

The Audit Division of the State Gaming Control Board: Overview of Organization and Current Tax Issues

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Introduction

The Audit Division (Division) of the State Gaming Control Board (Board) plays an important role in achieving the Board's overall goals: to ensure that gaming in this state is conducted with the utmost of integrity, and to ensure that all casinos are operated in a manner suitable to protect the public health, safety, morals, good order and general welfare of the inhabitants of Nevada.

This article will provide some insights into the functioning of the Division, and will discuss some tax issues of interest to the Nevada gaming industry.

Division Overview

The Division is primarily responsible for regulating the financial and operational activities of all Nevada casinos with annual gross gaming revenues in excess of \$1 million. As of January 1, 1994, 212 casinos fell under the Division's jurisdiction. The Division also oversees the activities of the state's slot route operators, disseminators, and satellite sports book operations.

As of the 1991 legislative session, the Division was authorized for a total of 104 agent positions and 13 support staff. These staffing levels allowed the Division to perform its various duties, and provided for the imminent growth of the Las Vegas casino industry. However, due to the state's fiscal problems, a 15 percent staff reduction was implemented in 1992.

The Division currently consists of eighty-nine professional staff and eleven support staff. A total of seventy-three employees are located at the Division's Las Vegas office, while twenty-seven are assigned to the Reno office. All agents in the Division hold accounting degrees, and over one-half are either Certified Public Accountants or have passed the CPA exam and are in the process of satisfying their experience requirement.

The Division's regulatory efforts are primarily directed towards four distinct work programs discussed below.

Work Programs

A. Audit Program

Annually, approximately 63 percent of the Division's manpower is directed to the Audit Program. The purpose of this program is to ensure that the state's casinos are properly accounting for gross gaming revenues and casino entertainment revenues, and are paying all associated fees and taxes. Equally important is the additional confirmation that the casinos are complying with all applicable gaming statutes and regulations, and are properly conducting casino operational activities.

For the fiscal year ending June 30, 1993, approximately \$6 billion in gross gaming revenues were generated by Nevada's casinos. Percentage fees paid on these revenues amounted to \$362.8 million, while the state collected \$23 million in casino entertainment taxes.

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A full compliance audit is comprehensive — usually encompassing an audit period of between two-and-one-half years and three years. An average audit will have three to four assigned agents, and approximately 1,400 man-hours will be expended. Field work for this size audit will take an average of three months to complete. Alternatively, smaller audits may take two agents a few hundred hours to accomplish while the largest casinos may require six or more agents expending a few thousand hours to complete. For the fiscal year ending June 30, 1993, the Division completed a total of 85 audits.

The Division is required to perform audit engagements in accordance with generally accepted auditing standards. During an audit, internal accounting controls are thoroughly evaluated to insure that the casino is operating properly and is complying with specific operational standards. Additionally, agents will perform an in-depth review of casino operating statistics to ensure that games and gaming devices are performing in accordance with industry norms. Numerous documents will be examined during the audit process, along with the casino's journals and ledgers.

At the conclusion of the field work, the audit team will discuss the audit findings with casino personnel during a closing conference. If the casino disagrees with any of the documented findings, they have the option of submitting the basis for the disagreement to the Board for consideration.

Approximately thirty to sixty days after the closing conference, and once the audit has undergone a complete review, the audit findings and the Division's audit opinion are presented to a member of the Board and are discussed at an internal Audit Committee meeting. If any tax assessments or refunds were noted by the audit team, these will be summarized in a Statement of Determination. Upon acceptance of the findings, the Board member will sign the Statement of Determination and authorize the billing for additional taxes or the payment of a tax refund.

If a licensee disagrees with any of the adjustments included in the Board's Statement of Determination, they may file a petition for redetermination with the Gaming Commission (Commission) and request a hearing on the matter. Such petition must be filed no later than thirty days after receipt of the statement. The petition process must be accomplished in accordance with the provisions of Nevada Revised Statutes (NRS) § 463.3883 and Nevada Gaming Commission Regulation 6.170.

Any violations of gaming statutes or regulations noted during an audit are summarized in a regulation violation letter which is sent by a Board member to the licensee so that the violations can be corrected. Unless otherwise specified, the Board typically allows for a thirty-day window for a licensee to confirm that corrective action has been taken.

Occasionally, violations noted during an audit may be determined to be very material or recurring in nature. In these situations the Board may instead elect to issue an Order to Show Cause (OSC) to the licensee, which outlines the problems noted and directs the licensee to show cause why a complaint should not be filed with the Commission. The OSC process is fact-finding in nature, but should be taken very seriously since an OSC is not issued unless the Board considers the violations to be of significant concern.

