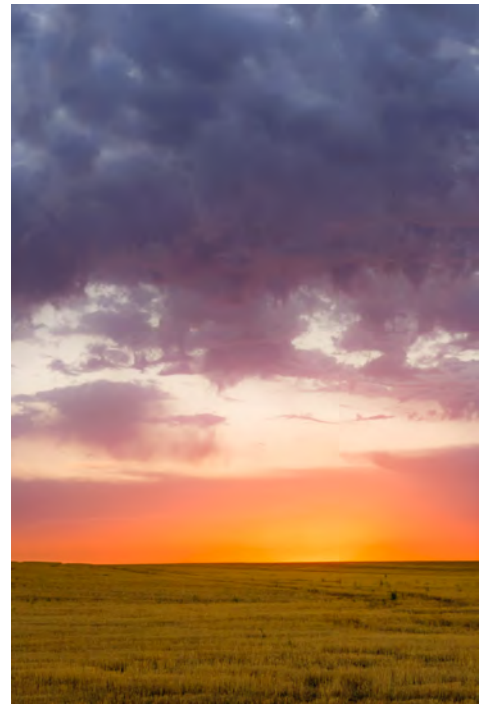


Department of Revenue

Sports Betting

Performance Audit
April 2022
2166P



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KERRI L. HUNTER, CPA, CFE • STATE AUDITOR

April 28, 2022

Members of the Legislative Audit Committee:

This report contains the results of a performance audit of the Division of Gaming within the Department of Revenue. The audit was conducted pursuant to Section 44-30-1510, C.R.S., which requires that the Sports Betting Fund be audited at least once before May 1, 2022, and at least every 5 years thereafter, as well as Section 2-7-204(5), C.R.S., which requires the State Auditor to annually conduct performance audits of one or more specific programs or services in at least two departments for purposes of the SMART Government Act. The report presents our findings, conclusions, and recommendations, and the responses of the Division of Gaming.

Kerri L. Hunter



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Report Highlights



Sports Betting

Department of Revenue, Division of Gaming
Performance Audit • April 2022 • 2166P

OFFICE OF THE STATE AUDITOR

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Key Concern

During the first year of regulating sports betting, the Division of Gaming (Division), within the Department of Revenue (Department), did not have an effective process to investigate sports betting operations for temporary licensure, or to collect sufficient documentation to determine if sports betting operations' monthly tax filings were accurate.

Key Findings

- As of March 2022, 35 out of the 39 (90 percent) licensed retail and internet sports betting operators held temporary licenses, which the Colorado Limited Gaming Control Commission (Commission) issued on the basis of limited background investigations the Division conducted. While a temporary license allows operators the same privileges as a permanent license, the Division's background investigations may not have provided assurance that the operators were suitable for licensure.
- The Division did not complete minimum background investigative procedures for the 5 licensed operators we sampled, and the procedures that were completed may not have provided relevant information needed to fully inform the Division's licensing recommendations to the Commission.
- We sampled 22 sports betting tax filings from May 2020 through April 2021 and found wide variation between the amount of wagering activity (i.e., bets, free bets, and payments to players) that operations reported after each gaming day compared to the totals they reported in their monthly tax filings. These variances ranged from an operation reporting \$1.4 million more in net sports betting proceeds in its daily wager reports than it reported in its monthly tax filing, to an operation that reported \$1 million less in net sports betting proceeds in its daily wager reports compared to its monthly tax filing. While some variation is expected since wagers may be altered, voided, or canceled after they are placed, operations do not always submit supporting documentation to substantiate changes to their reported net sports betting proceeds. As a result, the Division could not demonstrate if or how it verified that the tax filings were based on accurate data.
- The General Assembly may want to consider the effects of a Commission rule that allows sports betting operations to deduct and carry forward monthly operating losses, thereby reducing their sports betting tax liability, and whether that practice aligns with voters' and legislative intent. Between May 2020 and April 2021, the State collected \$6.6 million in sports betting tax. Our analysis of the 324 tax filings reported during this time period determined that if operations had not been allowed to deduct and carry forward operating losses, the State would have collected \$7.3 million, or an additional \$706,600, in sports betting tax during that first year.

Background

- In 2019, Colorado voters approved the legalization of sports betting in the state.
- The Commission and the Division are responsible for the regulation of sports betting activities in Colorado, including issuing licenses to operators, vendors, and employees involved in sports betting; collecting fees and taxes; and conducting audits to ensure proper reporting of wagers and taxes.
- Adults age 21 and older can place sports betting wagers in person at a licensed Colorado casino or online through a licensed Internet sports betting platform.
- The State imposes a 10 percent tax on the net sports betting proceeds reported by operators. Revenue generated from sports betting taxes is distributed to beneficiaries including entities that can demonstrate revenue loss attributable to sports betting, the Department of Human Services, and the Water Plan Implementation Cash Fund.

Recommendations Made

10

Responses

Agree: 10

Partially Agree: 0

Disagree: 0



Chapter 1

Sports Betting

In 2018, the U.S. Supreme Court struck down the Professional and Amateur Sports Protection Act, which had barred states from authorizing sports betting since 1993. Following the Supreme Court decision, through the passage of House Bill 19-1327, the General Assembly referred a ballot measure to voters that would legalize sports betting in Colorado. During the 2019 election, voters approved Proposition DD, which legalized sports betting for individuals physically located in Colorado who are aged 21 or older.

Starting in May 2020, individuals could place wagers on the outcome of a Colorado Limited Gaming Control Commission (Commission)-approved sports or athletic event, including amateur, professional, collegiate, international, and Olympic events [Section 44-30-1501(10) and (12), C.R.S.]. In addition, patrons could wager on any portion of an approved athletic event (e.g., the score at the end of a specific quarter played during a football game) or the individual performance statistics of athletes in one or a combination of sports events [Sections 44-30-1501(10) and (12), C.R.S.].

The Division of Gaming (Division) reported that from May 2020 to April 2021, the first full year of sports betting in Colorado, patrons wagered \$2.3 billion in Colorado on authorized sporting events, with the National Basketball Association basketball, National Collegiate Athletic Association (NCAA) basketball, and National Football League football having the most money wagered. Patrons can place wagers in person at a licensed Colorado casino or online through a licensed Internet sports betting platform. About 98 percent of sports betting wagers are made online. Patrons must be physically present in Colorado to bet on authorized sporting events [Section 44-30-1506(8), C.R.S.]. Sports betting operators that offer online betting are required to use geolocation technology to verify the physical location of patrons when they place wagers and block wagers made outside the state [1 C.C.R. 207-2 Rule 7.10]. The Division also uses geolocation technology to monitor the location of wagering activities for licensed operators.

Regulation and Operation of Sports Betting

In 1990, Colorado voters approved Article XVIII, Section 9 of the Colorado Constitution to legalize limited-stakes casino-style gaming (limited gaming) in the Colorado cities of Black Hawk, Central City, and Cripple Creek. The Limited Gaming Act of 1991 (Senate Bill 91-149) created the Division, within the Department of Revenue (Department), to license, implement, regulate, and supervise the conduct of limited gaming in the state. The bill also created the Commission within the Division. The Commission is composed of five members appointed by the Governor who are responsible for

promulgating rules and regulations governing the licensing, conducting, and operating of limited gaming, among other duties [Section 44-30-301, C.R.S.].

When sports betting was legalized, the General Assembly charged the Division and Commission with supervision of that industry, with the intent that sports betting could be seamlessly incorporated into the existing regulatory and taxing system for limited gaming [Section 44-30-102(3)(c), C.R.S.]. As such, the Division's oversight responsibilities to license, implement, regulate, and supervise the conduct of sports betting are similar to its responsibilities to oversee limited gaming [Section 44-30-202(1), C.R.S.]. With respect to sports betting, the Commission's responsibilities include:

- Promulgating rules governing the licensing, conducting, and operating of sports betting activities.
- Establishing and collecting fees and taxes upon persons, licenses, and gaming devices used in, or participating in, sports betting.
- Issuing temporary or permanent licenses to those involved in the ownership, participation, or conduct of sports betting.
- Upon complaint, or upon its own motion, levying fines and suspending or revoking licenses [Section 44-30-302, C.R.S.].
- Approving all sporting events (e.g., football games, golf tournaments, table tennis competitions, etc.) and leagues (e.g., National Football League, Professional Golf Association, International Table Tennis Federation, etc.) that can be wagered on, as well as types of bets (e.g., single game bets, parlays, over-under, pools, etc.) [1 C.C.R. 207-2, Rule 5.1].

In Fiscal Year 2022, the Division was appropriated \$39.6 million, although \$23.8 million (60 percent) of that amount was for distributions to gaming cities and counties. From its remaining budget of \$15.8 million, the Division allocated \$3.1 million to the sports betting unit. The sports betting unit consists of 18.8 full-time-equivalent employees who carry out administrative, compliance, auditing, and investigative activities, including:

- Conducting background investigations of businesses and individuals who apply for sports betting licenses.
- Performing pre-launch certifications of licensed sports betting operators.
- Conducting audits to ensure proper reporting of wagers and taxes.
- Inspecting sports betting operation facilities, servers, and systems.

- Investigating violations of sports betting statutes and rules [Sections 44-30-203, 204, and 1505, C.R.S., and 1 CCR 207-2, Rules 7.5 and 7.12].

Unless continued by the General Assembly, the Division's powers, duties, and functions are scheduled to be repealed on September 1, 2022 [Section 44-30-206, C.R.S.]. In October 2021, the Department of Regulatory Agencies issued a sunset review recommending that the Division be continued until 2033. In addition, the review recommended continuing the Division's regulation of sports betting until 2027, by which time the Division would undergo another sunset review after establishing a longer history of regulating sports betting in Colorado. As of April 25, 2022, legislation had not been introduced to continue the Division's powers, duties, and functions beyond August 31, 2022.

Licensing

The Commission is required to issue, deny, suspend, revoke, and renew sports betting licenses to individuals, firms, associations, or corporations, whether for-profit or not-for-profit, who engage in sports betting activities [Sections 44-30-1503(1)(a) and (3), C.R.S.]. The Commission issues several types of licenses depending on the type of sports betting activity that entities or individuals wish to conduct. For example, casinos that are licensed to operate limited gaming activities can obtain master licenses, which allow them to operate retail sports betting onsite in a casino and Internet sports betting through a branded online platform, or to contract with a third-party operator to operate retail or internet sports betting activities on the master licensee's behalf [Section 44-30-1505(2)(a), C.R.S.]. The Commission also issues licenses to retail and Internet sports betting operators, employees who manage or work for sports betting operators, and vendors that provide services to sports betting operators [Section 44-30-1505(2)(b), C.R.S., and 1 C.C.R. 207-2, Rule 3.1]. Licenses are valid for 2 years [Section 44-30-1505(4), C.R.S.].

Sports betting license applicants must pay an application fee as well as the costs of Division investigations into their backgrounds, suitability, and qualifications for licensure [1 C.C.R. 207-2, Rule 3.4 and 3.5]. Master and operator licensees must also pay annual operating fees every fiscal year in July to defray the increased costs to the Division and Commission of regulating sports betting [1 C.C.R. 207-2 Rule 7.1]. Licensing requirements vary by license type, but generally applicants with a criminal, financial, or licensing history that may undermine the public interest or trust in the integrity of sports betting are ineligible for licensure [Section 44-30-1503, C.R.S.]. After conducting its background investigation, the Division compiles the results into a report that is presented to the Commission with a recommendation regarding the applicant's suitability for licensure.

Following voter approval of proposition DD on November 5, 2019, the Commission adopted emergency sports betting rules approximately 2 weeks later on November 21 that allowed the Division to begin accepting license applications as of November 27, 2019. Although the legislation

that established a regulatory structure for sports betting (House Bill 19-1327) did not specify when sports betting activities had to begin, according to the Division, it interpreted the law's effective date (May 1, 2020) as the deadline for operationalizing sports betting in Colorado based on discussions with the General Assembly during the legislative process. In order to operationalize sports betting by its planned date of May 1, 2020, the Commission granted permanent "master" licenses to casinos that were already licensed to offer limited gaming, but granted temporary licenses to other applicants that applied for permanent licensure. The temporary licenses, which were valid for 2 years, were granted based on the results of limited investigations the Division conducted within several weeks, rather than the more thorough investigations that the Division planned to complete before issuing permanent licenses, which could take up to a year [1 C.C.R. 207-2, Rule 3.12]. When Colorado's sports betting industry began operating on May 1, 2020, the Commission had granted permanent licenses to 33 master licensees, in addition to 29 temporary licenses to retail and Internet sports betting operators.

Once a sports betting operator has been issued a license, it must obtain the Division's approval to launch sports betting activities. The pre-launch approval includes a Division review of the operator's required internal control procedures and house rules, certification of sports betting systems, review of vendors, and verification of financial reserves. Once approved, operators are required to prominently display their license and house rules to the public within the operators' licensed premises or Internet betting platforms, in addition to displaying responsible gaming information for the public [1 C.C.R. 207-2, Rules 6.8, 6.10, and 9.1].

Sports Betting Taxes

Statute imposes a 10 percent tax on each operator's net sports betting proceeds, which is defined as the total amount of all bets placed, excluding free bets (i.e., bets made using non-cashable vouchers, coupons, electronic credits, or promotions provided by sports betting operators), less all payments to players and less a 0.25 percent federal excise tax [Sections 44-30-1501(7) and 1508(1), C.R.S., and 26 U.S.C. 4401(a)(1)]. Based on our analysis of data from the Colorado Operations Resource Engine (CORE), the State's accounting system, from July 2020 through February 2022 (i.e., Fiscal Year 2021 and the first 8 months of Fiscal Year 2022), the Division reported about \$16.1 million in revenue from sports betting taxes.

