect the coins that have been dropped and push the "payout" button for the machine to drop coins for any accumulated credits.

Older machines have what is called a "hopper." This hopper is initially "filled" with approximately 300 coins and is intended to service any regular payouts of winning combinations. When a player puts coins in the machine, they fall into the hopper. As a result of customer play, the hopper accumulates more coins than it can handle. This causes coins in the hopper to fall out of the hopper into a bucket located in the lower section of the slot machine. On a regular basis, usually very early in the morning, there is what is called a "slot drop." A "drop" team of slot department employees opens all the slot cabinets, removes the buckets with the coins in them, puts an empty bucket in and takes the full buckets to the hard count room to be counted. At the same time, a second team drops all the currency bill acceptors and takes them to the soft count room to be counted. A report from the count is sent to the accounting department and compared to the slot system report to confirm that there are no differences (the matching of the actual currency and coin count with the computerized slot system meter reading).

Occasionally a slot machine hopper runs out of coins due to payouts to customers or a payout that is too big for the slot machine hopper to handle. In these cases, cash has to be taken from the casino cage to fill the hopper again (a "fill") or to pay out a large winning bet to a lucky customer (a "hand paid jackpot"). For these slot machines, gross revenue equals "drops" less "fills" to the machine and "hand-paid jackpot" payouts.

All newer slot machines take both coins or currency. The currency is accumulated in a currency acceptor box. While many of these machines are capable of paying out coins, the more

efficient approach is to only pay out with a cash voucher. When customers want to cash out with these machines, they hit the “payout” button that provides them with cash vouchers to take to the cashier, who pays them their winnings.

Casino Slot Machine Mix

While Cathy is concerned with currency and coins going into and out of the machines, Gonzalo is concerned with the types of machines from a marketing perspective. Gonzalo evaluated the current market in slot machines and has decided to acquire a variety of slot machines in order to provide potential customers with the fun and enjoyment that they are looking for. Four different styles of slot machines will be used in the casino: regular slot machines, participation slot machines, linked progressive slot machines, and wide area progressive slot machines. These machines will be the traditional type of machines which accept cash and bills, and pay out regular winners with coins.

Regular Slot Machines

The purchase of these machines results in ownership of the machine passing from the vendor to the casino. Payout tables are provided for these machines and are a function of the number of coins played. The machines have a fixed maximum jackpot which does not vary based on the amount of coins played. All revenues generated by the machine belong to the casino. All payouts and jackpots generated by the machine are the responsibility of the casino.

Participating Slot Machines

There are times that a slot machine manufacturer develops a product with a unique attribute, such as the International Game Technology Inc.’s (IGT) *Wheel of Fortune*, that customers prefer over other slot machines. They seem to provide the customer with more fun and entertainment. For example, many customers play the *Wheel of Fortune* in hopes of hitting a combination that allows them to spin the wheel for a bonus prize (You have to be a *Wheel of Fortune* fan to fully understand that concept!). The manufacturer of that machine will not sell the machine to the casino but enters into a lease participating arrangement that typically gives the vendor 20% of the net win. Although many casinos feel that this is a huge fee to pay to carry this product and do not like the sharing of revenue with the vendor, these machines have a customer following. Casinos believe that they need some of these machines in their casino for marketing appeal.

Under these types of arrangements, the manufacturer retains title to the slot machine. The casino pays the manufacturer a percentage fee for the use of the machine based on the total value of coins played. The casino will collect all the revenues and must pay all the payouts and jackpots. For example, IGT’s *Wheel of Fortune* participating arrangement calls for a 20% participating fee. Therefore, if \$500 of coins is played on the machine on a particular day, with a net win (coins in minus coins out) for that day of \$20, the casino would pay the vendor \$4 ($\$20 \times .20$) for that machine for that day. The Spanish Springs Casino has negotiated such an arrangement with another vendor (Wolf Pack Incorporated) to install ten of its machines and will pay a participating rate of 20% of the net win.