In limited cases where no fact-finding is deemed necessary, the Board may proceed to file a complaint with the Commission due to the severity of violations noted. Complaints may result in the imposition of fines, or the conditioning or revocation of a casino's license.

B. Interim Program

Proper regulatory oversight of the industry cannot be accomplished through the Board performing full compliance audits only every two-and-one-half to three years. Instead, it is imperative to periodically examine casino operations for continuing compliance with both the Board's internal control standards and the applicable gaming statutes and regulations. Accordingly, the Board's Interim Program is utilized.

Audit agents will from time to time perform interim work at a casino to evaluate certain aspects of a casino's operation. At times the casino's hard count or soft count procedures will be observed. At other times, pit personnel may be interviewed regarding fill procedures. Periodically, the adequacy of a casino's bankroll may be determined, or agents may investigate low table game hold percentages. The timing and type of procedures will vary from property to property, but the objective remains consistent — to ensure that the state's casinos continue to operate properly.

Approximately 11 percent of the Division's manpower is directed to the Interim Program. During the fiscal year ending June 30, 1993, agents conducted 224 interim contacts throughout the state. Interim contacts may take anywhere from a few hours to a few hundred hours depending on the type and scope of procedures to be performed. Any violations or internal control deficiencies noted during interim work will be communicated in a letter from the Board.

Because of the Board's limited staff, this program cannot be fully accomplished by audit agents alone. Accordingly, the Board and Commission have adopted regulations and standards to require internal auditors and independent accountants to also perform interim work. Independent accountant reports on internal control are forwarded to the Board, and reviewed by audit agents. Internal audit findings are reviewed during compliance audit field work, unless more immediate examination is determined to be necessary. The interim work performed by Board agents and supplemented by internal auditors and independent accountants has proven to be a successful regulatory mix for Nevada.

C. Regulation 6A Program

In 1985, the U.S. Department of the Treasury adopted regulations requiring casino compliance with currency transaction reporting requirements similar to those imposed on banks. However, Treasury regulations provided that a state could be exempted from complying with

the regulations if the state had in place a regulatory and statutory structure that substantially met the federal requirements. In May 1985, the Commission adopted Regulation 6A, "Certain Cash Transactions," which paralleled the federal currency regulations for casinos. Soon thereafter, the Board entered into a Memorandum of Agreement with the Treasury Department, whereby all enforcement activities concerning casino currency transactions were turned over to the Board, with the

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Treasury retaining certain reporting and oversight authority.

Approximately 11 percent of the Division's manpower is directed to the Regulation 6A Program, which consists of four primary functions:

1. Regulation 6A Audits

These consists of compliance walk-throughs and substantial testing of documentation. This work is normally performed in conjunction with a full compliance audit every two-and-one-half to three years.

2. Regulation 6A Interims

These consist of compliance walk-throughs and only limited testing of documentation. This function is performed at least annually at every casino with annual gross gaming revenues exceeding \$1 million. Casino branch offices throughout the United States and the world are responsible for complying with all applicable provisions of Regulation 6A. Agents will periodically inspect offices to insure that proper procedures are being followed regarding wire transfers, marker payments, and cash deposit activity.

3. Regulation 6A Forms Review

Currency Transaction Reports (CTRs) and Currency Transaction Incidence Reports (CTIRs) must be filed with the Division within fifteen days of the transaction date. The Division must then forward the forms to the Treasury Department's Detroit data processing center within ten days of receipt. In that ten-day period, the reports are reviewed for compliance with

Regulation 6A. If the forms are not properly executed, agents contact the casino regarding the violation and attempt to have the casino correct the filings. If not properly filed, licensees will be contacted by the Treasury to remedy the deficiencies.

4. Regulation 6A Participatory Transactions

Participatory transactions are cash transactions entered into with a casino by agents on a covert basis in order to confirm first-hand that a casino's Regulation 6A internal control procedures are functioning properly. The Board's primary focus during these procedures has been to verify that the casino will not enter into prohibited transactions with casino patrons contrary to Regulation 6A.020 (e.g., exchanging more than \$2,500 in small bills for large bills, patron receiving a casino check in exchange for greater than \$2,500 in cash, etc.). However, at times agents will enter into reportable cash transactions greater than \$10,000 to confirm that appropriate forms are filed, or enter into transactions between \$2,500 and \$10,000 to confirm that the transactions are recorded in multiple transaction logs.

The necessity for performing participatory transactions is determined case-by-case. This activity is normally directed at the larger casinos that typically enter into reportable or loggable transactions on a daily basis. However, smaller casinos may be targeted if recurring noncompliance with Regulation 6A has been observed.