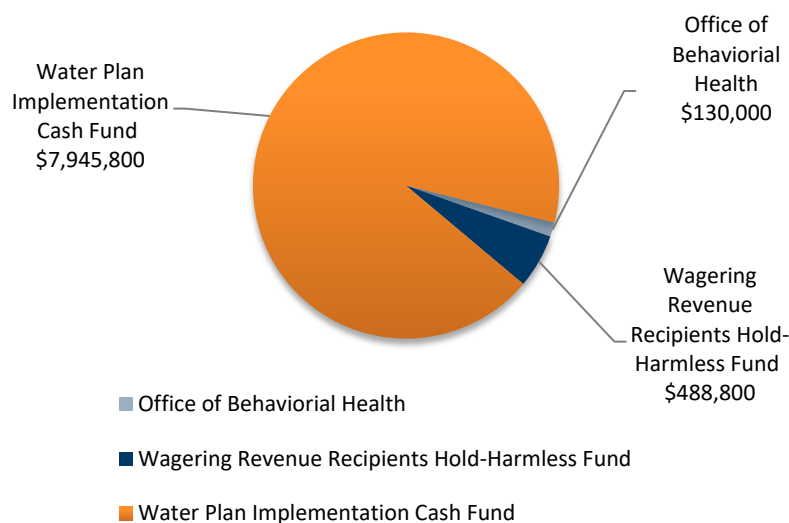
Sports betting tax revenue is deposited into the Sports Betting Fund (Fund), along with the Division's other revenue sources, which include license fees, fines, and penalties [Section 44-30-1509(1)(a), C.R.S.]. Statute [Section 44-30-1509(2), C.R.S.] creates a prioritized order of expenditures to be paid from the Fund as follows:

- Repay the General Fund for the Division's start-up costs related to regulating sports betting. In Fiscal Year 2020, the Division was appropriated \$1.6 million from the General Fund for start-up costs and transferred that amount back to the General Fund in March 2021.

- Pay the ongoing expenses related to administering sports betting that are incurred by the Department, Division, Commission, or any other state agency from whom assistance is requested by the Commission or Division Director.
- Transfer 6 percent of annual sports betting tax revenue to the Wagering Revenue Recipients Hold-Harmless Fund, which was created so lump-sum payments could be made to offset any demonstrable loss of revenue attributable to sports betting. Entities that are eligible to apply for those payments are the State Historical Fund; Colorado’s community colleges; Black Hawk, Central City, and Cripple Creek; Gilpin and Teller Counties; and any persons or entities who benefit from purse funds collected from horse racing.
- Transfer \$130,000 annually to the Office of Behavioral Health in the Department of Human Services for the operation of a crisis hotline for gamblers and to support counselors certified in the treatment of gambling disorders or individuals seeking that certification.
- Transfer the remaining unexpended and unencumbered funds to the Water Plan Implementation Cash Fund. The Colorado Water Conservation Board uses these funds to award grants for projects related to implementing the state water plan and to ensure compliance with requirements related to interstate storage and release, apportionment, and allocation of water [Sections 37-60-123.3 and 37-60-106.3(6), C.R.S.].

Exhibit 1.1 shows the distribution of sports betting revenue to beneficiaries during Fiscal Year 2021.

Exhibit 1.1
Distribution of Sports Betting Revenue to Beneficiaries
Fiscal Year 2021



Source: Division of Gaming.

Audit Purpose, Scope, and Methodology

We conducted this performance audit pursuant to Section 44-30-1510, C.R.S., which requires that the Sports Betting Fund be audited at least once before May 1, 2022, and at least every 5 years thereafter, as well as the State Measurement for Accountable, Responsive, and Transparent (SMART) Government Act [Section 2-7-204(5), C.R.S.]. Audit work was performed from May 2021 through April 2022. We appreciate the cooperation and assistance provided by the management and staff of the Department, Division, and Commission during this audit.

We conducted this performance audit in accordance with generally accepted government auditing standards (GAGAS). Those standards require that we plan and perform the audit to obtain sufficient, appropriate evidence to provide a reasonable basis for our findings and conclusions based on our audit objectives. We believe that the evidence obtained provides a reasonable basis for our findings and conclusions based on our audit objectives.

The key objectives of the audit were to determine whether (1) the State collects the appropriate amount of taxes from sports betting operators and (2) the Division has effective processes to ensure that only eligible sports betting operators are licensed.

The scope of this audit did not include work related to the Division's pre-launch review of sports betting operators, the Commission's process for authorizing specific sports for wagering, the Commission's methodology for setting licensing fees or distributions from the Sports Betting Fund, or the Division's monitoring and enforcement activities.

To accomplish our objectives, we performed the following audit work:

- Reviewed relevant state and federal laws; Commission rules; and the Division's policies and procedures, training materials, and other internal guidance.
- Interviewed Division management and staff and a member of the Commission to understand processes related to licensing and sports betting tax collection; staff from two sports betting operators to understand their tax accounting and reporting procedures; and staff from the Office of Legislative Legal Services to understand the extent to which Commission rules underwent legal review before they went into effect in April 2020.
- Analyzed tax filing and payment data from GenTax, the Department's tax processing system, as well as information that sports betting operators submitted to the Division with wager data, to determine whether sports betting taxes were calculated correctly, paid on time, and paid in full.

- Analyzed aggregate licensing data from MyLO, the Department’s electronic licensing database, to perform a data match between the MyLO and GenTax data to verify that all licensed sports betting operators with a potential tax liability paid taxes.
- Analyzed the Division’s investigative files and licensing documentation to assess how license applications are processed; how background investigations for temporary licenses are conducted; the scope and content of the Division’s background investigations; how the Division and Commission determine whether an applicant is qualified for licensure; and how the Division’s investigative process informs the Commission’s licensing decisions.
- Reviewed information about how other states with legalized sports betting calculate operators’ tax liability.

We relied on sampling techniques to support our audit work as follows:

- We selected a random sample of 22 monthly tax filings that seven sports betting operators submitted from the population of 324 monthly tax filings that 28 operators submitted from May 2020 through April 2021. This sample included 12 filings in which operators were profitable and owed sports betting tax and 10 filings in which operators lost money and did not owe tax. Filings in which no wager activity was reported were excluded from the population before we selected the sample. For each sampled tax filing, we compared wager data that sports betting operators submitted to the Division to the operators’ monthly tax filing, and we reviewed documentation of any communication that occurred between Division and operators’ staff related to discrepancies among those documents.
- We selected a random sample of five of the 19 Internet sports betting operators that had been issued temporary licenses and were active as of April 2021. We reviewed all of the investigative file documentation the Division had for the sampled operators to evaluate whether the Division’s processes provided assurance that approved applicants are qualified for licensure, based on requirements in statute and rule.

The results of our samples cannot be projected to the population. However, the sample results are valid for confirming whether the Division has effective processes to license sports betting operations and verify the accuracy of their reported tax liability and, along with the other audit work performed, provide sufficient, reliable evidence as the basis for our findings, conclusions, and recommendations.

As required by GAGAS, we planned our audit work to assess the effectiveness of those internal controls that were significant to our audit objectives. Details about the audit work supporting our findings and conclusions, including any deficiencies in internal control that were significant to our audit objectives, are described in the remainder of this report.

A draft of this report was reviewed by the Department, Division, and a member of the Commission. We have incorporated the Department's, Division's, and Commission's comments into the report where relevant. The written responses to the recommendations and the related implementation dates are the sole responsibility of the Division.

Chapter 2

Regulation of Sports Betting

In 2019, the General Assembly enacted House Bill 19-1327, which authorized sports betting in Colorado and charged the Colorado Limited Gaming Control Commission (Commission) and Division of Gaming (Division) with the regulation of legal sports betting. It was the intent of the General Assembly that by doing so, sports betting would be seamlessly integrated into the regulatory and taxing system established for limited gaming [Section 44-30-102(3)(c), C.R.S.]. It was declared by the General Assembly that “the success of sports betting is dependent upon public confidence and trust that activities related to sports betting are conducted honestly and competitively; that the rights of the creditors of licensees are protected; and that sports betting is free from criminal and corruptive elements. Public confidence and trust can be maintained only by strict regulation of sports betting” [Section 44-30-102(3)(e), C.R.S.]. The General Assembly also intended through enacting House Bill 19-1327 that sports betting revenues would be taxed and that the revenue would be directed to public purposes—primarily the state water plan.

The Commission is required by statute to promulgate rules governing sports betting. Statute states that those rules should address various aspects of sports betting activities, including the types of sports betting activities to be conducted and the rules for those activities; requirements, qualifications, and grounds for the issuance, revocation, and suspension of permanent and temporary sports betting licenses; the scope and conditions for investigations into the background of licensees and applicants for licenses; the ongoing operation of sports betting activities; and the percentage of the adjusted gross proceeds to be paid by each licensee to the commission, in addition to license fees and taxes [Section 44-30-302(2), C.R.S.]. The Division is charged with the responsibility to license, implement, regulate, and supervise sports betting [Section 44-30-202(1), C.R.S.]. The Division ensures the integrity of sports betting primarily through investigation of sports betting license applicants, in order to provide the Commission with the information it needs to reach a determination as to whether an applicant is suitable for a sports betting license. The Division also requires each licensed operation to submit documentation of their daily wager activity and monthly sports betting tax liability as one way of monitoring their operations.

Our audit work evaluated the effectiveness of the Division’s processes for licensing Internet sports betting operations and collecting sports betting tax. We focused our audit work on sports betting activities that occurred from January 2020 through April 2021, which was the first year after legalized sports betting became operational in Colorado. The Division reported that it faced several significant challenges getting sports betting up and running between the November 2019 election, when voters approved legalized sports betting, and the industry’s May 1, 2020, launch date in

Colorado. These challenges included an ambitious 5-month timeline to complete the rulemaking process and get a new unit implemented; challenges associated with the COVID-19 pandemic, including difficulties obtaining information from government agencies and businesses that were closed or operating in a limited capacity; travel restrictions that prevented Division investigators from obtaining information overseas about license applicants with international headquarters; transitioning to full-time remote working; moving hard copy files because the Division's physical office location changed; and a hiring freeze that prevented the Division from hiring additional staff to support the Sports Betting Unit. While we acknowledge these challenges, our audit work still identified opportunities for the Division to improve the effectiveness of background investigations of license applicants and ensure the accuracy of operations' tax payments. The remainder of this chapter includes our findings and recommendations, as well as a policy consideration for the General Assembly about whether the Commission's rules for computing operations' monthly tax liability align with voter and legislative intent.

Finding 1—Sports Betting Licensing

The Commission is responsible for issuing, denying, suspending, revoking, and renewing sports betting licenses [Section 44-30-1503(1)(a), C.R.S.]. The Commission issues licenses to sports betting operators (operators), which are persons who run a sports betting operation (operation) or wagering operation in which bets are placed on sports events through any system or method of wagering [Sections 44-30-1501(10) and (11), C.R.S.]. The Commission also licenses individuals working for an operation and vendors working with operators in Colorado. An entity may hold multiple types of licenses, including for multiple operations. Exhibit 2.1 details the types of sports betting licenses the Commission issues.

Exhibit 2.1
Types of Sports Betting Licenses

Sports Betting License Type	Who is this license for?
Master	Anyone with a retail gaming license (i.e., a casino). This license allows the holder to: (1) operate onsite retail sports betting on their casino premises, (2) operate Internet sports betting through an online gaming platform; or (3) contract with Retail operations and Internet operations to operate sports betting on the Master licensee’s behalf. A master licensee is permitted to contract with no more than one Retail operation and one Internet operation at a time.
Internet Sports Betting Operator ¹	An entity contracted with a Master licensee to operate sports betting through an online platform using a computer, mobile, or interactive device. Internet operations are not permitted to operate sports betting independently – only under a contract with a Master licensee.
Retail Sports Betting Operator ¹	An entity contracted with a Master licensee to operate retail sports betting on the Master licensee’s premises. Retail operations are not permitted to operate sports betting independently – only under a contract with a Master licensee.
Vendor Major	Any vendor that contracts with, or acts on behalf of, a Master, Internet operation, or Retail operation, licensee to manage, administer, or control bets made on a sports betting system; maintain or operate sports betting system software and hardware; or supply products or services.
Vendor Minor	Any vendor that contracts with, or acts on behalf of, a Master licensee, Internet operation, or Retail operation to carry out activities other than those of a Vendor Major licensee.
Key Employee ²	Any executive, employee, or agent of a sports betting business licensee who will be involved in the management of sports betting business operations.
Support Employee ²	All employees of a sports betting licensee not otherwise required to hold a key employee license, a vendor major license, or a vendor minor license.

Source: Section 44-30-1505, C.R.S., and 1 CCR 207-2 Rule 3.1

¹ An entity may hold both Retail operation and Internet operation licenses and can operate sports betting activities on behalf of multiple Master licensees at any time, but is required to have a separate license for each type of operation for each Master.

² Any person holding 10 percent or more effective ownership interest in the licensee business, and officers and directors, regardless of ownership interest or involvement in sports betting business operations that do not need a Key or Support Employee license must also apply as an “Associated Person” to the licensee and must be found suitable, but will not be issued a license. Additionally, any person holding less than 10 percent effective ownership in a privately held corporation (limited owner) must apply and be found suitable.