Linked Progressive Slot Machines

Progressive slot machines differ slightly from the regular slot machines. While each machine has normal payout tables like a regular slot machine, it also has a main jackpot that increases in value whenever the machine is played. Often these machines are linked electronically to other

machines in the casino so that play on the whole group of machines contributes to building up a larger jackpot. These machines are called progressive jackpot machines. They start with a “base jackpot” that continues to increase until the jackpot is hit. For example, there may be a machine, or group of machines, that starts with a base jackpot of \$100,000. Every time a dollar is played on any one of the linked machines, the jackpot increases by three cents. By the end of an accounting period, the jackpot may have increased substantially if the jackpot has not been hit. When the jackpot is hit, the displayed jackpot resets to \$100,000 and the process starts over. Based on discussions with the supplier, Cathy learns that the jackpot cycle is normally about four months. Similar to the regular slot machines, all revenues generated by the machine belong to the casino. All payouts and jackpots generated by the machine are the responsibility of the casino.

The casino will have a bank of 20 linked progressive jackpot machines, each linked to a progressive jackpot which will start at \$200,000. The lucky winner of this jackpot will receive the payout in ten equal payments over a ten-year period, with the first payment made at the time of the jackpot.

Wide Area Progressive (WAP) Slot Machines

WAP slot machines have elements of the participating machine and elements of the progressive machine. These machines are able to offer huge jackpots because the vendor is able to sign up a large number of casinos across the state of Nevada that are willing to have these machines in their casinos. Individually, these casinos could not afford the large jackpots, but as a group, they share the risks associated with the payment of the jackpot. Like participating machines, these machines remain the property of the vendor, and the casinos pay a leasing fee. However, the leasing fee only represents a portion of the payment that the casino pays. A second part of the payment represents a contribution toward the jackpot payout.

The WAP machines also have all the characteristics of a progressive machine. Like progressive machines, they are a series of electronically linked machines that start out with a base jackpot and then incrementally increase with each dollar played. The vendor electronically links all the machines in each participating casino throughout Nevada. The WAP jackpots build up at a much faster pace because of the number of machines at each participating casino throughout the entire state. The players at the different casinos contribute towards building up the progressive jackpot until the top award-winning combination is hit at one of the participating casinos.

When the jackpot is hit, it is the vendor who makes the payments to the winner. While the vendor pays the jackpot, each casino has contributed on a regular basis toward that jackpot as part of the combined jackpot/leasing fee that they pay.

IGT's *Megabucks* slot system epitomizes this type of machine system. The *Megabucks* jackpot starts out with a base jackpot of \$4,000,000 and progresses from there. The jackpot has reached as high as \$43,000,000. When the jackpot is hit, a new base jackpot of \$4,000,000 starts the new cycle.

Spanish Springs Casino has entered into an arrangement with IGT to have two *Megabucks* slot machines on its premises. The agreement calls for Spanish Springs Casino to remit to IGT on a weekly basis 6% of the currency played on the machine (Progressive System Fee). Cathy learns that approximately half of this fee goes to fund the *Megabucks* jackpot and the other half represents a fee for the use of IGT's machines. Historical data shows that the IGT jackpots are normally hit within four months.

SPECIAL JACKPOT PROMOTION

The casino has set up a special jackpot prize on a set of its dollar slot machines. This special prize is a new Ford Mustang convertible, and this prize is in addition to the normal jackpot payout for those machines. The casino has purchased the new Mustang convertible at a cost of \$15,000 from a local dealer seeking some advertising. The car has a retail price of \$20,000. This car is prominently displayed in the middle of the bank of machines. Gonzalo anticipates that the auto jackpot will have an operating cycle of four months before it is won.

GAMING CONTROL BOARD REGULATIONS ABOUT JACKPOTS

For each of the machines which have a variable jackpot and for special jackpot promotions, the Gaming Control Board requires that the size of the jackpot be clearly displayed on an electronic sign. In addition, it is illegal to “pull the plug” on a displayed progressive jackpot once it has built up. If a progressive jackpot had to be withdrawn because of a machine failure, for example, it would have to be immediately reinstated on another similar type of machine elsewhere in the casino.