In sum, all work performed pursuant to the Regulation 6A program is subject to review by the Treasury Department. Additionally, all internal audit work and independent accountant reports may also be scrutinized by the Treasury pursuant to the Memorandum of Agreement. Additionally, the Board reports to the Treasury quarterly as to the Board's Regulation 6A compliance efforts. Any material violations of the regulation must be reported to the Treasury Department within fifteen days of determination.

Violations of Regulation 6A noted during audits, interims, or participatory transactions may be documented in a letter from a Board member. Many times such violations may result in the issuance of an OSC or the filing of a complaint with the Commission, depending on the severity or the recurring nature of the problem. Considering the sensitive nature of the regulation, and the Treasury Department's reliance on the Board to effectively enforce Regulation 6A, the Board has acted quite harshly on noted noncompliance. Since 1985, the Board has filed nineteen Regulation 6A complaints with the Commission, resulting in the imposition of \$1,772,000 in fines and the addition of conditions to some licenses. The Board remains committed to strictly enforcing the provisions of Regulation 6A, thus ensuring that Nevada's casinos are not knowingly or unknowingly used in any type of money laundering activity.

D. Research and Development (R&D) Program

The Research and Development (R&D) Program utilizes approximately 6 percent of the Division's manpower. The program's activities are directed towards three major functions:

1. Associated Equipment Inspections

Generally, all equipment used in a casino, other than gaming devices, is considered "associated equipment" as defined in NRS 463.0136. The Board has statutory authority to inspect all associated equipment pursuant to NRS 463.670(4); however, the Board has primarily directed inspection efforts towards computerized casino applications and equipment that have either a direct or indirect effect on the proper reporting of gross gaming revenue. Associated equipment must be inspected and the Board must approve installation prior to the equipment being utilized in a casino operation. In accordance with NRS 463.670(5), developers of new associated equipment are charged inspection fees for agent time incurred in the systems review process.

2. Live Broadcasts

Licensed disseminators of racing information must comply with Regulations 20 and 21 which provide for the regulation of dissemination activities, especially the transmission of live televised broadcasts of horse and dog races from race tracks to Nevada's race books. This racing information is used by the books in paying off on winning race wagers. The Division is responsible for regulating these activities, including the review of proposals for the exclusive right to disseminate live broadcast signals submitted by disseminators. At times race tracks may be inspected by agents to insure that appropriate production procedures, including signal encryption, are being employed.

3. Off-Track Pari-Mutuel Wagering

A number of Nevada's race books are licensed under NRS 464.010 to participate in off-track pari-mutuel wagering whereby wagering in Nevada's books is combined with wagers at the race tracks through the use of a licensed systems operator. The Division is responsible for regulating the activities of the systems operator, the pari-mutuel books, and for reviewing agreements between Nevada's licensees and the race tracks for propriety and Regulation 26A.140 compliance.

Other Responsibilities

In addition to the four programs previously discussed, the Division has been assigned the following additional responsibilities:

A. Regulation 8.130 Agenda

Certain types of leasing and financing activities are required to be reported to the Board pursuant to Regulation 8.130. This information is reviewed, compiled and presented to the Board and Commission for approval. To insure that Nevada's casinos only enter into leasing and financing activities with appropriate lenders and lessors, the Division may participate in investigative activities where sources of capital may be of unknown or suspicious origin.

B. Financial Statement Review & Monitoring

Most casinos in Nevada are required to submit either reviewed or audited financial statements, depending on the amount of gross gaming revenues generated annually. The Division reviews these statements and directs extra monitoring efforts to those casinos with declining or substandard financial performance.

C. Industry Statistics Review

Periodically, the Division (in conjunction with other divisions and a Board member) will review and evaluate casino statistical performance. The objective is to identify declining statistical trends or unusual hold percentages, and to direct Board agents to those potential problem areas.

D. Internal Control

Internal control systems are reviewed for compliance with the Board's Minimum Internal Control Standards. Requests from casinos for variations from the Board's standards are reviewed and recommendations made for Board action.

Common Tax Assessments

The type of tax assessments levied by the Board will vary from property to property. However, there are three general areas of assessment that, more often than not, appear in Statements of Determination.

A. Credit Instruments

Unlike other gaming jurisdictions where taxes are paid on all gaming winnings, Nevada's gaming statutes and regulations provide that casino winnings derived from credit play are not taxable until either: (a) the casino collects on the credit instrument; or (b) the Board determines that the credit was not properly issued, collection efforts were not pursued, the credit instrument was improperly settled, or the licensee did not comply with other credit instrument criteria specified in the applicable statutes and regulations.