Colorado voters approved Proposition DD authorizing sports betting in Colorado in the November 2019 statewide election. The Commission adopted emergency rules on November 21, 2019, that allowed the Division to begin accepting applications on November 27 and the Commission to grant temporary licenses. The Division began accepting applications for all sports betting license types in December 2019. The process of licensing a new business to operate sports betting in Colorado begins with the business submitting an application to the Division. The application requires disclosure of information about the business’s prior history, including its gaming ventures in other locations; its ownership and control structure; the names of key directors, managers, and investors; and financial history. The business must also provide information on the owners, directors, corporate officers, and managers of the business, known as associated persons, and on the business’s holding, intermediary, and subsidiary companies, known as associated businesses.

The Division is then responsible for conducting background investigations into the applicants, including the associated persons and businesses. Under statute, the Division is authorized to conduct investigations into the character, record, and reputation of all applicants for sports betting licenses [Section 44-30-204(1)(f), C.R.S.] The Division uses the application as a starting point for its investigations. According to the Division, background investigations are an in-depth process that can take up to 1 year to complete for each licensee. However, the duration of each license investigation is determined by the complexity of the business. Prior to May 2020, the Division employed a staff of 13 criminal and financial investigators with the authority to “conduct investigations into the character, record, and reputation of all applicants” [Section 44-30-204(f), C.R.S.]. The Division reported that these investigators worked primarily for the Limited Gaming Background Unit, but the Division also leveraged them to conduct investigations of applicants for sports betting licenses. After May 2020, the Division reported that staff turnover and the Department’s hiring freeze resulted in the sports betting unit having only three investigators and one supervisor for most of Fiscal Year 2021. As of March 2022, the Division reported that it had seven sports betting investigators. The criminal investigators on staff are permitted to investigate the criminal, regulatory, and litigation history of businesses and people, in addition to the financial history of individuals, while the financial investigators carry out the financial investigation of businesses.

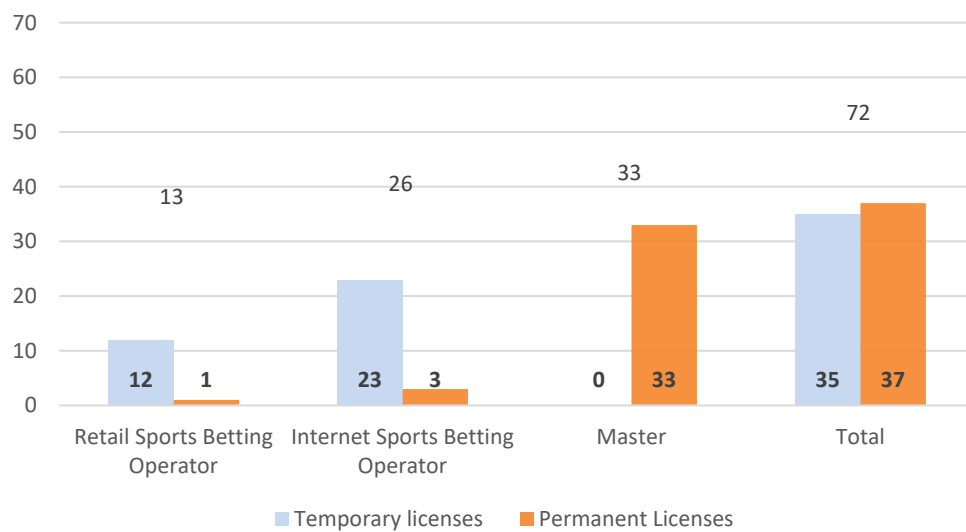
In order to operationalize sports betting by the planned May 1, 2020, launch date, the Commission used its authority to grant temporary licenses to applicants. The Commission’s decision of whether or not to approve an applicant for a temporary license was predicated on the results of limited preliminary investigations (temporary investigations) conducted by the Division and the Division’s recommendation on the suitability of the applicant. The Division reported that it restricted each temporary investigation to 3 weeks in order to operationalize the sports betting industry by May 1, 2020. The temporary investigations consisted of basic checks of the applicant’s business and one to two associated persons of the applicant (known as principals) to give the Commission assurance that the applicant was suitable. Temporary licenses are valid for 2 years and allow holders the same privileges as a permanent license, meaning that the licensees may commence sport betting activities, which include accepting wagers. According to the Division, after a temporary license is approved, the Division resumes its investigation of the applicant, their associated businesses, and other associated persons, and conducts additional investigative procedures that need to be completed as part of the final investigation. Rules allow the Commission to issue consecutive temporary licenses at their discretion and subsequently convert a temporary license to a permanent license upon completion of the final investigation.

The Division reported that its goal was to complete 10 final investigations per year for new operators in order for the Commission to convert the temporary licenses to permanent licenses. In the first 4 months of 2020, the Division received a total of 31 Internet and Retail sports betting operator applications, and the Commission granted its first temporary operator license on March 5, 2020. By May 1, 2020, the Commission had granted 29 temporary Internet and Retail sports betting operator licenses. During this time, the Division reported facing workload challenges because its

limited gaming investigations team had to conduct sports betting investigations, in addition to their regular limited gaming workload, until the pandemic-related hiring freeze was lifted and the Division could hire a sports betting investigation team. Along with processing sports betting operator license applications, the limited gaming investigation team had to process major and minor vendor license applications, which were necessary so that operators could begin operating.

As of March 2022, the Commission had approved the following licenses, by type, as shown in Exhibit 2.2.

Exhibit 2.2
Sports Betting Operator Licenses
January 2020 through March 2022



Source: Office of the State Auditor analysis of Division of Gaming licensing information.

What audit work was performed and what was the purpose?

We selected a random sample of 5 of the 19 Internet operators that had been issued temporary licenses and were active as of April 2021. The Commission issued temporary licenses to the sampled operators between March and May 2020. Although temporary licenses are only valid for 2 years, the Commission can reissue consecutive temporary licenses, and as of February 2022, Division staff reported that they were in the process of reissuing temporary licenses to all of the operators in our sample. We chose to limit our sample to only Internet operators because 98 percent of total sports betting wagers were placed online, as of April 2021, and Internet operators do not have the extensive regulatory history with the Division as Master licensees that conduct limited gaming activities. Of the five operators in our sample, four are established gaming companies with extensive licensing history outside of Colorado, while one was a startup company with no prior license history.

In addition, four of the five operators are subsidiaries of holding companies based outside of the United States, two of which are new to the United States, having only established U.S.-based subsidiaries to enter into the expanding domestic sports betting market since 2018, when the U.S. Supreme Court decision allowed sports betting to occur.

We reviewed all of the investigative file documentation the Division had for the sampled operators, including application materials provided by the applicants, Division-generated documentation of the investigative procedures carried out, correspondence with the applicants, and the reports presented to the Commission. Our review included the investigation materials for the associated businesses (intermediary and holding companies) of each applicant business in the sample and the associated people, including key licensees and limited owners. For the five operators in our sample, we also reviewed the documentation included in the Division’s investigative files associated with the 10 principals investigated for temporary licensure. Further, we reviewed statutes; Commission-promulgated rules; and Division policies, procedures, written guidelines, and training materials related to gaming and sports betting; and interviewed Division staff about the sports betting investigation and licensing processes.

The purpose of our audit work was to determine if the Division has effective and efficient processes for investigating sports betting applicants that provide assurance that approved applicants are qualified for licensure.

How were the results of the audit work measured?

The goal of investigating sports betting license applicants is to determine whether they meet the qualifications established in Commission rules and their suitability for licensure. In statute, “suitability” or “suitable” means, in relation to a person, the ability to be licensed by the Commission and, in relation to acts or practices, lawful acts or practices [Section 44-30-103(33), C.R.S.]. Conversely, “unsuitability” or “unsuitable” means, in relation to a person, “the inability to be licensed by the Commission because of prior acts, associations, or financial conditions, and, in relation to acts or practices, those that violate or would violate the statutes or rules or are or would be contrary to the declared legislative purposes” of the Colorado Limited Gaming Act [Section 44-30-103(34), C.R.S.]. According to the Division, it is using the existing limited gaming policies and procedures as a general guide for investigating sports betting applicants; and has adopted an abbreviated version of its typical background investigation process to conduct the limited investigations for temporary sports betting licenses. The Division reported that it discussed the scope of the temporary license investigations with the Commission before putting them into practice. The Division’s guidelines and statute address the following areas:

Criminal History. Statute prohibits individuals with specified criminal histories (and the businesses they have substantial control over) from obtaining a sports betting license. This includes anyone convicted of a crime involving gambling or misrepresentation; who makes money through criminal means; or who has engaged in illegal gambling [Sections 44-30-1503(3) and 44-30-509(1)(e), C.R.S.].

Each associated person to a sports betting business applicant, and key and support license applicants are required by statute to submit fingerprints to the Division [Section 44-30-1504(7)(a), C.R.S.]. The Division's license application requires each associated person to a sports betting business applicant, and key and support license applicants, to further disclose all arrests, convictions, and serious traffic offenses.

For purposes of a temporary investigation, the Division directed staff to submit applicants' fingerprints to the Colorado Bureau of Investigation (CBI) for both state and national criminal history record checks and to check other sources of criminal records, including CBI intelligence and Colorado arrest reports; the Colorado Criminal Information Center (CCIC) and National Criminal Information Center (NCIC); and CLEAR and Accurint reports, which compile public records from hundreds of databases. Investigators were directed to use these sources to verify an applicant's disclosures and identify sources of further information. According to the Division, it is necessary to check multiple sources, as not all records may be complete or different sources will have different details, to help the Division build a more complete profile of the applicant. Investigators were also directed to inquire with local law enforcement agencies in locations where the applicant or principals have lived, worked, or studied in the United States over the past 10 years to determine the disposition of disclosed criminal charges and identify any other criminal activities in those locations that were not disclosed.

Regulatory History. Although statute, rules, and policies do not explicitly prohibit an applicant from licensure based on regulatory violations, statute does allow the Commission to consider an applicant's regulatory history in deciding to approve or deny licensure [Section 44-30-505, C.R.S.]. Further, under statute, anyone who has been denied a gaming license of any type by the Commission once in the last year or twice in the last 3 years is not eligible for a sports betting license; statute precludes them from reapplying during these timeframes. [Section 44-30-519(1), C.R.S.] On the Division's application form, applicants are required to disclose their licensing history, including any gaming-related disciplinary actions, in any jurisdiction, foreign or domestic; the disclosures must include associated businesses.

For purposes of a temporary investigation, the Division directed staff to review MyLO, the Department's electronic licensing database, for the applicant's Colorado licensing history and to query the Department's case reporting system, Public Safety Records. Public Safety Records contains information on any negative contact a licensed entity or person has had with the Department, such as past disciplinary actions. Finally, the Division instructed investigators to contact gaming regulators in other U.S. jurisdictions where the applicant had applied for or held a sports betting license to gather information on their license status and conduct.

Financial Capacity and Operations. According to the Division and Commission, the financial review and analysis portion of an investigation is intended to provide information on the applicant's financial stability and capability to carry out their planned business operations; help determine whether the applicant and its principals conduct business professionally, legally, and ethically; and

ensure that the applicant's funds are derived from legitimate sources—meaning they are lawfully earned or obtained. Commission rules require that applicants for an operator license disclose a variety of financial information including whether the applicant, a principal, or an associated business has ever been involved in bankruptcy; was ever the subject of a complaint for violating antitrust, trade, or security laws; is delinquent on any government obligations; or has ever been a party to litigation. Applicants are also required to submit loan documents, business tax filings, financial statements, and documents showing the status of any litigation. In addition, statute and Commission rules require applicants to submit all contracts or proposed contracts with all other sports betting licensees, including the master licensee the applicant will be operating under, for the Division's approval [Section 44-30-1505(3), C.R.S. and 1 CCR 207-2, Rule 3.6].

For purposes of a temporary investigation, the Division directed staff to check the Colorado child support database; send inquiries to the IRS; and check GenTax, the Department's tax processing system, to verify payment of government obligations (e.g., child support, taxes, business fees) for the selected principals, and to obtain a credit report on each principal. The Division's guidance directs investigators to conduct a comprehensive review and analysis of an applicant's financial situation, which generally includes reviewing several years of tax returns, financial statements, bank statements, and funding information for the applicant and associated businesses; and reviewing tax returns, bank statements, and credit card statements for associated persons. The financial investigation also includes a series of financial analyses, such as financial statement comparison, break-even analysis, and cash flow assessment. With respect to litigation, the minimum investigation requirements in Division policy direct investigators to follow up on significant civil litigation disclosed by the applicant or principals to reveal information about personal habits, business practices, or other aspects of character and suitability.

Conflicts of Interest. Statute prohibits the following persons from having any ownership interest in or control of, or being employed by, a sports betting licensee: (1) anyone involved with a sports event upon which wagers can be placed, such as athletes, coaches, trainers, referees, teams, and managers for the event or of the sport's governing body that sanctions or governs the event; (2) anyone who advocates for players, referees, or others involved with the conduct of a sports event upon which wagers can be placed; or (3) a person who holds a position of influence or has access to nonpublic information that could affect the performance of a participant or the outcome of a sports event upon which wagers can be placed. These prohibitions do not apply to persons with less than a 10 percent ownership interest in the licensee or to an operation that does not offer wagers on the conflicting events, athletes, or teams [Sections 44-30-1502, C.R.S.].