PLAYERS LOYALTY CLUB CARDS

The casino will also issue players loyalty club cards free to any customer who wants one. All they have to do is provide the casino with their personal details. The casino uses this information for marketing purposes and to learn about player habits and preferences. The customers place their card in a slot in the slot machine whenever they play. The machine awards them points based on the amount of their bets. These points are recorded on a computer chip in the cards and are recorded on the casino’s computer system. Players can redeem the points to purchase a meal at the restaurant or to purchase merchandise at the casino’s gift shops. Customers accumulate one point for every \$1 that is played in the slot machine. Players can have a wonderful choice of food at the Casino Buffet when they have accumulated 1,000 points. The retail value of the buffet is \$16; the estimated cost is \$5. Cathy has talked with other casino operators and has concluded that 80% of the players will redeem their points.

FIRST MONTH OF OPERATION

Spanish Springs Casino opened its doors on September 1, 2005. Its slot computer system generated its first month report as presented in Table 1 for the month ending September 30, 2005.

CASE QUESTIONS

Gonzalo wants Cathy to provide an income statement for slot machine operations for the month of September. To complete this report, Cathy must address the following issues that relate to revenue recognition and proper matching of expenses to derive net win and other expenses. Review each of the following issues and be prepared to discuss the logic for properly classifying these revenues and expenses. In your discussion, be sure to reference the AICPA Casino Audit Guide.

TABLE 1
Spanish Springs Casino Monthly Slot Report
For Month Ending September 30, 2005

	<u>Actual</u>	<u>Theory</u>	<u>Variance</u>
Currency in	\$9,375,000	\$9,375,000	
Currency out (includes hand-paid jackpots)	<u>8,625,000</u>	<u>8,906,250</u>	
Net Win	750,000	468,750	281,250
Payback Percentage	92%	95%	3%

Included in above figures are the following

The 10 Participating Wolf Pack Inc. Machines	
Currency in	\$270,000
Currency out	243,000
Net win	27,000

Linked Progressive Slot Machines	
Currency in	\$411,666
Currency out	370,500
Net Win	41,166

IGT Megabucks Machines (WAP slot machines)	
Currency in	\$37,500
Currency out	31,500
Net Win	6,000

Player Club Points	
Accumulated Points	8,000,000
Redeemed Points	3,500,000

Additional information:

When the casino opened its doors, the IGT Megabucks progressive jackpot was displayed at \$4,540,372. On September 30, 2005, the jackpot had increased to \$6,892,490.

The progressive linked jackpot started the month with a progressive liability of \$200,000. On September 30, it had progressed to \$212,350. This jackpot has not yet been hit.

1. Use the September slot report to determine the numbers that Cathy would use to generate the September slot machine revenue figures. Provide a discussion for using the actual win versus theoretical win figures.

2. The casino must make a payment to Wolf Pack Inc. Determine the amount that must be paid. Discuss whether this participating fee expense should be subtracted from revenue to arrive at net win or whether it should be shown as an expense below the net win figure.
3. The linked progressive slot machines have generated \$411,666 in gross revenues but have yet to hit the progressive jackpot which initially started at \$200,000, and which currently stands at \$212,350. Discuss the possibilities for the recognition of a liability associated with this progressive jackpot. When this jackpot is paid out, it will be paid as a ten year annuity due. How does a payout such as this impact on the liability recognition? The current interest rate for annuities is 6%. If the jackpot is hit on October 1, what journal entry would be made when this progressive jackpot is won?
4. Spanish Springs received an invoice from IGT for its fee associated with the *Megabucks* machines. Determine the total fee assessment from IGT. How would this transaction be recorded in the Spanish Springs Casino ledger? Is there more than one option available? The IGT jackpot has accumulated to \$6,892,490. Discuss the handling of the revenues and associated expenses for this machine. Consider what would be reported as net win versus what is deductible as an expense. Should the casino record an asset for amounts paid each month to the manufacturer for the share of the cost of the jackpot? Should the casino record a liability for its share of the wide area progressive jackpot?
5. The casino has purchased a Mustang convertible automobile as a prize for a bank of slot machines. What issues must be resolved when matching the costs of the auto with the revenues being generated? Discuss the alternative values that could be used and the time period over which it might be expensed. Would the amount be classified as a gaming expense to arrive at net win or is it treated as a promotional expense?
6. According to EITF Issue 00-22, (*Accounting for 'Points' and Certain Other Time-Based or Volume-Based Sales Incentive Offers, and Offers for Free Products or Services to be Delivered in the Future*), the casino needs to place a value on these future liabilities and recognize them for financial reporting purposes. Determine the value for the accrual of player club points. What entry is made to record this accrual? When the player redeems points in the restaurant, what entry would be made? How will these items be reflected in the September income statement?
7. What is the final figure that Cathy would use for the adjusted net slot revenue? Distinguish between items that should be included as revenues and those which should be included as part of expenses.

