Accounting Issues for Publicly Traded Gaming Companies

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The expansion of gaming throughout the world has resulted in the emergence of large publicly traded corporations whose primary business activity is the operation of gaming facilities in various gaming jurisdictions. The availability of the public securities market has allowed gaming operators to expand and diversify operations into new markets and geographic locations.

This article discusses accounting issues common to public gaming companies active in the acquisition and development of new locations. It is divided into the following sections: Pre-opening Costs; Reporting on Cash Flow; Reporting and Revenue Recognition for Joint Ventures; Valuation Issues; and EDGAR and the SEC.[1]

Pre-opening Costs

The American Institute of Certified Public Accountants (AICPA) in its Audit and Accounting Guide for Audits of Casinos states that

> [S]ome or all cost related to the period before the opening of a casino, licensing costs, and costs of major entertainment productions are either charged to expense as incurred or deferred and amortized. These costs should only be deferred and amortized where it is probable that they will benefit future periods. . . . [D]eferred costs should also be amortized over their periods of expected future benefits.

Development of a new gaming facility often involves significant up-front costs associated with: hiring and training employees, marketing and promoting the facility in anticipation of opening, payment of one-time costs associated with obtaining the necessary licenses and permits to operate gaming in the jurisdiction, and fulfillment of obligations and promises made as conditions of licensing to provide facilities and improvements for the benefit of the community's economy and infrastructure. A careful analysis should be made to determine the nature, purpose, and benefit to the gaming facility of such costs. Based on this analysis, the costs will be segregated and grouped into appropriate categories. Costs that do not relate to physical assets constructed or acquired, inventories and supplies, or the organization and formation of legal entities, are typically considered pre-opening costs. The two most common and significant pre-opening costs are payroll costs for employees hired prior to opening, and advertising costs. The future benefit of such costs is questionable — and difficult if not impossible to assess.

Public companies usually prefer to defer recognition of the expenses related to such costs until after the facility is opened, to offset the expenses with revenues generated by the facility. A review of the accounting policies of various gaming corporations indicates that practices in the industry will vary — from recognition of the costs as incurred, to amortization over a period after opening of six months to five years. The specific history, facts, circumstances, and nature of pre-opening costs will dictate the company's ability to justify deferral and amortization over a future period.

It is noted that the Securities and Exchange Commission (SEC) routinely challenges the policy of certain public corporations regarding pre-opening costs. The SEC will assume that in the absence of a history of gaming operations by the company, insufficient evidence as to the recoverability of pre-opening costs will prevent deferral of the costs. Companies that have demonstrated the ability to generate profitable gaming operations, resulting in an assumption of high probability of recovery over the expected amortization period, and that the costs have

future probable benefits, have been allowed to defer the costs over some future period. The burden of proof rests with the company and its management.

Companies anticipating future expansion into new locations should carefully consider the existing alternatives regarding pre-operating costs, including: (1) taking the conservative approach of expensing pre-opening costs as incurred; (2) obtaining clearance from the SEC for the planned policy prior to the issuance of financial statements affected by the policy; or (3) adopting a policy and addressing the policy with the SEC when questioned, with the possible ramification of delaying a critical offering of securities or restating previously issued financial statements. The latter two approaches require significant fact-gathering and the development of key arguments that may be ultimately rejected by the SEC. The first approach may be less desirable to existing and future investors.

Reporting on Cash Flow

As gaming companies seeking expansion opportunities offer equity and debt securities for sale in the public market, the marketplace frequently focuses on the ability of the company to generate significant amounts of cash flow. One of the required financial statements under generally accepted accounting principles (GAAP) is the statement of cash flows, including a subtotal entitled "Cash Flow from Operations."

Most Master of Business Administration (MBA) programs focus on earnings before interest, depreciation, and taxes (EBITDA). Consequently, company managers and financial analysts have historically used EBITDA as a measure of a company's performance and ability to meet its debt obligations or to pay cash dividends. Frequently, the terms of an indenture related to debt securities offered in the public financial markets contain covenants and restrictions related to a company's EBITDA. As a result, and based on the advice of investment bankers, many companies have focused on EBITDA in Selected Financial Data, Management's Discussion and Analysis of Financial Condition and Results of Operations (MD&A), and other disclosure sections required in public filings with the SEC.