The Division's investigative work in each of these areas is documented in both hard copy and electronic files, which are used to prepare the reports for the Commission. The Division does not have written guidance on documenting investigations or on the contents of the temporary investigation reports presented to the Commission. The only references to the investigative files and reports were (1) in the Division's background investigations guidelines, which state "Assembling the investigative report will be a simple task if the investigators have...documented all the information

that was gathered” and (2) in Division training materials, which direct the investigator to ensure that the report is accurate and supported by documentation in the investigative file. In the absence of Division policies, we evaluated the adequacy of the investigative documentation to the extent that minimum investigation requirements were documented and the documentation reflected the content of the Commission reports. In addition, we evaluated the adequacy of the temporary investigative reports to assess whether they were supported by evidence in the investigative files and provided assurance of the applicant’s suitability. Thoroughly documenting investigations is necessary for Division management to ensure that the work is complete and accurate and that no disqualifying circumstances were overlooked by the investigator. Preparing complete and accurate Commission reports is necessary for ensuring the Commission’s licensing decisions are consistent, fair, and justifiable.

What problems did the audit work identify?

Overall, we found that during the first year of regulating sports betting, the Division did not have an effective process for investigating sports betting applicants for temporary licensure that provided assurance that approved applicants were qualified. Specifically, we found that the temporary investigations conducted by the Division of new sports betting business applicants during this time did not clearly provide assurance that the applicants met all the requirements in statute and rules to be qualified for licensure. The issues we identified include:

Planned investigatory work was not completed. We found that, for each of the approved applicants in our sample, the Division did not have evidence to show that all of the minimum checks that were expected as part of their temporary investigations were completed.

Criminal History. For three of the five (60 percent) operators and eight of the 10 (80 percent) principals in our sample, the Division did not have evidence that it had completed the minimum required criminal history procedures that it had established for temporary investigations. Specifically, we found the following:

- For five principals and three operators, the Division did not obtain CLEAR reports.
- For two principals, the Division did not obtain Accurint reports.
- For one principal, the Division did not conduct CCIC or NCIC checks.
- For three of the six U.S.-based principals, the Division did not obtain criminal history information from any local U.S. law enforcement agencies where the principal had lived, worked, or studied in the last 10 years. For two of those three principals, the Division did not provide evidence that it sent inquiries to local law enforcement agencies. For the other principal, the Division sent inquiries to law enforcement agencies but had not received any responses before recommending the applicant for licensure. Further, for the 3 U.S.-based principals where

the Division conducted at least one local law enforcement inquiry, only one had complete history from the law enforcement jurisdictions where the principal lived or worked in the past 10 years.

Regulatory History. For three of the five (60 percent) operators and six of the 10 (60 percent) principals in our sample, we found that the Division did not complete the minimum regulatory history procedures that it had established for temporary investigations. Specifically, we found the following:

- For one operator and six principals, there was no evidence that the Division reviewed the operator's and principals' licensing histories in the Department's MyLO system.
- For one operator, there was no evidence that the Division reviewed the Department's Public Safety Records (for past contact with the Division, such as disciplinary actions).
- For two of the four operators that reported having applied for or held a sports betting license in at least one other U.S. jurisdiction, the Division did not conduct any inquiries with gaming authorities in those jurisdictions. Additionally, for one operator that disclosed having applied for or holding sports betting licenses in several U.S. jurisdictions, the Division sent inquiries to some, but not all, of the jurisdictions that the applicant disclosed.
- For one operator that disclosed that they, or an associated business, had been subject to disciplinary actions related to sports betting activities by gaming regulators in four other states, the Division sent general inquiries to regulators in the four jurisdictions, but only had documented responses from one of the four.
- For one operator, we found the Division discovered violations that occurred in another gaming jurisdiction that the operator did not disclose, even though the operator was required to do so. Specifically, Division staff learned during its temporary investigation process that the operator's holding company was required to pay £6.2 million in regulatory settlements resulting from a 2018 investigation by the U.K. Gaming Commission, which identified a number of violations, including deficient anti-money laundering controls. However, the Division did not follow up on these violations with either the applicant or the U.K. Gaming Commission to determine if the operator's omission was deliberate or could have affected the operator's suitability for licensure. According to the Division, large fines are not out of the ordinary in the gaming business, and since the operator was still licensed and operating in the U.K., the Division assumed that the applicant was suitable for a temporary license in Colorado. The Division reported that it informed the Commission of its findings and conclusion.

Financial Capacity and Operations. For three of the five (60 percent) operators and three of the 10 (30 percent) principals in our sample, the Division did not have evidence that it had completed the

minimum financial procedures that it had established for temporary investigations. Specifically, the Division did not have documentation of the following:

- For two operators and two principals, there was no evidence that the Division had queried GenTax to ensure that the businesses and principals were not delinquent on Colorado tax obligations.
- For three operators and one principal, there was no evidence that the Division had submitted inquiries to the IRS to verify the businesses and applicants were not delinquent on their federal taxes. However, the Division told us that it began phasing out these queries around February 2020 as part of the standard investigation procedures because the IRS was not consistently responsive and subsequent closures of some IRS offices due to COVID-19 added further difficulties.

Temporary investigations did not provide adequate assurance of suitability. While the Division did not complete a number of investigative procedures that were planned for the temporary investigations, we also found that some checks that were completed may not have provided reasonable assurance of an applicant's suitability or they omitted risk areas.

International Investigations. All five operators in our sample had some type of international presence, either because they were headquartered overseas or because they were licensed to conduct sports betting activities internationally. We found that the Division had no procedures to verify the financial history of these operators' international business activities. Further, although the Division sent an inquiry to an international regulator to obtain information about one operator in our sample, the Division did not conduct any other inquiries with gaming regulators, or any inquiries with local law enforcement agencies outside the United States. The Division told us that its investigators prioritized domestic regulator checks and were not expected to follow up on operators' international licensing or criminal history, including disciplinary actions, due to time constraints and challenges obtaining information from outside of the United States while COVID-19 restrictions were in place. As a result, the Division only had a limited picture of these applicants and their principals, which did not provide assurance that the applicants were qualified or suitable for licensure. The Division reported that it plans to complete international checks as part of the final investigations. Further, the Division told us that privacy laws in many countries present complications in obtaining criminal and financial information, and conducting inquiries with entities outside of the United States is a time-consuming process since most inquiries are sent by postal mail, rather than electronically.

In terms of the individuals who are associated with our sampled operators, four of the 10 principals in our sample are located outside of the United States, and four of the five business applicants in our sample are held by parent businesses outside of the country. Since the Division did not pursue international checks, the Division was not able to verify the criminal history of the four international principals. Further, we found that some of the checks that were completed were likely of limited relevance to the international principals, particularly for those who had not had a significant

presence in the United States, such as for school, work, or past residency. This is because most standard checks included in the temporary investigation contain only Colorado or U.S.-specific records, or are queried based on a subject's Social Security Number, such as the CLEAR report, credit history report, or Colorado child support records. The Division has not established alternative or supplementary procedures for international applicants.

Further, we found that the Division did not have processes to translate documents in other languages during the temporary background investigations. For example, one of the applicants in our sample provided tax returns in Spanish, however there was no indication that the Division was able to read the returns as provided or had them translated. The Division reported that it plans to pay for translation services as part of the final licensing investigations.

Financial Investigations. We found that financial procedures in the temporary investigations did not verify the applicants' financial capabilities, and the Division told us that the financial procedures were the most limited portion of the temporary license investigations. For example, the documented financial procedures generally only verified any bankruptcies the applicants disclosed and that the applicants and their principals were current on their government payment obligations in the United States. As a result, virtually all of the financial details included in the temporary license reports, which the Commission relies on to verify that an applicant is financially capable of their planned business operations, were self-reported by the applicants, rather than based on the conclusions of a Division investigator.

According to the Division, there were no financial investigators conducting financial analysis for temporary investigations in 2020, so financial investigations were limited to what could be carried out by the criminal investigators on staff. The Division reported that more in-depth financial procedures conducted by a financial investigator are included in the final investigations.

Incomplete Documentation. We identified problems with the Division's documentation related to conflicts of interest, investigations, and Commission reports.

Conflicts of Interest. We were unable to verify that the Division had vetted the applicants in our sample, including their associated businesses and persons, for statutorily prohibited connections with sporting events or organizations. The Division told us that it met with businesses before they submitted applications to inquire about any potential conflicts of interest and identify solutions if conflicts did exist. However, the Division did not have documentation of any these meetings for any of the applicants in our sample.

Investigative Files. We found that the investigative files the Division had for the sample of five operators and 10 principals that we reviewed was inconsistent and incomplete. In addition to the specific items of evidence the Division did not have, as noted in the previous bullets, the Division did not have documentation of interviews for six principals, and the Division also did not keep all relevant emails. Further, the investigative files did not contain notes or other documentation

reflecting the investigators' reasoning, decision-making, areas of concern, or barriers encountered in the investigation. For example, the Division told us that it declined to follow up on disclosed or discovered gaming violations in the United Kingdom because political changes there had resulted in a stricter and more punitive regulatory environment. While the Division indicated that any violations and resulting disciplinary actions were low-risk and not potential areas of concern, and the Division reported that it provided this information to the Commission, the Division had no documentation of the reasoning for this decision.

Commission Reports. We found that four of the operator investigative reports in our sample contained statements that either conflicted with evidence in the investigative file or for which there was no supporting evidence. For example:

- Four reports contained statements that the Division had carried out procedures for which there was no documentation or that were not complete at the time the report was written. These procedures included fingerprint-based background checks, local law enforcement inquiries, and NCIC and CCIC database inquiries. For example, one report stated that local law enforcement inquiries had been completed on one of the principals and no areas of concern were found. However there was no evidence that any local law enforcement inquiries had been completed.
- Two reports included licensing details that were inaccurate. According to the Division, investigators were only expected to include domestic sports betting licenses in the report but, we found the licensing information included in two reports was inconsistent with this and further conflicted with information disclosed by the applicant. For example, one report stated that the applying business held current gaming licenses in seven other U.S. states. However, the business's application disclosed that only one of these licenses was current, and all of the other licenses had expired before the application was submitted.
- One report stated that the applying business had no current or pending legal matters, but the application disclosed that the business was a party to an ongoing lawsuit.

Further, the reports did not contain language notifying the Commission about any limitations on the investigation that led to information in the report being unverified or incomplete. For example, the Division told us that they were not able to verify the financial details included in the reports during the temporary investigations and these figures were self-reported by the applicant. The Division told us that the Commission was aware that the temporary investigations were limited and of what specific areas were not covered. However, because we found the work completed for each temporary investigation was not consistent among operators and principles in our sample, the Commission may not have had a clear picture of what information was self-reported by applicants and what had been substantiated by the Division. Nonetheless, Division management and the Commission Chair stated that they believe the Commission was provided a detailed picture of the licensees' information.

Why did these problems occur?

The Division told us that several factors outside its control affected its investigations of sports betting applicants. First, the Division said it received a higher-than-expected volume of applications between December 2019 and May 2020 and did not have enough licensing staff and investigators to handle the workload. The increased workload was further exacerbated by a Department-wide hiring freeze in early 2020 resulting from COVID-19-related budget constraints, as well as staff turnover and retirements that resulted in the Sports Betting Unit having three investigators and one supervisor for most of Fiscal Year 2021. Second, COVID-19 restrictions beginning in mid-March 2020 meant that investigators were unable to obtain certain documents and information from government agencies and businesses that were closed or operating at a diminished level. In addition, some investigative information was lost when the Division started storing information electronically, rather than in hard copy, during the COVID-19 pandemic. As a result of these challenges, the Division narrowed the scope of its Sports Betting license investigations, deferring the majority of the work until after temporary licenses were issued. While it was clear from our work that these factors did create hurdles for the Division, we also identified underlying shortcomings in the Division's investigation processes that contributed to the problems we found, as described below.

Lack of a Documented Risk-Based Investigation Approach. The Division had initially planned to follow the existing limited gaming model for its sports betting investigations. The Division also reported that prior to receiving sports betting license applications, Division investigators conducted an overall review to develop a risk-based background investigation process and standardized report template for the temporary licensing process and reporting to the Commission. However, the Division did not provide documentation to show that the process it envisioned was formalized or communicated to all investigators. Further, the procedures for limited gaming investigations have not been reviewed for possible revisions since 2016, at the most recent, and more importantly, do not reflect a risk-based approach to investigations that are tailored to the sports betting industry. As a result, the Division's sports betting investigations were not designed to consider the risks inherent to that industry, achieve defined objectives to address such risks, or ensure the investigations provided the right type and amount of information for prudent licensing decisions. The lack of such a risk-based system affected both the limited investigations for temporary licenses and has the potential to impact the final investigations for permanent licenses.

First, the Division told us that the scope of the temporary investigations was guided primarily by what work could be conducted within roughly 3 weeks; the Division did not evaluate the overall investigation process to decide what work needed to be done to provide a sound, if minimal, basis for licensing decisions, and what could reasonably be postponed. However, the Division told us that it has already recognized that some investigative procedures are unproductive, such as sending inquiries to the IRS because the agency was not responsive, and has deliberately omitted the related procedures from the temporary investigations. According to the Division, there is information in the applications and likely other procedures and sources it has long used in investigations that do not provide useful information or are no longer accessible.

Second, the temporary investigation process has provided the Division an opportunity to evaluate the importance of much of its traditional investigatory work. By recommending licenses based on these limited investigations, which did not include review or follow up on a substantial amount of evidence and documentation provided by the applicants, the Division has recognized that some of the work traditionally done in an investigation may not be necessary. For example, according to the Division, some of the documentation that we found was missing from the investigative files was deemed by the Division as not essential or low priority and too time consuming for the temporary investigation. This raises a question as to how much of this information is needed for a permanent license, which offers the licensee no more rights or privileges than a temporary license. Furthermore, since the Division has not established guidance for sports betting license investigations, staff conducting investigations for sports betting licenses rely on the Division's existing guidance for limited gaming. That guidance directs investigators to pursue many avenues of investigation and allows them discretion in the work they complete, but does not identify priorities to target work to address areas of risk. The Division told us that investigators and their supervisors may discuss potential risks and brainstorm ideas for each investigation, but this risk-based approach has been an informal process that is not documented in the investigative files or reports, which may lead to inconsistencies in the rigor of different investigations.

