

THE FUTURE AUDIT OF INTERNET CASINOS (RSA): ANALYSIS CRUCIAL TO MITIGATING SIGNIFICANT RISK TO THE AUDITOR

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Abstract

This paper synthesises, as its primary aim, through an integrative literature review, a new perspective on two major implications of the proposed legalisation of internet casinos in South Africa, which is: the effect on the auditor's business risk as well as the effect on audit risk. As its secondary aim the paper argues that legalisation of internet casinos in South Africa is imminent and that relative to other business, heavy reliance will be placed on the external auditor to ensure the internet casinos' compliance with various laws. The relevance and application of an integrative literature review is motivated. International perspectives are applied to the South African context. The paper demonstrates the relationship between the concepts of the auditor's business risk and audit risk by establishing that the auditor's business risk flows from possible accountability that may stem from significant audit risk that is not addressed during the audit engagement. The paper argues that the operational context of an internet casino in South Africa will be relatively unique and that three interrelating factors will create significant audit risk. The three significant factors are shown to be going concern, regulatory and information technology impacts. Failure by the auditor to recognise and respond appropriately to this audit risk may lead to serious consequences for the practitioner which may include regulatory intervention, reputational based losses or litigation. The impact of the International Standards on Auditing in this context is explored throughout and it is concluded that adherence to these standards will sufficiently mitigate significant audit risk as well as the auditor's business risk.

Keywords: Audit risk, internet casinos in South Africa, auditor's business risk

1. INTRODUCTION

On 28 September 2011 internet based gambling from within the borders of South Africa became widely and finally accepted as illegal. Although the National Gambling Act (RSA 2004a) (hereafter referred to as the "NGA") states in section 11 that "A person must not engage in or make available an interactive game [which includes internet gambling]..." internet casinos continued trading arguing that their service was not accessed in South Africa. The Supreme Court of Appeal in the case of *Casino Enterprises v The Gauteng Gambling Board* (653/10) [2011] ZASCA 155 (28 September 2011) rejected this notion and the court ruled in favour of the Gauteng Gambling Board despite arguments that Piggs Peak Casino's gaming servers are located in Swaziland and hence South African Law does not apply.

As elaborated on further in this paper: In addition to the possibility of penalties and imprisonment (NGA section 83), the main reason why rational internet casino operators and participants should want to comply with the judgment is the threat of forfeiture of participants winnings as mandated by the NGA section 16. An example of confiscated winnings can be found in Kashiefa (2013). The fact that South Africa may be on the brink of legalising and awarding licenses to online casino's (ENS 2010) means that operators should not want to be "blacklisted" and excluded from the future licensing process based on current infringements.

It is this legalisation and normalisation of internet gambling in South Africa that is of interest to the statutory auditor.

2. METHODOLOGY

2.1 Research motivation and aim

The catalyst for this paper was the assenting to of the National Gambling Amendment Act (RSA 2008d) (hereafter referred to as the "NGAA"). The resulting licenced internet casinos would constitute, in terms of their operational environment, a "new" South African business that would require an annual independent audit. The arguments of legalisation and the audit requirement which are secondary but necessary aims of this paper are discussed below.

Any audit or engagement inherently leads to three major risks, which are. "... [the] client's business risk (also referred to as [the audited] entity's business risk), audit risk and auditor's business risk." (Colbert, Luehlfing and Alderman, 2009). It is accepted that for a new business or industry the risks are inherently even more pronounced. Colbert et. al. (2009) collectively names these three risks as "engagement risk".

Additionally, auditors are also required to follow appropriate procedures for client and engagement acceptance (ISQC1 par 26) (ISA 220 par 12). By highlighting the engagement risk this paper assist the auditor in complying with ISQC1 and ISA220.

Thus this new business form and its effect on the mentioned components of engagement risk is what motivated the paper. This forms the primary aim of the paper.