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THIS IS ADDITIONAL INFORMATION THAT COULD BE GIVEN TO STUDENTS INSTEAD OF HAVING THEM DOWNLOAD THE VARIOUS WEBSITES.

APPENDIX A – EXTRACTS FROM NEVADA GAMING CONTROL BOARD REGULATIONS

Nevada regulations include the following that relates to revenue recognition and deduction to arrive at net gaming revenues for slot machines.

6.110 Gross revenue computations.

2. For each slot machine, gross revenue equals drop less fills to the machine and jackpot payouts. Additionally, the initial hopper load is not a fill and does not affect gross revenue. The difference between the initial hopper load and the total amount that is in the hopper at the end of the licensee's fiscal year must be adjusted accordingly as an addition to or subtraction from the drop for that year. If a licensee does not make such adjustments, or makes inaccurate adjustments, the audit division may compute an estimated total amount in the slot machine hoppers and may make reasonable adjustments to gross revenue during the course of an audit.
6. In computing gross revenue for a slot machines, keno and bingo, the actual cost to the licensee, its agent or employee, or a person controlling, controlled by, or under common control with the licensee, of any personal property distributed as losses to patrons may be deducted from winnings (other than costs of travel, lodging, services, food, and beverages) if the licensee maintains detailed documents supporting the deduction.
7. If the licensee provides periodic payments to satisfy a payout resulting from a wager, the initial installment payment when paid and the actual cost of a payment plan approved pursuant to Regulation 5.115 and funded by the licensee may be deducted from winnings.
8. For payouts by inter-casino linked system operators a licensee may deduct from winnings its pro rata share of an inter-casino linked system payout, except for a payout made in conjunction with a card game, pursuant to NRS 463.3715(5) under the provisions of its contract with the operator of the system and in accordance with the requirements stated herein.
11. Payout receipts and wagering vouchers issued at a game or gaming device shall be deducted from gross revenue as jackpot payouts in the month the receipts or vouchers are issued by the game or gaming device. Payout receipts and wagering vouchers deducted from gross revenue that are not redeemed within 60 days of issuance shall be included in gross revenue. An unredeemed payout receipt or wagering voucher previously included in gross revenue may be deducted from gross revenue in the month redeemed.

APPENDIX B -EXTRACTS FROM THE AICPA’S CASINO AUDIT GUIDE**Extract from Chapter 1 — Description of the Industry****Slots and Other Coin-Operated Gaming Devices**

1.24 Slots and other coin-operated gaming devices are machines in which the player generally deposits one or more coins for a chance to win a jackpot or other payoff. Payoffs may be based on the alignment of like symbols appearing on three or more narrow cylindrical drums, called reels, but there are many variations. These devices may also be machines that simulate other games, such as poker or blackjack, on a video screen. In addition, gaming manufacturers have offered multi-linked progressive systems to casinos. These systems provide the casino operator with the ability to provide significantly larger jackpot offerings in the casino and at the same time reduce the casino’s risk for funding the jackpot since the administrator of the multi-linked progressive system is responsible for paying such jackpots from funds accumulated in a trust. The trust is established for the purpose of collecting from each participating casino their contractual portions of the drop from such machines and maintaining the trust sufficient to satisfy the previously awarded and current accrued progressive obligations. Typically, the progressive amount increases as a function of each coin played in any machine linked to the system.

Extract from Chapter 2 — Accounting and Financial Reporting

2.01 Most of the accounting and financial reporting practices of the gaming industry are essentially the same as those of other industries. However, some accounting and financial matters are peculiar to the gaming industry and are explained in this guide.