The Division confirmed that the final investigation process, while prolonging the work, does not always result in investigators obtaining meaningful information and may not be the most efficient use of an investigator's time.

Lack of Written Policies for Sports Betting Investigations. The Division reported that it has relied on its existing process for conducting limited gaming investigations to complete investigations for sports betting licenses. In May 2021, the Division issued some sports betting specific policies and procedures, but these do not address licensing and investigations. Since sports betting was legalized, the Division has not methodically reviewed the limited gaming investigation procedures to incorporate or develop separate written guidance that is relevant to sports betting investigations.

One area we identified in our audit where the Division needs to develop written procedures is the investigation of applicants from outside the United States. The Division told us that there are several barriers to collecting information from other countries, but did not have alternative procedures in place to compensate. For example, investigations of businesses and individuals in other countries can be difficult due to strict privacy laws, some of which do not allow certain records to be released to regulatory agencies. The Division has not established alternate means of acquiring essential information, such as routinely asking applicants from other countries to acquire the records themselves and submit them to the Division. The Division has additionally not provided investigators with any written guidance or additional training on how to navigate international investigations and available sources, and instead relies on each investigator to do their own research on the legal parameters that may impact their investigation. Further, the Division told us that as of February 2022, CBI no longer provides CBI intelligence reports to investigators, which often

included an Interpol check for international criminal records. This means the Division will need to find other sources for non-US criminal checks.

Finally, the Division's overall approach to regulation dictates the need for a risk-based investigative process predicated on defined objectives and implemented through comprehensive written policies and procedures to achieve the strict regulation required by statute. Statute states that "the success of sports betting is dependent upon public confidence and trust...[which] can be maintained only by strict regulation of sports betting" [Section 44-30-102(3)(e), C.R.S.]. We recognize that background investigations are just one part of the Division's overall regulatory framework, which also includes a compliance unit to ensure that operators have the internal controls and sports betting systems required by rules, an audit team monitoring wagers and revenue, and a disciplinary process for violations of statute or rules. However, the background investigations are a critical component of ensuring that only applicants determined to be suitable, as defined by statute, are granted sports betting licenses.

Overall, the Division views sports betting as an industry that is evolving and expanding quickly. The Division believes that operators will maintain compliance and report violations, driven by their desire to continue to participate in the industry and avoid the risk of legal penalties and loss of investment. Any reported violations may lead to disciplinary action by the Commission, such as the levying of monetary penalties or the suspension or revocation of a license. As a result, staff told us that the Division trusts the industry to self-regulate to a large degree, although Division management stated that they believe a strong regulatory process has to be in place. However, for this regulatory framework to be effective, it is important that the Division improve its investigative and licensing process to help prevent unsuitable businesses from entering the industry to begin with.

Lack of Written Policies and Procedures for Commission Reports and Documentation. The Division does not have policies and procedures that outline the content that must be included in the reports prepared for the Commission. Although Division investigators use a template when preparing reports for the Commission, we found that the content of the reports vary. For example, some reports only listed operators' sports betting licenses in other states but not in international jurisdictions, while other reports included operators' international sports betting licenses, and still other reports listed expired licenses that were not related to sports betting. Therefore, guidance in this area could help ensure that report content is consistent and the Commission has all of the information it needs and, for the temporary investigations, has a clear understanding of the scope of the work completed and the work that is outstanding.

Similarly, the Division has no written policies or guidance that clarify the information that must be documented as part of the investigations, including investigator-generated documents, such as notes, and materials from other sources, such as the applicant or other agencies. Further, existing policies and procedures do not outline the purpose or extent of supervisory reviews of investigations. The Division told us that supervisors review the investigation files and Commission reports. However, we found no evidence of supervisory reviews in any of the investigative files we reviewed, and the

Division did not have any written guidance on what the reviews should cover, including whether they should identify when expected investigative procedures have not been done or errors in Commission reports.

Why do these problems matter?

The Division's bifurcation of sports betting investigations into temporary and final investigations resulted in the licensing of operators in the sports betting industry without full assurance of their suitability, which may erode public confidence in the Division and the industry. The temporary investigations have not provided comprehensive, verified information in the following areas.

- **Incomplete Criminal and Regulatory History.** By postponing inquiries on criminal and regulatory history for applicants outside the United States, the Division does not have assurance that these operators are legally eligible for licensure and that sports betting is free from criminal or corrupt elements, as required by statute [Section 44-30-102(3)(e), C.R.S.]. If a principal has never spent significant time in the United States and the Division does not conduct inquiries with local sources in other countries, that principal could have an extensive criminal history that could disqualify them from licensure. For example, one operator in our sample, including the holding company and all subsidiaries, are owned entirely by one individual who had no historical presence in the United States. Their residential, business, education, and legal histories spanned several other countries, none of which will be investigated until the final investigation.
- **Limited Financial or Operational Investigation.** The sports betting businesses that received temporary licenses have undergone a very limited financial review and analysis, although a Commission member told us that the financial details from the investigation are needed to assess if an operator has the financial fitness to carry out sports betting in Colorado. For example, in two of the five operator files we reviewed, the applying business or their holding company reported net operating losses in the last 3 fiscal years. Such losses may be indicators of problem areas in the businesses' financial situations, although the Division has no written standards or metrics for use in assessing what financial data signals areas of concern. The Division told us it would further assess these businesses and may look into the losses, but only as part of the final investigations.

The Division also opted to delay inquiries on disclosed litigation until the final investigation, meaning the Division has not verified whether the potential costs of the litigation will impact the applicant's operations or financial standing, or whether the litigation presents concerns regarding the applicant's integrity or compliance with the law. For example, one applicant in our sample disclosed several lawsuits in the last 8 years that included allegations of breach of contract and breach of fiduciary duty. The applicant said these were decided in their favor but were under appeal or in settlement; however, the Division did not verify the status as part of the temporary investigation. Finally, the Division deferred the collection and review of contracts to the final investigations,

except for the contracts the operators have with the casinos that will serve as the Master licensee for the operations.

In spite of the Division not verifying that applicants had funding from legitimate sources, are financially stable, or have a history of operating in a legal and ethical manner, those applicants are now licensed operators trusted with a high-value industry; according to wager reports published by the Division, between May 1, 2020, and April 30, 2021, sports betting patrons in Colorado wagered upwards of \$2.3 billion. As discussed, we found issues with the investigative files for all five of the operators we reviewed; these operators accounted for more than \$895 million in wagers that patrons placed with the operators' Internet operations between May 1, 2020, and April 30, 2021. Operators with temporary licenses also have not been reviewed by the Division with respect to their litigation or contracts. The delay of these financial and operational reviews increases the risk that the Commission has unknowingly licensed an unsuitable operator, potentially putting patrons at risk and undermining public confidence in the industry.

The problems we found related to information in Commission reports that was not supported by documentation mean there is a risk that the Commission makes licensing decisions that are not fully based on facts and are defensible. According to Commission members and the Division, the Commission uses the information in the report to determine if an applicant poses any threats to the integrity of the sports betting industry and has the financial standing to carry out their planned operations. However, since many of the details in the reports were not verified and some lacked details or were inaccurate, it is unclear how the Commission can rely on the reports to inform their licensing decisions. The problems we found with documentation not only prevent us from conclusively reporting the extent to which planned checks were done (as opposed to simply not being documented), but also preclude us from verifying that the Division has sufficient means to ensure there are no conflicts of interest prohibited by statute.

The Division's approach to the temporary investigations has left a backlog of outstanding work as of March 2022. Specifically, 35 of the 39 licensed operators in Colorado still hold only temporary licenses. The Division told us its initial goal was to complete 10 final investigations per year. However, during the 22-month period between May 2020 and March 2022, the Division had completed only four final investigations, and the Commission issued permanent licenses to those operators. The Division could not provide us an estimated date for completing the remaining final investigations, but said at the current rate it could be years. Additionally, since temporary licenses expire 2 years after their date of issue, the Commission must reissue temporary licenses for any operator whose final investigation is not completed within 2 years. The Division reported that it will need to conduct additional investigatory work, comparable to the initial temporary investigation, to verify the operator's continuing suitability so that the Commission can reissue temporary licenses. We found that the Commission will need to reissue 32 temporary Internet and Retail sports betting licenses in Calendar Year 2022. The reissuance process adds workload that must be finished before the Division can continue its efforts to complete the outstanding final investigations.

The delays in completing the final investigations have also led to inefficiencies. For example, one operator in our sample was acquired by another gaming company after receiving a temporary license and all of the principals initially investigated have since departed, rendering much of the work from the temporary investigation obsolete. The extended intervening time between issuing a temporary license and completing the final investigation means that similar changes could occur for other operators, and that additional evidence could arise that might increase the operator's riskiness and impact an operator's eligibility. Additionally, the Division reported that its sports betting unit has experienced significant staff turnover since January 2020, meaning that work conducted by one investigator for a temporary license will likely be completed by another investigator. Such changes in personnel require the new investigator to spend time familiarizing themselves with the work to date and can lead to duplicative efforts.

Delays in the investigations and inefficiencies could also result in higher costs to operators. Operators pay the Division for the cost of the background investigations; each operator pays a \$10,000 deposit with its license application that the Division draws upon throughout the investigation, including an hourly rate for investigation activities. If the Division's cost for the investigation exceeds the deposit, the applicant must provide additional funds to cover the excess. As of March 2022, the Division has had to request an additional \$10,000 from one operator to pay for continued investigation costs.

Recommendation 1

The Division of Gaming (Division) should improve the efficiency and effectiveness of sports betting license investigations by incorporating them into a regulatory framework that provides the strict regulation intended by statute. The Division should develop written policies and procedures for sports betting investigations that include the following elements:

- A. The minimum essential information needed to support a recommendation of temporary versus permanent licensure to ensure that applicants who are issued both types of licenses meet appropriate statutory and regulatory qualifications.
- B. A risk-based approach that clearly defines the objectives of the investigation process, identifies high-risk areas, and establishes investigative procedures to target those risk areas that will be applied consistently to all investigations.
- C. Clear parameters on the quantity and quality of evidence needed to develop consistent conclusions in the risk areas specific to sports betting.
- D. Guidance for navigating international investigations and identifying available information sources, while accounting for legal restrictions that may impact the investigation.

- E. Information that must be contained in investigative reports prepared for the Colorado Limited Gaming Control Commission to ensure that the reports include information on the scope of work completed and the basis of the Division's recommendations.
- F. Requirements for documenting investigative work, including expectations for what external documents must be maintained, what Division-generated documents should be present, and how investigators should record their reasoning and decision making.
- G. A standardized supervisory review process for investigations that identifies the purpose of the reviews with respect to ensuring the quality of the investigations and the accuracy of the information in the investigative reports.

Response

Division of Gaming

- A. Agree

Implementation Date: February 2023

The Division plans to engage a technical writer to review current policies and procedures. The policy review will include writing new policies and procedures where needed for Sports betting and updating current policies and procedures as needed. The goal is to ensure that all policies conform to current statute and rules of the Commission and Division and that there is uniformity, where needed, across all Gaming policies.

The Division of Gaming/Sports Betting will ensure that the policies and procedures developed will include appropriate statutory and regulatory qualifications for applicants. These policies will specify what information and qualifications are needed by the Division to support the recommendation for licensure before the Commission. The information and qualifications enumerated will be specific to the recommendation of a temporary or permanent license. All policies that involve issuance of licenses will be reviewed and approved by the Commission.

- B. Agree

Implementation Date: February 2023

The Division plans to engage a technical writer to review current policies and procedures. The policy review will include writing new policies and procedures where needed for Sport betting and updating current policies and procedures as needed. The goal is to ensure that all policies conform to current statute and rules of the Commission and Division and that there is uniformity, where needed, across all Gaming policies.

The Division of Gaming/Sports Betting will ensure that the policies and procedures will clearly define the objectives of our risk-based approach in the investigative process. These policies will specify and target those risk areas. The Division will establish investigative procedures and training will be applied consistently to all investigations. As policies are developed that identify high risk areas and establish investigative procedures they will be taken for review and approved by the Commission.

C. Agree

Implementation Date: February 2023

The Division plans to engage a technical writer to review current policies and procedures. The policy review will include writing new policies and procedures where needed for Sports betting and updating current policies and procedures as needed. The goal is to ensure that all policies conform to current statute and rules of the Commission and Division and that there is uniformity, where needed, across all Gaming policies.

The Division of Gaming/Sports Betting will ensure that the policies and procedures will clearly define parameters on the quantity and quality of evidence needed to develop consistent conclusions in the risk areas specific to sports betting and how that evidence should be documented. These policies will specify the quantity and quality of evidence presented in the investigative report. The Division will establish investigative procedures and training will be applied consistently to all investigations. As policies are developed to establish these investigative procedures they will be taken for review and approved by the Commission.

D. Agree

Implementation Date: February 2023

The Division plans to engage a technical writer to review current policies and procedures. The policy review will include writing new policies and procedures where needed for Sports betting and updating current policies and procedures as needed. The goal is to ensure that all policies conform to current statute and rules of the Commission and Division and that there is uniformity, where needed, across all Gaming policies.