The aim is also not to discourage auditors from accepting these engagements but in fact it is hoped that by conceptualising the significant risks, auditors are empowered to seek these engagements. The final outcome is to assist auditors in realising and responding to the most significant risks.

2.2 Research design

Mouton (2013:175-180) states that a literature review is a form of a non-empirical study and finds value in a literature review as an exercise in inductive reasoning to come to a proper understating of a specific domain of scholarship. He states that a typical application of the literature review is the “Integrative literature review”.

Torraco (2005:356) defines the integrative literature review as follows: “The integrative literature review is a form of research that reviews, critiques, and synthesizes representative literature on a topic in an integrated way such that new frameworks and perspectives on the topic are generated.”

Torraco (2005:356-362) clearly motivates the value and rigorousness of an integrative literature review and amongst others states that it is “a sophisticated form of research that requires a great deal of research skill and insight”. He also states that there is no standardised format for an integrative literature review but summarises the essentials for a proper integrative literature review: “Authors of review articles are expected to identify an appropriate topic or issue for the review, justify why a literature review is the appropriate means of addressing the topic or problem, search and retrieve the appropriate literature, analyse and critique the literature, and create new understandings of the topic through one or more forms of synthesis.” This paper through the various sections complies with these recommendations.

Torraco (2005:362) then describes the process of synthesis as follows: “Synthesizing the literature means that the review weaves the streams of research together to focus on core issues rather than merely reporting previous literature. Synthesis is not a data dump. It is a creative activity that produces a new model, conceptual framework, or other unique conception informed by the author's intimate knowledge of the topic. The result of a comprehensive synthesis of literature is that new knowledge or perspective is created despite the fact that the review summarizes previous research.” (Torroco, 2005:362).

This approach fits the purpose of the paper: The author being a Chartered Accountant (SA) with intimate knowledge of auditing as well as having practical knowledge of internet casino's will synthesise various South African laws, standards and international research and trough logical and conceptual reasoning conclude with a diagram which will demonstrate the paper's achieving of its aim.

2.2.1 Selection of Literature

Both Mouton (2013: 180) and Torroco (2005: 360) emphasise that the author should explain selection criteria of literature in order to promote validity of the paper:

The selection of literature started with a review the NGAA. Based on indications in this act and the author's insight, further laws and auditing standards were selected. A further search was done on electronic online databases as accessed through the University of the Free State's library system. These databases include HeinOnline, Oxford Journals, Lexis Total Research System etc.

The website of the Independent Regulatory Board for Auditors (<http://www.irba.co.za/>) was also of great use, especially as it summarises all the main laws usually applicable to the external auditor. Through these searches international perspectives was also gained in order to apply them to the South African context.

2.2.2 Structure of the paper

In order for the paper's primary aim of to be relevant and logical it is necessary to argue the concepts, as secondary aims, of inevitable legalisation of South African internet casinos as well as that the current and proposed laws will require an annual statutory audit.

Section 3 addresses the concept of inevitable legalisation and section 4 the requirement of an audit. Section 5 provides the necessary background of the auditing and accounting standards in South Africa and section 6 then address the components of engagement risk which is the primary aim of this paper. Section 7 briefs an overview and through a diagram demonstrates the newly gained insight which was synthesised through the integrative literature review.

3. INEVITABLE LEGALISATION

Although the NGAA was assented to in 2008, it has not yet been proclaimed. As stated above internet gambling is thus still illegal in South Africa.

The NGAA provides for the licensing of online casinos. The fact that both the NGA schedule of transitional provisions (section 5) and the NGAA aims to promote regulation of internet gambling is a clear indicator of government policy. ENS (2010) attributes the delay in proclamation and subsequent legalisation to "objections of various interested persons, including land-based casinos and anti-money laundering authorities." These objectives have been dismissed in international literature and the author of this paper believes that legalisation is inevitable due to the following reasons:

- Tax revenue to the South African government can be significant and will eventually counter lobbying form land-based casinos. Internationally this argument is strongly supported by Valasek (2007:772) and Weinberg (2005:320).