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The SEC historically has objected to the inclusion of EBITDA, on the basis that this measure is not determined (or defined) in accordance with GAAP. In cases where the SEC has allowed a company to include the disclosure, it has required that the entity add a note to each presentation of EBITDA explaining: (1) how EBITDA was derived, along with disclosure as to the purpose for presenting EBITDA and why it will enhance a reader's understanding of the company's financial condition, results of operations and cash flows; and (2) that the measure of EBITDA should not be construed by the reader as an alternative to operating income (as an indicator of the entity's operating performance) or as an alternative to cash flows (as a measure of liquidity). In addition, within MD&A, the SEC has required companies to restrict discussion of EBITDA to the section entitled "Liquidity and Capital Resources," and to balance the discussion of EBITDA in such section with equally prominent discussions of cash flows from operations, cash flows from investing activities, and cash flows from financing activities as shown on the Statement of Cash Flows for the same periods as EBITDA is described.

This additional disclosure required by the SEC when EBITDA is presented is cumbersome to the presentation and if not handled properly by the company it can cause delays in getting a registration statement cleared and declared effective by the SEC. Proper planning and preparation in anticipation of the SEC requirements can mean fewer SEC comments and will shorten the clearance process. This results in greater flexibility with the critical time schedule of a public offering of debt or equity securities.

Joint Ventures — Reporting and Revenue Recognition

As existing public gaming operators seek to diversify and expand their operations, they may choose to enter a new jurisdiction on their own, as a partner in a partnership or joint venture, or as an operator/manager with no equity interest in the project. The latter two options provide certain benefits to the operator other than the potential for huge profits. These benefits may include less capital outlay up front, sharing of the risk of failure, increasing the chances of winning the exclusive right to operate in a particular jurisdiction, obtaining rights or preferential land cost on prime locations, or synergy from sharing equipment, technology and resources. The downside is that the operator must give up a portion of the profit from the operation to his partners or the project owner.

Agreements will vary in each circumstance — providing the parties with differing levels of control and rights, and obligation and responsibility. Accordingly, cash flows, revenues, and profits may be allocated in various ways and forms. Often, the agreements are executed without the help of a lawyer, a tax accountant, or an accountant familiar with financial reporting by public corporations. In such cases, the results can be disastrous will and have differing affects on the company's financial statements, which the financial markets use to evaluate financial strength, stability, and performance.

Fortunately, most companies recognize the need to involve the lawyers and tax specialist early in the process. However, the financial reporting specialist is often left out until it is time to report on the activities associated with the transaction. A company may enter into a transaction intending to consolidate the joint venture financial statements with their own, but because of the lack of a controlling interest in the project, they are precluded from doing so. Accounting for investments under the cost method, the equity method, or the consolidation methods of accounting, is each very different. Each will result in significantly different income statements and balance sheets, viewed differently by the investing public and the financial analyst. A financial reporting specialist can assist the company in structuring the transaction to ensure that assets used or contributed to the project are valued for financial reporting purposes as intended by the contributing parties.

Joint venture agreements are generally structured to maximize the return of capital to each party in accordance with the perceived contribution to the project by each party. Consequently, many agreements address allocations of cash flow and liquidation of assets upon termination of the agreement. Because cash flow may vary significantly from net income or loss as reported in accordance with GAAP, what is perceived to be the profit and loss allocation of the parties may significantly differ from the real allocation as reported in accordance with GAAP. The accountant or auditor of the financial statement must consider all of the facts of the agreement, including the legal obligations of each party, and as a result, determine a method for properly allocating the net income of the joint venture as determined in accordance with GAAP, on a different basis than the percentage ownership in the project or the stated allocation of cash flows from the operation. Since each joint venture may differ significantly from another, it is impossible to fully explain and consider all possible outcomes in this article. However, it is important to note that the auditor will consider all factors — including, legal obligations to fund the project, preferential rights, guarantees and distributions made to one party or another, guarantees of return of invested capital prior to splitting of profits, substance of the transaction versus the form, and the liquidation preference and rights of each party.

Specialized terminology used in agreements may have a different meaning under GAAP that is intended by the lawyers or the joint venture parties. A careful review of the financial terms and conditions by a qualified financial reporting specialist can prevent later confusion and misunderstanding as to the correct meaning of the agreement. Proper use of a specialist (usually the company's auditor) should minimize surprises in financial reporting as a result of the annual audit and can minimize costly litigation from ambiguous agreements.

Valuation Issues

The expansion of gaming has resulted in acquisitions of assets and businesses to be converted for use in new gaming enterprises. A company may be willing to pay a higher price for the assets than the current use would justify, simply because the change in use to gaming has the potential of bringing large profits and cash flows not previously realized. A careful

analysis must be performed when a business is acquired to ensure that the purchase price is properly allocated to the individual assets and appropriate lives are used to depreciate such assets. Often the assets are located and used in geographic locations for which no prior gaming history is available. Consequently, the future recovery of the asset cost may be in question.