The Division of Gaming/Sports Betting will ensure that the policies and procedures will provide guidance on how to navigate international investigations and identify available information sources, the legal restrictions and logistics of gathering the information that impacts those investigations. Additionally, the Division has identified vendors that can navigate these information sources more efficiently. The Division will evaluate these available resources and secure services that can provide the needed background information needed for international applicants. The Division will establish investigative procedures and training that will be applied consistently to all international investigations. As policies are developed to establish these investigative procedures they will be taken for review and approved by the Commission.

E. Agree

Implementation Date: February 2023

The Division plans to engage a technical writer to review current policies and procedures. The policy review will include writing new policies and procedures where needed for Sports betting and updating current policies and procedures as needed. The goal is to ensure that all policies conform to current statute and rules of the Commission and Division and that there is uniformity, where needed, across all Gaming policies.

The Division of Gaming/Sports Betting will ensure that the policies and procedures will clearly define the information that must be contained in investigative reports prepared for the Colorado Limited Gaming Control Commission to ensure that the reports include information on the scope of work completed and the basis of the Division's recommendations. The Division will establish investigative procedures and training that will be applied consistently to report preparation and the information presented to the Commission. As policies are developed to establish these investigative procedures to ensure that the reports include information on the scope of work completed and the basis for the Divisions recommendations they will be taken for review and approved by the Commission.

F. Agree

Implementation Date: February 2023

The Division intends to engage a technical writer to review current policies and procedures. The policy review will include writing new policies and procedures where needed for Sports betting and updating current policies and procedures as needed. The goal is to ensure that all policies conform to current statute and rules of the Commission and Division and that there is uniformity, where needed, across all Gaming policies.

The Division of Gaming/Sports Betting will ensure that the policies and procedures will clearly define the need for documenting investigative work, including expectations for what external documents must be maintained, what Division-generated documents should be present, and how investigators should record their reasoning and decision making. The Division will establish procedures and training that will be applied consistently to investigative work and what is included in the investigative file. Additionally, the Division will develop procedures for where and how files associated with the investigation are stored.

G. Agree

Implementation Date: February 2023

The Division plans to engage a technical writer to review current policies and procedures. The policy review will include writing new policies and procedures where needed for Sports betting and updating current policies and procedures as needed. The goal is to ensure that all policies

conform to current statute and rules of the Commission and Division and that there is uniformity, where needed, across all Gaming policies.

The Division of Gaming/Sports Betting will ensure that the policies and procedures will clearly define a standardized supervisory review process for investigations that identifies the purpose of the reviews with respect to ensuring the quality of the investigations and the accuracy of the information in the investigative reports. The Division will standardize the format for each type of license background report. Additionally, the Division will define a clear chain of review and develop procedures for how files associated with the investigation are routed through the review process and what signatures are required on the report. The Division will establish procedures and training that will be applied consistently to the review process.

Finding 2—Verification of Sports Betting Tax Liability

Each month, operations are required to pay “a tax on sports betting activity, at the rate of ten percent of net sports betting proceeds.” Net sports betting proceeds means the total amount of all bets placed by players in an operation—including Internet operations—excluding free bets, less all payments to players and less all excise taxes paid pursuant to federal law. Payments to players include all payments of cash premiums, merchandise, or any other thing of value” [Sections 44-30-1501(7) and 44-30-1508(1), C.R.S., and 1 CCR 207-2 Rule 4.1(1)]. “Free bet” means a bet made by patrons using non-cashable vouchers, coupons, electronic credits or electronic promotions provided by Sports Betting Operations” [1 CCR 207-2 Rule 1.4(9)].

The Division maintains the following documentation related to an operation’s reporting of its sports betting tax liabilities:

- **Daily Wager Reports (Submitted by Operations to the Division).** Operations are required to maintain records of all bets placed, including personally identifiable information of the bettor when available, amount and type of bet, time the bet was placed, location of the bet...[and] the outcome of the bet [Section 44-30-1506(5)(b), C.R.S.]. Prior to May 2021, the Division *requested* that operations provide information about aggregate wager activity on a daily basis only. At a minimum, operations were asked to submit information about total wagers accepted, free bets wagered, and total payments to players (including winnings, voids, cancellations and resettlements) since those amounts provide the basis for calculating the amount of sports betting tax the operations owe. Some operations submitted this data using a Division-created template, while other operations supplied additional information beyond the required fields, in some cases including detailed records of every wager placed. According to Division staff, they evaluated the daily wager reports for anomalous patterns or evidence of errors, such as unusually high betting activity for a sporting event or incorrect calculations. As of May 2021, the Division implemented policies that began *requiring* operations to submit wagering statistics on a monthly and yearly basis, in addition to the daily reports, via email or Google Docs [Division Policy 7.8].

- **Monthly Pre-Reconciliation Reports (Prepared by Division Staff).** Each month, Division staff collate the individual daily wager reports that operations submitted during the previous month into a single report for each operation. In each report, Division staff also calculate aggregate data showing the operation’s total wager activity during the month. We refer to these reports as pre-reconciliation reports because they do not reflect any adjustments that operations might have made to their wager data after submitting the daily wager reports to the Division.
- **Monthly Tax Filings (Required Submission by Operations to the Division).** Operations are required to submit monthly tax returns that include a computation of the monthly tax due through the GenTax system. The tax returns are due “no later than the 15th day of the month succeeding the calendar month in which the net sports betting proceeds were received” [1 CCR 207-2, Rule 4.1(2)].
- **Free Bet and Adjustment Reports (Prepared by Division Staff).** At the same time that operations submit their monthly tax filings, Division staff request that operations also submit documentation showing any adjustments made during the month to the total wagers accepted, total free bets wagered, and total payments to players. Division staff then use this information to prepare reports, referred to as free bet and adjustment reports, to account for differences in wagering activity that operations report in their daily wager reports compared to their monthly tax filings. For example, during a given month, an operation’s total wagers will change if patrons wager on sporting events but then later cancel those bets before the sporting events occur. The operation’s daily wager report, as well as the monthly pre-reconciliation reports that Division staff prepare based on the daily wager reports, would include the original bets in the total wager amount, while the operation’s monthly tax filing would exclude cancelled bets from the total wager amount. According to Division staff, they compare the Division-prepared pre-reconciliation monthly reports to the free bet and adjustment reports to identify any variances. If variances are found, Division staff stated that they conduct further investigations to determine why the operations’ reported wager amounts are different and whether operations calculated their tax liabilities correctly. For example, operations may provide additional explanation in emails, when this is requested by Division staff.

What audit work was performed and what was the purpose?

We reviewed statutes, rules, and Division policies; interviewed Division staff and management; and conducted virtual walkthroughs of accounting and tax filing procedures with staff from two operations. In addition, we reviewed and analyzed GenTax data containing all tax filings and tax payments that operations submitted from May 2020 through April 2021, which was the first year that sports betting was legal in Colorado. Using that aggregate data, we recalculated each operation’s reported tax liability.

We also selected a sample of 22 monthly tax filings that seven operations submitted from the population of 324 monthly tax filings that 28 operations submitted from May 2020 through April

2021. This sample included 12 filings in which operations were profitable and owed sports betting tax and 10 filings in which operations reported negative net sports betting proceeds and did not owe tax. Filings in which no wager activity was reported were excluded from the population before we selected the sample. For each sampled tax filing, we compared data in the daily wager reports, monthly tax filings, and free bet and adjustment reports to quantify any differences, and we reviewed documentation of any communication that occurred between Division and operations staff related to discrepancies among those reports.

The purpose of the audit work was to determine whether operations submitted accurate calculations of their monthly sports betting tax liabilities to the Division from May 2020 through April 2021.

How were the results of the audit work measured?

The Division is responsible for implementing, regulating, and supervising the conduct of sports betting in Colorado [Section 44-30-202(1)(b)(I), C.R.S.]. In House Bill 19-1327, the General Assembly further declared, “Public confidence and trust can be maintained only by strict regulation of sports betting” [Section 44-30-102(3)(e), C.R.S.].

Operations are required to have sports betting systems that can generate reports necessary to record the adjusted gross receipts, patron liability, ticket redemption, and such other information relating to sports betting as deemed necessary by the Division Director or as required by internal controls [1 CCR 207-2, Rule 7.8(1)(a)]. Division staff told us that, prior to May 2021, although they did not specifically require operations to submit information about total wagers accepted, free bets wagered, and total payments to players, staff requested that operations submit this information, and the Division reported that operations did. In May 2021, the Division implemented policies that required operations to submit daily, monthly, and yearly reports that contain wagering statistics. However, those policies were not in place during the period we reviewed (i.e., from May 2020 through April 2021).

State Controller policy requires all executive branch agencies to follow the *Standards for Internal Control in the Federal Government* (Green Book). Organizations implement internal controls to help them achieve their objectives and to ensure compliance with state law [Section 24-17-102, C.R.S.]. We applied the following Green Book principles to assess the Division’s regulation of sports betting tax payments:

- Management designs appropriate types of control activities for the entity’s internal control system. Control activities help management fulfill responsibilities and address identified risk responses in the internal control system.
- Management establishes activities to monitor performance measures and indicators. These may include comparisons and assessments relating to different sets of data to one another so that analyses of the relationships can be made and appropriate actions taken.

- A variety of control activities are used in information processing. Examples include edit checks of data entered...[and] comparing file totals with control accounts.
- Management clearly documents internal control and all transactions and other significant events in a manner that allows the documentation to be readily available for examination [Principle 10.03].

What problem did the audit work identify?

Overall, we found that during the first year of regulating sports betting, the Division did not collect sufficient documentation to determine if the monthly tax filings that operations submitted were accurate. Specifically, we found:

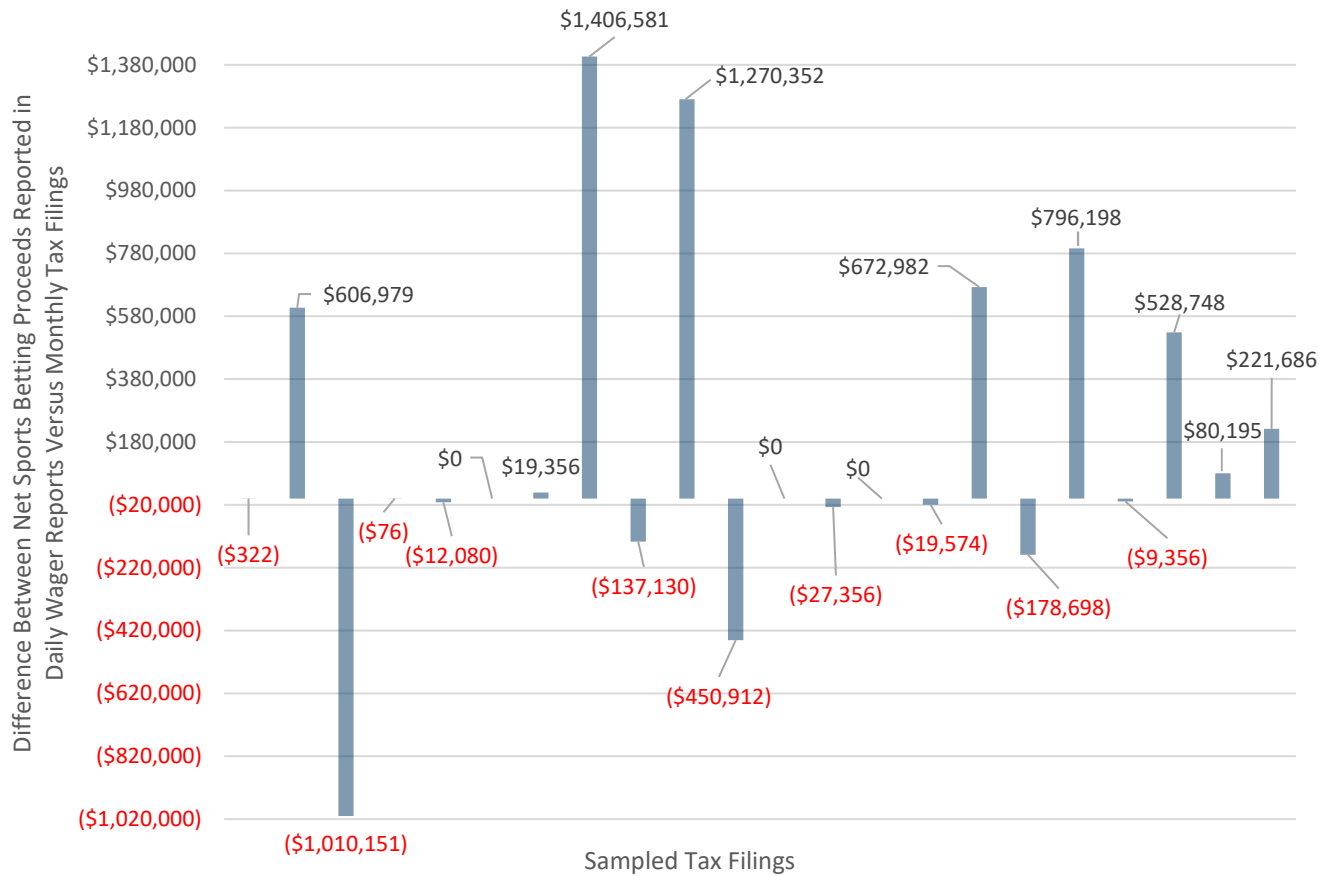
Variances in Reported Wagering Activity. We compared the monthly pre-reconciliation reports, monthly tax filings, and free bet and adjustment reports for the 22 sports betting tax filings in our sample and found that the information the operations reported in their monthly tax filings matched the data they submitted for the free bet and adjustment reports. However, for 19 of the 22 filings we sampled, we found wide variation between the amount of wagering activity (i.e., bets, free bets, and payments to players) that operations reported after each gaming day compared to the totals that they reported in their monthly tax filings. These variances ranged from an operation reporting \$1.4 million more in net sports betting proceeds in its daily wager reports than it reported in its monthly tax filing, to an operation that reported \$1 million less in net sports betting proceeds in its daily wager reports compared to its monthly tax filing. For these two operations, this means that one paid \$141,000 less in sports betting tax than would have been expected based on information in its daily wager reports, while the other operation paid \$101,000 more in sports betting tax.