- Concerns of money laundering, problem gambling, fraud and underage gambling can and should be effectively regulated (Valasek 2007:760-766) (LaBrie, Kaplan, LaPlante, Nelson and Shaffer 2008:415) (Andrie 2004:1389) (Weinberg 2005:326) (Friedrich 2003:387). LaBrie et al (2008) in a detailed empirical study found problem gambling in terms of internet casinos for European participants to be very limited.
- Information technology programmed controls and audits can negate the various negative concerns. The sunk cost of policing illegal casinos can be great (Friedrich 2003:387).
- The proliferation of internet casinos (Mostert: 2013). A rational government would rather “tap in” by legalising and taxing licensed casinos since rational players would rather gamble at a well regulated and controlled internet casinos in order to avoid operator fraud, confiscation of winnings or prosecution. An example of this player preference can be seen from Reviewed Casinos (2014).
- International co-operation in regulating internet casinos will be inevitable (Valasek 2007:782) (Weinberg 2005:307), especially for countries such as South Africa which belongs to the World Trade Organisation. Weinberg (2005:307-308) clearly shows that the situation of internet casinos being legal in one jurisdiction whilst being illegal in another is for various reasons intolerable.
- Prohibition of internet casinos may have unintended consequences. An example would be an alternative unregulated financial services industry (Weinberg 2005:294), the so called “black market”.

4. REQUIREMENT OF AN ANNUAL EXTERNAL AUDIT

It is almost certain that any business operating as a legalised internet casino in South Africa will be legally required to have its annual financial statements audited. The arguments are stated below. In fact it is very likely that due to the concerns of money laundering, problem gambling, fraud and underage gambling (Valasek 2013:760), many different audits including but not limited to detailed systems audits, special compliance audits, surprise audits, internal audits, integrated audits and voluntary audits will be required in order to build trust and prove the effectiveness and benefits of regulation.

Although the statutory audit of annual financial statements will include elements of these “special” dedicated audits, the purpose of a statutory audit of the annual financial statements is to, whilst adhering to the applicable auditing standards, express an opinion over the fairness of the financial statements and their compliance with an identified financial reporting framework and any applicable statutory requirements. (Refer to the Companies Act section 1 (RSA 2008a) and the Auditing Profession Act section 1 (RSA 2005) (hereafter referred to as the “APA”). This paper focuses on this statutory annual financial statements audit.

The NGA section 87 grants the Minister of Trade and Industry the right to stipulate regulations for interactive gaming (the “Interactive Gambling Regulations”). The proposed regulations was gazetted for public comment on 27 February 2009 and in number 23(3)(f), 23(4) and 23(5) that specifically mention auditors, indicates the high probably of a requirement of an annual audit of the entity's financial statements (RSADTI: 2009).

Additionally the interactive gambling regulations in number 27(3) have the effect of only awarding licences to businesses trading as companies (read with RSA DTI 2010:22 which explains the cessation of the Close Corporation business form). This would make sense in light of the two major benefits of the company as business form which is: the company being a separate legal person and issues around succession of ownership. In terms of section 30(2) of the Companies Act which as well as number 28(2) of the Companies regulations 2011 (RSA DTI:2011) it is a certainty that internet casinos licenced in South Africa will be required to have their annual financial statements independently audited.

5. AUDITING AND ACCOUNTING STANDARDS AND RULES IN SOUTH AFRICA

The external audit profession in South Africa is regulated under the APA by the Independent Regulatory Board for Auditors (the “IRBA”) (APA section 2 and section 3).

As discussed in section 4 of this paper the purpose of a statutory audit of the annual financial statements is to, whilst adhering to the applicable auditing standards, express an opinion over the fairness of the financial statements and their compliance with an identified financial reporting framework and any applicable statutory requirements.

Section 4(1)(e) of the APA mandates the IRBA to prescribe auditing standards. The IRBA have legally adopted International Standards on Auditing (the “ISA's”) (IRBA 2013 par 8) and (IRBA 2013a). These standards give detailed guidance on audit methodology and non-compliance can have serious consequences for the auditor as discussed later in this paper.