In December 1990, the Financial Accounting Standards Board (FASB) issued a discussion memorandum related to "Accounting for the Impairment of Long-lived Assets and Identifiable Intangibles." In November 1993, the discussion memorandum was revised and issued as an exposure draft requiring comments from interested parties by March 15, 1994. At issue are the following four topics:

1. How should impairment be measured?
2. When should impairment be measured?
3. Recognition of impairment.
4. Display and disclosure of impairment.

In the exposure draft, the FASB listed a few examples of events or changes in circumstances that suggest the recoverability of the carrying amount of an asset should be assessed. These include: (1) a significant decrease in the market value of an asset; (2) a significant change in the extent or manner in which an asset is used; (3) a significant adverse change in legal factors or in the business climate that affects the value of an asset; (4) accumulation of costs significantly in excess of the amount originally expected to acquire or construct an asset; and (5) a projection or forecast that demonstrates continuing losses associated with an asset. The rapidly expanding gaming market has included examples of each of these events.

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In recent comment letters received by public gaming companies from the SEC, such companies have been required to specifically state the company's accounting policy governing the measurement of possible impairment to significant assets in the financial statement footnotes. The focus has usually been on significant intangible assets such as good will, but can extend to property, plant and equipment where permanent impairment may have occurred. Companies forced into bankruptcy due to poor operating performance and the inability to meet debt service obligations usually find that a permanent impairment has occurred and as a result must recognize significant assets write-downs. The SEC is forcing public companies to properly take responsibility for monitoring impairment and recognizing write-downs from impairment at the earliest possible date, rather than skirting the issue due to uncertainty and the judgmental nature of estimates. The increased competition in gaming, the uncertain nature of the regulatory environment, and the significant expenditures being made to construct or purchase gaming operations, all require constant evaluation by company management to ensure proper recognition of asset impairments as they occur or become apparent.

Due to the significant amounts that may be written off and the infrequent nature of such write-offs, most companies attempt to report such write-downs on their income statements below the operating income line item. The SEC has taken the position that such write-downs relate to the operating assets of the company and therefore should be included in operating expenses. Generally, attempts by public companies to classify amounts differently have failed. Proper planning and evaluation of a company's operations by management can result in minimizing the need to recognize such impairments by choosing appropriate asset lives and classifying values to the appropriate categories. Appropriate management and control of the construction process can insure that construction costs are spent in the proper areas, maximizing value for the dollar spent. Many bankruptcies stem from unfamiliarity with the gaming industry and construction process, resulting in poor planning of a project and poor control over the monitoring and use of construction funds.

EDGAR and the SEC

Over the past ten years, the SEC has been experimenting with the process of companies filing their periodic 1934 and 1933 Act reports electronically, rather than in paper form. In

1993, it moved from experimentation to implementation. All companies that currently report to the SEC are required to begin filing electronically some time between 1993 and 1996. The SEC assigned each company to a group and established a phase-in schedule for each group. New SEC registrants are currently required to phase in with the last group in 1996.

The SEC has established a computer system and programs for receiving and manipulating electronic data received from companies. To communicate with the SEC electronically, companies are required to get a personal computer-based program from the SEC, and are required to establish certain security-based passwords with the SEC. The computer program is called EDGAR — an acronym for the SEC's Electronic Data Gathering, Analysis, and Retrieval System. The system is designed to accept textual information (alphabetic and numerical data) only and will not currently support graphical information such as pictures, charts, or graphs that are commonly printed in shareholder annual reports. The biggest challenge for companies that have already converted to EDGAR has been to develop a systematic, simple, and accurate process for converting the information produced in their computer word processing program to the computer format required by EDGAR. It is not an easy or efficient process. In addition, many quality control and security issues exist that may not be initially apparent to the user companies.

On the positive side, the new SEC system has the potential to provide users of financial information with more timely, useful, and relevant information about their investment choices. Eventually, certain information filed with the SEC will be available almost instantaneously to the general public. Many unanswered questions exist as to the long-term effects of electronic filing, though most believe that the benefits will outweigh the costs. Further questions about EDGAR should be addressed to an SEC accountant or lawyer.

References

[1]Sources for this article include: AUDIT AND ACCOUNTING GUIDE FOR AUDITS OF CASINOS, including conforming changes as of May 1, 1993 (American Institute of Certified Public Accountants, 1993). Financial Accounting Series No. 132-B, Exposure Draft related to Proposed Statement of Financial Accounting Standards Accounting for the Impairment of Long-Lived Assets (Financial Accounting Standards Board, 1993). SEC Handbook, RULES AND FORMS FOR FINANCIAL STATEMENTS AND RELATED DISCLOSURES (CCH 1993). A survey of various letters from the SEC to individual registrants during the two-year period ended December 31, 1993, performed by the author.