Some variation between the pre-reconciliation reports and monthly tax filings is to be expected because of the nature of the sports betting industry and the way betting transactions occur. Division staff explained that wagers on sporting events may be altered, voided, or canceled after they are placed, and these changes may not occur on the same day as the initial wager. For example, a wager placed on the first day of the month for an event the following weekend may appear in the daily wager data that is used to compile the pre-reconciliation report. The wager might then be canceled on a different day, before the event has occurred, resulting in a change to the actual wager activity for the month, which will not be reflected in daily wager reports or the pre-reconciliation monthly report compiled from the daily reports.

Exhibit 2.3 shows the variation we found between the pre-reconciliation reports and tax filings for the tax payments we sampled.

Exhibit 2.3

Comparison of Daily Wager Reports Versus Monthly Tax Filings



Source: Office of the State Auditor analysis of 22 sampled sports betting tax filings that seven operations submitted from May 2020 through April 2021.

While some variation between the daily and monthly reports is expected, we found that operations do not always submit supporting documentation to substantiate changes to the net sports betting proceeds that are reflected in their monthly tax filings compared to their daily wager reports.

The Division reported that staff will follow up with operations to request an explanation of why the initial wagering data that they submitted in their daily wager reports did not match the data they submitted with their tax filings to inform the free bet and adjustment reports. However, there was no documentation to show that Division staff followed up with the operations that submitted 15 of the 19 tax filings in our sample where the wager data that the operations submitted to inform the free bet and adjustment reports did not match the original wager data. Division staff reported that some correspondence and supporting documentation related to the reconciliation process was lost and could not be recovered because the material had not been saved.

For the other four filings in our sample, Division staff provided copies of email correspondence in which they discussed differences between the pre-reconciliation and free bet and adjustment reports with operations' staff. However, the emails contained only self-reported statements from operations staff about changes that were made to the wagering data without any additional documentation to justify the changes. For example, for one of the tax payments in our sample, Division staff emailed operations staff to ask why total wagers the operation reported in its monthly tax filing were \$581,100 less than total wagers the operation reported in its daily wager reports. The operation's staff did not address Division staff's question about why there was such a large discrepancy, but instead stated that the operation's calculation of the total discrepancy was \$30 less than the Division's total. In the body of the email, the operation's staff listed dollar amounts for tickets resettled, vouchers unredeemed, and tickets cancelled to show how the operation calculated the total discrepancy they were reporting. Division staff responded, "That makes sense – thanks!" and did not follow up about the discrepancy that prompted the original email communication.

Why did this problem occur?

Overall, the Division has not established an effective sports betting tax reporting and verification process to ensure that tax filings are accurate.

The Division does not require operations to provide documentation to substantiate changes to reported wager activity. The Division only requires that operations provide total wager activity, total payments to players, and total free bets for each sport; it does not require them to provide any kind of supporting documentation from specific wagers to show that the aggregate data is correct. Although not required to do so, we saw that some operations provided complete information about every wager that was placed, which allowed Division staff to understand why the amount of wagers reported in the tax filings differed from the daily wager reports. The Division reports that its approach to tax filing reconciliations includes reliance on the operations to self-regulate their adherence to statute and rule. According to the Division, there is a low risk of operations filing taxes based on fraudulent wager data and operations are unlikely to misreport data because they have invested large sums of money in obtaining sports betting licenses, which they do not want to lose, and because they risk criminal prosecution if they commit fraud.

In addition, the Division reported that it relies on independent integrity monitors to ensure that operations are reporting all wager data accurately. The independent integrity monitors are "an independent individual or entity approved by the [Division] Director or Director's designee to receive reports of unusual betting activity from a Sports Betting Operation for the purpose of assisting in identifying suspicious betting activity" [1 CCR 207-2, Rule 1.4(10)]. When operations identify unusual betting activity, they are required to submit betting information to an integrity monitor that has been approved by the Division [1 CCR 207-2, Rules 7.5(5) and 8.1(2)]. That information must include: "time of wager; odds of wager; location of wager; amount of dollars wagered; win amount of wager; wager type; and team, side or total the wager was placed upon" [1 CCR 207-2, Rule 8.1(1)]. In addition, operations are required to submit yearly reports to the Division

that detail the operations' integrity monitoring efforts and summarize any unusual betting activity or other suspicious betting activity notifications issued during that time period [1 CCR 207-2, Rule 8.1(5)]. However, this monitoring is not intended to provide routine verification of operations' tax filings and does not serve as an adequate substitute for requiring operations to submit documentation to substantiate their reported wager activity. Integrity monitors are only supposed to look for, and issue reports about, unusual or suspicious wager activity [1 CCR 207-2, Rule 8.1].

As a point of comparison, we reviewed the Division's requirements for casinos that submit gaming tax filings and found that casinos must provide monthly reports that are similar to those for operations. However, casinos must also submit complete financial records annually. Casinos that report \$10 million or more in annual adjusted gross proceeds are required to have their financial records audited by an independent certified public accountant, and the Division can require other casinos to have their annual financial records audited, whereas operations are not subject to these same requirements [1 CCR 207-1, Rules 30-1619 and 30-1620]. If operations were required to submit complete audited financial records, the Division could use that information to verify the accuracy of wagering data that operations report with their monthly tax filings.

The Division has not established sufficient policies and procedures for staff to use when verifying the amount of taxes filed. During the first year of legalized sports betting (May 2020 through April 2021), the Division did not have written policies or procedures to guide Division staff on what steps should be taken to verify that operations paid the correct amount of sports betting taxes. In May 2021, the Division implemented some new policies and procedures to document its sports betting audit processes. These policies included requirements for Division staff to store all wager reports submitted by operations in a central repository on Google Drive and to produce monthly workbooks to document all of the information that it received from each operation. However, as of March 2022, the Division still had not established policies and procedures related to verifying the wager data reported by operations.

The Division does not effectively use its audit staff to verify the accuracy of operations' sports betting tax filings. The Division has two audit staff who are responsible for collecting and analyzing operations' wager and tax-related data. However, the Division only leverages one staff auditor to perform job duties that relate to auditing operations' tax filings, such as reviewing monthly tax filings and comparing those to operations' daily wager reports. The other staff auditor told us that one of their primary responsibilities is compiling operations' daily wager reports into the monthly pre-reconciliation reports so that the Division can inform the public about general industry statistics, such as the extent of wager activity for different types of sports. Given that the Division has reported challenges related to limited staff resources, requiring audit staff to analyze and compile daily wager reports in order to produce general industry statistics detracts from time they could spend on other activities that are more directly related to ensuring the accuracy of operations' tax filings.

Why does this problem matter?

Without an effective process to verify the accuracy of operations' monthly wager activity, the Division cannot ensure that they pay the appropriate amount of sports betting tax to the State. The operations in our sample reported tax liabilities of about \$3 million in tax, but that amount would have been about \$292,000, or almost 10 percent, higher if operations had calculated their tax liability based on the original wager data they submitted. If the Division does not prepare free bet and adjustment reports based on verified information, then the Division cannot ensure that operations paid the full amount of taxes owed.

The Division's tendency to accept operations' explanations of changes in their tax liabilities without providing sufficient supporting evidence could also create a climate in which fraud may occur more easily. If the wagering data that operations report is accepted without much scrutiny, then operations are unlikely to see the Division's auditing processes as a deterrent against either falsifying figures or tracking data without showing due diligence to ensure its accuracy.

Recommendation 2

The Division of Gaming (Division) should ensure the accuracy of sports betting operations' (operations) monthly sports betting tax payments by:

- A. Requiring operations to provide documentation to support the wager amounts reported, including any adjustments that are made to those amounts during each month.
- B. Implementing additional policies and procedures for Division staff to use when verifying the wager data that operations report and the amount of tax they have paid.
- C. Reassessing how Division audit staff can be more effectively used to verify the accuracy of operations tax filings.

Response

Division of Gaming

- A. Agree

Implementation Date: September 2022

The Division is currently engaged with the Governor's Office of Information Technology (OIT) to develop our sports betting data management system. OIT has been selected to develop our data initiative to provide structure, consistency and standardization for how the Gaming Division collects, stores, shares and reports on sports betting data submissions. The automation

of the reports will free up resources to be more effective in other projects/initiatives and operational processes.

The Division of Gaming/Sports Betting will ensure that there is a standard reporting process and template for Sports Betting operators to remit for monthly tax reporting. The Division will ensure that Sports betting operators provide documentation to support the wager amounts reported, including any adjustments that are made to those amounts during each month.

The Division will clearly define a standardized process for documentation of what external documents must be maintained, and what division and operator generated documents should be present. Additionally, the Division will develop procedures for where and how files associated with monthly tax filings submitted by the sports betting operators are stored. The Division will establish procedures and training that will be applied consistently to the audit review process and what is included in the monthly submission files.

B. Agree

Implementation Date: February 2023

The Division is currently engaged with the Governor's Office of Information Technology (OIT) to develop our sports betting data management system. OIT has been selected to develop our data initiative to provide structure, consistency and standardization for how the Gaming Division collects, stores, shares and reports on sports betting data submissions. The automation of the reports will free up resources to be more effective in other projects/initiatives and operational processes.

The Division intends to engage a technical writer to review current policies and procedures. The policy review will include writing new policies and procedures where needed for Sports betting and updating current policies and procedures as needed. The goal is to ensure that all policies conform to current statute and rules of the Commission and Division and that there is uniformity, where needed, across all Gaming policies.

The Division will implement additional policies and procedures for Division staff to use when verifying the wagering data that operations report and the amount of tax they have paid. The Division will establish procedures and training that will be applied consistently to the audit review process to ensure the accuracy of sports betting operations' monthly sports betting tax payments.

C. Agree

Implementation Date: February 2023

The Division is currently engaged with the Governor's Office of Information Technology (OIT) to develop our sports betting data management system. OIT has been selected to develop our

data initiative to provide structure, consistency and standardization for how the Gaming Division collects, stores, shares and reports on sports betting data submissions. The automation of the data collection and storage process will free up resources to be more effective in other projects/initiatives and operational processes.

The Division intends to engage a technical writer to review current policies and procedures. The policy review will include writing new policies and procedures where needed for Sports betting and updating current policies and procedures as needed. The goal is to ensure that all policies conform to current statute and rules of the Commission and Division and that there is uniformity, where needed, across all Gaming policies.

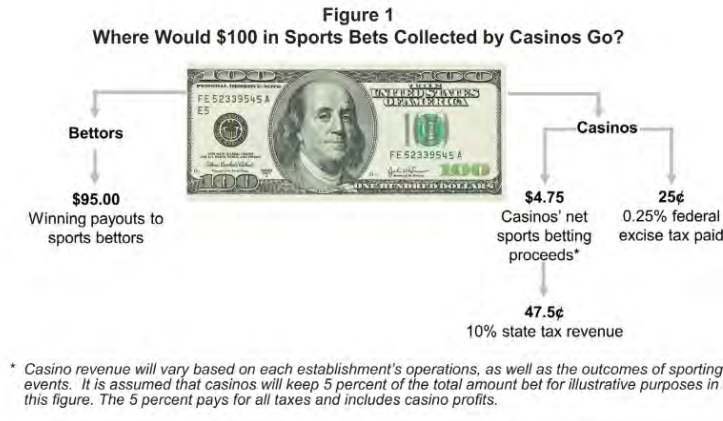
The Division will assess the current utilization of resources and implement additional policies and procedures for Division staff to use when verifying the wagering data that operations report and the amount of tax they have paid. With the implementation of the Sports betting Data system, the audit team will be able to run reports generated from direct daily data feeds from the operators and verify them to the monthly tax obligations. The Division will establish procedures and training that will be applied consistently to the data review process to ensure the accuracy of sports betting operations' monthly sports betting tax payments.

Finding 3—Policy Consideration Related to Operating Loss Deductions

In 2019, when Colorado voters were asked to approve Proposition DD to legalize sports betting, they received information about the referred measure in the State Ballot Information Booklet (Booklet), which explained sports betting, how it would be regulated, how much estimated revenue sports betting taxes could generate, and the planned uses of those tax funds. The Booklet stated that sports betting tax revenue would be used to create a dedicated source of funding to address statewide water needs, fund gambling addiction services, and pay for the regulation of sports betting. The Booklet also included an estimated range of taxes that could be collected from sports betting, from \$16 million to \$29 million per year, and the ballot initiative specifically asked voters to approve a 10 percent tax on net sports betting proceeds and a tax increase of up to \$29 million annually.

Proposition DD did not specifically define how net sports betting proceeds would be calculated, although the Booklet included the following figure (Exhibit 2.4), which suggested that net sports betting proceeds would be calculated by starting with total bets (wagers) and then subtracting payouts to winners and a federal excise tax.

Exhibit 2.4
Depiction of the Net Sports Betting Proceeds Calculation Provided to Voters



Source: 2019 State Ballot Information Booklet, Colorado Legislative Council.