The financial reporting framework applicable for most profit driven companies in South Africa (such as internet casinos) is the International Financial Reporting Standards (IFRS). IFRS are prescribed per the Companies Act section 29(5) and the Companies Act regulations number 27 (RSADTI: 2011).

6. ENGAGEMENT RISK

In dealing with concepts such as “engagement risk”, “audit risk” and “significant”, literature sometimes attributes different meanings. It is prudent to define these concepts on condition that the motivation and definition is credible.

The respected American Institute of Certified Public Accountants (AICPA) defines engagement risk as comprising: "client's business risk (also referred to as entity's business risk), audit risk and auditor's business risk" (Colbert et al, 2009). This source is applied since although the ISA's and by extension the APA set regulations around client acceptance, the issue of the auditor's business risk is, for the purpose of this article more clearly expressed by the AICPA in Colbert et al (2009). In this paper the client's business risk is grouped with the going concern risk as part of audit risk below.

The AICPA in Colbert et al (2009) defines the auditor's business risk as addressed in the American Statements on Auditing Standards (SAS):

"The concept of auditor's business risk was introduced in the standards in a footnote to SAS No. 47 as simply business risk. Specifically, SAS No. 47 indicates that... in addition to audit risk, the auditor is exposed to loss or injury to his professional practice from litigation, adverse publicity, or other events arising in connection with financial statements that he has examined and reported on..." and "...auditor's business risk includes the risk of other costs (whether an audit failure is alleged or not) such as fee realization and reputational effects from association with the client." ISA 200 par A33 does support this definition briefly. Note that instances where the auditor have observed all the rules and regulations and gave an appropriate audit opinion yet still experience a significant business risk is beyond the scope of this article.

In terms of audit risk the AIPCA (Colbert et al 2009) and ISA's (ISA 200 par 13(c)) is in agreement that the concept refers to the auditor expressing an inappropriate audit opinion when the financial statements are materially misstated. It is clear that audit risk leads to, and is the major component of, the auditor's business risk since an incorrect audit opinion can lead to serious negative consequences for the auditor.

Significant risk for the purpose of this paper refers to risks, that if it materialise, on its own could lead to an inappropriate audit opinion (audit risk), and through this audit risk as well as the direct risk of legal non-compliance lead to an business risk to the auditor that is serious enough to conceivably lead to the auditor closing or losing his business. It is beyond the scope of this paper to discuss all the compliance matters of internet casinos or all sources of audit risk. Only risks that are considered significant and that may not be that evident due to the unique nature of an audit of an internet casino will be discussed.

6.1 Auditor's business risk applied

Base on the above definitions; the auditor's significant business risks within the scope of the paper can be classified as follows:

6.1.1 Loss of right to practice

Arguably the most significant risk for an auditor is the loss of registration by the IRBA i.e. loss of the right to practice. Section 1 of APA defines improper conduct as "...any non-compliance with this Act or any rules prescribed in terms of this Act or any conduct prescribed as constituting improper conduct..."

The matter is not trivialised in the APA and a due process including inspection, investigation, charging and hearing is prescribed. But it is conceivable that an auditor who either knowingly or through severe negligence is found as not complying to ISA's or the APA directly (especially section 44(3) which details the auditor's duties and the section 45 duty to report on irregularities) can face the following sanctions from section 51 of the APA:

"(3) (a) If the registered auditor charged is found guilty of improper conduct, or if the registered auditor admits to the charge, the disciplinary committee must either-

- (i) caution or reprimand the registered auditor;
- (ii) impose on the registered auditor a fine not exceeding the amount calculated according to the ratio for five year's imprisonment prescribed in terms of the Adjustment of Fines Act, 1991 (Act No. 101 of 1991)
- (iii) suspend the right to practice as a registered auditor for a specific period:
or
- (iv) cancel the registration of the registered auditor concerned and remove his or her name from the register referred to in section 6.
- (b) The disciplinary committee may impose more than one of the sanctions referred..."