Casino Revenue Recognition

2.02 Casino revenue is reported on the accrual basis. Revenue recognized and reported by a casino is generally defined as the win from gaming activities, that is, the difference between gaming wins and losses, not the total amount wagered.

Promotional Allowances

2.03 Promotional allowances (complimentaries, or comps) represent goods and services, which would be accounted for as revenue if sold, that a casino gives to customers as an inducement to gamble at that establishment. Examples are rooms, food, beverages, entertainment, and parking. The cost of providing promotional allowances is included in costs and expenses.

2.04 The retail amount of promotional allowances is often disclosed in the financial statements. This disclosure, if made, is preferably made in the financial statement notes. However, the retail amount of promotional allowances may be included in gross revenues and offset by deducting it from gross revenues on the face of the income statement. The retail amount of promotional allowances should not be included in gross revenues and charged to operating expenses because that would overstate both revenues and expenses.

Preopening, Licensing, and Major Entertainment Production Costs

2.06 Some or all costs related to licensing costs and costs of major entertainment productions are either charged to expense as incurred or deferred and amortized. Preopening costs should be charged to expense as incurred. Licensing and major entertainment production costs should only be deferred and amortized where it is probable that they will benefit future periods. The costs of major entertainment productions are usually amortized over the period that management believes the

productions will run. Other licensing costs should also be amortized over their periods of expected future benefit.

Income Taxes

2.07 Financial statement reporting for casinos differs from income tax reporting, resulting in deferred income taxes when (a) recognition of casino receivables is used for financial statements and the "when collected" method is used for income tax reporting, (b) costs are deferred for financial statements and are charged to expense for income tax reporting, and (c) progressive slot jackpots are accrued based on meter readings for financial statements and are charged against revenue when paid for income tax reporting.

Slot Club Promotional Systems

2.08 For marketing and customer tracking purposes, casinos typically offer slot club promotional programs wherein a patron registers with the casino and receives a magnetic card that is inserted into a card reader connected to the slot machine. When properly inserted into the card reader, the customer is able to accumulate "points" for each amount played on the slot machine. A customer usually may redeem such points for cash, gifts, food and beverage, hotel rooms or other goods and services. Cash received by the customer is typically but not necessarily put back into slot machines. The casino believes it is better able to track customer play and at the same time give incentives to its repeat and loyal customers.

Base Jackpots

2.09 Base jackpots are charged to revenue ratably over the period of play expected to precede payout; however, if immaterial, they are charged to revenue when established. Any portion of the base jackpot not charged to revenue when the jackpot is paid is charged to revenue at that time.

2.10 Normally, progressive slot machines contain base jackpots that increase at a progressive rate based on the number of coins played. (For example, each time a one-dollar coin is played, the amount of the jackpot is increased by five cents.) The accrual of the liability and the reduction of revenue as the amount of the jackpot increases results in recognition of liabilities and matching of costs and revenues.

Participating Slot Machines

2.11 In some operations, the casino pays a percentage of the win of participating slot machines to slot machine lessors. In those cases the win is usually recorded as revenue, and the participating fee is shown as an expense.

Extracts from Definitions

base jackpot. The fixed, minimum amount of a slot machine payout for a specific combination.

coin-operated gaming device. Any of a variety of mechanical or electronic apparatus used in connection with gaming. Includes slot machines and electronic video games such as poker, blackjack, craps, and keno.

complementaries (comps). Promotional allowances to customers.

gross gaming revenue (win). The net win from gaming activities, which is the difference between gaming wins and losses before deducting costs and expenses.

handle. The total amount wagered.

hold percentage (PC). The relationship of hold to drop or handle.

jackpot payout. The portion of a jackpot paid by slot personnel. The amount is usually determined as the difference between the total posted jackpot amount and the coins paid out by the machine. May also be the total amount of the jackpot.

machine payout. The number of coins paid out to the customer by a coin-operated gaming device as the result of a winning combination.

progressive slot machine. A slot machine, with a payoff indicator, in which the payoff increases as it is played.

slot machine. See coin-operated gaming device.

theoretical hold. The intended hold percentage or win of an individual coin-operated gaming device as computed by reference to its payout schedule and reel strip settings.

win. See gross gaming revenue.