Following the 2019 election, provisions in statute and rule went into effect. First, House Bill 19-1327 established the 10 percent tax rate that voters had approved in Proposition DD and defined “net sports betting proceeds,” which is the basis (generally referred to as the tax base) on which the tax rate is applied [Sections 44-30-1501(7) and 1508(1), C.R.S.]. Second, in April 2020 the Commission promulgated rules for calculating and collecting the sports betting tax. These rules require operations to submit tax returns and payment of their tax obligations each month and specify how the tax base and tax liability should be calculated [1 CCR 207-2, Rule 4.1(2)].

What policy issue did the audit identify?

Commission rules for calculating the sports betting tax result in tax revenue that may be lower than voters and the General Assembly intended because the Commission adjusted the tax base used to calculate the tax revenue. Simply put, any tax revenue is calculated as follows:

$$\begin{array}{l}
 \text{Tax Base} \\
 \times \text{ Tax Rate} \\
 = \text{ Tax Revenue}
 \end{array}$$

In statute, the sports betting tax base is the net sports betting proceeds, defined as the total amount of all bets placed by players in an operation, excluding free bets, less all payments to players, and less all excise taxes paid pursuant to federal law [Section 44-30-1501(7), C.R.S.]. “Free bet” means a bet made by patrons using non-cashable vouchers, coupons, electronic credits or electronic promotions provided by Sports Betting Operations” [1CCR 207-2 Rule 1.4(9)]. Statute does not limit the amount of free bets that operations can deduct when calculating their net sports betting proceeds, and

statute is silent on whether operations’ free bet deductions can exceed their total wagers, thereby resulting in a loss and a \$0 sports betting tax liability. Further, statute does not contemplate whether operations can apply losses from a given month to their tax liability calculations in future months.

The Commission’s rules modify the formula for calculating the tax base by allowing operations to deduct any amount of free bets when calculating their net sports betting proceeds and applying any losses when calculating their tax liability in future months. Specifically, as part of each operation’s monthly tax liability calculation, Rule 7.8 states, “If the amount of net sports betting proceeds on a gaming day is a negative figure, the Sports Betting Operation shall remit no sports betting tax for that reporting period. **Any negative net sports betting proceeds shall be carried over and calculated as a deduction** on the subsequent gaming days until the negative figure has been brought to a zero (0) balance” (emphasis added) [1 CCR 207-2, Rule 7.8(2)(b)]. This adjustment, which the Division refers to as the “loss carry forward” deduction, is not provided for in statute nor was it contemplated in Proposition DD. Exhibit 2.5 shows the deduction authorized by Rule 7.8 (shown in blue text).

**Exhibit 2.5
Comparison of Net Sports Betting Tax Liability Calculation in Statute and Rules**

Statute [Sections 44-30-1501(7) and 44-30-1508(1), C.R.S.]	Commission Rules [1 CCR 207-2, Rule 7.8(2)(b)]
Total Bets Placed	Total Bets Placed
– Free Bets	– Free Bets
– Payouts to Winners	– Payouts to Winners
– Federal Excise Tax	– Federal Excise Tax
	– Losses carried forward
= Net Sports Betting Proceeds (the Tax Base)	= Net Sports Betting Proceeds (the Tax Base)
x Tax Rate of 10%	x Tax Rate of 10%
= Sports Betting Tax Liability	= Sports Betting Tax Liability

Source: Office of the State Auditor analysis of statute and rule.

Our audit work found that implementation of Rule 7.8 has reduced the amount of tax revenue collected from operations compared to what voters and the General Assembly might have intended. The Rule also has resulted in an effective tax rate of 9 percent, instead of the 10 percent rate that voters and policy makers approved. The lower revenue ultimately hampers the State’s ability to fulfill Proposition DD’s goals of addressing statewide water needs, offering gambling addiction services, and covering the cost of regulating sports betting.

From May 2020 through April 2021, the first full year of legalized sports betting, the State collected \$6.6 million in sports betting tax. We analyzed data on the 324 state tax filings from all 28 operations that filed taxes during that year and calculated their monthly tax liabilities without applying loss carry forward deductions. We found that if the operations had not been allowed this deduction, the State would have collected \$7.3 million, or an additional \$706,600, in sports betting tax during that first

year. Over this period, the operations applied loss carry forward deductions totaling about \$706,600, with the deductions for each operation ranging from \$0 to \$236,000. Further, the operations had a remaining aggregate amount of \$495,000 in loss carryforward deductions that could be applied to tax filings after April 2021.

For each of the 324 tax filings that operations submitted from May 2020 through April 2021, we divided the amount of tax paid by the net sports betting proceeds to see how applying the loss carry forward factored into the tax rate that operations paid. Our analysis found that sports betting tax rates ranged from 0 percent to 10 percent as follows:

- 147 filings (45 percent) were based on a 0 percent tax rate.
- 21 filings (7 percent) were based on tax rates ranging from 1 to 9 percent.
- 156 filings (48 percent) were based on a 10 percent tax rate.

Exhibit 2.6 shows the actual amount of sports betting taxes paid, net sports betting proceeds, and the amount of operating loss deductions that operations used during the first year of legalized sports betting (May 2020 through April 2021). As shown, in one instance, an operation reported \$53.4 million in total wagers but paid \$0 in sports betting taxes because the operation reported operating losses that offset positive net sports betting proceeds in 2 different months during the year.

Exhibit 2.6

Sports Betting Operation Tax Filing Analysis, May 2020 through April 2021

Sampled Sports Betting Operation ¹	Total Wagers	Net Sports Betting Proceeds Reported by Operation ²	Sports Betting Tax Liability With No Operating Loss Deduction ³	Actual Sports Betting Tax Paid With Operating Loss Deduction Applied	Difference in Sports Betting Tax Liability Due to Operating Loss Deduction ⁴
1	\$844,523,572	\$23,988,946	\$2,819,715	\$2,613,481	(\$206,234)
2	\$630,808,828	\$20,511,510	\$2,079,052	\$2,051,151	(\$27,901)
3	\$530,996,418	\$11,383,332	\$1,374,340	\$1,138,333	(\$236,007)
4	\$59,400,772	\$1,399,939	\$209,578	\$140,155	(\$69,423)
5	\$53,452,155	(\$1,472,244)	\$46,466	\$0	(\$46,466)
6	\$44,573,106	\$867,183	\$126,336	\$91,143	(\$35,193)
7	\$42,128,192	\$524,575	\$71,721	\$52,457	(\$19,264)
8	\$36,914,839	\$1,021,955	\$126,851	\$102,196	(\$24,656)
9	\$20,511,540	\$2,436,782	\$243,678	\$243,678	\$0
10	\$15,582,016	\$261,847	\$64,175	\$36,600	(\$27,575)
11	\$13,507,824	\$876,381	\$87,638	\$87,638	\$0
12	\$5,745,930	\$276,389	\$33,181	\$30,995	(\$2,187)
13	\$4,722,296	(\$23,123)	\$15,276	\$15,057	(\$219)
14	\$4,586,033	(\$202,170)	\$8,756	\$857	(\$7,900)
15	\$4,582,325	(\$221,859)	\$325	\$325	\$0
16	\$4,564,453	(\$340,199)	\$954	\$712	(\$242)
17	\$3,329,681	(\$144,324)	\$5,493	\$2,804	(\$2,688)
18	\$2,419,383	\$75,758	\$7,576	\$7,576	\$0
19	\$598,352	\$124,390	\$13,155	\$13,155	\$0
20	\$483,523	\$4,405	\$512	\$440	(\$71)
21	\$118,737	\$18,831	\$2,283	\$1,904	(\$379)
22	\$88,009	\$497	\$1,186	\$1,125	(\$61)
23	\$63,596	\$16,818	\$1,682	\$1,682	\$0
24	\$14,310	\$4,481	\$472	\$448	(\$24)
25	\$12,840	\$3,719	\$372	\$372	\$0
26	\$2,707	(\$415)	\$69	\$0	(\$69)
27	\$253	\$248	\$25	\$25	\$0
Total	\$2,323,731,689	\$61,393,652	\$7,340,866	\$6,634,309	(\$706,557)

Source: Office of the State Auditor analysis of GenTax tax filing data from May 2020 through April 2021.

¹ One operator that was licensed but did not report any sports betting activity during the year was excluded from this table.

² Total net sports betting proceeds is the cumulative annual sum of each month's net sports betting proceeds that operations reported during the year.

³ Since operations report net sports betting proceeds and pay sports betting tax on a monthly basis, operations might report a tax liability in months when they report positive net sports betting proceeds but a \$0 tax liability when they report negative sports betting proceeds. Therefore, an operation's total annual sports betting tax liability might not equal 10 percent of its total net sports betting proceeds for the year.

⁴ This amount equals total operating loss deductions that operations applied during the year. This amount was calculated using the Division's process, which is calculated by taking 10 percent of an operation's negative net sports betting proceeds. This methodology differs from Rule 7.8, which states that the operating loss deduction should be incorporated into the calculation of net sports betting proceeds. The resulting sports betting tax liability ends up being the same, regardless of which method is used to calculate the operating loss deduction.

We analyzed revenue data for a longer period of time, from July 2020 through February 2022, to see how applying a 10 percent tax rate, instead of a 9 percent tax rate, affected the amount of sports betting tax revenue that the State collected. Our analysis of data from the Colorado Operations Resource Engine (CORE), the State's accounting system, during this time period showed that the Division reported about \$16.1 million in revenue from sports betting taxes, which we assume reflects an effective 9 percent tax rate. If the Division had not allowed loss carry forward deductions, we estimate that operations would have paid an additional \$1.8 million in sports betting taxes based on an effective 10 percent tax rate.

The Division told us that, as part of the rulemaking process, it researched other states' sports betting rules and held meetings with stakeholders. According to the Division, it proposed the loss carry forward language in Rule 7.8 based on a similar sports betting rule in Indiana, which Division staff considered to be a best practice in the industry. Division staff also said that they considered the loss carry forward to be consistent with Colorado law that allows other types of businesses to deduct and carry forward operating losses when calculating their state income tax liability [Section 39-22-504(1)(a), C.R.S.].

We researched laws related to sports betting tax in other states that allowed legalized sports betting as of February 2022, and found that while some other states, such as New Jersey and Indiana, do allow some type of deduction, they are generally framed differently than Colorado's deduction because of other differences in the tax formulas among the states. For example, both Indiana's and New Jersey's laws allow operations to deduct winnings they pay to players, but they do not allow free bet deductions, as Colorado's does.

Allowing loss carry forward deductions could incentivize operations to offer large free bets and/or set odds that result in larger player winnings to reduce the operations' tax liability. Department staff stated that they believe some operations that reported high losses could be losing money intentionally to gain market share, but the Division has not conducted an analysis or investigation to verify, or assess the pervasiveness of, such intentional losses. Further, staff within the Department's Taxation Division confirmed that corporations engaged in activities that are subject to the gaming tax and/or the sports betting tax are also subject to the income tax imposed by Title 39, Article 22 of the Colorado Revised Statutes. This means that sports betting operations benefit from being able to deduct and carry forward losses twice—both from their state income and sports betting tax liabilities.

Additionally, the Commission has not applied the same perspective to the limited gaming industry in Colorado because Commission rules do not explicitly permit casinos to deduct any losses before calculating their gaming tax liability. Instead, the Commission accounts for free bets when setting the limited gaming tax rate each year. Statute does not specify a tax rate for limited gaming and, instead, allows the Commission to set this rate by rule, although statute does state that the "commission shall not set the tax at more than forty percent of the adjusted gross proceeds" [Section 44-30-601(1), C.R.S.]. Adjusted gross proceeds is defined as "the total amount of all wagers

made by players on limited gaming less all payments to players,” and payments to players include all payments of cash premiums, merchandise, tokens, redeemable game credits, or any other thing of value [Section 44-30-103(1), C.R.S.]. The Commission established a graduated tax on gross proceeds that ranges from 0.25 percent to 20 percent. Annually, the Commission can modify gaming tax rates to reflect free play offered by licensees to players [1 CCR 207-1, Rule 30-1403]. The Division reported that since casinos cannot separately deduct free play or excise tax from their gaming tax liability, it is unlikely that their adjusted gross proceeds would result in a loss. Historically, casinos have not reported losses when filing their gaming tax, and Commission rule does not include a provision explicitly allowing casinos to deduct and carry forward any losses from their gaming tax liability. However, in the event that casinos do report an operating loss—which could potentially occur during periods when casinos are shut down, such as during the COVID-19 pandemic—the Division reported that it would allow casinos to deduct and carry forward any losses.

Policy Consideration

The Commission has broad authority to “establish and collect fees and taxes upon persons, licenses, and gaming devices used in, or participating in, limited gaming or sports betting,” as well as to establish rules for how sports betting taxes are calculated [Section 44-30-302(1)(a) and (j), C.R.S.]. Additionally, the Division does not view free bet deductions, the ability for operations to carry forward operating losses, or the resulting sports betting tax losses as problematic since the General Assembly made a policy decision to authorize the deductions. Further, since statute does not provide direction on how deductions should be handled when they result in negative net sports betting proceeds (i.e., operating losses), the Division believes the Commission acted within its authority to promulgate rules allowing operations to carry forward operating losses from month to month. Nonetheless, the General Assembly may want to consider the effects of Rule 7.8 and the extent to which allowing operations to deduct operating losses, thereby reducing their tax liability, aligns with voters’ intent in approving Proposition DD and legislative intent, as reflected in statute. Since these are matters for policymakers to consider, we issue no recommendations in this section.



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