6.1.2 Loss of reputation

It is widely accepted amongst auditors that loss of reputation is a significant risk. The catalyst was the demise of one of the biggest international audit firms, Arthur Andersen, after auditor fraud in the USA during the Enron scandal. A good summary can be found in McRoberts (2002) and Cahan and Zhang (2006:49). If a South African auditor of a licensed internet casino fails to detect significant non-compliance with the NGAA or consumer activism takes hold, an audit firm may face significant risk. Negative publicity especially if the auditor has no defence in terms of complying with ISA and the APA, could significantly harm the auditor's reputation especially amongst prospective clients (e.g. shareholders of companies). Although auditor liability is restricted in section 45 of the APA, it is conceivable that litigation in terms of the Consumer Protection Act (RSA 2008b) may involve the auditor which can lead to significant reputational risk (this is an area for further legal research).

6.1.3 Financial losses from client litigation

After the Enron scandal this risk is ever present. It is strongly recommended for auditors to have professional indemnity insurance (SAICA 2009). Although relatively rare in the South African context, losses from client litigation remains a significant risk to the auditor especially if gross negligence can be proven. Auditors will have to ensure compliance with ISA's in order to defend their practice. The risk will initially be higher due to the internet casino as a new audit environment in South Africa.

6.2 Audit risk applied

6.2.1 Going concern, regulatory and information technology impact

IFRS requires Financial Statements to be prepared on the going concern basis. This refers to the assumption that an entity is a going concern and will continue in operation for the foreseeable future. Hence, it is assumed that the entity has neither the intention nor the need to liquidate or materially curtail the scale of its operations. If such an intention or need exists, the financial statements may have to be prepared on a different basis and, if so, the basis used is disclosed (Framework par 4.1). This assumption has a fundamental impact on the value of all elements of the financial statements.

ISA 570 requires the auditor to gain sufficient appropriate audit evidence about the appropriateness of the going concern assumption in the preparation of the financial statements. The auditor's report needs to be modified when a material uncertainty exists. The different forms of modifications are stated in ISA 570 par A20-A27. Failure to modify is a prime example of audit risk materialising.

Based on the previous statements in this paper on the popularity of internet gambling and the author's own experience, it is submitted that the major going concern threat for a licenced internet casino will not be financial survival (as is the case with most other business) but regulatory compliance in order to stay licenced. In particular (ISA 250 par 7) the auditor will have to design additional and specific audit procedures (which may include reliance on other auditors or experts) to test compliance with material aspects of the NGA, NGAA, the Interactive Gambling Regulations, the Companies Act, the Income Tax Act (RSA 1962) and other taxation laws. If these "primary acts and regulations" are not adhered to the auditor will have to consider at least possible material non-compliance with the following "secondary" legislation i.e. the Financial Intelligence Centre Act (RSA 2001) ("FICA"), Financial Advisory and Intermediary Services Act (RSA 2002) ("FAIS"), Financial Intelligence Centre Amendment Act (RSA 2008c) ("FICAA"), Prevention and Combatting of Corrupt Activities Act (RSA 2004b) ("PRECCA"), Prevention of Organised Crime Act (RSA 1998) ("POCA"), Protection of Constitutional Democracy Against Terrorist and Related Activities Act (RSA 2004c) ("POCDATARA").

All of these acts may be significantly breached because internet casinos receive deposits electronically. The “primary” act and regulations set various requirements for the handling of electronic deposits and other matters such as underage access, gambling on credit etc. The “primary” legislation often cross refers to the “secondary” legislation (e.g. NGAA preamble) and will probably be amended should conflict or omissions be proven. If an internet casino does not comply with the legislation, its licence could be in jeopardy and the going concern assumption seriously compromised. An example of going concern risk in term of being licenced is the previous operator of the South African National Lottery, Uthingo Management (Pty) Ltd who, since losing the lottery licence in March 2007 have become dormant (Bloomberg 2014).