Accordingly, as long as casinos comply with a very specific set of criteria, tax payments can be deferred on credit winnings until such time as the credit instruments are paid by the customer. The majority of Nevada casinos do a good job complying with the credit instrument requirements of NRS 463.371 and Regulation 6.120. However, the following assessment areas have been noted at a number of casinos:

1. Lack of Collection Efforts

Casinos must attempt to collect on outstanding credit instruments at least once every ninety days. If this collection effort is not initiated, or if the collection effort is not properly documented, the uncollected instrument will be taxed.

2. Agents Requested Not to Confirm Credit Instruments

During a Board audit, agents may determine the necessity for sending a confirmation letter to certain customers to verify that a casino re-

ceivable is still outstanding. If a casino requests that a patron not be contacted, this request will be honored. However, taxes must be paid on the unpaid credit instrument pursuant to NRS 463.371(1).

The Board may also deem it necessary to contact customers who have had credit instruments settled for less than full value, or have had the instruments fully written off. Once again, if a casino requests that the customer not be contacted, taxes must be paid on the uncollected portion of the settled or written-off instruments.

3. Improperly Documented Settlements

There are a number of reasons for assessing on credit instruments (*i.e.*, no credit check, marker missing, marker not signed, marker forged, no collection effort, etc.). However, if a casino enters into a settlement agreement with the customer and the casino properly documents the settlement, none of these assessment bases may be used.

Although the documentation requirements for settlements are fully defined in Regulation 6.120(6)(b), agents have noted a number of instances of improperly completed settlement forms. Common deficiencies relate to the forms being undated, the settlement amount not written in words, or the form not signed by the patron or the appropriate casino employees. If the form is deficient, assessments may be made if credit instrument assessment bases are discovered.

4. Credit Instrument Activity on Tax Returns Doesn't Reconcile

One of the first audit steps performed during a Board audit of credit instruments is to ensure that all marker issuances and payments are supported by detailed documentation, and that the documentation is consistent with the general ledger and the licensee's tax returns. Agents many times will note that based on the supporting documentation of credit issuances and unpaid instruments, it appears that a certain amount of collections will have taken place during an audit period. However, when this figure is compared to the collections figure reported on the NGC - 1 tax returns, a material difference is discovered. If the collections figures on the tax returns are less than the collections supported by documentation, this figure will be

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assessed by the agents unless explanations can be provided by casino personnel. If material discrepancies are noted, agents will request that the casino reconcile the differences.

Casinos are advised to perform a monthly reconciliation of credit instrument activity on the tax returns to supporting documentation so that discrepancies can be resolved in a timely manner.

B. Promotional Items

The full statutory definition of "gross revenue" is provided in NRS 463.0161. Basically, gross revenue is cash won from customers less cash paid out to customers during a gaming activity where there is a risk of loss to both parties. Numerous instances have been noted where promotional or marketing expenses were deducted from gross revenue. Other promotions have been observed where promotional items with cash or other intrinsic value were given to customers, or wagered by the customers, but were not included in the computation of gross revenue.

Due to the amount of promotional adjustments noted during Board audits and the number of questions received from the public, the Board is in the process of drafting regulations that will eventually provide specific guidance for the accounting and tax effect of promotional items.

C. Casino Entertainment Tax

Casinos are encouraged to periodically confirm that the accounting systems in place for the recording of entertainment taxable sales are functioning as designed. Many instances have been noted during audits where drink sales in lounges during entertainment periods were not denoted as taxable, while in other instances the opposite was seen — sales were rung up as taxable with no entertainment provided.

Another recurring problem relates to beverage sales made in lounges during breaks. Regulation 13.020(6) requires that the casino entertainment tax be paid on sales made during breaks unless the casino can demonstrate that a sale was made after the conclusion of a show, and the patron left before the start of the next show.

Entertainment taxable items included in packages (*i.e.*, show tickets, or "free" drinks in lounges) are subject to the casino entertainment tax. The sales price of the package should be proportionately allocated to all elements of the package, and the entertainment tax paid on the allocated value. A casino should not arbitrarily consider a show ticket or lounge drink to be a "comp" — this will result in a tax assessment where noted.

As with promotional items, the casino entertainment tax laws and regulations are being reviewed for potential amendments where warranted.

Conclusion

This article has provided insight into the functions of the Audit Division and the Board's audit process. Nevada's regulatory model has proven to be successful, and the Division will continue to attempt to balance good regulatory control with operational freedom for the state's casinos. The Division looks forward to the future challenge of regulating Nevada's dynamic gaming industry with its growth, diversity of operations, and technological advances.