The major importance of Information Technology's (IT) integrity and effectiveness for a licensed internet casino is immediately obvious. The IT is the business. Both operational going concern and compliance related going concern are dependent on the IT being secure, effective and operating. It follows that the auditor will have to perform detailed and sufficient procedures on the IT system which may include reliance on other auditors or experts (Also mandated by the entire ISA315 and ISA330).

7. CONCLUSION

Diagram 1 illustrates an overview of this paper, demonstrates how this paper achieves its aims and is stated as the final product of the integrative literature review. It shows that Section 3 and 4 achieves the secondary aims of the paper by demonstrating legalisation and the audit requirement of internet casinos in South Africa. Section 5 is shown to set the applicable context of accounting and auditing standards from which engagement risk, the primary aim of this paper can be conceptualised in Section 6.

Diagram 1 visually illustrates that in addition to some direct risks, audit risk is a significant component of the auditor's business risk. The reader is reminded of the special insight gathered in Section 6 which is that the audit risk is based on regulatory and IT operational going concern risk as opposed to the “normal” financial going concern risk. The regulatory compliance and IT operational integrity of the internet casino is crucial to the auditor's final opinion, thus creating significant audit risk.

As stated in Section 6, if the statutory auditor demonstrates and details compliance with all International Standards on Auditing in the executed audit methodology by paying special attention to standards and laws mentioned in this article, the business risks of litigation and right to practice will be sufficiently mitigated. The auditor will also have a strong defence against any reputational risks.

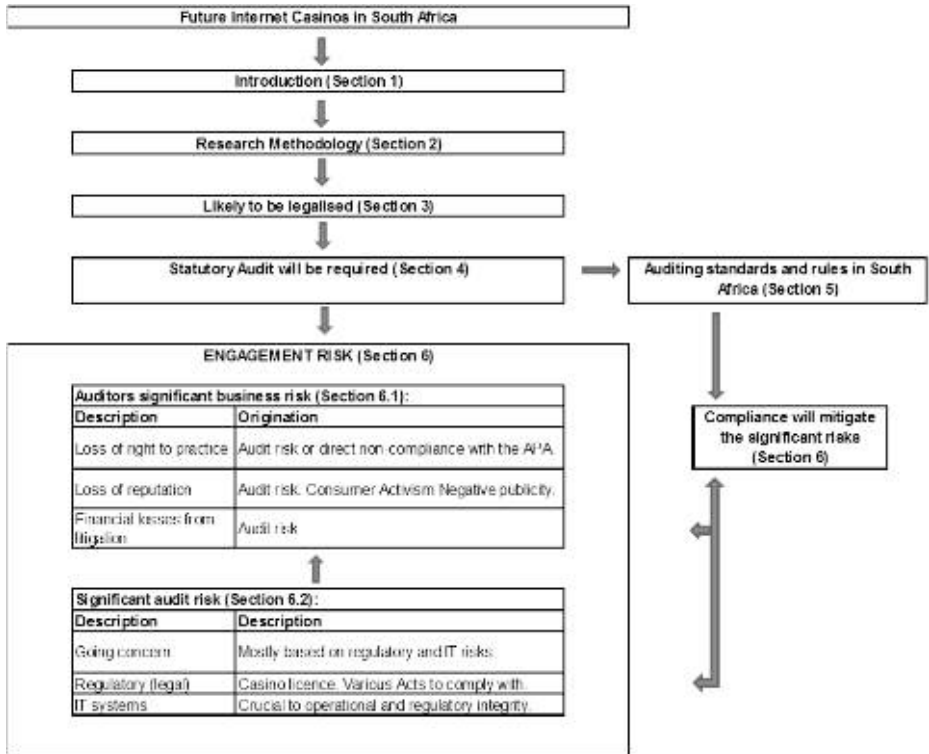


Diagram 1: Diagrammatic overview of this paper

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